HollAnd Advisors

Holland Views – General Motors – Price: $30.88; MCap: $48,232m

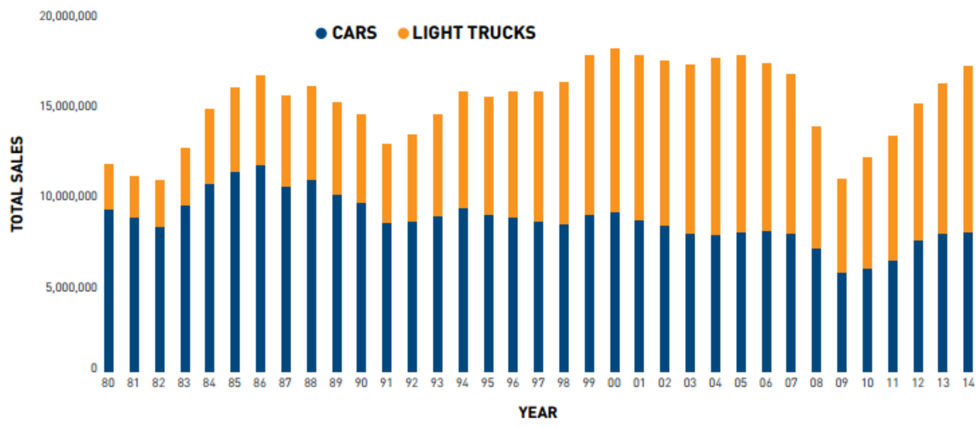
Not your father's cycle

We wrote at length on General Motors in 2014[1] and, in the face of much scepticism, the company has actually exceeded almost all expectations of it. We remain of the view that post the 2008 TARP bail-out GM was reincarnated. While the name of the business remains the same, the culture of the business has been completely reworked. Our original work on GM in 2014 led us to believe that the 'new GM' is a *completely* different business from its pre-2008 former self. It's not that the 'leopard has changed its spots' – more that the 100-year old leopard (GM was born in 1908!) died in 2008 and its new successor was born with new DNA. We all know GM has been 'restructured' but this is such an over-used term that few, it seems, give it sufficient thought or significance.

The new GM has ultra-flexible cost structures in place as reflected in its new union work practices, consolidated dealer networks and a much lower 'break-even' level. It is also currently operating very well surprising many a sceptic: US profitability is at record highs helped by high factory utilisation and new product line-ups, Chinese JV profitability defies macro forecasters and finance arm profits are set to rise sharply. Finally, it has a new-found capital discipline and looks to be well managed.[2] And yet, despite a lowly 5x PE, Mr Market remains apathetic. We suggest he remains anchored in cycles of the past.

> **'Anchoring' *Cognitive Bias***: *The tendency to rely too heavily, or "anchor", on one trait or piece of information when making decisions.* - Wikipedia

Fig.1: That 2009 anchor is strong.



Source: autoalliance.org

Scar Tissue is a strong influencer

As former transport and semiconductor analysts (not to mention investment bank employees), your authors have had first-hand experience of many a deep cycle. We still have the scars of extrapolating one too many cyclical peaks! So looking back, what were the hallmark traps that cyclical investors fall into, that were only obvious with hindsight? Or, with an eye to inversion – what does an investor not want to see in an operationally geared cyclical business:

[1] Please see report: Holland Views – GM – What you win, when you win April 2014

[2] Please see report: Holland Views – GM – Watch what they do (and do) December 2014

- Above-trend demand
- Capacity being added right at the top of the cycle (i.e. without discipline)
- Fragmented and irrational competition
- Supply chain inefficiencies leading to excess stocking levels
- High (and sometimes partly hidden) fixed costs

It is our contention that none of the above circumstances apply to the US auto manufacturers today – an industry that, prior to 2008, experienced regular cyclical wipe-outs. As you know, we are generally very wary of cyclical investments and are loath to rely on forward earnings models even for defensive businesses, but we think the valuation case for GM is so compelling that we must highlight it to clients.

So what warrants a 5x PE multiple? We suggest it reflects the scar tissue that most of GM's long-standing observers retain from previous cycles. Conversely, the opportunity for those investors of an open-mind is clearly that Mr Market does not believe in reincarnation. It is broadly assumed that GM today is again at the top of the cycle with a deep downtrend imminent. This is perhaps understandable as the new GM, which kicked-off in 2009, has not lived through a full cycle yet. Mr Market is also rightly sceptical that an industry renowned for capital destruction can be taken seriously no matter how well it is run. On this point, whilst the analogy is far from perfect, we note similarities with the airline sector. There too, a breed of new managers were born seeing the harsh realities of its past and for a while at least now they have run the sector with much greater capital discipline and a much closer eye to shareholder returns.

Now, we are not here to say that auto sales are no longer economically sensitive – of course they are. Rather, we think (as per our bullets above) that the auto industry is not necessarily today seeing excess demand (average US truck age is still 13 years according to GM). In addition capacity and competition are acting broadly in a rational fashion, stocking levels are closely monitored and cost bases can cope with a fall in volumes. Perhaps most importantly, this is an industry that has shifted its emphasis from volumes to profits and the market leader, GM is at the forefront of that change in mentality. Mr Market might want to reconsider that 5x PE for a company currently making an ROIC of 30% and aggressively re-purchasing its own shares.

In this note we refresh our/your memories on three core issues:

1. The cycle – this time it is different enough to suggest a share price mispricing.
2. The changes within GM are monumental and lasting.
3. Capital allocation is now very shareholder centric.

Cycle watchers are looking back to 2009

Fig.1 above gave a helpful breakdown of US auto market split between cars and light trucks (pickups). Trucks being more profitable are therefore a crucial (though not the only) lever for operational leverage of the auto manufacturers. You may suggest, it looks from the chart that we are back close to a peak in truck sales. But, as we have mentioned previously, the average age of light truck in the US has risen steadily for the last 20 years from 8.3 years in 1995 to 11.4 years in 2014 (currently 13 years according to GM). This is a very important context – Please see the Appendix for the underlying data.

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