

UBS Investment Research
US Automotive Sector

Americas

Automobiles

Sector Comment

Are The Big 3's Problems Solvable?

15 May 2006

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■ Highlights from our "Q-Series" Elite Dealer Summit

The domestic auto industry is arguably facing its most difficult time. Key issues include a steady loss of market share, unrelenting competitive pressure, geographic weakness, shifting mix, high gas prices, rising interest rates and high inventory levels. With substantial headwinds, we've asked many of the nation's auto dealers - Are the Big 3's Problems Solvable?

■ UBS and BelAir Partners joined forces

To answer the question, UBS and BelAir Partners brought together experts including public and private auto dealers, industry observers, and a high level UAW leader to give us their opinion if the Big 3's problems are solvable.

■ A Tough Road Ahead

The general conclusion points to GM and Ford fighting for their lives. Though most agreed on their respective survival, topics including a reallocation of dealer capital, too tough competition, lack of management leadership, and unclear understanding of their customers stood out.

■ Fundamental hurdles keep us cautious on Ford and GM

The problems facing the industry are not quickly fixed. Given our view of a lack of pent-up demand for autos and likelihood of modest sales decline, our cautious view of the sector remains unchanged. We have a Reduce 2 rating on GM and a Neutral 2 rating on Ford.

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Executive Summary

The domestic auto industry is arguably facing its most difficult times right now. The Big 3 have steadily lost market share for the past 25 years to ever tougher competition. Ford and GM are going through major restructuring programs to right-size their capacity, with every management move closely scrutinized by investors and the media. GM is currently launching the T900, its most important and profitable platform, though \$3/gallon gas is clearly having an impact on the segment industry-wide. Interest rates are creeping higher, inventories are quite high for GM and Chrysler, and the Big 3's Midwestern stronghold is underperforming the national economy. Delphi, GM's largest supplier, has filed chapter 11 and is looking to the courts to throw out their current labor contracts. Such a move has been promised to be met with a crippling strike by the UAW.

Can these problems be overcome? Are the Big 3's problems solvable?

To answer the question, UBS and BelAir Partners joined forces to bring together 25 of the most influential auto dealers in the nation along with a senior UAW leader and many industry observers.

Universally, the crowd voiced loud concerns about the health of GM and Ford. The dealers highlighted their frustration with tepid customer interest in GM and Ford products, the impact of too many Big 3 dealers on profitability, and lack of management leadership. This is in addition to the challenging issues that are well outside of Detroit's control such as rising interest rates and the impact of regional economic differences on their performance.

Though no participant thought the end was near for either company, none thought there was a near-term solution to the problems either. It was suggested that little could be done to quickly capitalize on the robust population growth of key states such as Florida and California when the Big 3 have such a small (and declining) market share there. That said, the UAW aggressively portrayed itself as a progressive organization willing to partner with the companies and play a role in addressing the problems. Clearly, recent partnerships with auto suppliers suggest this willingness.

However, talk of the reallocation of dealer capital away from the Big 3 and the enthusiasm about new product and an aggressive plan to target the Midwest from Toyota dealers returning from recent company-sponsored sales events keeps us concerned about the domestic players.

We reiterate our Reduce 2 rating on General Motors and our Neutral 2 rating on Ford.

Are the Big 3's Problems Solvable?

The perspective of the dealers: How they spend their capital

The valuations of recent auto dealership transactions clearly highlight how franchise owners view the industry.

Blue Sky Value

Blue Sky value is basically the goodwill of a franchise. The majority of a franchise's Blue Sky value depends on the brands that the dealership carries, but factors such as real estate and location also play a role. As presented by BelAir Partners, a leading auto dealer M&A firm, domestic franchises carry lower Blue Sky multiples than the competition.

- Lexus: >6x
- BMW, Mercedes: 5x-6x
- Honda, Toyota: 4x-5x
- Acura, Audi, Infiniti, Nissan: 4x-4.5x
- Cadillac, Chevrolet, Chrysler: 2x-3.5x
- Buick, Ford, Lincoln, Mercury, Pontiac: 0 to negative Blue Sky multiple

Furthermore, valuations tend to be higher in the "sunbelt states" based on continued population growth forecasts. This compounds the relative lack of interest in domestic franchises given their relatively weak market share in these desirable areas. In addition, several dealership owners reported swapping the showrooms of their shrinking Big 3 and growing non-Big 3 franchises to better allocate space.

Perspective of the Private Auto Dealers – What they own and why

Our dealer panel consisted of representatives from Friedkin Companies (owner of Gulf States Toyota), Fitzgerald Auto Malls (over 20 stores, recognized as one of the most innovative auto retailers), and The Herb Chambers Companies (\$1.3b in revs, sixth largest privately-held dealer group in US).

The panel agreed that they all made conscious decisions to have a disproportionate number of stores selling foreign brands than Big 3 brands. The number of dealerships for each brand was a deciding factor as it drives vehicle throughput and profitability. It was noted that Honda sells 400k Accords

through 1000 dealerships while Ford is targeting the sale of 200k-250k the Ford Fusion / Mercury Milan / Lincoln Zephyr triplets through 4000 dealerships.

While Herb Chambers thought the Big 3 franchise valuations may have reached an attractive entry point, the others noted that the Big 3 should reduce their number of brands. It was noted that weak Big 3 dealer profitability limits reinvestment in the dealership (while the growing competition has newer stores). This was likened to the “silent killer” as the older stores become less competitive. Further, the Big 3’s financial health limits their ability to keep pace with changing engine technology and that, if anything, the sale of GMAC could reduce dealer confidence in GM as a company.

Weak floor traffic at Big 3 dealers was cited as a sign that the new strategy of backing away from incentives is not working. High-profile incentives were thought likely to return. A lack of understanding with respect to who their customers are and what they want was highlighted as a reason for the poor customer perception of Big 3 brands as was their consistent, relatively poor performance in *Consumer Reports*. This perception problem was thought to be a major risk to GM’s efforts to rebuild Saturn. Weak residuals also mark a substantial challenge.

Table 1: Vehicle Sales per Dealership

Franchise	Industry
Toyota	1486
Lexus	1442
Honda	1240
Ford	413
GM	297

Source: United Auto Group

Perspective of a Public Auto Retailer - UAG

It was the view of Walter Czarnecki (the Vice Chairman of United Auto Group, #2 publicly traded auto dealer in the US) that the Big 3 clearly understand the challenges they face and are taking necessary action. That said, despite this relative optimism, UAG derives the overwhelming majority of its revenue from foreign brands with a concentration in Toyota, Lexus, Honda, and Acura.

With respect to the current GM-Delphi-UAW situation, Mr. Czarnecki voiced his opinion that GM will take any necessary action to avoid a strike. That said, he spoke kindly about his dealings with the UAW when he worked at Detroit Diesel, citing their ability to work together when everybody had the necessary information to make an educated decision. On the other hand, he did question whether GM dealers will have the same comfort in GMAC following GM’s controlling stake sale to Cerberus. As well, he singled out the long-term

financing deals the Big 3 have relied upon as damaging for the brands and for the dealers as it takes buyers out of the market for too long.

The Labor Perspective

It is clear that the UAW is working hard to portray itself as a much more progressive organization than it has admittedly been in the past. Bob King, VP of organizing with a focus on auto suppliers, very freely acknowledged that the model that the UAW and automakers used in the past no longer works. The UAW's goals and ideals remain unchanged, though the strategy has turned to partnerships with companies in an effort to combat the challenges of a global industry.

Mr. King highlighted that the UAW is not a detriment to productivity and quality by illustrating that 7 of the top 10 N. American plants and many of the most reliable vehicles are organized and manufactured by the UAW or CAW, respectively. That said, it was clearly frustrating that recent plant closure and vehicle cancellation announcements have included some of these "success stories."

The UAW also floated the notion of partnering with dealerships, primarily in the service departments. There was a suggestion that the UAW could potentially increase sales by steering members to a unionized partner dealership. From the UAW's perspective, an organized network of dealerships could be a source of new employment for downsized OEM workers. Key takeaways from the pitch include higher job retention, improved worker qualifications, better safety and productivity, joint lobbying.

This pitch was not enthusiastically received by the dealers.

Perspective of Industry Observers

Our panel consisted of Dave Power (founder of JD Power), Glenn Mercer (McKinsey), and two journalists – Alex Taylor (Fortune) and Tom Walsh (Detroit Free Press).

Again, the group voiced clear concern for GM and Ford. A lack of leadership was cited often for the current situation, with Dave Power pointing to a lack of workable ideas stemming from executive teams hurt by a steady brain drain.

The primary discussion surrounded ways to attract people to Big 3 dealerships. The conclusion – it won't be easy. 1) There are too many dealerships. The NADA "union" needs to be broken. Dealer rationalization needs to occur to boost profitability, which in turn would be used to modernize the dealerships. 2) There is too much negative news. There is no "Buy American" mentality to fall back on. 3) Fix the brands. Kill the weak brands and shrink GM and Ford to more manageable sizes.

■ **Statement of Risk**

The global auto industry is highly cyclical, vulnerable to sudden shifts in consumer sentiment, employment, interest rates, and general economic activity. Automobile manufacturers typically have significant unfunded postretirement liabilities, which may be highly sensitive to asset values, interest rates, healthcare inflation and other actuarial assumptions. Parts suppliers are further exposed to customer pricing pressure, shifts in OEM market share, volatile production schedules, and unforeseen changes in technology.

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UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	Buy 2	FSR is > 10% above the MRA, lower degree of predictability	Buy	39%	35%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	Neutral 2	FSR is between -10% and 10% of the MRA, lower degree of predictability	Hold/Neutral	50%	33%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	Reduce 2	FSR is > 10% below the MRA, lower degree of predictability	Sell	11%	27%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 March 2006.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for the equity risk premium and not a forecast).

Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

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US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

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Companies mentioned

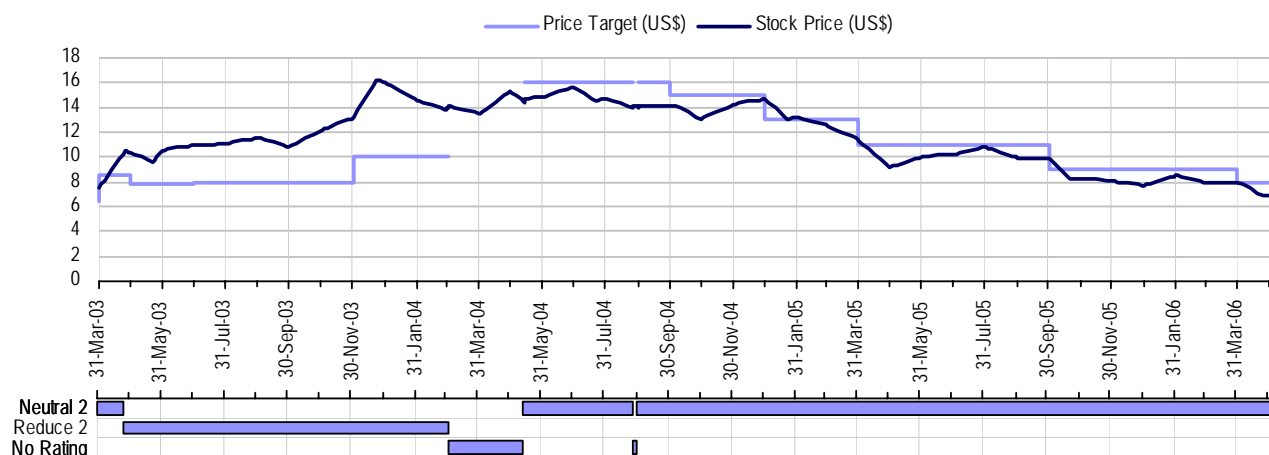
Company Name	Reuters	Rating	Price	Price date/time
DaimlerChrysler ^{2c,4b,18,25}	DCXGn.F	Neutral 2	€41.97	12 May 2006 23:39 BST
Ford Motor Co. ^{2b,4a,6a,6b,6c,7,14,18,24,25}	F.N	Neutral 2	US\$7.11	12 May 2006 19:36 EDT
General Motors Corp. ^{2a,4a,5,6a,6b,6c,7,14,18,25}	GM.N	Reduce 2	US\$26.05	12 May 2006 19:36 EDT

Source: UBS. BST: British summer time; EDT: Eastern daylight time.

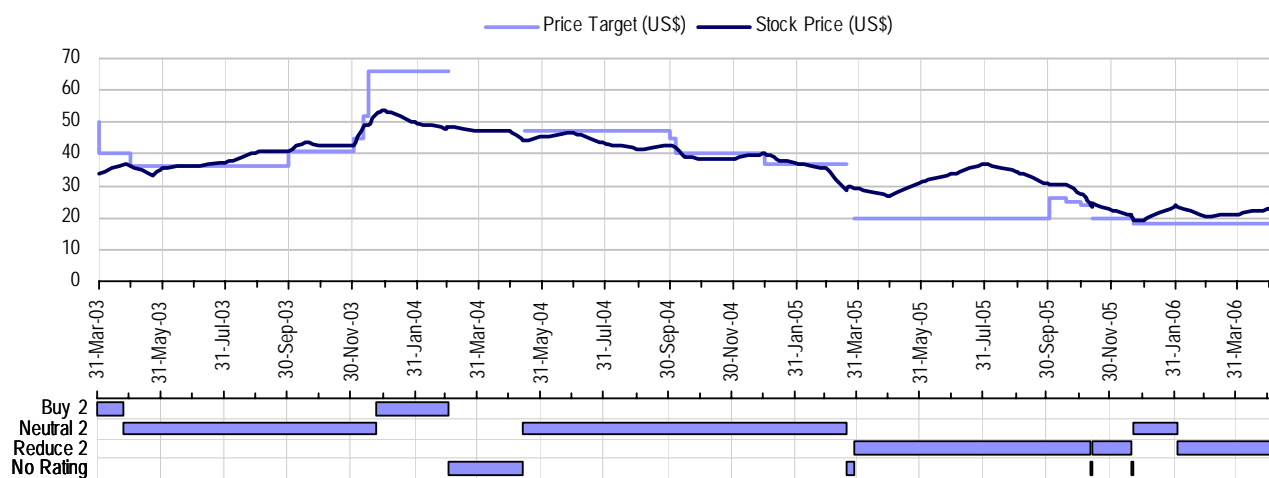
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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Ford Motor Co. (US\$)



General Motors Corp. (US\$)



Source: UBS; as of 12 May 2006.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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