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Cars in stock

Evan Lorenz writes:

What's wrong with Detroit? Though 49,000 union workers struck General Motors Co. on Sept. 15, American auto dealers held more GM vehicles in inventory on Sept. 30 (81 days supply) than they did on Aug. 31 (77 days supply). That, among other things, is what's wrong with Detroit.

GM and Ford Motor Co. (GM and F, respectively, each on the New York Stock Exchange) share the spotlight in this unfolding analysis. Facts, figures and trends provide the illumination. For instance: Auto loans are lengthening, used-car prices are flattening, the financial health of the American consumer is deteriorating and the supply of leased vehicles entering (or about to enter) the used-car market is growing. In preview, on the optically cheap shares of GM and Ford, *Grant's* is bearish.

"Going into August, everything seemed fine," Daniel Ruiz, the founder of Blinders Off LLC, an automotive-research boutique, tells me. "Used-car values were holding up as they had for the entire year. But, during the Labor Day weekend, automakers dropped their strategy of holding up new-car prices. They started discounting cars heavier for the Labor Day weekend."

Sales incentives—discounts by any other name—jumped by 4.9% in September to $3,975 per vehicle, according to the auto-data provider ALG. Those swollen dealer inventories had something to do with the promotional impulse (up by 39% from a year ago, in the case of Ford's F-series trucks), as did a wave of off-lease vehicles returning to the market (used-vehicle stocks show a 9.6% increase in the year to date, vs. a 2.5% decline through the same span last year, according to Ruiz).

Years ago, some of us wondered how the automakers would solve the problem of car prices rising faster than incomes. Extending auto-loan durations proved one stopgap, leases another. As a proportion of retail sales, leases climbed as high as 30.1% in 2016, from 13% in 2009. As most such contracts run for three years, vehicles leased in 2016, the peak postcrisis year in new-vehicle sales, are hitting the market now.

News of a 1.2% dip in the annualized selling rate of 17.2 million autos for September would seem to qualify as a mild kind of disappointment. But that bland fact masks a 12% drop in the retail portion of the mix, notes Cox Automotive, Inc. What filled the breach were fleet sales. A big corporate tax cut can do temporary wonders for business investment, but it's profits that finally control the corporate purse strings. On this score, FactSet Research Systems, Inc. projects a downturn of 4.6% in S&P 500 earnings in the September quarter; it would be the third consecutive quarterly reduction in blue-chip net income.

What ails Detroit even more than the inherently difficult, capital-intensive nature of the auto business itself is the pinched American consumer. To swing the $37,590 average sticker price for a new car (that's 61% of median household income), the typical buyer needs more debt and more time in which to repay it. In the 10 years through June 30, the sum total of auto loans outstanding grew by a cumulative 75%, trailing only the 119% surge in student borrowing, among the major categories of household indebtedness. For comparison, nominal GDP rose by 49% over the same span. In the second quarter, 32.5% of new-auto loans stretched for 72 months or longer; a decade ago, less than one-tenth of such loans ran for more than those six years.

The longer the term of your loan, the slower your accretion of equity. And because most new-car purchases hinge on

Ford Motor Co.
in $ millions

	2014	2015	2016	2017	2018	TTM*
revenues	$144,077	$149,558	$151,800	$156,776	$160,338	$158,418
profit before tax	1,280	10,179	6,784	8,159	4,345	2,892
net income	1,260	7,327	4,589	7,731	3,677	2,169
automotive debt	13,824	12,839	15,907	15,931	13,547	14,464
Ford Credit debt	104,712	119,417	126,464	137,757	140,066	141,470
other debt	635	598	599	599	600	600
cash	31,150	38,827	35,176	33,951	38,927	33,951
total assets	209,227	225,491	238,510	258,496	256,540	262,184

* For the period ended June 30, 2019.
sources: company reports, the Bloomberg

a trade-in, lower used-car prices spell trouble for the new-car market.

In its second-quarter "State of the Automotive Finance Market" report, Experian noted that an all-time-high proportion of prime (62.5%) and super-prime (46%) customers bought used vehicles, perhaps indicating that new-car prices have overshot incomes. To entice these buyers off the used-car lots and back to the showroom, Detroit will likely have to reduce prices, in the process exerting further downside pressure on the values of used cars. Looming lease returns certainly don't help, either.

Auto debt, like student debt, is hard to shake off. Don't pay, and the repo man takes your car. And while no one can repossess your education, student debt is nondischargeable in bankruptcy. What's left to the cash-strapped consumer is unsecured debt. "What we are finding is that folks are putting everyday expenses—groceries, gas, diapers, those kinds of things—on credit cards, and they are not being paid off at the end of the month," says Michael Micheletti, the head of corporate communications for Freedom Financial Network, America's largest debt-restructuring company.

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Month 123 of America's longest business expansion finds the jobless rate at a 50-year low of 3.5% and household net worth at an all-time high of $113.5 trillion. In September, a 2.9% year-over-year uptick in average hourly earnings topped the 1.7% increase in the consumer price index. Over the past decade, as the Fed does the figuring, the ratio of household debt-servicing costs to income has shrunk by 2.7 percentage points, to 9.7%.

But prosperity has not showered its blessings on all. The post-2008 decline in mortgage rates entirely explains the drop in the household debt-service ratio; renters saw no benefit. Over the past decade, hourly earnings have compounded at a 2.4% rate, trailing the 3% rise in the rent component of the CPI (as well as the 2.9% medical component of that index). Homeowners possess not only their dwelling places but also most of America's wealth.

A simple statistical expression of inequality is the difference between median and average. Thus, the Fed's 2016 triennial Survey of Consumer Finances found that the median household income of $52,700 was only slightly more than half of the average income of $102,700. And the median net worth of $97,300 was just 14% of the average net worth of $692,100. As for renters, they weighed in with net worth of only $5,200. No doubt, renters loom large among the 39% of households that could not meet an unexpected $400 expense without borrowing or selling possessions, again according to the Federal Reserve. Micheletti tells me that Freedom sees no improvement in the financial status of its more than 300,000 customers over the past 18 months, gains in the labor market notwithstanding.

For the relative stability of used-car prices, you can thank natural disasters (fires on the West coast and hurricanes on the East) and, oddly enough, ride-sharing. "When ride-sharing started taking off, there was a concern that personal ownership would decline," says Anil Goyal, executive vice president of operations at Black Book. "In fact, it has been the opposite. You had part-time drivers who were subsidizing their monthly payments with ride-sharing. You are seeing ownership go up because of ride-sharing. The off-lease market has been a sweet spot for part-time drivers."

The problem is that no one in the supply chain of Uber Technologies, Inc. or Lyft, Inc. seems to earn its cost of capital. In the second quarter, Uber and Lyft showed a combined loss of $1.5 billion, and an informed consensus holds that the duo's drivers would be better off working in fast food (*Grant's*, Nov. 2, 2018).

Nor are there signs of an imminent turnaround. In 2020, the California law reclassifying gig workers as permanent employees will come into force. On Jan. 1, Uber and Lyft must begin to pay Social Security and Medicare taxes on their drivers' earnings and offer those newly fledged employees health insurance (*Grant's*, Sept. 20). As to whether the automakers earn their cost of capital, more later.

General Motors Co.
in $ millions

	2014	2015	2016	2017	2018	TTM*
revenues	$137,958	$135,725	$149,184	$145,588	$147,049	$145,128
profit before tax	4,246	7,718	12,008	11,863	8,549	9,297
net income	3,949	9,687	9,268	-3,864	8,014	9,107
automotive debt	9,084	8,535	10,560	13,502	13,963	16,047
GM Financial debt	29,304	45,479	64,563	80,717	90,988	91,114
cash	28,176	23,401	24,801	23,825	26,810	24,121
total assets	177,311	194,338	221,690	212,482	227,339	233,737

* For the period ended June 30, 2019.
sources: company reports, the Bloomberg

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The bull case for the domestic automakers begins with mid-single-digit price-to-earnings ratios of the shares of GM (5.7 times), Ford (7) and Fiat Chrysler Automobiles N.V. (4.9). It proceeds to claims of fundamental improvement in business operations.

"What GM has done, starting with the financial crisis, is they have improved the structural profitability of the business at the expense of market share and volumes," a bullish friend of this journal tells me (he asks to go nameless). "In the financial crisis they got rid of some underperforming, poorly positioned brands like Pontiac. Subsequent to the crisis, they had exited markets around the world where they could not be structurally competitive," including Europe, Russia and Venezuela.

In the cause of fattening profit margins, Ford is following GM, the U.S. market-share leader, by curtailing production of most sedans (announced in 2018) and embarking on a global restructuring program. Both companies are spending billions to consolidate factories, revamp product offerings and produce more vehicles on fewer platforms. GM is striving to cut costs by $6 billion by year-end 2020 (vs. $11.9 billion in operating profits in the 12 months ended June 30); Ford is shooting for a 6% operating margin in Europe vs. 0.7% in the second quarter.

Not content to improve in the here and now, GM is developing autonomous vehicles for the future. SoftBank Group Corp. and Honda Motor Co. Ltd., are investors at a $19 billion valuation in that effort—Cruise is its name—which, for context, is worth 37% of GM's current market cap. It's not bad for a unit that generated a $448 million operating loss in the first half. In the first half alone, Ford laid out $552 million, pretax, to fund an autonomous and electric-car initiative in partnership with Volkswagen A.G.

But pending the arrival of tomorrow, GM and Ford are focused on the domestic markets for pickup trucks, SUVs and crossover SUVs (CUVs). In the second quarter, before corporate disposals, GM generated $3.2 billion in operating profit, compared with Ford's $1.9 billion. Overseas operations tax GM with a small loss (equal to 1% of second-quarter operating income) and Ford with a larger loss (17%).

"For three years, we've been hearing that off-lease pricing was going to peak and cause a deterioration in used-car pricing, which would then translate into lower new-car sales," our unnamed bull comments. "We're now at the tail end of it, and, quite frankly, it hasn't happened."

We bears would find these arguments more persuasive if the insiders believed them, too. As it is, GM officers and directors dumped $18.9 million of stock in the last year; Fiat insiders, $47.2 million. Excluding an $8 million purchase by William Clay Ford, Jr., great-grandson of founder Henry, Ford insiders sold a net $2.2 million of stock. Maybe it's meaningful that selling was heaviest at Fiat, the cheapest of the three on a price-to-earnings basis.

"The bulls say five to seven times earnings," Zachary Truesdell, co-founder and portfolio manager of Matador Global Management, tells me. "I say, five to seven times what earnings? Peak, all-time-high earnings in a cyclical, capital-intensive industry. By the way, capex outpaces D&A in this industry. If you look at the big three in the United States, depreciation and amortization is about 70–75% of capex. They have to continue plowing money back into these businesses." The Street estimates that GM and Ford will make $4 billion and $1.2 billion in free cash flow in 2019, which would value the companies at 12.8 and 30.3 times estimated FCF, respectively. Such a cash-flow multiple, in GM's case, would be more than twice its price-to-earnings ratio; in Ford's case, more than four times.

The automakers' very success since the Great Recession (when, let it not be forgotten, GM and Chrysler became wards of the state) presents problems, too. The unions that allowed their loss-ridden employers to bring aboard more low-cost temporary workers no longer feel the old postcrisis capital-labor solidarity. According to an Oct. 10 Bloomberg dispatch, 10% of the combined workforce of GM, Ford and Fiat are temps, earning around 40% less than union workers and receiving fewer benefits. Limiting the use of temps and creating a pathway for these lower-paid workers to become full-time employees is a point of contention in week five of the GM strike.

History will show that the automakers are almost always restructuring while never (at least, not so far) managing to improve through-the-cycle margins. "These guys are perpetually cost-cutting," Truesdell says. "This is always going on. By the way, they were doing this pre-recession. Alan Mulally had gone to Ford and turned everything on its head. These are really bad, competitive businesses that are perpetually looking for ways to cut costs, but everyone is doing that."

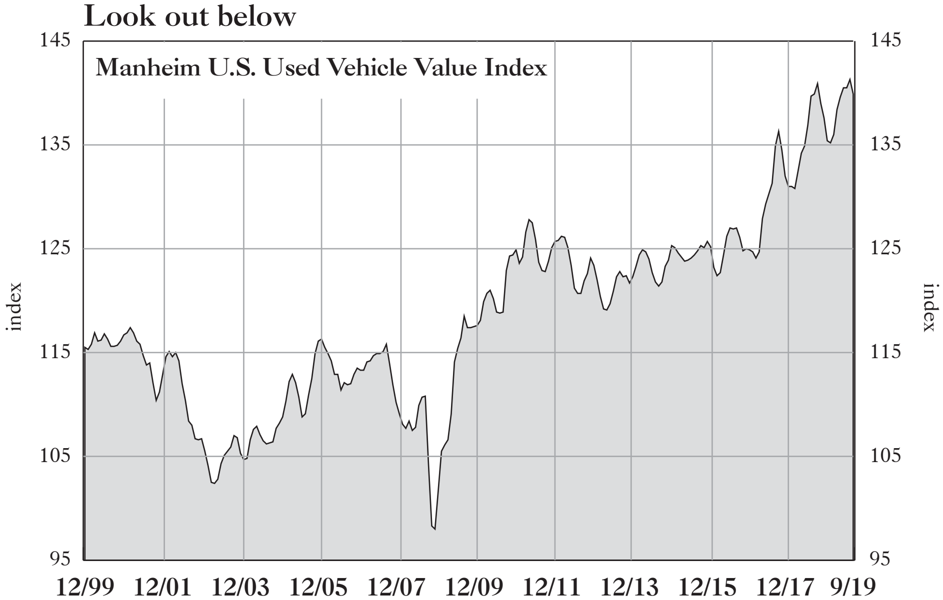
In an April 29, 2015 presentation titled "Confessions of a capital junkie: an insider perspective on the cure for the industry's value-destroying addiction to capital," the late Fiat CEO Sergio Marchionne opened up on a not-so-well-kept secret: Automakers do not earn their cost of capital over a cycle. Marchionne advocated for industry consolidation and cost-sharing. Based on Bloomberg calculations, GM and Ford generated returns of 6.2% and 2.5%, respectively, on invested capital in 2018.

Meanwhile, competition is hotting up in the lucrative pickup, SUV and crossover categories. "As the European guys face slowing demand in Europe and the market in the United States has shifted to CUV, large SUV and pickups fairly aggressively," says Truesdell, who is short GM, "you've seen a spate of new launches in the full-sized SUV market. BMW launched the X7, which is their biggest SUV ever. Mercedes made their GLS, which is their biggest SUV. VW started selling the Atlas in 2017. Subaru launched the Ascent in Q3 2018. Kia just debuted the Telluride. I haven't even gone through the big three OEMs' launches."

As for off-lease supply, it can show up in droves when least convenient. The previous leasing cycle peaked in 1999; in that year, vehicle sales financed by lease recorded their high as a percentage of all-vehicle sales—the figure was 28% vs. the aforementioned 30.1% in 2016 (*Grant's*, Feb. 24, 2017).

Off-lease vehicles climaxed at 3.45 million in 2002, but remained elevated into 2004. The burden of this supply surely contributed to a 12.8% drop in the Manheim U.S. Used Vehicle Value Index between February 2001 and April 2003. In 2004, Ford Credit recognized a gain of $768 per leased vehicle return. By 2007, that gain had turned into a

Look out below



source: The Bloomberg

$1,446-per-vehicle loss. As used and new autos competed for the same customers, new-car discounts deepened. Between 2005 and 2007, a period bracketing the tops of the housing boom and the prior business cycle, GM and Ford suffered $48 billion in cumulative losses in their respective automotive divisions.

With the Sept. 9 Moody's downgrade to Ba1, Ford is one-third junk (S&P and Fitch continue to call it triple-B). But in the bulge in pickup-truck inventory, the F-series manufacturer faces a perhaps more immediate problem.

"They are most heavily weighted to the pickup-truck sector," says Ruiz. "If you look at their financials, North America accounts for more than 100% of earnings because they lose money elsewhere. As long as North America is OK, there is a case for Ford. But if North America declines, that is the only thing they have for their health. So, of the total vehicles they produce, 37% is F-series, and that represents a much larger percentage of earnings because that is their highest-margin vehicle. If they cut production in F-series, what else is left there for a credit agency to do but cut the rating?"

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What might GM be worth? Our short-seller takes a stab at the analysis. Santander Consumer USA Holdings, Inc., one of the largest subprime auto lenders, and Ally Financial, Inc., GM's old captive finance unit, trade at an average of one-times book, Truesdell observes. Valuing GM's finance subsidiary at the same multiple gives a $12 billion valuation. If you know the returns on invested capital, the weighted average cost of capital and the earnings growth rate, you can calculate the multiple of invested capital at which a company ought to trade. Truesdell uses a 6% through-the-cycle ROIC, an 8% WACC and a 2% growth rate. They together yield a multiple of 0.66 times, which values the auto unit at $33 billion. Adjusting for net cash on the auto side ($2 billion) and pension obligations ($16 billion), he gets an overall valuation of $31 billion, or $21.67 per share vs. the current price of $36.26. *Grant's* concurs.

On June 30, Ford Credit showed equity of $15 billion and invested capital (in the automotive division) of $40.1 billion. The auto business would then be valued, using the same 0.66 times multiple, at $26.5 billion. Adjusting for excess cash ($3.1 billion) and pension obligations ($15.2 billion) yields an overall valuation of $29.5 billion, or $7.37 per share vs. the current price of $9.07. Ford, however, has lower returns on capital than post-bankruptcy GM. If we used a 0.55 multiple of invested capital, Ford would be worth $6.26.

Historically, the auto industry has trailed in both booms and recessions. Since year-end 2017, GM and Ford have fallen by 5.1% and 18.3%, including reinvested dividends. Over the same period, the S&P 500 has returned 16.1%. There is one silver lining: GM and F might just be the tickers and CUSIPs to buy coming out of the next downturn.

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