

## **Cantor Viewpoint**

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### **GM: New Strategic Choices Loom**

*The downward financial spiral at General Motors could point the company toward some new strategic avenues, that may include a change of management, splitting GM automotive operations from GMAC, gaining greater flexibility from the UAW on legacy costs and job security, and seeking direct subsidy from Washington.*

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**G**eneral Motors' latest bombshell opens the final chapter in a long-running transition toward what will ultimately be a smaller company that focuses more on the bottom line than on keeping assembly lines running to meet obligations to a bloated force of production workers and retirees.

Along the way, GM likely will shed its investment-grade senior debt rating. Even though both GM and Ford already are investment-grade credits in name only - both firms' bonds yield more than the average B- rated industrial bond (the gap exceeding 100 bps in GM's case) - the now-palpable shift to an "official" high-yield designation will pose challenges for both money managers and Wall Street in managing the recycling of some \$301 billion of GM and General Motors Acceptance Corp. debt from one asset class to another.

#### **Company Problem or Industry Problem?**

From a macroeconomic perspective, GM's huge downscaling of profit expectations announced early Wednesday represents a further headwind for future growth in US manufacturing payrolls, in our opinion.

The impact on the real economy will be all the greater if GM's North American sales downturn turns out to be an industry-wide phenomenon. Early indications are that it isn't. Ford reaffirmed its 2005 profit target Wednesday (while tilting toward the "lower end" of its \$1.75-1.95 EPS forecast range - not surprising in view of sales levels for the first two months of the year), and Ford shares as well as those of Japanese auto makers posted relatively mild declines following the GM announcement.

Even though GM has enough liquidity to avoid a cash-flow crisis, its downwardly spiralling financial results and an associated upturn in cost of capital, pose strategic issues that extend beyond the well-known challenges involving product design and positioning, health-care costs, foreign competition, and fuel prices. In our opinion, strategic alternatives that may now attract greater attention over the course of 2005 include:

### **Leadership Change, Labor Relief, Federal Subsidy**

***More-explicit moves to detach General Motors Acceptance Corp.***, the profitable mortgage and secured vehicle lending arm that is the official issuer of a majority of GM's consolidated debt, from the parent General Motors Corp. and its troubled worldwide automotive operations. GM has only recently taken some very tentative steps in that direction. We would expect these efforts to accelerate if the parent falls into the BB rating category.

***A change of leadership.*** GM's projected Q1 loss will be the first in any year's Q1 since 1992, and Wednesday's 13% share-price plunge takes GM stock to a level last seen in early 1993. Not coincidentally, that was also a period when GM ousted its CEO due to poor financial performance. The current management team led by Chairman and CEO Rick Wagoner has focused less on product innovation and more on holding the line on US production and staffing levels, and maintaining the flow of cash to GM's massive pension and health care funds.

***Relief from obligations to labor unions.*** After vehicle design and marketing strategy, labor relations represent the single biggest challenge facing GM. UAW contracts saddle GM (as well as Ford) with ever-rising health care and retirement costs, while preventing the company from re-sizing the manufacturing work force to a level at which it could be cost-competitive and consistently profitable. As the range of turnaround options shrinks, GM may find its unions more receptive to renegotiating the most onerous contract provisions.

***Some form of direct relief from Washington.*** The US auto industry has frequently sought and received White House help on trade and foreign-currency matters, and is currently pressing hard for reforms that could stanch the crippling growth of employer health-care costs. However, even if GM does not suffer a liquidity crisis, its troubles could still worsen to the point where some form of company-specific or industry-specific subsidy - perhaps pegged specifically to health care cost inflation or fuel prices - would become a credible proposal.

### **No Fresh Production Cuts - Yet**

General Motors stunned the US bond and stock markets Wednesday with its 7:30 a.m. announcement that it expects a Q1 loss of -\$1.50 per-share (excluding special items) and full-year EPS of \$1.00-\$2.00, compared with its own previous projections of a break-even or better first quarter and \$4.00-\$5.00 EPS for all of

2005. Operating cash flow for 2005 is now projected at negative -\$2 bln, versus GM's previous target of +\$2 bln.

The company blamed the dramatically weaker outlook on "lower North American sales and production volumes, a tougher pricing environment, and a more car-based sales mix." Automotive operations outside North America and its GMAC financing arm are on track to meet or beat their 2005 profit targets, GM added.

GM's statement did not announce any new production cuts or other initiatives to address the shortfall. Indeed, the company said planned capital spending for 2005 remains at approximately \$8 bln, or \$1 bln above 2004. We expect that GM will further reduce output targets on April 1, when announcing unit sales for March.

### **Rating Firms Weigh In**

The major credit rating agencies each lowered their views on GM in different ways. Fitch immediately cut both GM and GMAC senior unsecured debt from BBB to BBB-, cut both entities' commercial paper from F2 to F3, and retained a negative outlook. Moody's placed GM and GMAC long-term ratings on review for a possible downgrade (it currently assigns a Baa2 rating to parent GM and Baa1 to GMAC), and also placed the short-term rating on review for GM but not GMAC.

Standard & Poor's action was the most cautious of the three rating firms. It slapped a negative rating "outlook" on both entities, without actually initiating a review or changing the current rating. However, S&P already rates GMAC (as well as GM) at BBB-, the lowest investment-grade rating. Before today, both Fitch and Moody's had rated GM one notch above there.

Moreover, S&P's commentary had a severe tone, indicating that a downgrade to junk could come soon even without a formal review. In its announcement, S&P credit analyst Scott Sprinzen was quoted saying: "We now view the rating as tenuous. The rating could be lowered at any point if we came to doubt that GM was on a trajectory to improving its financial performance to more satisfactory levels in 2006 and beyond."

S&P's Sprinzen provided more detail in a subsequent conference call, saying that a downgrade could occur if 2005 EPS falls below \$1.00, the low end of GM's revised guidance.

Moody's also provided details on what GM must do to maintain a Baa2 rating, the next-to-lowest investment-grade rating. By 2007, it must raise EBITA margin to 4% (from less than 1% in 2004); raise fixed charge coverage to a 4.0-4.5 range (from under 2.0 last year); and retained cash flow and free cash flow must

exceed 50% and 15% of total net debt, respectively (versus about 35% and 10% last year).