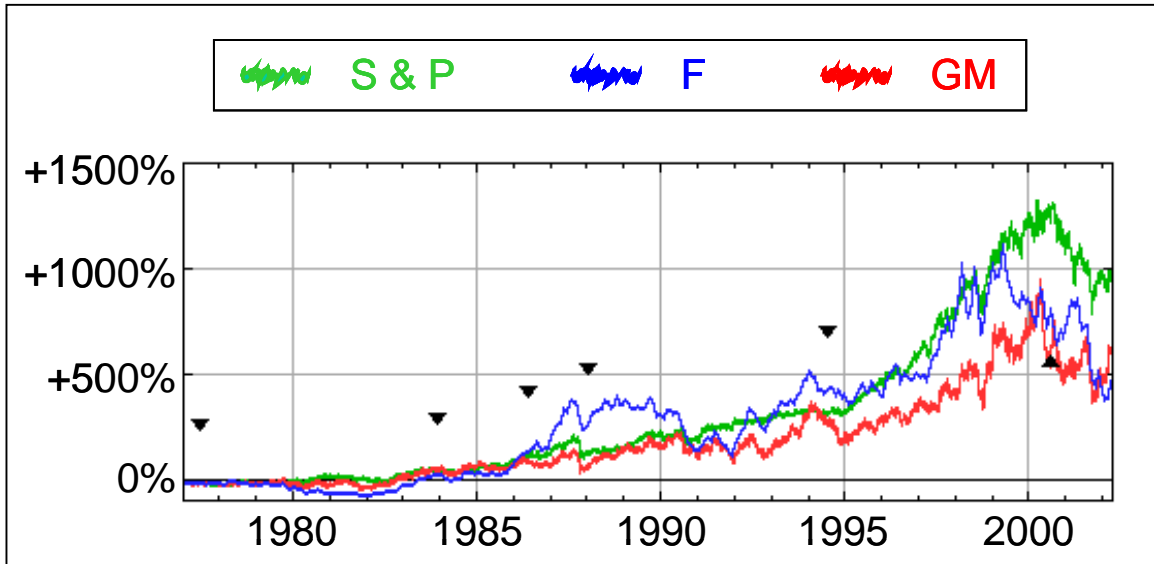


WHAT WALL STREET WANTS . . . FROM THE AUTO INDUSTRY



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A Study Prepared For: 

The statements, findings, and conclusions herein are those of the authors and do not necessarily reflect the views of the project sponsors.

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STUDY INTRODUCTION

The ownership shares of a majority of major automotive firms have been publicly traded for many years. As a result, the managers of public automotive firms are committed to the goal of maximizing shareholder value through growth in earnings and/or providing the highest possible rate of return on invested capital. Public automotive firms, of course, are nominally controlled by elected boards of directors who represent shareholders in the management of the companies. However, not all shareholders are equal in terms of influence. It is not infrequent to find over 50 percent of the share ownership of a major motor vehicle or auto parts firm in the hands of a relatively small number of powerful institutional investors. Usually, these investors are mutual and pension funds that have invested a small percentage of their huge asset holdings in automotive equity for various reasons.

The reasons for investment in automotive equity and the expectations of those who manage these investments should matter a great deal to automotive management. At the very least, major shareholders can directly influence the very capital structure of the automotive corporation. Large shareholders with relatively poor expectations of future company earnings can induce management to raise dividend payouts or use cash for the repurchase of stock – forcing a firm to rely on debt to finance capital expenditures or necessary acquisitions. At the most, major shareholders can convince a board of directors to completely and suddenly replace senior management or to sell all or part of the firm. Of course, major trades executed by large shareholders can and have been an influential source of fluctuations in share prices – even over relatively long periods of time.¹

In fact, it was the increasing and striking reliance of major automotive supplier firms during the late 1990s on debt issuance to finance capital expenditures and major acquisitions that originally motivated this survey study. Automotive equity, it seemed in the late 1990's, had reached a nadir in the eyes of major investors. The "dot.com" boom dominated the attention of the institutional and retail investing community and the popular media. The automotive industry, many investors reasoned, was long overdue

¹ For a recent exposition on the potential power of a small number of shareholders, see: Coyne, Kevin P. and Jonathan W. Witter, "What makes your stock price go up and down," *The McKinsey Quarterly*, 2002, Number 2.

for another sales correction that would bring on the massive earnings losses, dividend cuts, and share price declines experienced by major domestic firms in 1992. Despite a continuous series of restructuring campaigns, mergers, and foreign acquisitions, launched by automotive firms in the late 1990s – backed by record profits in the U.S. domestic light truck market – automotive equity lagged far behind the overall securities market in appreciation. Today, several automotive suppliers have even removed the word “automotive” from their corporate name. “What does Wall Street Want?” was and is a refrain muttered by more than a few senior automotive managers in this era of record low ratios of automotive share price to earnings. This study identifies analysts’ expectations and prioritizes strategies for the industry to become a desired investment instrument.

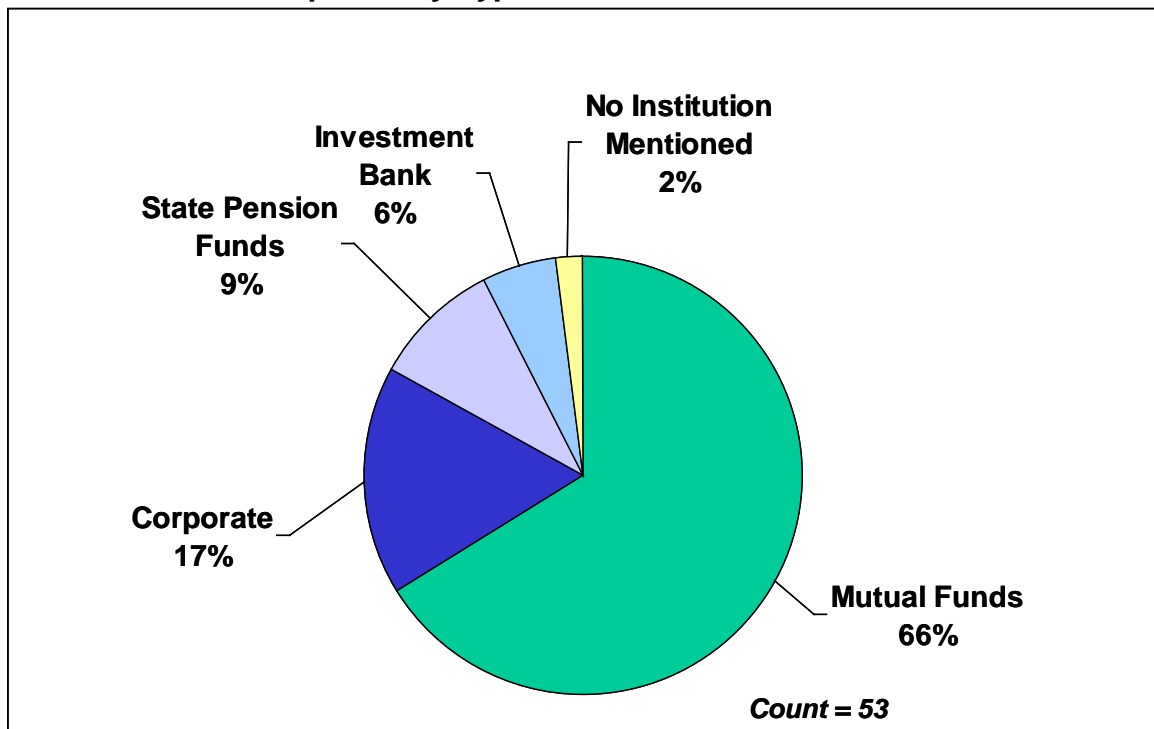
PART I THE PERCEPTION OF AUTOMOTIVE EQUITY

1.1 A SURVEY OF PERCEPTIONS AND EXPECTATIONS

Our study is an attempt to find out just what Wall Street wants from the automotive industry and how major investors perceive automotive investment compared to all other types of equity. Our investigation is based on a survey of “buy-side” investors and analysts conducted in February 2002. The client list of automotive financial analyst David Bradley, of JP Morgan Securities Ltd. was used as the sample population. Our survey was carried out, with the strong assistance of JP Morgan Securities Ltd. Listed U.S. and Canadian investors were surveyed by mail and e-survey. Buy-side investors in Mexico and outside of North America were surveyed by e-mail. The authors at CAR developed the questionnaire. Fifty-three managers of automotive equity responded to the survey in less than four weeks. A distribution by type of investment institution is shown in figure 1. As shown in figure 1, about 66 percent of respondents represent mutual funds. This percent share is supplemented by 9 percent of total respondents being located in related state or public pension funds. About 17 percent of respondents are employed at automotive firms owning automotive equity in other auto firms. Finally, 6 percent of our respondents are employed at investments banks.

Respondents are asked to give the dollar value of the total equity holdings of their institutions. The mean response is an impressive \$56.2 billion. If this mean is taken as a reliable estimate for the entire sample – total equity holdings held by the responding firms to this survey amount to almost \$3 trillion. Indeed, almost without exception – the largest mutual and pension funds in the U.S. financial community responded to the survey. For respondents, the mean percentage of total equity holdings invested in automotive equity is about 2.5 percent or about \$1.4 billion for each responding institution. The mean estimate of total automotive equity held by our sample, then, is about \$75.5 billion.

Figure 1
Response by Type of Investment Institution



1.2 THE OVERALL RATING OF AUTOMOTIVE EQUITY

An initial question in our survey asks respondents to place automotive stocks in one of three categories: as a trading instrument; a long run investment grade, or “buy and hold” investment; or a combination of the two (trading instrument and buy and hold). This fundamental split in motivation for stock ownership reflects a natural division among investors in financial markets of all types. As shown in figure 2, about 44 percent of our sample say they view automotive stocks as purely trading instruments.

Robert Shiller and others have defined such an approach to stocks in general or certain stocks as a form of short-term or short horizon “value investing.”²³ This strategy for investors concentrates on investment in stocks that are temporarily “under-priced” in the market relative to their “true” value as determined by “wise” analysts. The assumption is that the stock price will appreciate to its true value in a short period of time as information is disseminated and the rest of the market “catches up.” A short time horizon value investor would, of course, sell the stock when this occurs. Similar strategies also apply to stocks that are determined as “over-priced” by the usual analyses of value.

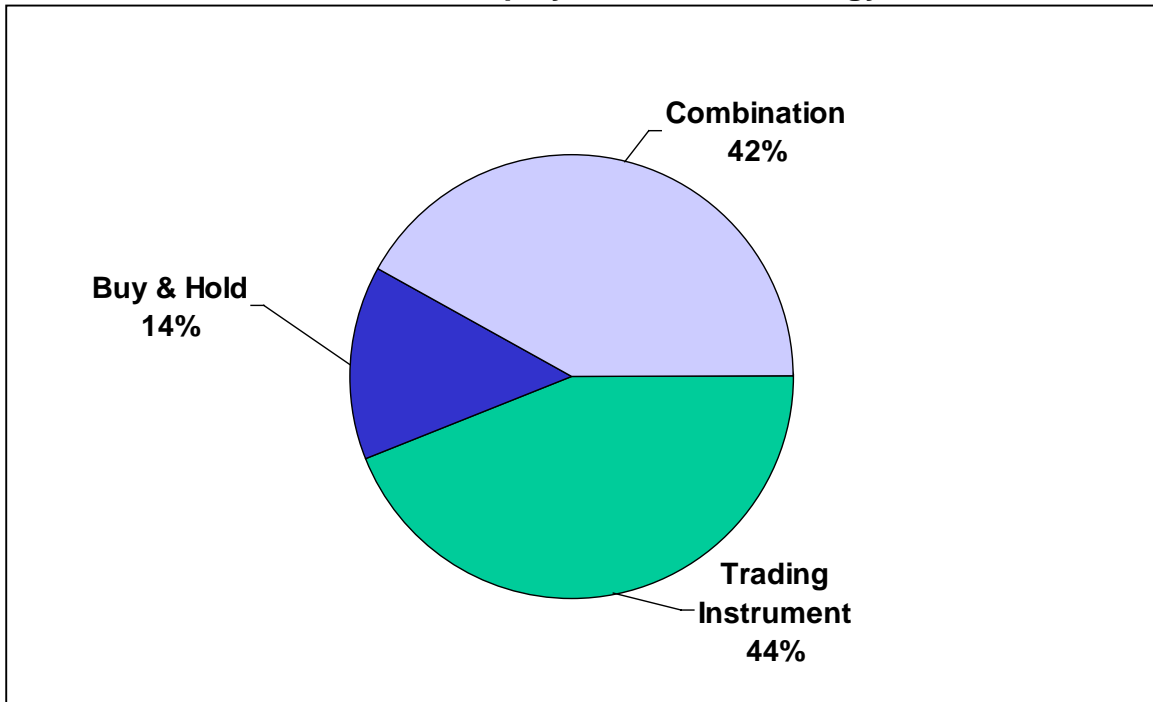
The problems for automotive management produced by short-time horizon value investors are directly related to their short ownership intentions. Typically, ownership periods for such investors are less than a year and their interest in corporate policies that affect long-term earnings such as long-term strategies or fundamental, ongoing restructuring is low. In fact, the very nature of the automotive product development cycle works against such long-term interest. Even the fastest automotive firm in the world still requires at least 30 months to develop a new vehicle (much longer if new powertrain components are involved). Therefore, short horizon investors are most interested in buying automotive stocks when product pipelines are full and the product development cycle is moving from capital expenditure to revenue generation.

Also, the auto industry is often unfavorably compared to so-called high-tech firms that introduce products on a faster cycle and have a high marginal profit returns on incremental sales. Serious restructuring, of course, requires far longer time periods than product development in practice to produce effects on earnings. This could explain why only 14 percent of our sample classified automotive equity as a pure long-term buy and hold investment.

² Shiller, Robert J., *Irrational Exuberance*. Broadway Books, New York, 2000. p. 180.

³ Cottle, Sidney, Roger F. Murray, and Frank E. Block. *Graham and Dodd's Security Analysis, Fifth Edition*. McGraw-Hill Book Company, New York, 1988, pp.497-509.

**Figure 2
Institutional Investor
Automotive Equity Investment Strategy**



A buy and hold investment strategy, or long term horizon value investing, may indeed reflect a number of motives. Once again, investors assume they recognize a value opportunity in an automotive equity, but this time it is long-run in nature. This is still a rejection of an “efficient markets” hypothesis regarding equity investment. In other words, investors assume they recognize a long-run earnings path for an automotive stock that the rest of the market temporarily fails to see. This may be based on a perceived superior knowledge of long run, management capability or of a positive future product introduction, or even a favorable view of the company’s overall growth in the industry’s market or of the industry’s position in the sales cycle. On the other hand, other reasons to buy and hold automotive equity long term may exist. These involve portfolio balancing with cyclical stocks, or with stocks that maintain superior dividend payouts to meet a portfolio’s income needs.

About 42 percent of our sample rate automotive stocks as both trading and buy and hold investments. In other words, at least 56 percent of our sample holds at least some automotive equity for long-term performance. These buy and hold investors may

possess greater interest in long-term strategies of automotive firms and the long-run growth of the industry's market. Indeed, it can be argued that the opinions of such long-term investors should "matter" more to automotive managers since the time horizons of these investors closely match that of executive managers. In the same respect, the opinions of value investors, or traders, should matter far less – except when their behavior complicates the process of a major acquisition or merger or when executive performance criteria is linked to share price appreciation. The ability of management to sway corporate valuation dramatically in a short time period is limited, due to the large number of outstanding shares, which are characteristic of vehicle manufacturers and top-tier supplier firms.

Our respondents are also asked for three "most important areas of historical performance" that influenced their rating. This was essentially a question regarding the individual investor's key measures of performance. Overall, two performance ratios, price to earnings (P/E) and enterprise value to sales or to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) are frequently and equally mentioned.⁴ Other measures such as discounted cash flow, price to sales, and price to book are occasionally mentioned.

1.3 AUTOMOTIVE RELATIVE TO OTHER EQUITY

Our respondents are asked to evaluate automotive stocks compared to other equity instruments on a series of 5-point scales that provide a contrast in performance characteristics. For example, respondents are asked whether they evaluate automotive stocks as income instruments (high dividend yield as a major source of return) or as investments that generate capital appreciation (share price appreciation), relative to other equity. As shown in figure 3, the mean score of 3.5 indicates that the overall sample rated automotive stocks only somewhat closer to a capital appreciation investment rather than an income instrument. Figure 3 also shows separate breakouts for respondents who hold auto equity for trading purposes only versus those who hold at least some auto stocks as long-term investments. We will refer to the former

⁴ Given the historic swings in industry profitability that make P/E ratios near meaningless at cycle's peak and troughs, analysts prefer the EV/Sales or EV/EBITA measures as more reflective of a firm's valuation to the market or its peer group.

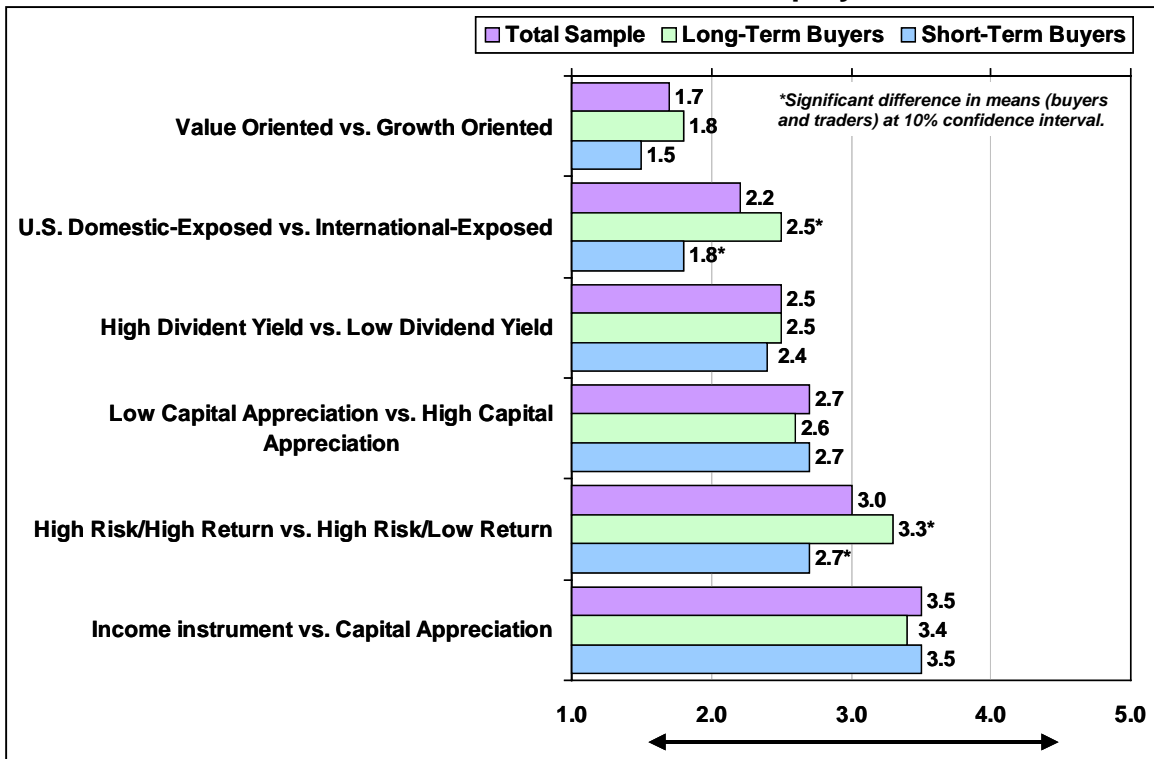
investors consistently throughout the remainder of this study as short-term value investors or buyers, and the latter group, buy & hold investors, as long-term value investors or buyers. No significant difference in this rating was shown between the two groups on the rating of automotive equity as a capital appreciation instrument versus an income instrument.⁵

Respondents were then asked whether automotive equity was evaluated as “high risk/high return” or “high risk/low return” compared to other types of equity. In this case, the overall sample mean of 3.0 shows neutrality, but a significant (at 10%) difference in means was determined between traders and long-term investors. Clearly, short-term buyers ranked auto equity as closer to the “high risk/high return” alternative than did long-term buyers. This is most likely due to short-term buyers making calculated timing decisions of investment based on perceived industry sales and company product cycles. Accurately predicting company earnings and industry sales cycles is very risky. Yet correct investments in trough periods can pay off handsomely if investors disinvest near the peak in the profit or sales cycle.

Both short term and long-term buyers rank auto equity as more “value oriented” than “growth oriented.” However, a significant difference in means appeared between the two investor groups on the question of whether auto stocks were more domestic versus international exposed. Short-term buyers generally thought that auto stocks were exposed more to changes in domestic variables, while long-term buyers thought this was less true. This is not unusual, as short-term buyers would be looking at near-term earnings outlooks dominated by the near-term macroeconomics of the U.S. economy and a company’s domestic customer base. Long-term investors, on the other hand, are more likely to be influenced by the prospects of longer-term developments such as global vehicle programs and international customer diversification.

⁵ We will frequently show separate results for short-term and long-term buyers. We tested for difference in means between the two groups at the 10% level. An asterisk indicates that the hypothesis of no significant difference was rejected at 10% level (2-tail) of confidence. All of our total sample means were tested and passed the 10% level of confidence.

**Figure 3
Automotive Relative to Other Equity**



Finally, both short-term and long-term investors generally rate automotive stocks as low in capital appreciation and high in dividend yield compared to other types of equity in general. This is consistent with the perception of the automotive industry as a mature sector. Mature industries generally throw-off more cash than they consume (hence providing strong dividend yields) and are tied more strongly to overall economic cycles (making it difficult to earn greater than market returns except through a value-oriented strategy).

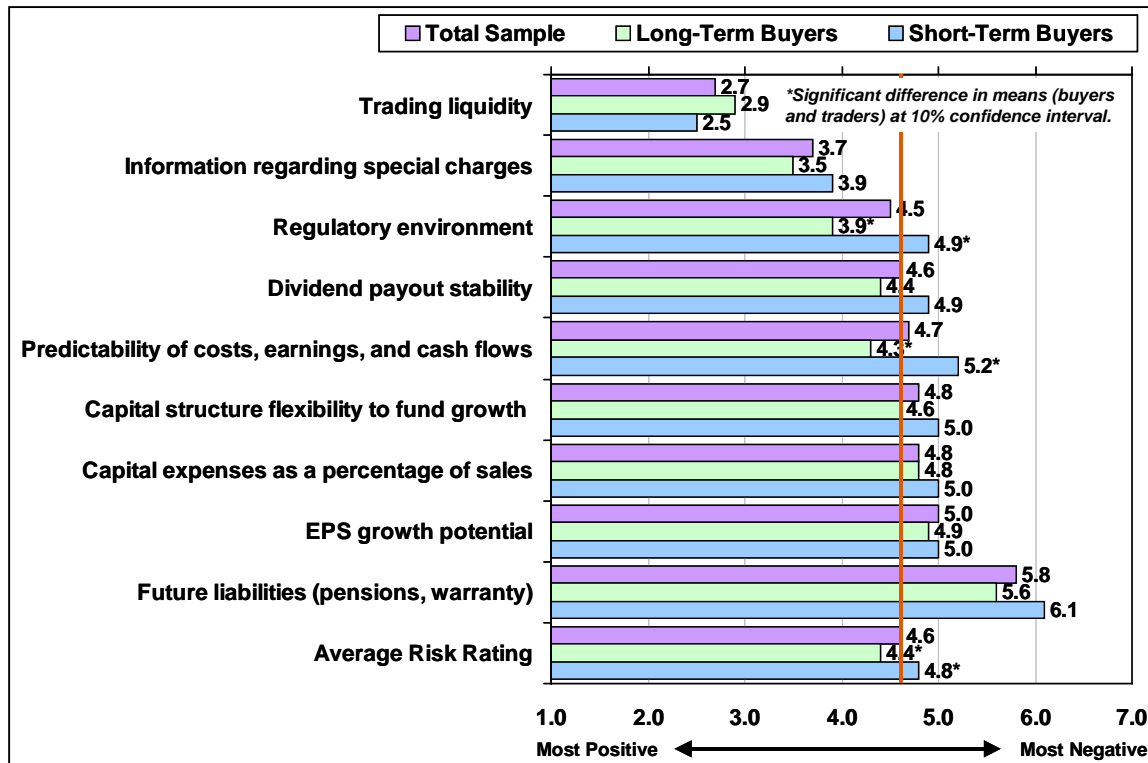
1.4 THE RELATIVE RISK OF AUTOMOTIVE STOCKS

Risk is always a key parameter in equity valuation analysis. Some measure of risk is typically used in the discounting of future corporate earnings or in the required rate of return needed to attract capital for any equity at a given price. The automotive industry has long been labeled as a cyclical industry given its pattern in consumer and business fleet sales and vehicle production. Investors have traditionally expected the performance of auto industry earnings to mirror shifts in industry sales. Yet the industry

may also carry an added burden of uncertainty, or the inability to correctly foresee risk. Our survey asked long-term investors to rank automotive stocks against other types of equity in terms of a number of elements of performance risk. A rating of one was most positive and a rating of seven was most negative. Figure 4 presents the results or mean scores for nine types of performance risk, which we show for the total sample, short-term, and long-term investors.

We display the full sample ratings of risk elements or components in order of most negative through most positive. A major element of risk for our respondents, with an overall rating of 5.8, was “future liabilities,” or the future pension, health care, and warranty obligations of automotive firms. Both short-term and long-term investors rate this element of risk far more negatively than any other risk component. This raises the issue of whether the Firestone debacle for Ford and the looming cost of Big Three pension obligations are perhaps negatively influencing perceptions of automotive risk. In fact, vehicle manufacturers and suppliers are recently becoming more “transparent” to analysts on these very topics.

Figure 4
Automotive Risk Relative to Other Stocks



Other top risk components include two types of capital costs (capital structure flexibility and capital expenses as a percentage of sales), the predictability of costs and earnings, and the automotive regulatory environment. Short-term buyers perceive the last two elements as a far greater, relative risk element for the automotive industry than do long-term investors. This may be due to the fact that earnings warnings and regulatory issues are immediately responded to by analysts, usually with a corresponding earnings and stock outlook caution. Also, a company’s response and recovery to these challenges are likely outside of the typical short-term buyer’s time horizon. This adds perceived risk to automotive equity ownership. This significant difference in ratings could imply a greater knowledge on the part of long-term investors than that generally possessed by short-term buyers of auto equity.

Do institutional investors generally perceive automotive equity generally as riskier than other types of equity? Are their evaluations of automotive risk more cautious for traders than long-term investors? The answer to both questions is apparently yes. Short-term buyers rated the risk components at a mean rating of about 4.8 on a seven-

point scale compared to an average rating of almost 4.4 for long-term buyers. This difference in mean ratings, small though it appears, proved to be significant in analysis.

PART 2 REQUIREMENTS FOR FUTURE FINANCIAL AND OPERATIONAL PERFORMANCE

2.1 FINANCIAL PERFORMANCE

We ask our respondents to list their “desired targets” in a number of areas of financial performance they deem necessary to consider vehicle manufacturers and supplier equities as desirable investments. We ask the respondents to consider three future time periods: the current year of 2002, the year 2005, and the year 2010. Response to these questions is only partial. On average, about half the sample respond to each of the financial measures shown in table 1. This response rate is in strong contrast to the almost 100 percent rate on categorical questions discussed in part 1 and part 3. The lower response prevented CAR from generating separate breakouts on necessary financial performance for short and long-term buyers.

Table 1 clearly illustrates that investors desire stronger performance from automotive firms in the future. Investors also require stronger performance from supplier firms than for vehicle manufacturers. The mean targets for 2002 will be difficult for almost any automotive firm to meet in the highly competitive North American market. Vehicle manufacturers (OEMs) are desired to produce an operating margin of 5.8 percent in 2002 and a 7.9 percent rate by 2010. Investors also require a return on investment (ROI) of 9.3 percent in 2002 and almost 14 percent by 2010. These are rates the average S&P 500 firm generally met in the mid-1990s through 2000. A major contribution to returns, as far as investors are concerned, will not arise from falling capital expenses as a percentage of sales. Targets for this performance ratio remain constant at 4.3 percent in 2002, 2005, and 2010.

Table 1 shows generally higher targets are desired by investors for supplier firms compared to vehicle firms. Suppliers are desired to produce an operating margin of 7.7 percent in 2002 and a 9.7 percent rate by 2010. Investors also require suppliers to produce a ROI of 11.6 percent in 2002 and almost 15 percent by 2010. Although these are higher return targets that set for vehicle firms, the rate of improvement through 2010

is more modest. It is interesting to note that few firms in the S&P 500 will accomplish the targets set by respondents for auto suppliers in 2002. Also, investors do require suppliers to accomplish their higher return from falling capital expenses – which are desired to fall from a level of 6.5 percent in 2002 to a lower level of 4.2 percent in 2010.

Table 1
Desired Automotive Targets for Financial Measures

	2002	2005	2010
(OEM) Operating Margin (EBIT)	5.8%	7.2%	7.9%
(OEM) Return on Investment	9.3	12.1	13.8
(OEM) Dividend Yield	3.1	2.9	2.7
(OEM) Interest Expense Coverage Ratio	3.5	4.2	4.5
(OEM) Sales Growth Rate	3.1	3.9	3.9
(OEM) Free Cash Flow Growth Rate	4.4	5.6	5.8
(OEM) Capital Expenses as a Percentage of Sales	4.3	4.3	4.3
(SUP) Operating Margin (EBIT)	7.7	8.5	9.7
(SUP) Return on Investment	11.6	13.5	14.7
(SUP) Dividend Yield	3.8	2.2	2.2
(SUP) Interest Expense Coverage Ratio	4.1	4.8	5.5
(SUP) Sales Growth Rate	5.2	6.3	6.3
(SUP) Free Cash Flow Growth Rate	5.2	6.7	7.2
(SUP) Capital Expenses as a Percentage of Sales	6.5	6.2	4.2
<i>OEM = Vehicle Manufacturing Firms SUP = Automotive Suppliers</i>			

2.2 OPERATING PERFORMANCE

We also ask our respondents to list their “desired targets” in a number of areas of operating performance they deem necessary to consider vehicle manufacturers and supplier equities as desirable investments. Once again, we ask respondents to consider three future time periods: the current year of 2002, the year 2005, and the year 2010. Response to these questions is again only partial, although as is the case for the financial performance means, the majority of the performance means tested at the 10 percent level of significance. The performance measures also provide a fascinating inspection of the both investors’ requirements for company performance and their apparent knowledge of current automotive industry practice in many areas.

Table 2 first shows investor requirements on annual cost reduction performance through 2010. Respondents expect vehicle firms to reduce their annual cost of goods sold by 5.6 percent in 2002, and to reach achieve cost reductions of 4.2 percent in both

2005 and 2010. It is useful to compare these percentage reductions to those required of suppliers for the same three years since it is highly probable that suppliers will face pass-through price cuts for components from their customers. As the middle of table 2 not unexpectedly demonstrates, suppliers are required to make roughly the same cost reductions, if not a little higher, in each of the three years.

Table 2
Desired Automotive Targets for Operating Performance

	2002	2005	2010
(OEM) Annual cost of goods sold percent reduction (percent)	5.6	4.2	4.2
(OEM) Product development speed (months)	23.6	20.5	18.3
(OEM) Order to deliver speed (days)	39.5	30.2	25.2
(OEM) Average capacity utilization rate (%)	83.2	88.4	89.2
(OEM) Sales and general administration and expense percent reduction (%)	8.0	7.7	7.1
(OEM) Level of manufacturing vertical integration (%)	39.5	35.0	27.8
(SUP) Annual cost of goods sold percent reduction (%)	5.7	4.2	4.1
(SUP) Product development speed (% decrease)	8.1	11.2	10.0
(SUP) Average capacity utilization rate (%)	83.9	89.6	89.8
(SUP) Sales and general administration expense percent reduction (%)	8.0	7.7	7.0
(SUP) Level of manufacturing vertical integration (%)	46.1	43.3	40.0
<i>OEM = Vehicle Manufacturing Firms</i>		<i>SUP = Automotive Supplier Firms</i>	

Respondents are asked to list their required product development speed in months for vehicle manufacturers. The 2002 mean of almost 24 months must be seen as almost unrealistically fast for major re-skins of current models performed by even the fastest competitors in the industry today. The 18-month cycle listed for 2010 must be also recognized as a worthy goal still far out of reach of even the quickest automotive firms. Investors also expect suppliers to significantly reduce their product development speed by large percentages now and in the future. Suppliers are expected to shorten their product cycle by over 8 percent in 2002, and 10 to 11 percent in 2005 and 2010.

Investors appear to hold realistic demands for performance in vehicle firm order to delivery speed. Vehicle firms are expected to delivery product to customers in about 40 days in 2002, perhaps a performance already accomplished by several top firms today, and then reduce this period to 25 days by 2010. Many programs planned by the largest vehicle makers are now in the process of making this critical inventory and marketing operator possible within the next eight years.

Investors also hold highly realistic demands for performance on the critical operating measure of capacity utilization for both vehicle and parts makers. Both vehicle and supplier firms are expected to achieve at least 83 percent utilization in 2002 to qualify as worthy investments. This base expectation must be seen as highly reasonable to ensure profitability for the average automotive firm. The bar rises to the 88-89 percent rate in 2005-2010 for both types of firms. One must also view this requirement as reasonable and the target of most firms' current strategic plans regarding capacity and consolidation.

A stern requirement, for especially vehicle firms in 2002, is the investor demand for percentage reductions sales and general administration expenses. Stockowners require vehicle firms and suppliers to reduce these costs by 8 percent in 2002, and follow these reductions with further improvements of declines in the seven percent range in both 2002 and 2010. The difficulty with meeting the current reduction is the general level of incentive spending now thought necessary to hold sales share in the hyper-competitive market of 2002. Although advertising budgets have been slashed, there has been little improvement in incentive costs of all kinds in recent months or weeks in the U.S. market.

Finally, respondents are asked to list their demands regarding an especially strategic percentage in the North American automotive industry: vertical integration in manufacturing. The 2002 level for vehicle makers was 39.5 percent – clearly an overestimate with the spin-off of both the Delphi and Visteon parts divisions of General Motors and Ford Motor Company. A truer current level for “Big Three” integration would be in the range of 32-33 percent, with the Chrysler group uncomfortably at the high end of the range. Investor demands for the future, however, are realistic targets for many firms. Investors expect vehicle firms to produce no more than 27.5 percent of manufacturing cost within their firms by 2010 – a level still higher than perhaps that which Honda and Toyota now operate. The demands for supplier integration are more difficult to gauge since it may depend on which tier of supply is being referenced. What is clear is that investors demands for a reduction in integration for suppliers are more moderate than those placed on vehicle makers. The range of improvement, 46.0

percent in 2002 to 40.0 percent in 2010, should not be too difficult for large first-tier system suppliers to accomplish.

2.3 GROWTH IN DOLLAR SALES AND PERCENTAGE IMPROVEMENT IN COST REDUCTION

Investor expectations concerning overall industry growth and pace of improvement can, of course, influence the rating of any specific automotive equity. We ask our respondents first for their expectations of annual growth in constant dollar sales of light vehicles in the U.S. market through 2010. We follow this question by asking our respondents what minimum annual constant dollar sales growth rate would be necessary to make vehicle firms an attractive investment. As shown in table 3, the mean response to the first question is 3.0 percent, and the answer to the second about 3.7 percent. No significant difference between trader and buyer expectations is found through testing on these questions. The 3.0 percent per annum expectation regarding growth in real dollar vehicle sales does appear to be low to the CAR authors given the 4.5 percent annual growth rate in U.S. sales actually achieved by the industry during 1980-2000. However, if history proves to be more accurate than our respondents, the 3.7 percent required rate of growth in sales should be easily accomplished. If revenue growth history is less accurate, however, there will be continued pressure to increase productivity and cut costs to improve financial returns.

In order to gauge the pace of change in another competitive domain, we finally ask our respondents for their vehicle manufacturer and supplier requirements for overall annual cost reductions and percentage reductions in the number of competitors. Our results for these questions for the entire sample are given in table 4. Vehicle firms are expected to annually reduce their overall costs by 4.9 percent and suppliers by somewhat less, or 4.3 percent. Of course many vehicle firms are currently asking suppliers for price givebacks in the range of 5 percent per year and first-tier suppliers are certainly passing this demand through to their own suppliers. Respondents also expect the number of competitors to fall in the vehicle market by about 9 percent. Since there are currently 21 vehicle firms in the U.S. market, it appears that our respondents expect at least two firms to exit the market without replacement. Supplier markets are required to consolidate at an even faster pace – a reduction of over 12 percent –

although we do not query respondents as to how supplier markets are to accomplish this concentration.

Table 3
Annual Industry Revenue Growth Expectations vs. Requirements Through 2010
 (constant dollars)

Expected growth rate for constant dollar vehicle sales	3.0%
Minimum annual constant dollar vehicle sales growth rate required for investment	3.7

Table 4
Investor Requirements for Automotive Annual Cost and Competitor Reductions

	Vehicle Firms	Suppliers
Annual Cost Reduction Percent	4.9%	4.3%
Percent Reduction in Competitors	9.0	12.3

A final and critical question we ask our respondents is their comfort level regarding the minimum market capitalization of a supplier stock needed to protect investors. Our mean response for the whole sample is about \$1.8 billion. This cutoff in market cap, of course, disqualifies a host of medium sized independent supplier firms from traditional institutional equity investment and indeed, through mergers or privatization, the number of these medium cap firms dramatically declined during the 1990s. The effect of an equity market cap requirement placed by institutional investors on firms in the late 1990s has never been openly linked to the restructuring (through mergers and acquisitions) that occurred in the U.S. auto supplier industry in that period.

PART 3 STRATEGIES AND FINAL CONCLUSIONS

3.1 INVESTOR RATINGS OF STRATEGIES FOR AUTOMOTIVE VEHICLE FIRMS

Major shareholders can, of course, influence through many channels the business strategies pursued by the company management. However, the popularity with shareholders of many alternative strategies can change over time for many reasons as well. Our survey asks major holders of automotive equity for their direct assessment of a number of possible automotive strategies meant to improve an automotive company's financial performance. Two sets of strategic alternatives are

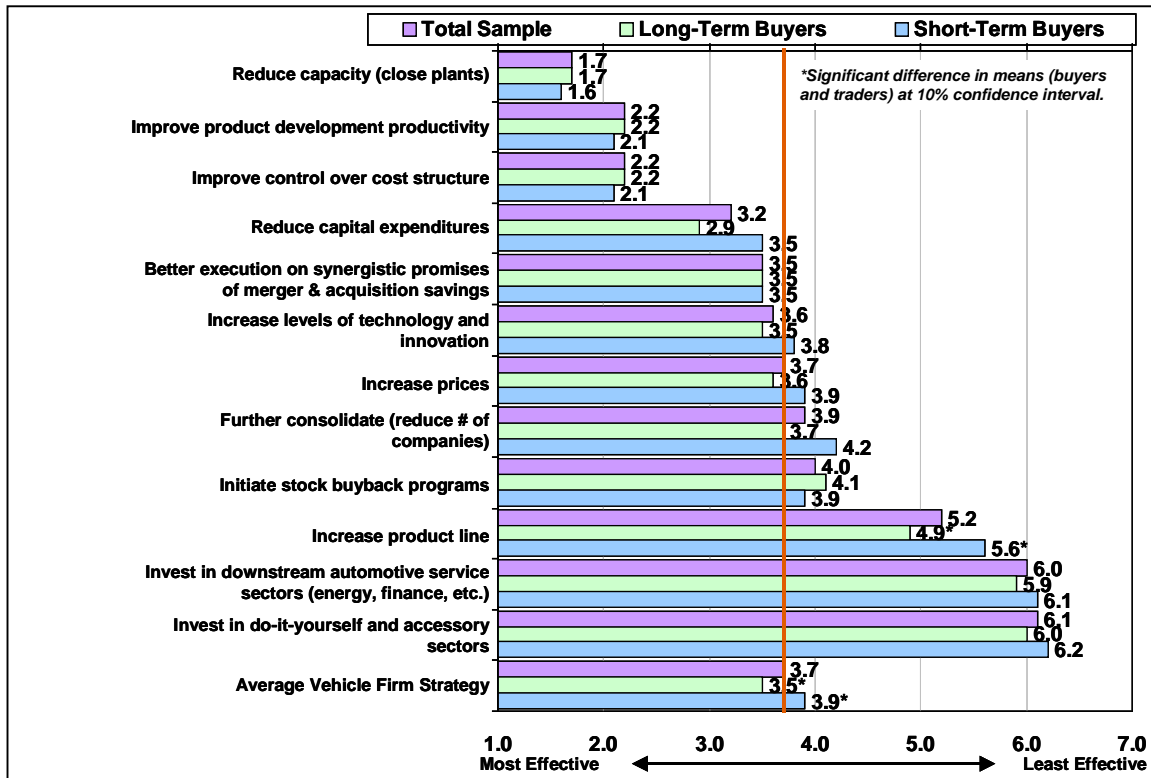
included in the questionnaire: one set for vehicle firms, and one set for major supplier firms. We ask respondents to rank each separate strategy on a scale of 1 to 7 in terms of whether it would be the most effective (a rating of 1) or least effective (a rating of 7) in improving an automotive company's performance.

Vehicle Firm Strategies

Our results for vehicle firm strategies are shown in figure 5 in order of most effective through least effective based on mean scores. The most popular strategy by far is "close plants," with a mean score of 1.7, followed by two strategies with identical mean scores of 2.2: improve product development productivity and improve control over cost structure. These three top choices of strategies by investors rank well ahead of the fourth highest ranked strategy of reducing capital expenditures. The least popular strategies involve downstream market investment activities in the service sector, or the sale of do-it-yourself parts and accessories. In fact, the rankings for these last two activities are the two most highly correlated across respondents. The correlation can only be interpreted as a strong message from large investors for auto vehicle firms to focus only on core operations connected with selling new vehicles. Clearly, institutional investors are trying to reinforce the lessons learned at Ford, Nissan, and Fiat when strategies, operations and cost structures swayed too far from core automotive markets.

We test for differences in rankings between respondents who are short-term and long-term buyers and identified only one strategy on which they disagree. Short-term buyers were even less enamored than long-term investors with a strategy that calls for an increased product line – although both types of investors clearly did not rank this company option very highly. This is consistent with the differences between the time horizon of a short-term buyer and the typical revenue generation cycle of a new product introduction. Another interesting result was the relatively low ranking given by all respondents to the industry option of further company consolidation. Perhaps this is a reflection of the fact that both DaimlerChrysler and Ford Motor Company are selling at market capitalizations below their pre-acquisition levels.

Figure 5
Rating of Vehicle Firm Strategies



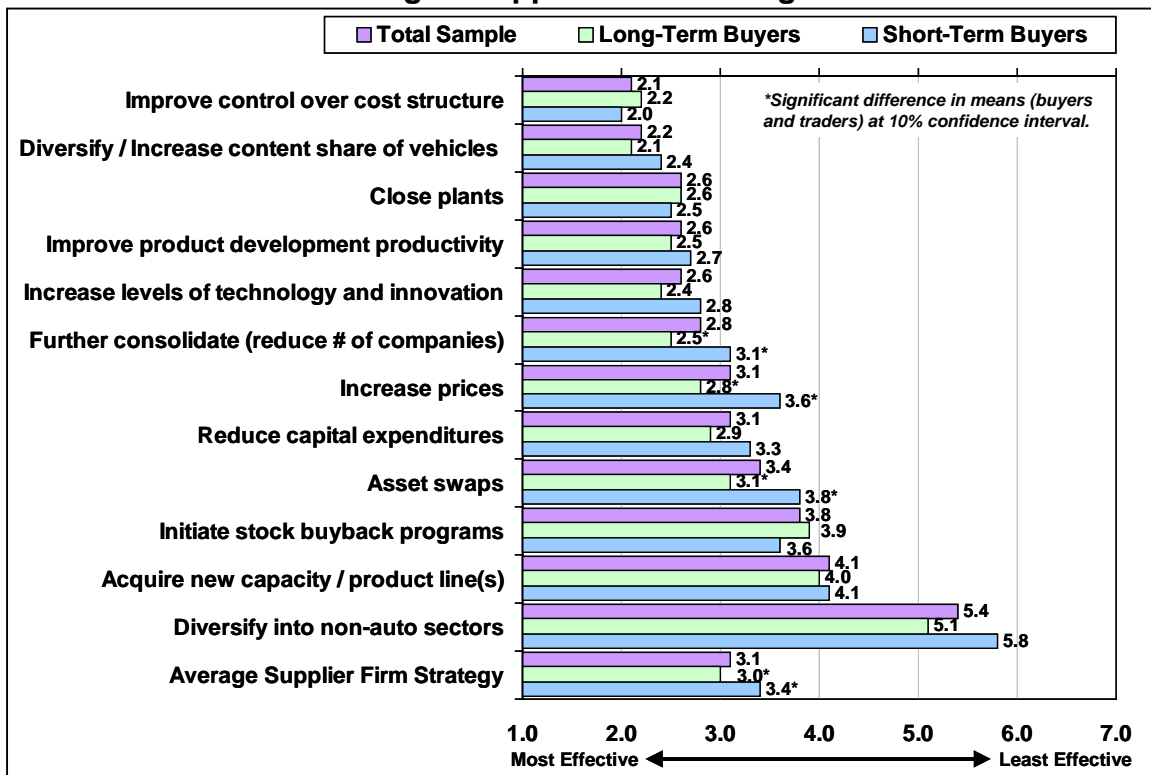
Finally, we sum the scores across the vehicle strategies for both categories of investor, short-term buyers and long-term investors, and test the proposition that long-term investors would rank vehicle company strategies in general as more likely to be effective than did short-term buyers. Our results show that this hypothesis cannot be rejected at a very high level of significance. This is consistent with our findings that short-term investors view automotive equity as more a high risk/high return instrument and do not offer the time horizon given by long-term investors to “get the strategy or operating performance right.”

Supplier Firm Strategies

Our results for supplier firm strategies are shown in figure 6 in order of most effective through least effective based on mean scores. The most popular strategy by far is, “improve control over cost structure,” with a mean score of 2.1, followed closely by the market strategy, “diverse/increase content share of vehicles” with a mean score of 2.2. These two top choices of strategies by investors rank ahead of the third and

fourth highest ranked strategies of “close plants” and “further consolidate.” However, an interesting comparison with the vehicle ratings shows that investors hold favorable views of the strategies of both capacity reduction and company consolidation for suppliers, when they only backed the former and not the latter for vehicle firms.

Figure 6
Rating of Supplier Firm Strategies



The least popular supplier strategies involve diversification into non-automotive business sectors with a very low ranking of 5.4, and somewhat unpopular rankings for asset swapping and stock buyback programs. Clearly, institutional investors are asking the suppliers to deliver on fundamental business practices, not strategies of financial engineering.

We also test for differences between short-term and long-term buyers in their rankings of supplier strategies. The two types of investors disagree on at least three strategies. Short-term buyers are even less enamored than long-term investors with a strategy that calls for further consolidation of supplier firms. This could be related to how fragile current supplier balance sheets are and the risk that additional leverage perceived required to consolidate the industry may have to trigger an earnings warning.

Certainly, not within the time horizon of a short-term buyer. Short-term investors are also less supportive than long-term investors of actions by suppliers firms to acquire new product lines. This may relate to the longer time periods needed to realize gains from new automotive products. Finally, short-term buyers are far less supportive than long-term investors of supplier strategies to increase prices. This most likely reflects the long-term pricing agreements worked into automotive contracts, placing a valuation premium on cost reduction over revenue enhancement through pricing. In fact, as was the case in ratings of potential vehicle firm strategies, long-term investors were significantly more positive about possible supplier strategies than were traders.

Finally, it should be noted that the ratings of our respondents, both short-term and long-term buyers, are significantly more positive regarding the effectiveness of possible supplier strategies than they were for basically the same set of strategies for vehicle firms. The generally positive support for management initiatives in the supplier sector appears to reflect differences in investor expectations about the future financial and operating performance of manufacturers and suppliers discussed in part 2 above. It is also clear that there will be more pressure on auto firms by Wall Street to consolidate in the supplier sector. The question still remains whether Wall Street will provide the flexible financing and robust balance sheet structures to get the job done.

PART 4 FINAL CONCLUSIONS

Our survey of automotive investors produces a strong list of conclusions on the subject of automotive equity compared to other equity investments.

- 1) Both traders and long-term buyers rate automotive equity as primarily a value and income investment. Ownership returns are expected from short-term ownership and dividends, not from long-term capital appreciation.
- 2) Clearly, investors regard automotive equity as generally riskier than other types of equity except on the issue of trading liquidity. In particular, investors' rate automotive equity as especially risky in terms of required capital expenditures, long-run growth in earnings per share, and future liabilities.

Overall, traders rate automotive equity as a riskier investment than long-term buyers.

- 3) Investors have set tough targets for the industry in terms of current and long-term financial performance. Investors also require automotive suppliers to outperform vehicle-manufacturing firms on growth in sales, operating margins and ROI performance. Vehicle firms are required to outperform suppliers only in dividend yield.
- 4) Investors appear to hold modest expectations regarding the overall trend in constant dollar sales for the industry. Investors require strong reductions in overall costs on an annual basis, but hold modest expectations regarding reductions in the number of competitors in both the vehicle and suppliers industry markets.
- 5) Perhaps because of their generally flat industry sales projections, investors require automotive firms to increase their returns now and in the future through better operating performance. Strong improvements in annual cost and sales expense reductions, product development speed and capacity utilization rates are required of both vehicle and supplier firms. Investors who hold very realistic expectations of current and potential levels of performance stress both better operating performance and use of capital on the part of automotive firms.
- 6) Investors hold strong preferences regarding potential automotive strategies on the part of industry firms. Investors strongly encourage vehicle firms to close excess capacity, improve product development performance, and improve control over their cost structures. Investors rate such strategies as the enlargement of product lines, and diversification into the service sector very poorly. In fact, the last named strategy was the most negatively rated item in the entire survey.
- 7) Investors strongly encourage suppliers to adopt strategies that improve their control over costs. They also encourage suppliers to increase their content share of the vehicle while closing excess capacity and improving productivity of product development. On the other hand, investors, oppose creative

financial programs on the part of suppliers, and especially rate poorly potential diversification into non-automotive markets.

- 8) Overall, short-term buyers are less enamored with automotive corporate strategies compared to long-term investors. Investors as a group appear to recommend only improvements in operations for vehicle firms – not market related programs (new products and programs). Investors also support strong improvement in operations for suppliers, but somewhat more weakly support supplier strategies that lead to further industry consolidation and vehicle content share for the individual supplier.

Finally, we believe this survey and analysis provides an important snapshot of major institutional investors' perceptions of the automotive industry and its investment opportunities. More importantly, however, our study underlines the importance of effective communication between automotive management and major shareholder groups. Only through an on-going mechanism of shared perceptions and information can management and investors agree on basically what Wall Street fairly and reasonably wants from the auto industry.