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Bullish on the one with the hair

"Charlie," General Motors CEO Rick Wagoner addressed the talk-show host Charlie Rose on Aug. 18, 2008, the year of the 100th anniversary of GM's founding, "I think the future's very bright." Let us only say that the former GM boss was early. Now unfolding is the bullish case for the company they call—but may not long continue to call—Government Motors.

How the mighty GM, the corporate edifice built by Durant and Raskob, Sloan and Wilson, became a supplicant to Timothy Geithner's Treasury Department, side by side with the U.S. Postal Service, Fannie Mae and Freddie Mac, is a sad story oft told. Lackluster products, unfunded pension liabilities, immense losses and reduced liquidity mortally weakened the maker of Corvettes, Cadillacs and Rivieras—and of Corvairs and Volts and subprime mortgages, too. In 2009, General Motors fell like a half-rotten tree.

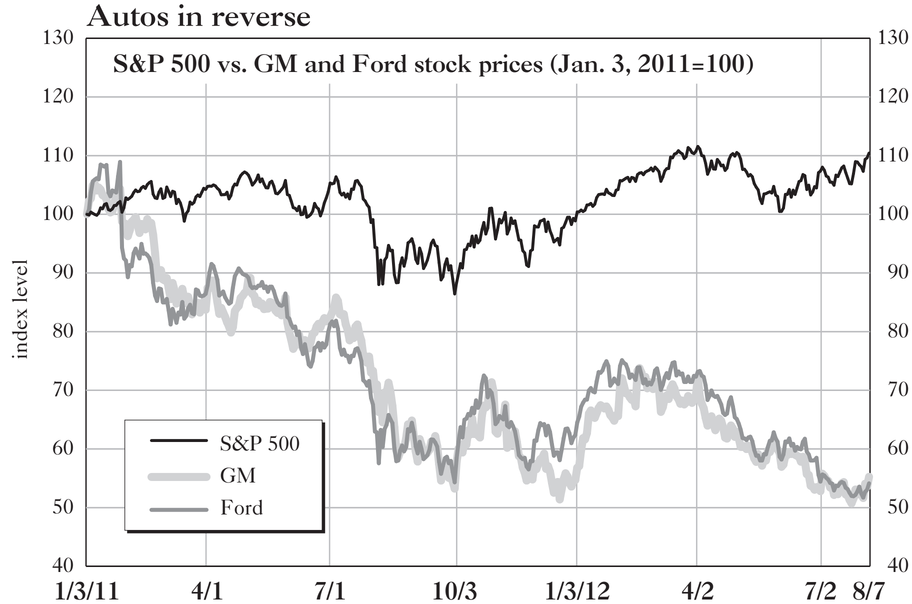
Six weeks after a $50 billion, taxpayer-financed tow into the Chapter 11 garage, however, there emerged the reorganized GM. You could hardly tell it was the same company. Compared to the pre-bankruptcy lemon, "new" GM boasted 40% fewer dealers and $79 billion less debt. It gained a few things, too: wage concessions from the United Auto Workers Union and billions of dollars worth of tax-loss carryforwards. On Nov. 18, 2010, came the IPO, priced at $33 a share. On Jan. 6, 2011, came the intraday high of $39.48 a share. From that day til this, the stock has been sawed in half.

The bill of particulars against GM makes familiar reading. Thus, the company derives 17.8% of its revenue from Europe and 19% of its net income from China. It ranks fifth in sales but 20th in profits on the 2012 *Fortune* 500 roster. It's losing domestic market share, and rock-bottom interest rates have inflated the value of its pension obligations. The executive suite seems to have a revolving door. A June review of GM's new minivan, the Spin, on The Truth about Cars Web site, ran out under the headline, "Dog of an engine devours any desire to buy." European inventories are high and rising. And if all that weren't bad enough, the company has an itchy minority owner in the U.S. government. Of the 1.57 billion GM shares outstanding, the Treasury owns—and will sooner or later sell—500 million.

Mr. Market is as fed up as anyone. At five or so times the 2013 earnings estimate, and at 1.8 times enterprise value to projected EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), the stock is seemingly valued for every contingency except good news.

Then, again, the worldwide auto business is running on the valuation rims. Archrival Ford, the North American auto company that didn't go running to the government in 2009 (except for a $5.9 billion Department of Energy "green" retooling credit), is quoted at 6.15 times the 2013 estimate, and at a 2.5 multiple of EV to 2013 EBITDA. Like GM, Ford has its problems in Europe. Unlike GM, however, Ford

Autos in reverse



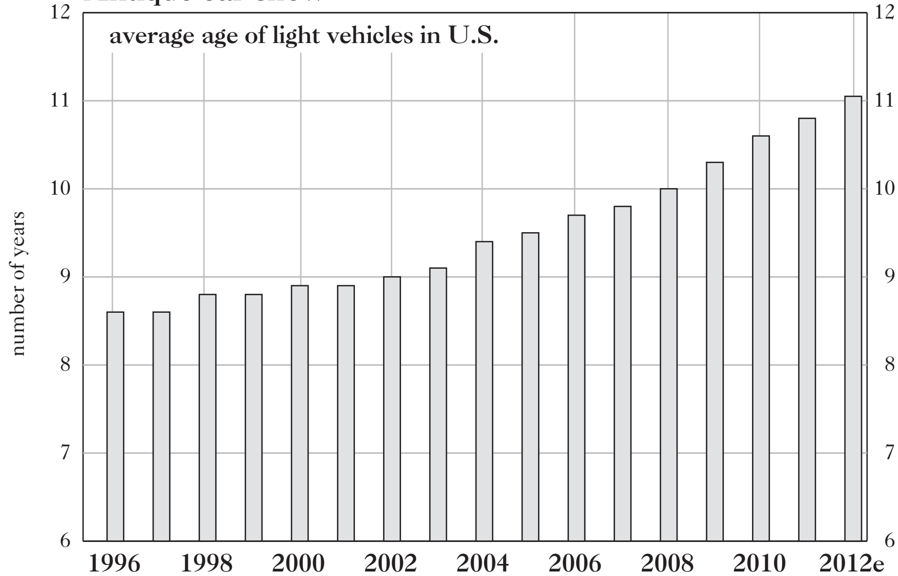
source: The Bloomberg

is thriving in North America. It has regained its investment-grade debt rating and reinstated the dividend it stopped paying in 2006.

Volkswagen, the world's No. 2 automaker by production, is quoted at 5.3 times the 2013 estimate and at a dividend yield of 2.23%. Perhaps investors worry about the German company's home continent, or about VW's proclivity for discounting—you can buy a 2012 Golf today for €12,990, compared to the original list price of almost €17,000—or about the risk that management might not seamlessly execute its plan to replace many different engineering and production platforms with a single platform, a project known as the "modular transverse toolkit." Or, perhaps, the market is casting a wary eye toward China, where VW sold 28% of its vehicles in the first half of 2012 (do not be concerned about the People's Republic was the message from the Volkswagen second-quarter conference call). Or—yet another possibility—the problem is governance. No ordinary public company, "Volkswagen is basically now an Austrian family-owned company that coincidentally happens to be traded on the exchange. . . . [I]t's not exactly a company run for shareholders." So said Ferdinand Dudenhöffer, director of the Center for Automotive Research at the University of Duisberg-Essen, in March on the occasion of the nomination of the wife of Chairman Ferdinand Piech to VW's board of directors. Top owner of Volkswagen shares, with 50.7% of the outstanding, is Porsche Automobil Holding SE, i.e., the Porsche-Piech family. Second-largest holder is the German state of Lower Saxony, home to VW headquarters as well as to six VW plants and many of its half-million employees. By dint of that investment, Lower Saxony holds veto power over major VW corporate decisions. It seems a fair guess that the politicians won't vote their stock as, say, Carl Icahn would.

The question, therefore, is not whether the automakers are driving on economic black ice, but whether the market has adequately, or more than adequately, compensated for that known risk. In the case of GM, we think it has more than compensated. Much has gone wrong with the company that Peter Drucker extolled more than 60 years ago in his ground-breaking management study, "The Concept of the Corporation." And much will continue to go wrong, no doubt. Yet the post-Wagoner management team is effecting improvements, and the post-2008-09 auto market seems ripe for recovery—timing uncertain, we hasten to add.

Antique car show



sources: WardsAuto.com, R.L. Polk & Co., JPMorgan

In the palmy days of 2007, Americans bought 16 million cars and trucks, a number that seemed a reliable floor but hardly a ceiling. However, we Americans bought not with cash but with credit, credit that was supported by bloated real estate collateral. Cars busted along with houses, the annual vehicle selling rate plunging to 10.4 million units in 2009. It recovered to 11.6 million units in 2010 and 12.8 million in 2011. And the rate may reach 14 million or even 14.5 million units in 2012. As for the prospects of ever returning to the mountain top of 16 million units, they are, in fact, surprisingly good. One doesn't have to assume growth in vehicles per household to get there, only continued population growth of a little under 1% per year. At that rate the automakers would return to the good old days of 16 million sales as soon as 2015.

The buying drought of recent years has put some fancy figures on American odometers. At 11 years, the average car and truck on American highways in 2011 was the oldest on record. Considered in tandem with the reciprocally low rate of scrappage, the aging of the American fleet will presumably set consumers to hankering after that new-car smell. And more and more can afford it. To purchase and finance an average-priced new car required 23.2 weeks of median family income as of the first quarter, according to the Comerica Auto Affordability Index. That was within a whisker of the all-time most affordable period, the third quarter of 2009, and compares with the post-1978 average of 26.9 weeks of income.

There is another silver lining to GM's difficulties. As an IRS-conferred consolation prize for the eight consecutive quarters of red ink logged between 2007 and 2009, the company, as of year-end 2011, owned $47.2 billion of deferred tax assets before valuation allowances. While analysts may quibble about the correct discount rate to apply to the net operating loss, they will concur that GM is unlikely to be paying taxes to the U.S. government for another six years at least.

At the June 12 annual meeting, Daniel F. Akerson, chairman and CEO, pledged to "make GM great again," and in the same breath mentioned the disparity between sales and earnings that is so glaringly evident in the *Fortune* 500 rankings. As it is, GM is producing operating margins of not quite 6%—last year, it delivered sales of $150.3 billion, adjusted EBIT of $8.3 billion and $4.58 of diluted earnings per share. So far in 2012, it has generated sales of $75.4 billion, adjusted EBIT of $4.3 billion and diluted earnings per share of $1.49. And how might management make the leap from federal dependence to capitalist greatness?

"Our journey starts with our products," the CEO answered, "and I am pleased to report that we are now in the early days of one of the biggest global product offensives in our history. The impact of new vehicles will be especially profound in the United States, where about 70% of our nameplates will be new or freshened over the course of 2012 and 2013." Examples include the Chevrolet Spark mini-car, the Buick Verano Turbo and the new Cadillac XTS and ATS luxury sedans.

As to whether GM's new product "offensive" is so markedly bigger and better than anyone else's, colleague David Peligal remarks: "It's all about the timing. GM will have an edge in so-called refreshes in both 2013 and 2014. By the looks of a chart in a July 18 JPMorgan research report, GM's North American product-refresh rate is larger by about 25% in 2013 and 8% in 2014. A bigger difference, though, is that, while Ford will be revamping low-margin vehicles, GM will be focusing on high-margin ones. Full-size trucks are where the money is—they may produce earnings before interest and taxes of $10,000 each, or about 10 times the EBIT of a small car. GM will sell more of these trucks and at a better price point.

"Something else about new products," Peligal proceeds, "they command better prices than showroom-worn merchandise. Over the five-year life of the typical automobile or truck product line, or—as they say in Detroit—'platform,' years one and two deliver better prices than years four and five. In the second place, new offerings make for better market share. In large pickup trucks, GM's top profit driver (a sweet spot for the Big Three generally, as pickup-truck drivers as a class tend to buy American and only American), it has ceded domestic market share to Ford and Chrysler because the competition's offerings are newer and shinier than GM's. In the seven months through July 31, GM claimed around 36% of the American truck market, down from 40% just three years ago. Why buy this year's Chevrolet Silverado or GMC Sierra when, in 2013, GM management will pull back the curtains on the new K2XX platform?

"Putting it all together," Peligal winds up, "if we're right that the industry will grow in North America, and that GM can regain a measure of market share, you could see the company's top line in North America climb to $100 billion from $90 billion. If management can find its way to a 10% operating margin, roughly 220 basis points more than it is posting today, therein lies $2 billion to $3 billion of improvement in operating profit, equal to $1.11 per share to $1.67 per fully diluted share—none of which will be taxed for a long, long time."

Well and good, a bear might interject, but GM has three hurdles to clear. The first is miniature interest rates, and a paradoxically high hurdle it is. With pension assets of $109 billion and pension obligations of $134 billion, the company faces an unfunded liability of $25 billion (as of year-end 2011 measured under GAAP conventions). As part of a drive to close the deficit, management is offering lump-sum payments to some retirees in lieu of a promised stream of pension income. Also in the cause of pension "de-risking," GM is paying Prudential Financial no less than $4 billion to take $26 billion of liabilities off its hands.

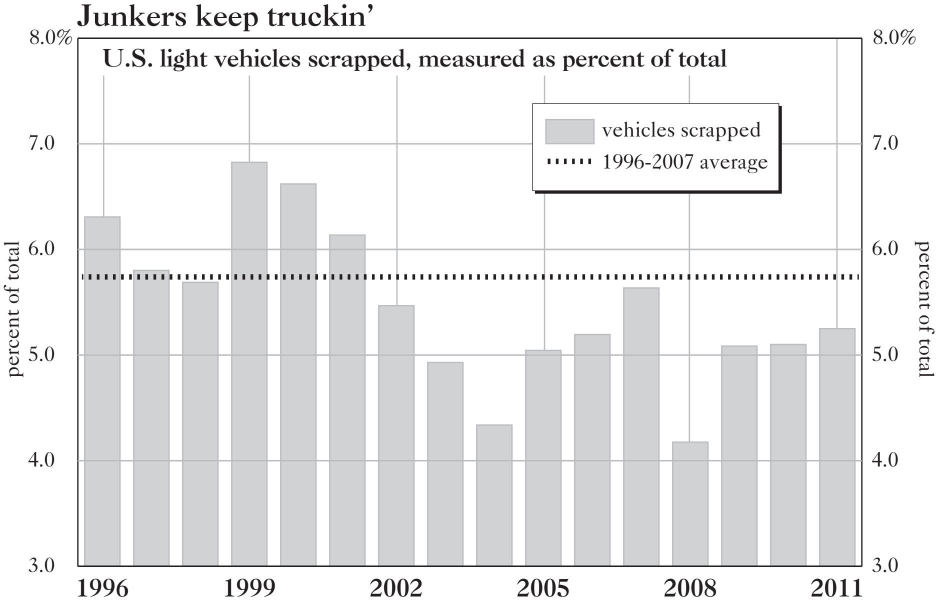
However, as fast as the front office can de-risk, the Federal Open Market Committee re-risks. Low and lower interest rates require a pension obligor to come up with more and more capital. One thousand dollars will generate $60 a year of interest income at a 6% interest rate, but it takes $2,000 to generate the same income at a 3% interest rate.

While it's a stretch to call GM a back-door play on rising interest rates, there is some element of truth in that notion, at least in the matter of pension obligations. According to the 2011 10-K report, a 25 basis-point rise in the discount rate, considered in isolation, would reduce the U.S. pension benefit obligation by $2.66 billion. Given that the unfunded portion of the company's pension obligation comes to $24 billion (or will when the Prudential deal closes), the return of the 10-year Treasury note to the alpine heights of 3% would shrink that obligation to $8 billion ($2.66 billion times six increments of 25 basis points comes to $16 billion).

Incidentally, GM's pension fund last year deftly boosted its bond allocation to 66% of the portfolio from 41% in 2010. By so doing, it returned 11.1% in a year when the S&P 500, with dividends reinvested, was up 2.1%. Kudos to the portfolio managers. And double kudos if they manage the trick of getting out of bonds, when the time comes, as profitably as they got into them.

On balance, in the article of interest rates, we would venture (borrowing from former GM chief Charles Wilson) that what is good for the country is good for General Motors and vice versa. Normalized interest rates, borne of rising prosperity, would be good for the country and GM alike. As it is, a qualified customer can finance a 2013 Cadillac XTS luxury sedan at 3.9% APR for 60 months. Gently rising rates

Junkers keep truckin'



sources: WardsAuto.com, R.L. Polk & Co.

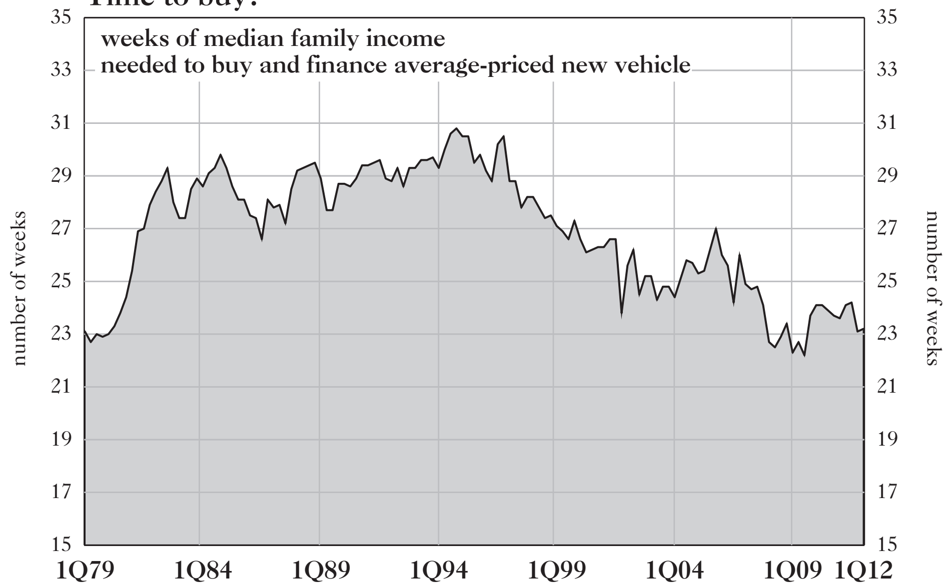
(underscore "gently," please) might be just what the doctor ordered.

Hurdle No. 2 is the state of the vehicle business in what Google is wont to call the "Rest of the World." Last year, GM produced nine million cars and trucks in 30 countries. Some 72% of those sales took place outside North America. And of these sales in the hinterlands, 43.4% occurred in the so-called emerging markets, e.g., Brazil, India, Russia, China, etc. Europe accounted for 1.7 million sales, or not quite 27% of the non-North American total.

Of Europe, the best that can be said—and it is no small thing—is that everybody hates it. In 2010, General Motors Europe, a.k.a. GME, produced an operating loss of $1.95 billion on revenues of $24.1 billion. In 2011, the European division turned in an operating loss of $747 million on $26.8 billion of revenue. And in the first six months of 2012, GME delivered an operating loss of $617 million on $11.4 billion in revenue. Just when the European auto business might be put to rights is anyone's guess. Ford is on record as saying not for five years. Sergio Marchionne, CEO of Fiat, calls the old Continent "a bloodbath of pricing and it's a bloodbath on margins." According to a July 25 research bulletin from Deutsche Bank, European automakers are operating at only 72% of capacity, compared to 98% in the United States. Is it so hard to imagine the statesmen and stateswomen of Europe coming together to forge a constructive solution to the raging sovereign debt crisis? Or to imagine the European Central Bank lending a hand with a generous outpouring of new paper euros, thereby igniting the mother of all relief rallies and a few quarters, at least, of commercial recovery? Well, yes, it is very hard to imagine these things, especially the first, but we owe it to ourselves to try. There is probably no more hardened consensus of opinion than that Europe is a lost cause.

As for China, GM operates through joint ventures of which it owns just shy of 50%. To date, what's been good for China has been very good for GM, its JVs commanding a 14% share of the market, tops in the People's Republic. And China has remitted a steadily rising stream of net income back to Detroit: $753 million in 2009, $1.31 billion in 2010, $1.46 billion in 2011 and $719 million in the first half of 2012.

Time to buy?



source: Comerica Economic Insights

This publication, as bearish as it is on China, regards GM's exposure to the People's Republic as perhaps the greatest risk the market has not adequately discounted. South America, the company's main emerging-markets underachiever, sends home a pittance of earnings, or a small net loss, on revenues in the neighborhood of $16 billion. Even a 3% EBIT margin would produce a swing in net income to $500 million from minus $100 million. To effect the desired results, GM has been working to reduce break-even costs (via lower headcounts and more advantageous union contracts) as well as by introducing such new products as the Chevrolet Cobalt and the Chevrolet Cruze.

Hurdle No. 3 is the overhang of U.S. Treasury-owned shares, 500 million, or just over 30% of the total. Many ask: Why get into GM before the government gets out? To get out whole, Secretary Geithner would need a price of $53 a share. With the 2012 presidential election looming, let us say it is unlikely that the Obama administration will choose to call attention to its investment in GM with a pre-November sale. Yet, one day the feds will sell—Mitt Romney is on record as pledging an early liquidation, should the former private-equity titan win the White House. As for the former community organizer, he, too, would likely entertain a motion to sell if he won a second term.

Then, who would buy? Not likely the oft-burned retail investor. Neither the casual institutional investor who, after a cruise through the relevant Bloomberg pages, judges GM to be a low-margin business making hard-to-differentiate products—really, our imagined portfolio manager will reason, GM might as well be a call on the macro economy. A much more likely candidate for the purchase of the people's stock is GM itself.

Certainly, the company has the resources, Europe or no Europe, and China or no China. As of June 30, the balance sheet showed $32.6 billion of cash and marketable securities against $5.1 billion of debt.

"If you think about their current cash position and what is really required for them to run the business," Peligal says, "GM would probably say that $25 billion of liquidity would suffice. The company already has a $5 billion revolving line of credit. Ford, with a smaller balance sheet, has a $10 billion revolver. But say that GM is willing to borrow no more than $5 billion. Any way you slice it, the company sits with just under $35 billion of available liquidity (after giving effect to the $4 billion earmarked for Prudential Financial). At $20 a share, the Treasury's stake is worth $10 billion—and GM has that $10 billion to spend. And what better use of cash than to buy in shares valued at five times the estimate and at less than two times EV to EBITDA?"

So how do we value Government Motors? Acknowledging that the exercise is an art, not a science, let us proceed. Enterprise value, as you know, is defined as equity market cap plus debt at par minus cash, though there are wrinkles.

Peligal presents the *Grant's* estimates. "Let's use 1.8 billion fully diluted shares, taking into consideration the conversion of the convertible preferred, which makes a fully diluted equity market cap of $36.45 billion. To which we add: $5.1 billion of debt, $910 million of minority interest, $7.2 billion of other post-employment benefits (OPEB), $6.9 billion in preferred and $24 billion for unfunded pension liabilities. Which adds up to $80.56 billion.

"From which," Peligal proceeds, "we subtract $16 billion in net operating loss, $4 billion for GM Financial (valued at book), $10 billion for the Chinese joint ventures (to the earnings of which we assign a P/E multiple of 6.3 times), $28.6 billion of cash and marketable securities (anticipating the year-end payment to the Pru) and $300 million for the corporate stake in Ally Financial. What you're left with is an enterprise value of $21.66 billion. We assume that 'core,' or nonfinancial GM, can produce $12 billion in EBITDA. Dividing $21.66 billion by $12 billion, we find that an investor can buy GM at 1.81 times EBITDA, compared to the 3.5 times EV-to-EBITDA multiple at which the likes of Magna International, Delphi and Tenneco change hands."

Do we hear the objection that, only a few months back, this once-and-future American jewel was valued at the supposedly incredible, never-to-be see-again bargain multiple of two times EBITDA? Cheap stocks do get cheaper. However, given the strength of the company's post-bankruptcy financial position, we judge a permanent impairment of capital unlikely. More likely, we believe, is the risk of nothing much happening for a very long time.

As for something—anything—going right, who knows? Last month, three Chevrolet models—the subcompact Sonic, the compact Volt and the Avalanche pickup—earned the "best in segment" award from J.D. Power and Associates, the most of any brand (seven other brands snagged two awards). On the higher end, the first compact Cadillac in 25 years, the ATS, won huzzas from Aaron Bragman, industry analyst for IHS Automotive: "Driving wise, I think it's extremely comparable [to the BMW 3 Series]…. It feels very German to me in terms of the way it drives." Quoth Mike Colias of *Automotive News* on Monday, "In many ways, GM is in better shape than it has been in decades."

"I prefer it partly because of the hair," an investor tells Peligal when asked why he likes GM more than the safer, more flourishing Ford. GM does, indeed, have a full head of hair, i.e., of troubles, risks and contingencies. But let the record show that the company has survived moments far hairier.

"The automobile market had nearly vanished and with it our income," writes Alfred P. Sloan Jr. in "My Years with General Motors," concerning one such patch of rough road. "Most of our plants and those of the industry were shut down. . . . We were loaded with high-priced inventory and commitments at the old inflated price level. We were short of cash. We had a confused product line. There was a lack of control, and of any means of control in operations and finance, and a lack of adequate information about anything. In short, there was just about as much crisis, inside and outside, as you could wish for if you liked that sort of thing."

This was the crisis of the depression of 1920-21, a slump that, for GM, was worse by far than the Great Depression of the early 1930s. It was in 1920 that William C. Durant, the company's founder, ran up an unpayable margin debt trying vainly to prop up the sinking GM share price. To the rescue rode E.I. du Pont de Nemours & Co. and J.P. Morgan & Co.—and out on the Detroit pavement went Durant. But GM and Durant's creditors were saved.

In relating this story of decline and fall and triumphal redemption, Sloan recalls how difficult it would have been to try to compete with Henry Ford in the low-price end of the automobile market: "No conceivable amount of capital short of the United States Treasury could have sustained the losses required to take volume away from him at his own game," as Sloan put it.

Writing in the glory years of the early 1960s, Sloan could not have dreamt that the day would come when GM would indeed have to call on the Treasury. Yet, though that evil day has come, it will surely go. Before very long, Government Motors, like the depression of 1920-21, will be a chapter in the history books.

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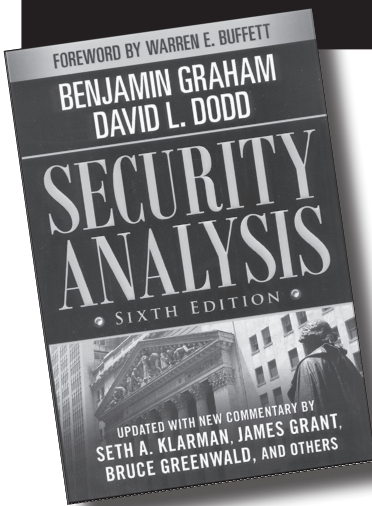

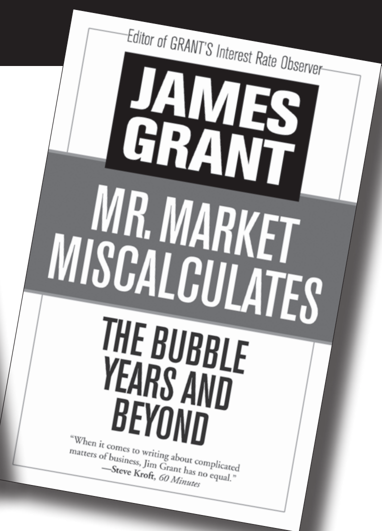

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