

# GRANT'S

INTEREST RATE OBSERVER®

Vol. 34, No. 10b

Two Wall Street, New York, New York 10005 • www.grantspub.com

MAY 20, 2016

## Transmission mechanism

Cheery news on retail sales last week lifted stock prices and set headline writers to speculating about a consumption-driven economic revival. Now unfolding is a speculation about a profit-driven investment decline. Allison Transmission Holdings, Inc. (ALSN on the Big Board), designer and manufacturer of fully automatic truck transmissions, is the company under the *Grant's* lens.

This publication is guarded as to America's macroeconomy, bearish on Allison. A cyclical stock that dances to the beat of a cyclical industry (as well as to the cha-cha-cha of the Federal Open Market Committee), ALSN changes hands at 20 times trailing net income, 23 times the forward estimate and 4 times Mar. 31 book value. The short interest, at 1.07% of the float, is negligible, and the Street (11 buys, five holds, no sells) is bullish. Moody's rates the \$2.37 billion of Allison debt Ba2, meaning speculative-grade-but-we've-seen-worse; operating income covers interest expense by a factor of 3.7:1.

Founded in Indianapolis in 1915, Allison is still there. No longer a General Motors subsidiary (it was cut loose in 2007), the company went public in 2012 after five years under the private-equity wing of the Carlyle Group and Onex Corp. Some 2,700 Allison employees manufacture 13 different transmission models as well as the accompanying branded replacement parts and support equipment. Allison products feature in a wide range of end markets, from school buses to motor homes to utility trucks to fracking pumps.

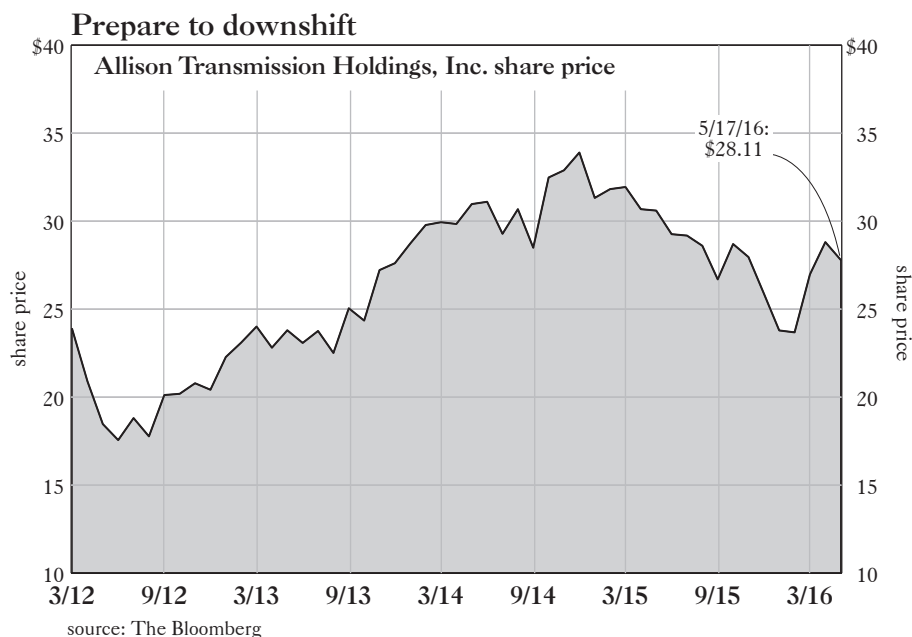
The biggest product segment in the top Allison division is the so-called Class

8 truck segment—the Class 8 *straight-truck* segment. You might have read about the collapse in overall Class 8 sales, down 39% year over year at the latest tally. Observers blame the weak freight environment for that recession-like swoon.

The specific source is the tractor trailers, to which Allison has small exposure; most 18-wheelers come equipped with manual transmissions. Allison's kind of Class 8 trucks are construction vehicles, garbage trucks and other unified-body behemoths. The Class 8 straight-truck segment delivers 22.9% of Allison's sales (the segment's earnings are undisclosed) and no small portion of prospective growth: Perhaps 30% of the single-body Class 8 truck population is still stick-shift.

It's no front-page news that Allison has been struggling. Measured year over year in the first quarter, revenues of \$462 million were down by 8% and operating profits of \$112.2 million were down by 21%. Sales were lower in every market segment except "Defense," which was flat, and "Outside North America on-Highway," which was up by 23%. A relative bright spot was the key "North America on-Highway" division, which generated \$257 million in sales, down by just 4%.

Just what accounts for this shaft of (dim) sunlight is unclear. Allison's first-quarter press release describes weakness in the demand for "Rugged Duty Series" models, meaning (as the Allison website explains) "construction, refuse and municipal/utilities services" vehicles.



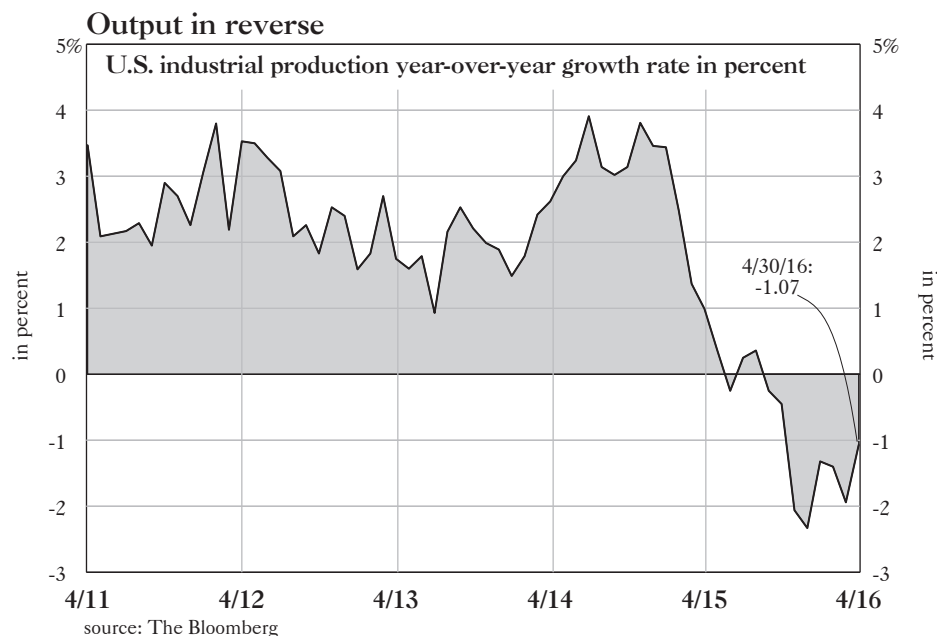
As Allison declined to come to the phone to explain, colleague Harrison Waddill sought counsel from Kenny Vieth, president and senior analyst at Americas Commercial Transportation Research, prime provider of commercial-vehicle industry data. Why would someone decide to buy, or not buy, a big new straight truck? asked Waddill.

"Construction is a big driver of that space," Vieth replied. "State and local government budgets are drivers of that space as well. I would add that a lot of buyers of vocational vehicles [a.k.a. Class 8 straight trucks] tend to be smaller buyers as opposed to mega fleets, so I think consumer confidence is certainly a component of the health of that market as well."

Inventories play a big part, too, as Allison management itself noted in the company's first-quarter earnings call. The overhang of unsold Class 8 vehicles (i.e., Allison's kind of single-body trucks) would likely dampen vehicle-production schedules beyond the first half of this year, the front office said. Vieth elucidated: "I think one of the biggest problems in the Class 8 market is with the robustness of Class 8 demand last year as the industry built a lot of inventory, and so there is a new inventory bubble in both the straight and the tractor market. But in the tractor market you've got overcapacity and a new vehicle-inventory bubble, whereas in the truck part of the market it wasn't so much that people added too much capacity, it's just kind of slow economic growth and a new vehicle-inventory bubble."

The investment story on Allison very largely turns on Class 8 demand, about which not even the company seems to have a precise idea. To the analysts who dialed in to hear about first-quarter results, the CEO, Lawrence E. Dewey, was more vagueness than light: "[In] the overall Class 8 straight-truck [market], everyone is trying to get a handle on how far down that's going to be year over year in terms of the total market size. So we haven't seen yet any appreciable difference there [in pickup of demand]."

The difficulty, notes a sell-side analyst, is that the market data are sprinkled far and wide: "It's a little bit harder to get your arms around what's happening in the straight-truck space because a lot of the buyers of that equipment we don't cover the way we do with the tractors where there are a



lot of large fleets buying them. It's a more varied number of buyers."

Waddill pressed Allison: Could they not clarify the Class 8 situation? "We appreciate your interest in the company but are going to pass on scheduling an interview at this time," came the reply. Thwarted at the source of the informational river, Waddill proceeded to explore the tributaries.

"Allison disclosed in their most recent 10-K that Daimler AG represented 21% of net sales in 2015," he relates. "Freightliner, a manufacturer of Class 8 straight and tractor trucks, is a Daimler Trucks North America brand. To get a better sense of what's really going on in the Class 8 straight-truck market, I called 47 Freightliner dealers across the country. Out of those 47, 14 Freightliner salesmen agreed to speak with me. They resided in the following states: Arizona, California, Illinois, Maryland, Mississippi, Nebraska, New Jersey, Pennsylvania, Texas and Wisconsin. I tallied the responses as 'municipal up,' 'municipal down' or 'municipal flat'; 'private/fleet up,' 'private/fleet down,' 'private/fleet flat' and 'not sure.'"

"In terms of municipal buying of Class 8 straight trucks, there were six down responses, three up responses, three flat responses and one unsure. A salesman from Pennsylvania described it this way: 'It's like the municipalities' money dried up or they're spending it somewhere else and the private buyers have disappeared.' A salesman from Arizona had another explanation for the dearth of municipal sales: 'The thing is

that when people aren't spending any money, they're not collecting any taxes—sales taxes that would go into the general fund to buy trucks.'

"With respect to private/small-fleet buyers," Waddill goes on, "there were eight down responses, three up responses and three flat responses. It's important to note that one of the Wisconsin dealers reported an increase in sales on the municipal and private/small-fleet side. This was the result of a strong marketing push on the dealership's part, 'so it's not that more people are buying trucks, it's that more people are buying Freightliner instead of Peterbilt and Kenworth,' as one of them said. This is more likely a flat situation, as both of these brands also offer Allison transmissions. Salesmen in Austin, Texas, and California reported stability in both their municipal as well as private/small-fleet purchases.

"Over the course of my calls," Waddill concludes his travelogue, "a handful of themes continued to emerge. The state of the used-truck market is dire. People are holding onto their trucks for much longer because, as a salesman in New Jersey relates, 'the market has been rough the past six years or more, but also when they're going to buy new trucks the cost of a new truck has gone up significantly because of all this new emission equipment. So a lot of people are saying, 'Wow, I can't even afford this.'" Lastly, as a salesman from Illinois told me, 'the few that are buying trucks, it's not a "I'm going to buy a truck just