

April 5th Market Update – The Auto Task Force

Part 1: The Government's View – Auto Task Force

Background:

Chrysler and GM each signed a Loan and Security Agreement with Treasury Dep't on December 31st. These agreements, as well as plans submitted on February 17th, laid out conditions that needed to be met by March 31st. They were not satisfied (in either case).

To date, GM has received \$13.4 billion and Chrysler has received \$4 billion.

The companies have asked for \$21.6 billion more:

1. GM has asked for \$16.6 billion more.
2. Chrysler has asked for \$5 billion more.

This past week, the Administration's Auto Task Force announced their findings (see below). The Administration is basically asking the companies to prove that they are viable. They are being supplied with working capital until this is proven.

Key Findings on GM

1. GM is in early stages of operational turnaround and has improved:
 - a. Purchasing has become global and benefits from scale
 - b. Product design has resulted in global platforms (leveraging scale)
 - i. Created 2008 Car of the Year (Malibu and Cadillac CTS)
 - c. Manufacturing has become more flexible
 - i. Resulted in increased utilization (spreading fixed costs)
 - d. Brand rationalization announced
 - i. Divesting or shutting down Saab, Saturn and Hummer
 - e. Dealer network is being reduced
2. Much more progress needs to be made and GM thinks it will take years.
3. GM's assumptions are very optimistic. Examples include:
 - a. .3% / yr loss of market share even though:
 - i. have been losing .7% / year for 30 years
 - ii. reducing fleet sales and shutting brands = 1.8% of sales
 - iii. plan includes keeping many brands that distracts mgt, scatters marketing and hurts consumer perception
 - b. contribution margin increasing from 30.4% to 30.8%, even though:
 - i. increasing focus on cars (which have lower margins)
 - ii. consumer perception of low quality which increases discounting
4. GM has other problems, including:
 - a. Too many brands

- i. Diminishes brand equity
 - b. Too many dealers
 - i. Hurts prospects of strong dealers (who could drive incremental sales)
 - ii. Large closure costs (that competition won't incur)
 - c. Europe has been a drag for over a decade
 - i. In last 13 years, mkt share has dropped from 12.9% to 9.3%
 - ii. Company has high fixed costs and low capacity utilization
 - iii. European business can eat up capital
 - d. Disproportionate share of profits are from high margin trucks and SUVs
 - i. In 2008, only 9 of top 20 profit contributors were cars
 - e. GM is one generation behind in "green" cars
 - i. Volt is going to be much more expensive
 - f. Legacy liabilities will be \$6 billion / yr in 2013
 - g. Even with bold assumptions, GM projects negative free cash flow over next six years
 - h. GM is already behind on its 2009 volume assumptions
 - i. The progress has been too slow
- 5. Conclusion: current plan is not viable
 - a. Need a substantially more aggressive restructuring plan

Key Findings on Chrysler

1. Chrysler has made a few improvements:
 - a. Reduced structural costs 29% from 2007 to 2009
 - i. Mostly reduced salaried headcount (60% reduction from 2000 - 2010)
 - b. Improving capacity utilization
 - i. Closing two assembly plants and five engine plants in next 5 yrs
 - c. Negotiating improved wage rates
 - i. Should be lowered to benchmark by 2010
 - d. Making efforts to improve quality of product and interior content
2. Chrysler has made unrealistic assumptions in their plan to become viable:
 - a. Assume mkt share will be maintained
 - i. Have lost 5% since 16.2% peak in 1998
 - ii. Even minivan segment has dropped from 39% to 33% since 2006
 - iii. Few signs they can reverse perception of inferiority
 - b. Plan relies on Financing arm that is in trouble
 - i. 34% of customers are subprime or near-subprime (difficult financing right now)
 - ii. More stringent financing standards will hurt demand

- iii. 48% of buyers have used Chrysler Financing and this unit is having trouble raising capital
 - c. Plan assumes only modest decline in prices
 - i. Ignores the high competition and the customer perception
 - ii. Plan projects 25% less incentives than historic average
 - d. Plan assumes constant margins as they move to lower margin vehicles
 - i. Assume less price incentives and better cost mgt
- 3. Chrysler has too many challenges to overcome as a stand-alone entity:
 - a. Limited scale in a capital intensive business
 - i. Limits product development budget (50% of engineers that GM dedicates to this)
 - ii. Lower volume platforms (forces them to amortize R&D and cap ex into smaller base)
 - iii. Ultimately have less ability to innovate
 - iv. Can't exert pressure on suppliers
 - v. Fixed costs are spread over smaller base
 - b. Quality is low (and perception of quality is low)
 - i. Every single brand is in bottom quartile of JD Power APEAL score
 - ii. Consumer Reports didn't recommend any Chrysler product
 - iii. Takes long time to change perception (40% of quality problems are design related)
 - c. Product Mix is unfavorable
 - i. No product pipeline for small cars
 - 1. Small cars are 21% of mkt (Chrysler 3%)
 - 2. Medium cars are 25% of mkt (Chrysler 7%)
 - ii. Chrysler is focusing on trucks and SUVs to lift profitability
 - 1. If gas prices increase, they're dead
 - iii. No money to do catch up R&D
 - iv. Spending much less on powertrain development than competition
 - d. Chrysler is only OEM to not invest in flexible manufacturing
 - e. Geographic Concentration
 - i. Heavily weighted to North America
 - ii. Little exposure to emerging markets
- 4. Conclusion: not viable on own
 - a. Partnership with Fiat (or someone else) could lead to viability

Key Finding of Obama Administration

1. GM's February 17th plans do not indicate viability (positive FCF).
 - a. GM needs more aggressive strategy with greater stakeholder concessions
 - b. Rick Wagoner is stepping down and GM will separate CEO / Chairman positions
 - c. Government will supply 60 days of working capital while GM works on more aggressive plan
 - d. New plan must focus on:
 - i. Sustainable profitability
 - ii. Healthy balance sheet (reduced debt)
 - iii. Headcount reductions, more flexible manufacturing, brand and dealer reductions
 - iv. Fuel efficient cars
 - e. Best path may be expedited, court supervised process to eliminate unsustainable liabilities
 - i. Gov't will stand by GM through process
2. Chrysler can't be viable as stand-alone company
 - a. Need to transform processes and products to improve efficiency, reduce costs and improve quality
 - b. Chrysler does not have the capital to invest in these improvements
 - c. Fiat partnership could help:
 - i. Lead to manufacturing more fuel efficient cars
 - ii. Managerial expertise (Fiat has turned around in last 5 yrs)
 - iii. Complementary product mix and geographic reach
 - d. Terms of deal must change
 - i. Fiat was getting ownership before taxpayers repaid
 - ii. New cars must be built in US
 - e. If deal is done in 30 days, gov't will consider \$6 billion loan
 - f. Chrysler and Fiat must understand:
 - i. Chrysler must reduce debt burden (all unsecured debt and equity and majority of secured debt)
 - ii. Must get greater concessions from UAW
 - iii. Chrysler and Fiat must show how they will have positive FCF
 - iv. Chrysler and Fiat must not have an agreement that requires US to loan \$6 billion
 - v. Chrysler must show ability to finance cars by dealers and consumers
 - vi. Chrysler needs a plan to get this done and it may be an expedited bankruptcy process
3. Government will give confidence to buyers and suppliers:
 - a. Gov't-funded protection for warranties
 - i. Manufacturer will contribute 15% and Treasury 110% so that estimated cost is covered at 125%
 - b. Supplier support program (\$5 billion to guarantee repayment)

- c. Continue use of TALF to guarantee financing to consumers
- 4. Appoints Director of Recovery for Auto Communities and Workers
 - a. Worker retraining
 - b. Local economic development

Part 2: Wagoner Fired

A Brief Wagoner Summary

1. By most accounts, Rick Wagoner sounds like a decent guy who was asked to step down and did so. Decency aside, it was time for a change.
2. He was a Harvard MBA and he had a long successful career with GM. He became CFO at the age of 39.
3. He was credited with hiring Bob Lutz to run Product Development.
4. Part of the blame that has been put on him is that he wasn't a big enough prick to the unions.
5. He was too loyal to dealers and he didn't want to eliminate brands. While he got rid of Oldsmobile, it was only after government pressure that he planned to eliminate Saab, Saturn and Hummer.
6. He put big bets on trucks and SUVs and this bet lost big when gas prices spiked.
7. He was blamed for not doing enough to solve labor costs – although he had clearly started the process. (It didn't help that he specifically said that he was not going to eliminate the jobs bank in 2005.)
8. He inherited a company that had accumulated problems (particularly costly retiree benefits and union contracts) over 90 years and he couldn't solve it. (Of course, the thought that we're going to solve these problems in the next 60 days is hilarious.)
9. He is not receiving severance pay. He will leave with approximately \$21 million. Apparently, \$20MM is from pension benefits. He has \$535K in deferred compensation. He is eligible for equity grants of \$366K. He owns stock worth \$560K. The stock was worth \$3.9MM a year ago.
10. His salary this year was \$1. His replacement, Fritz Henderson, will receive \$1.3 million.

The Value of Signals

President Obama likes the idea of signals. Getting rid of Wagoner signaled many things:

1. Greater government involvement.
2. AIG isn't going to happen again – we're not going to give you \$170+ billion without making some serious changes.
3. It's the government's way or the highway. If your company receives money from the government, CEOs may need to step aside if White House is not happy with performance.
4. A new beginning.
5. The need for urgency.
6. Unions and bondholders better work something out...otherwise you might not like the change.
7. It's difficult to lose \$80 billion in four years and keep your job...

Issues to Think About With Respect to Wagoner

1. The government has taken control of Fannie, Freddie and AIG and they have replaced the CEO.
2. GM is currently more like Citi and BAC. So why didn't we replace Pandit and Ken Lewis?
 - a. Citi is too complex and it may be hard to find a replacement.
 - b. Ken Lewis did the government a favor by acquiring Countrywide and Merrill – so the government has difficulty dumping him.
3. Why didn't the government try to force the UAW to replace Ron Gettelfinger – the UAW's president. The idea behind this thought is that new people could have come in without any baggage.
 - a. The UAW didn't directly receive government money (although the government could have made his stepping down a condition of future funding).
 - b. It would be hard to get the union workers to buy in to any agreement if they felt that they didn't have their leader representing them.
4. Why was Robert Nardelli allowed to stay at Chrysler (since he also submitted a proposal that was not viable)?
 - a. He was seen as an outsider.
 - b. Chrysler is going away – the government doesn't want to have upheaval which could slow down the transaction.
5. Will this make other CEOs afraid to ask for a bailout?
6. Fritz Henderson supposedly designed GM's plan which was submitted to the government on February 17th (and had many crazy assumptions). How did he end up with the CEO position?
 - a. Henderson has a similar background to Wagoner. He's also a Harvard MBA and served as CFO.
 - b. He was known in GM for instituting change.
 - c. He ran GM Europe and oversaw the sale of GMAC.
 - d. He has traveled to 45 countries.
7. Maybe this action gave more teeth to the banks' stress tests.
 - a. Maybe these will be viability tests.

The Directors are Next...

1. Wagoner was also relieved of his position as Chairman of the Board.
 - a. I'm not sure that we wouldn't have been better off having him remain on the Board, although not in the position of Chairman.
 - b. He was replaced by Kent Kresa (former CEO of Northrop Grumman). Kresa is 71 years old.
2. It is estimated that six of GM's directors will be replaced.
3. George Fisher, the lead independent director is thought to be at risk. Fisher was Kodak's CEO in the late 90s. His lack of success in turning Kodak around made him a perfect candidate for GM's board...
4. Why would anyone want to be on this Board? This is like a puppet dictatorship.

Part 3: Obama

Key Points from Obama's Speech

1. The problem was a failure of leadership – from Washington to Detroit. He said that tough decisions were constantly put off to the future.
 - a. He clearly didn't want to put the blame on the workers.
 - b. He discussed the fact that the auto industry lost 400,000 jobs last year (plants, suppliers, dealers, etc.) and that Michigan has 12% unemployment.
2. We can't let the auto industry vanish.
3. Everyone will have to make sacrifices – unions, creditors, dealers and suppliers.
 - a. He should have focused on taxpayers!
4. The US will lead the world in the building the next generation of clean cars.
5. We can use legal structure to make it easy for GM and Chrysler to eliminate old debts and help them get back on their feet to a path of success.
 - a. It's strange to hear a President discuss the merits of bankruptcy.
 - b. It's odd to think about the President promoting the termination of agreements with workers.
 - c. Jenny heard this and started talking about how she could use the "legal structure" to eliminate her biggest problem.
6. He said that the government will purchase cars through the Recovery Act.
 - a. It turns out that American cars are a perfect fit for government work. You only have to show up 60% of the time.
7. The IRS will alert people about a new tax benefit that may allow you to deduct the sales tax and excise tax bought between February 16th and the end of 2009.
 - a. The problem is that the average savings will be ~\$300 and that is not that significant.
8. Congress will consider a bill in which you are compensated for scrapping old cars and fuel-inefficient cars.

Issues to Consider With Obama's Speech

1. Is Obama bluffing because he wants the bondholders and UAW to give in?
2. No one is ever going to be 100% in agreement with a plan like this. But I was happy to see that the Administration didn't just hand out money.
 - a. I was impressed with the fact that Obama said things that the unions didn't want to hear.
 - b. After this crisis is over, maybe this is the type of President who could actually speak the truth about other serious issues such as Social Security.
3. I think a lot of people are concerned about the Administration trying to set the direction for a corporation – e.g., the focus on clean energy cars.
4. The President did not directly ask Americans to buy American cars.
 - a. His Press Secretary said that the President was absolutely doing that.
 - b. It's a dangerous road to go down – with the fear of protectionism.
5. Obama could incur the wrath of the unions. He won Michigan, Ohio and Indiana.
 - a. He is effectively lowering their wages.
 - b. He is hurting retiree benefits.
6. Apparently, his focus on union workers is not playing well with American non-union workers that work for foreign manufacturers.
7. Obama has populists on his side, but he wants to keep manufacturing jobs.
 - a. 59% of Americans disapprove of the loans that have already been made to Chrysler and GM. These numbers are similar in the Midwest.
8. Obama says the government has no interest in running GM.
 - a. Similarly, Jenny has said that she has no interest in being married to a nerd.
 - b. My response to Barack and Jenny..."too late."
9. Obama is going to find it difficult to separate himself from the auto industry and their problems.
 - a. He is going to face an incredible amount of political pressure.
10. If nothing gets worked out and he has to let a bankruptcy judge make some ugly decisions about the UAW, it's going to hurt him politically.
 - a. With that said, maybe this was something that could have only been done by a Democrat. If a Republican tried to do this, the partisanship would have been tremendous.
 - i. I can badmouth my siblings, but you better not...

Part 4: GM

The Last Few Years

1. GM hasn't had a profit since 2004.
 - a. They have had losses of \$82 billion since then.
2. Stock was trading above \$70 when Wagoner took over in June 2000.
 - a. Now, company has a market cap below \$2 billion.
3. One-half of GM's unionized task force has been laid off or taken buyout packages.
 - a. The UAW has agreed to a two-tier system where new employees make \$15 / hour.
4. BAC analyst (John Murphy) says that GM has \$62 billion of obligations to employees.
 - a. This is approximately 35X market cap.
5. There is so much focus on GM North America. But GM Europe is also hurting.
 - a. They have 54,000 employees in Europe.
 - b. They have been losing money or breaking even for a decade.
 - c. They lost \$2.88 billion in 2008.
 - d. They say they need \$4.4 billion in loan guarantees from European governments.
 - e. They are cutting back on launches and advertising.
 - f. They are engaging in aggressive discounting.
 - g. They are deferring tax payments.
6. They have been restructuring for 30 years.
 - a. Maybe this is about more than costs.
 - b. Maybe the quality of their cars is horrible.
 - c. Maybe their reputation is permanently impaired.
 - d. Maybe this restructuring won't do anything.

GM's Plans

1. Clearly, GM needs to cut jobs, dealers and brands.
 - a. New CEO Fritz Henderson says that they will close more plants, lay off more workers and speed up consolidation.
 - b. He said that he would do whatever is necessary – even if that means bankruptcy.
2. Déjà vu – Henderson minimized the need for a new labor contract.
 - a. Also said that they wouldn't kill more than three brands.
 - b. Said the company will work to maintain leading US market share.
3. There has been a lot of talk about the need to get rid of the Hummer brand.
 - a. The Hummer gets terrible gas mileage.
 - b. It is symbolic of conspicuous consumption.
4. In 2008, GM burned through \$1 billion of cash every three weeks.
5. They need concessions from creditors.
6. The scariest thing is that there is talk about the GM Volt. This car is going to cost approximately \$35K!
 - a. You have to question whether this car is commercially viable at this price.
7. GM's revival plans assume car sales of 14.3 million cars per year.
 - a. Currently, we're selling less than 10 million.
 - b. It's not obvious that this is impossible.
8. Barclay's analyst Brian Johnson says that GM's forecast of operating profits of \$47.1 billion between 2010 and 2014 is unlikely.
 - a. Subtracting cap ex of \$25.5 billion leaves \$21.6 billion.
 - b. Paying off interest, debt maturities, pension and health-care contributions requires \$35.4 billion.
 - c. Even if the health care costs are cut by 90% and unsecured debt payments are cut in half, cash flow would still be negative.
9. Making unrealistic assumptions is not impressive.
 - a. It furthers the belief that GM is in denial.
10. GM ultimately needs to improve quality and eliminate discounting.

GM Needs Concessions

1. GM needs concessions from:
 - a. UAW
 - b. Bondholders
2. GM wants UAW to accept stock for the retiree healthcare fund.
3. GM needs to reduce \$27 billion of unsecured debt to \$9 billion.
 - a. Goal is to get bondholders to exchange 2/3 of debt for equity and more debt.
 - i. GM wants government to insure debt.
 1. This would be another wealth transfer.
 - ii. Hard to want stock if you fear bankruptcy.
4. Problems:
 - a. Creditors want UAW to give in first.
 - i. UAW wants creditors to give in first.
 - b. UAW assumes that the gov't will always step in.
 - c. Bondholders believe that Obama would never let the company fail b/c he needs the unions in order to get elected.
 - i. Obama said he wouldn't let the industry go away.
 - d. Bondholders want a viable plan before they will negotiate.
 - i. Circular argument – it's hard to be viable with high debt levels.
5. I struggle with the UAW's position against the bondholders...
 - a. What do they say...you loaned us money and we are overpaid...so you need to make concessions?
6. GM has cut their offer to bondholders from 33 cents to 24.5 cents:
 - a. 8 cents in cash
 - b. 16.5 cents in new unsecured debt
7. Approximately 80% of the debt is held by large investors and hedge funds.
 - a. Some are vulture investors.
8. It's hard to get the creditors to act when they believe that Obama won't allow the auto industry to fail.
9. Without government financing, all creditors are in trouble.
10. Bondholders could threaten to hold up bankruptcy proceedings.

Bankruptcy

1. A few things to remember:
 - a. Bankruptcy judge could void contractual obligations to dealers under state franchise laws
 - b. Unsecured debt has priority over common stock.
2. New CEO Fritz Henderson has said that he is open to using bankruptcy to help solve GM's problems.
3. If there is a bankruptcy:
 - a. Government would love for it to be pre-packaged – where creditors have agreed to everything. There have only been three other pre-packaged bankruptcies where the firm has more than \$10 billion of assets.
 - b. Government may try to use the DIP financing as a threat to force creditors to participate in pre-packaged bankruptcy.
 - i. No one believes government will withhold financing.
 - c. The fear is a chaotic bankruptcy that drags on.
 - d. More likely that gov't will have some creditors signed up for an agreement while others will fight.
 - e. If this happens, gov't will use a sale authorized under Section 363 of the bankruptcy code to sell the good assets to a new company.
 - i. Old GM will retain the bad assets.
 - ii. Sale of shares in new company will largely go to old company.
 - iii. Bankruptcy judge can order this sale over creditor objections.
4. The US is one of the big debtholders in these two companies.
 - a. I assume that if we pre-package a bankruptcy, it will not include the taxpayer being wiped out?
5. We will see massive advertising campaign to convince us that bankruptcy doesn't create problems for buyers.
6. Most importantly: realize that bankruptcy is the natural result for companies which have both business risk (cyclicality and operating leverage) and financial risk (debt). The amazing thing is that they've been able to put it off for so long.

Unbelievable

1. This week, GM rolled out two new programs:
 - a. Protection of trade-in values
 - i. Eliminate negative equity if you sell or trade-in during next three years
 - b. Guarantee of loan payments if buyer loses job
 - i. Can miss up to 9 payments of up to \$500
 - ii. You must be eligible for state unemployment benefits

Think about this...GM is effectively providing unemployment insurance and is doubling down on the value of cars. (Maybe they are reinsuring through AIG...either way, you and I are offering this insurance.)

Part 5: Key Thoughts on the Chrysler News

I'm Not Convinced that Fiat Can Save Chrysler

1. Fiat has never been successful in the US. Regardless of the fact that management has turned Fiat around in Europe, you really need to be skeptical about their potential for success here.
2. The Administration is excited about the technology of Fiat being shared with Chrysler. While Fiat has improved the quality of their product, I'm not convinced that the American consumer will associate quality with Fiat.
3. Even if you assume that the deal with Fiat happens, AND you assume that Fiat has great technology, it will take a significant amount of time before this impacts Chrysler.
4. In 2001, GM negotiated a European alliance with Fiat. GM ended up paying \$2 billion to get out of that deal.

What If the Fiat Deal Doesn't Happen

1. The deal is VERY likely to happen.
2. Some people still feel that Chrysler should merge with GM and they should focus on being the "big car" manufacturer. It's really hard for me to understand the rationale of "crap + crap = golden egg." The last time I heard that, I was looking at a CDO.
3. If the Fiat deal doesn't happen, would the Obama administration really let Chrysler liquidate? Doubtful, but a pleasant thought all the same.
4. Closing Chrysler would eliminate 14% of US light vehicle manufacturing capacity.
5. It's hard to understand how Chrysler will get rid of \$9 billion of debt (as the government wants them to do). Secured lenders will be better off seizing assets in bankruptcy.
6. Most of the unsecured debt is held by JPM, C and GS.

Cerberus

1. Cerberus has apparently given up on their 80% stake in Chrysler. They know it's worthless.
2. Cerberus is still trying to profit from their investment in Chrysler Financial and GMAC.
3. Cerberus' chief (Feinberg) is trying to get federal money for Chrysler Financial and GMAC. He is also looking for government help in merging the two financial units.
4. When the government allowed GMAC to become a bank holding company, they rejected Chrysler Financial's bid to do the same. A lot of the problem is the idea of the government subsidizing a private equity firm's investment property.

Random Fact Hotline

1. The government has basically said that Fiat's investment in Chrysler will get Fiat a 20% stake rather than a 35% stake that was previously discussed.
2. The government has also said that the government must be paid back before Fiat can raise their stake above 50%.
3. This past week, Canada gave \$201 million to Chrysler Canada.

Part 6: Final Facts

1. Auto sales have dropped from approximately 16 – 17 million cars per year (in the US) to a pace that puts us below 10 million per year.
2. In March, US sales industrywide were down 37%. All US car manufacturers were down at least 36%:
 - a. Honda -36.3%
 - b. Toyota -39%
 - c. Chrysler – 39.3%
 - d. Ford -41%
 - e. GM -44.7%
3. Car manufacturers offered a record \$3,169 incentive per car sold.
 - a. 30.1% jump from a year earlier
 - b. 5.7% increase from February
4. We had 19.1 million manufacturing jobs in 1980. We have 12.4 million today.
5. You would expect that all of this bad news would really hurt the people who live in Detroit. But, here's the great thing...they don't know all of this is going on. Gannett's Free Press and MediaNews Group's News limited home delivery to Thursday and Friday.
6. Congress is considering a "Cash for Clunkers" program, where people will be rewarded for trading in old cars or gas guzzlers. I'd like to see a similar program used to retire some members of Congress.
7. It will be interesting when people study Cerberus and their role in driving Chrysler into the ground. Their behavior does not speak well for private equity. It won't be long before we'll hear of possible regulation of dividends and capital structure...
8. China is saying that they want to be the leader in all-electric cars. There's only one problem with this: no one has made an all-electric car yet, so there really isn't the technology to steal. Other than that, it's a fine plan.