CAPITAL ADVISORS

RESEARCH UPDATE
April 17, 2017

SECTOR REPORT – AUTO STOCKS
Ford Motor Co. (F: ~$11)
General Motors (GM: ~$34)

- We believe the leading North American auto stocks – **Ford** and **General Motors** – may be structurally mispriced.
- We estimate that both companies have restructured their business models sufficiently to achieve breakeven profit margins, or better, at the bottom of a recession.[1]
- This contrasts with the "old" **Ford** and **GM**, whose losses during the contraction phase of each auto cycle frequently wiped out whatever profits accumulated during each expansion.
- By sustaining profitability throughout the economic cycle, **Ford** and **GM** would experience a step-change higher in their average return on capital, allowing full-cycle returns at both companies to exceed their cost of capital for the first time in decades.
- We believe the restructured business models at **Ford** and **GM** can deliver similar (or better) returns on capital across the economic cycle compared to many leading industrial companies like **Caterpillar (CAT: ~$94)**, **Deere (DE: ~$109),** and **Dow Chemical (DOW: ~$61)**, to name a few.
- This is relevant for investors because the stock prices of **Ford** and **GM** trade at a *much* lower price-to-earnings ratio (P/E) compared to other economically sensitive industrial stocks.
- If/when investors come to believe that **Ford** and **GM** can sustain a more attractive return on capital over time, we believe both stocks could be re-valued higher to bring their P/E ratios more in line with other economically sensitive industrial stocks.
- Counterintuitively, the catalyst for such a re-valuation might be a downturn in the auto sector, which would allow **Ford** and **GM** to "prove" the resilience of their business models.
- We do not expect either stock to perform well during the early stages of an industry downturn, which might explain their recent underperformance.
- However, we can imagine two possible scenarios for a reversal of the recent weakness in both stocks:
    1) North American auto sales could stabilize at a healthy, albeit lower run rate, to alleviate investors' apparent fear of a deeper downturn for the sector, or
    2) **Ford** and **GM** might demonstrate sustained profitability in spite of a deeper downturn for the industry, thereby proving the merit of their restructured business models.
- In the meantime, shareholders of both companies can enjoy a very generous dividend yield – roughly 5.4% at **Ford** and 4.6% for **GM** at their recent share price.[2]

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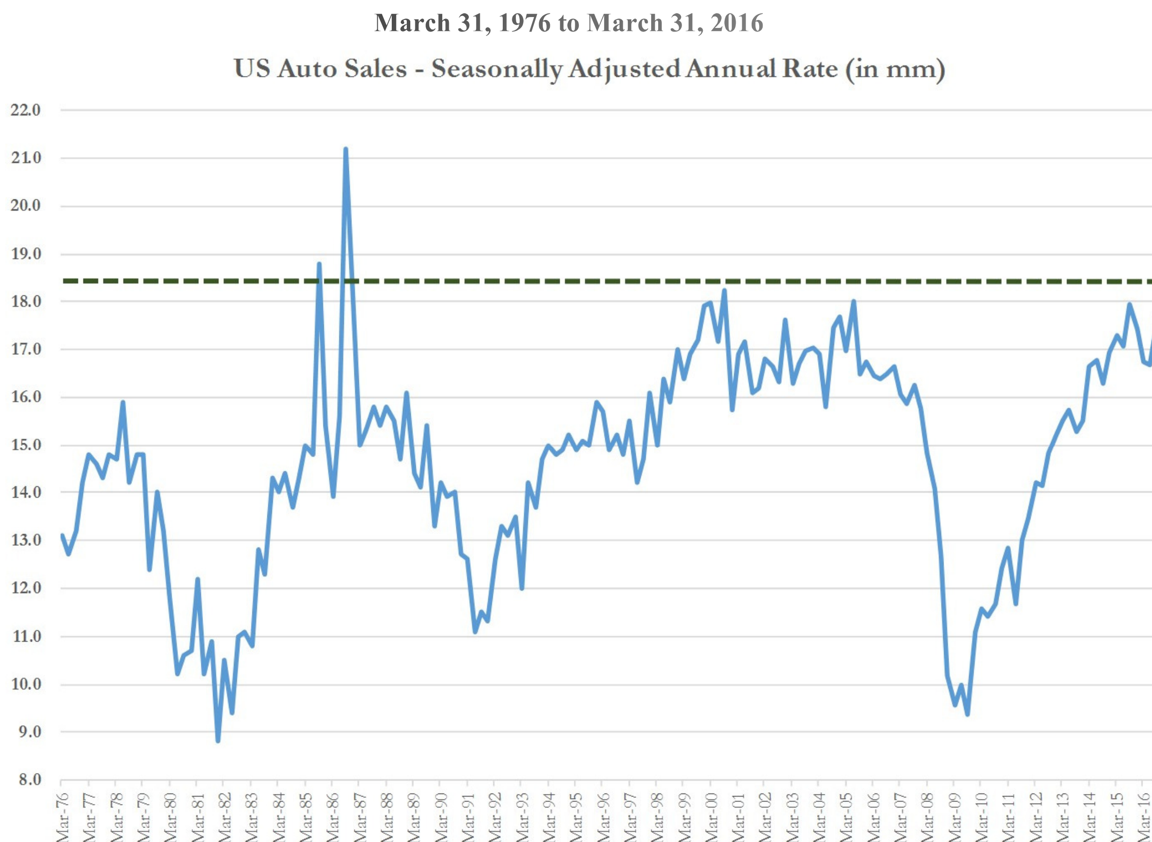
[1] Source: Company presentations; http://gmauthority.com/blog/2016/03/general-motors-north-america-reduces-break-even-point-says-alan-batey/

[2] Source: Bloomberg

The management teams at **Ford** and **GM** have guided investors to expect their North American units can breakeven with industry-wide sales of approximately 10-11 million units.[3] To put this figure into perspective, the annual run rate of North American auto sales has been between 16 and 18 million for the past three years (see chart below). Unit sales dipped below 10 million briefly in the spring of 2009, before recovering strongly thereafter. Auto sales never dropped below 15 million during the shallow recession in 2001-02, while the low point during the recession in 1990-91 was approximately 11 million units.



Source: Zerohedge.com; http://www.zerohedge.com/news/2017-01-04/

If the auto companies' guidance for their "new" breakeven point proves to be approximately correct during the next industry downturn (which some commentators believe may be upon us), the full-cycle return on capital for both companies should be *significantly* higher than anything they have experienced over the past several decades, when losses tended to offset profits over each complete cycle. Indeed, if management's guidance is close to right, the financial characteristics at **Ford** and **GM** would rival that of many leading industrial companies whose stocks enjoy a much higher P/E ratio, on average, compared to **Ford** or **GM**.

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[3] Company presentations; http://gmauthority.com/blog/2016/03/general-motors-north-america-reduces-break-even-point-says-alan-batey/

The table below illustrates a striking lack of distinction between the autos and a diverse mix of economically sensitive industrial companies across two common measures of business profitability – Return on Equity (ROE)[4] and Return on Total Capital (ROTC).[5] We note that both **Ford** and **GM** generated a higher average ROE over the past five years compared to the industrial companies listed. Indeed, **Ford** delivered the third highest ROE within the list of 11 industrial leaders, while **GM's** results would rank fourth.

Business Profitability
Trailing 5-Year Average
Jan. 1, 2012 to Dec. 31, 2016

Autos	**5-Yr. Avg. ROE**	**5-Yr. Avg. ROTC**
Ford	22.9%	7.4%
General Motors	19.5	10.1
Autos Average	**21.2%**	**8.8%**
Industrials		
Caterpillar	18.2%	7.9%
Deere	28.5	19.1
Dow Chemical	16.6	10.6
Eaton	13.2	9.3
FedEx	16.8	11.0
Fluor	17.4	13.4
International Paper	20.1	8.1
Johnson Controls	15.7	11.0
Nucor Steel	8.2	5.9
Southwest Airlines	21.9	16.7
United Technologies	18.6	12.5
Industrials Average	**17.7%**	**11.4%**

Source: Value Line; Capital Advisors

Admittedly, the trailing five-year period has been a healthy one for the auto industry, particularly in North America. This may flatter the comparison in favor of the autos by a bit. However, economic conditions were also stable for the industrial companies on the list during the time of this comparison.

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[4] Return on Equity (ROE) measures the net income of a business as a percentage of the company's equity capital. ROE is a common measure of business profitability attributable to the net equity capital of the enterprise.

[5] Return on Total Capital (ROTC) measures the net income of a business as a percentage of the company's total capital, including equity and debt. ROTC is a common measure of business profitability attributable to the total capital of the enterprise, including outstanding debt.

Despite perfectly respectable profitability metrics for the autos, as illustrated above, their stocks trade at a dramatically lower P/E ratio compared to other industrial sectors. This is true regardless of whether the P/E is calculated with forward estimated earnings, trailing 12-month earnings, or 5-year average earnings. The table below illustrates this dynamic. Notice that *none* of the comparison companies even comes close to the P/E ratio of the auto stocks, regardless of the methodology used to calculate the P/E:

Stock Market Valuation
Using Three Versions of the P/E Ratio
Jan. 1, 2012 to Dec. 31, 2016

	Price-to-Earnings Ratio (P/E)		
Autos	**2017 Estimate[6]**	**Trailing 12-Mos.[7]**	**5-Year Average[8]**
Ford	7.1	6.5	7.3
General Motors	5.6	5.3	8.3
Autos Average	**6.4**	**5.9**	**7.8**
Industrials			
Caterpillar	30.4	29.8	16.2
Deere	22.0	23.8	15.3
Dow Chemical	15.5	17.2	21.3
Eaton	16.8	16.6	17.5
FedEx	14.6	17.4	24.6
Fluor	18.0	17.0	12.7
International Paper	14.1	16.1	23.9
Johnson Controls	15.0	14.9	13.0
Nucor Steel	14.2	25.3	33.9
Southwest Airlines	14.1	14.4	26.8
United Technologies	17.2	17.0	18.0
Industrials Average	**17.4**	**19.0**	**20.3**

Source: Bloomberg; Value Line

The only explanation we can surmise for the remarkable valuation discrepancy between the auto stocks and the rest of the industrial complex is that the majority of investors must not believe the auto companies have changed their ways.[9] Investor skepticism on this topic is understandable because the claims of the auto companies have yet to be tested by an actual industry downturn.

Ironically, this skepticism might set up a counterintuitive situation whereby a downturn for the auto industry might prove to be *beneficial* for certain stocks within the sector. We would not expect these stocks to perform well during the early signs of deterioration for the sector, which may explain their recent underperformance. However, an actual downturn might be required to settle the debate between the bulls and the bears, and what these stocks need more than anything is a higher P/E ratio.

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[6] The P/E based on 2017 estimated earnings is derived from the Bloomberg consensus estimate for each company's earnings per share in 2017.

[7] Trailing 12-Month P/E is calculated by dividend the recent stock price by earnings per share over the most recent four quarters.

[8] The 5-year Average P/E is calculated with each company's average earnings per share over the five calendar years 2012 through 2016.

[9] The following link offers an example of the skeptical viewpoint of the auto sector restructuring narrative: http://www.autonews.com/article/20160224/OEM01/160229923/gm-ford-have-underestimated-vulnerability-to-recession-analyst-warns

The wide disagreement that seems to exist among investors about the potential resilience of **Ford** and **GM** may present an unusually attractive investment opportunity, in our opinion. We consider the opportunity to be "unusual" due to a substantial margin for error that may exist for taking the optimistic side of this debate.

Consider, for example, a hypothetical scenario where the guidance from the auto companies turns out to be just partially right. Imagine that instead of the breakeven point for these companies being in the 10-11 million unit range for North American auto sales, it turns out to be 13-14 million units instead. We estimate this less hopeful scenario would still represent a *dramatic* improvement in the full-cycle return on capital performance at **Ford** and **GM**.

With this perspective in mind, it seems reasonable to believe that a slightly less onerous valuation discount might be achievable for the auto stocks in time. If we assume an average discount of around 50% compared to the industrial comparison group from above it could have a material impact on the potential stock price of **Ford** and **GM**.

To be clear, a valuation discount of 50% would still reflect deep investor distaste for auto stocks relative to other economically sensitive industrial companies. Moreover, we believe a 50% discount would not do justice to the improvement these companies will have made if they push their breakeven point down to 13-14 million units. Here is the data based upon the three valuation methods used above:

Implied Stock Price Targets
Assuming a 50% P/E Ratio Discount
Data as of April 17, 2017

	P/E Methodology			
Implied Stock Price	**2017 Estimate**	**Trailing 12-Mos.**	**5-Year Average**	**Range of Upside Potential**[10]
Ford	$14	$16	$16	27% - 45%
General Motors	$52	$60	$41	21% - 76%

Source: Bloomberg; Value Line; Capital Advisors

The data above is hypothetical, and intended for illustration purposes only

The auto companies may never achieve a more generous valuation multiple from the stock market, and even if they do, we cannot predict when it might happen. Yet the potential cost for being wrong about these stocks seems more than reasonable, because both companies pay their shareholders generously to be patient.

The regular quarterly dividend at **Ford** works out to a current yield of approximately 5.4% at its recent stock price. However, **Ford** has also paid a "special" dividend in each of the past two years to bring the average yield over 6% on a trailing basis. The recent dividend yield for **GM** is approximately 4.6%. The dividend at both companies is well covered by earnings, and both companies receive an investment-grade credit rating from the major ratings agencies.

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[10] Estimated upside potential is based upon the recent stock price on 4/17/17 of $11.24 and $33.78 for Ford and GM, respectively.

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