

U.S. Autos & Auto Parts

 Equity

The Restructuring of the N.A. Auto Industry; CAR Conference Notes

- **What's New?** — On August 4, we had the privilege of speaking at the Center for Automotive Research (CAR) annual Management Briefing Seminars conference in Traverse City, Michigan. Our presentation focused on both the risks and opportunities around vehicle density as it relates to the outlook for U.S. auto sales. Our slide presentation is contained in this report.
- **Industry Undoubtedly on Better Footing...** — Following massive restructuring over the past year, the auto industry is showing signs of health that haven't been observed in many years. Industry margins in some cases have returned to peak levels on still depressed volume, balance sheets have shed tens of billions in net debt and automakers are showing rare pricing discipline. Our constructive Auto investment thesis anticipates that valuations will continue to improve as these structural improvements, along with a cyclical volume recovery, lead to a multiple re-rating vs. pre-downturn levels, when the industry looked far more toxic.
- **...Yet Prosperity Still Requires 14-15mln SAAR** — Although the industry has restructured to presently profit under an 11-12mln U.S. SAAR, true prosperity will still require a healthy sales recovery to 14-15mln, in our view. This is because break-even points will eventually rise as inflation and regulatory costs begin to creep up. At the same time, underfunded pension plans remain a risk to balance sheets. Our analysis around pent-up demand keeps us optimistic, as we do not believe consumers are planning to meaningfully de-stock their vehicle fleets going forward, which supports our above consensus SAAR view. However, we remain concerned that economic stagnation risks prolonging the consumer "confidence gap" we see, thereby still posing a risk to future de-stocking. If the economy fails to narrow the "confidence gap", we continue to see compelling solutions in job assurance programs, which we believe could change the course of the cycle.
- **Industry Participants Generally More Optimistic** — Based on discussions with industry participants, we sensed a more constructive tone around the outlook for improving OE-supplier collaboration, profitability and avoidance of repeating past mistakes. While several issues remain, notably pricing pressures and regulatory uncertainties, our sense is that industry does regard recent progress as a structural shift in industry health as opposed to a temporary phenomenon.
- **Bullish Auto Investment Thesis; Buy BWA, LEA, ARM & MGA** — Combined with our constructive outlook for a global volume recovery, the industry seems well-positioned for earnings growth & margin expansion. Multiples may also rise on reduced industry toxicity and still low valuations (~4.0x Fwd EBITDA). We prefer suppliers over OEMs for a volume recovery and we seek out market share gainers while striking a balance between low valuations and margin upside potential.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 1. Comp Sheet

U.S. Autos & Auto Parts - Comparables Sheet

Valuation Metrics

	Rating	Market Cap	Share Price	Target Price	EV/ EBITDA			P/E			FCF Yield			EV/Sales
					2010E	2011E	2012E	2010E	2011E	2012E	2010E	2011E	2012E	2011E
American Axle	--	755	\$10.14	--	4.8x	4.3x	4.0x	8.4x	6.5x	5.8x	22%	9.5%	--	65.0%
ArvinMeritor	1H	1,520	\$15.77	\$20	10.6x	6.4x	4.7x	45.9x	10.1x	6.2x	1.5%	6.8%	10.0%	41.0%
BorgWarner	1M	6,060	\$46.94	\$53	9.6x	8.0x	7.1x	17.4x	13.8x	12.0x	4.1%	5.6%	5.8%	110.9%
Ford	2H	53,789	\$12.98	\$10	5.4x	5.0x	4.9x	7.4x	8.0x	7.7x	8.3%	11.5%	10.3%	51.3%
Goodyear Tire	2H	2,794	\$11.45	\$16	4.2x	3.4x	2.9x	87.7x	8.4x	5.3x	NM	5.4%	2.9%	31.0%
Johnson Controls	2H	20,246	\$29.60	\$34	9.5x	7.8x	6.9x	15.1x	12.3x	10.6x	6.2%	7.2%	8.6%	62.3%
Lear	1H	4,377	\$81.05	\$93	4.8x	4.0x	3.6x	13.5x	11.5x	9.9x	6.5%	5.9%	9.3%	28.3%
Magna	1H	8,490	\$75.00	\$88	4.7x	3.9x	3.6x	12.2x	10.0x	9.2x	8.5%	8.9%	10.3%	31.5%
Tenneco	--	1,713	\$28.13	--	5.5x	4.5x	3.9x	18.3x	11.0x	8.7x	5.7%	7.9%	10.6%	42.5%
TRW	--	4,861	\$37.19	--	4.3x	4.0x	3.7x	8.6x	7.6x	7.2x	10.7%	10.1%	10.5%	43.6%
Average:					6.3x	5.1x	4.5x	23.4x	9.9x	8.3x	8.1%	7.9%	8.7%	50.7%
Average Traditional Light Autos (ex. JCI, ARM & BWA)					4.8x	4.1x	3.8x	22.3x	9.0x	7.7x				

Fundamental Metrics

	Revenue			Growth 2012/'10	EBITDA			EPS			Growth 2012/'10	Citi EPS vs. Consensus		EBITDA Margin	
	2010E	2011E	2012E		2010E	2011E	2012E	2010E	2011E	2012E		2010E	2011E	2011E	Last Peak
American Axle	2,193.5	2,354.4	2,563.0	16.8%	\$322	\$354	\$379	\$1.21	\$1.56	\$1.74	43.9%	100%	100%	15.0%	13.8%
ArvinMeritor	4,744.9	5,488.0	6,288.7	32.5%	\$213	\$351	\$480	\$0.34	\$1.55	\$2.53	635.6%	117%	102%	6.4%	5.5%
BorgWarner	5,243.6	6,166.1	7,033.6	34.1%	\$715	\$852	\$961	\$2.70	\$3.40	\$3.90	44.6%	99%	97%	13.8%	14.7%
Ford	109,692.7	115,471.7	120,211.7	9.6%	\$10,872	\$11,928	\$12,141	\$1.75	\$1.63	\$1.69	-3.6%	99%	85%	10.3%	8.7%
Goodyear Tire	17,787.5	18,458.4	20,428.2	14.8%	\$1,369	\$1,685	\$1,950	\$0.13	\$1.36	\$2.15	1543.6%	33%	88%	9.1%	8.6%
Johnson Controls	33,969.8	36,465.9	38,879.7	14.5%	\$2,388	\$2,907	\$3,278	\$1.95	\$2.40	\$2.79	43.0%	99%	100%	8.0%	8.4%
Lear	11,266.8	13,008.2	14,167.9	25.7%	\$767	\$928	\$1,025	\$6.00	\$7.04	\$8.20	36.7%	115%	92%	7.1%	8.7%
Magna	21,261.5	23,000.3	24,281.5	14.2%	\$1,552	\$1,866	\$2,016	\$6.16	\$7.48	\$8.20	33.0%	118%	122%	8.1%	11.7%
Tenneco	5,581.7	6,637.6	7,860.9	40.8%	\$511	\$624	\$723	\$1.54	\$2.56	\$3.25	111.1%	100%	100%	9.4%	9.5%
TRW	13,301.6	14,084.4	15,126.5	13.7%	\$1,436	\$1,543	\$1,656	\$4.34	\$4.88	\$5.18	19.4%	100%	100%	11.0%	11.1%
Average:				21.7%							250.7%			9.8%	10.1%

Credit & Other Metrics

	% of Revenue			% of Revenue			Pension Status				Net Debt/EBITDA		Credit Ratings	
	N.A.	Europe	Asia	D3 N.A.	VW	Daimler	U.S.	Non U.S.	Total	% EV	2010E	2011E	Moody's	S&P
American Axle	95%	3%	NA	86%	--	--	\$115	\$146	\$261	17.1%	2.4x	2.2x	Caa1	B-
ArvinMeritor	58%	22%	10%	NA	NA	NA	\$321	\$196	\$517	23.0%	3.4x	2.1x	B3	B-
BorgWarner	28%	56%	16%	17%	16%	6%	\$47	\$183	\$230	3.4%	1.1x	0.9x	Ba1	BBB
Ford	54%	32%	14%	NA	NA	NA	\$6,181	\$5,781	\$11,962	20.2%	0.5x	0.5x	B1	B+
Goodyear Tire	43%	36%	10%	--	--	--	\$1,931	\$784	\$2,715	47.5%	2.1x	1.7x	Ba3	BB-
Johnson Controls	49%	39%	12%	--	--	--	\$645	\$441	\$1,086	4.8%	1.0x	0.8x	Baa2	BBB
Lear	30%	47%	13%	41%	10%	--	\$39	\$92	\$131	3.6%	NM	NM	B1	B
Magna	47%	49%	4%	44%	12%	10%	\$16	\$19	\$35	0.5%	NM	NM	--	BBB
Tenneco	45%	44%	11%	22%	9%	4%	\$142	\$73	\$215	7.6%	2.2x	1.8x	B2	B
TRW	25%	58%	12%	27%	19%	--	\$411	\$112	\$523	8.5%	0.9x	0.8x	B2	BB-
											1.7x	1.4x		

Source: FactSet, Company Reports and Citigroup Investment Research

Figure 2. Slide Presentation

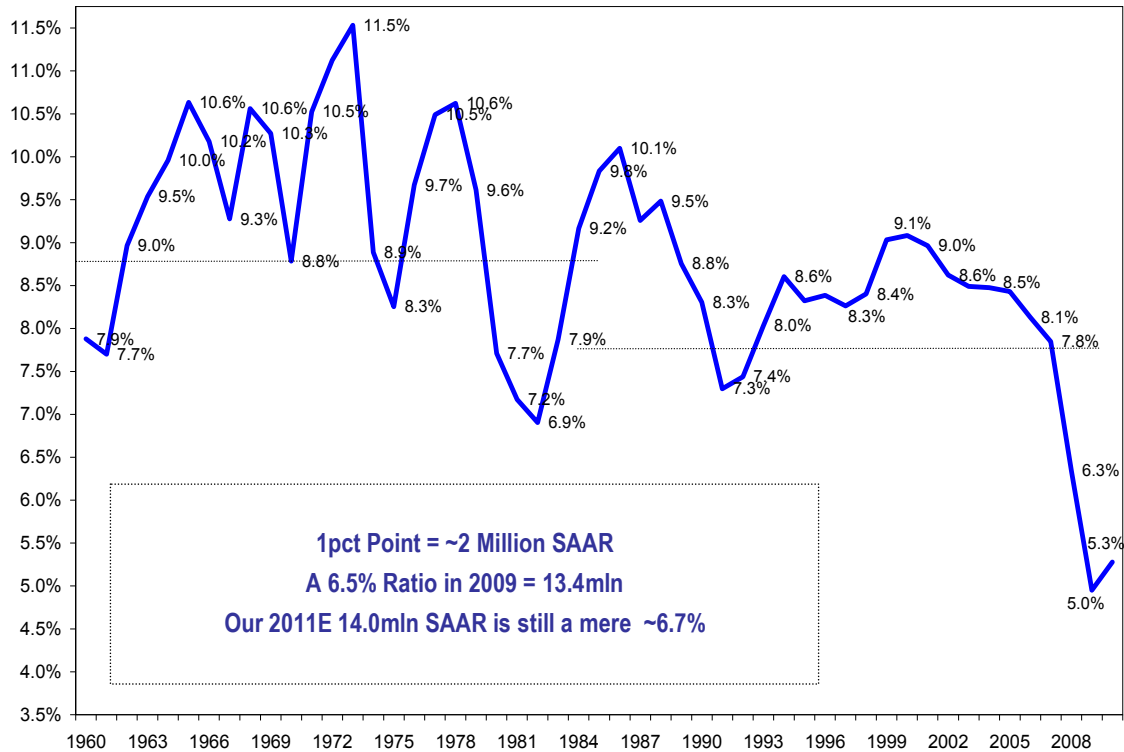


Automotive

The Restructuring of the North American Auto Industry

How Bad Was It?...

U.S. Light Vehicle Sales per Licensed Driver (1960-H1 2010)



Source: Ward's, FHWA, Company reports and CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 3. Slide Presentation



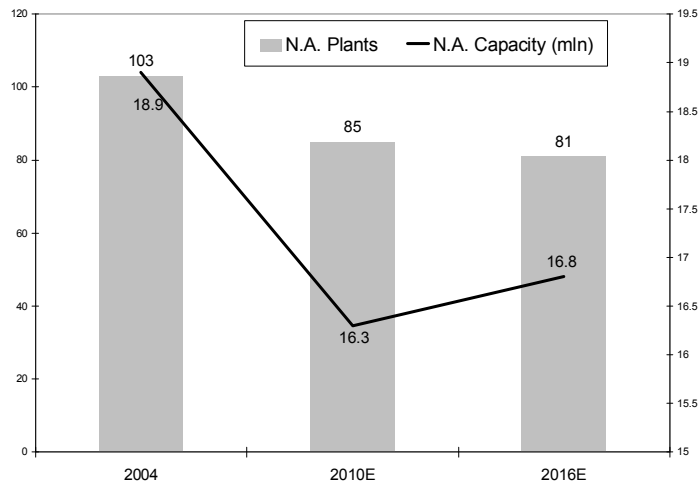
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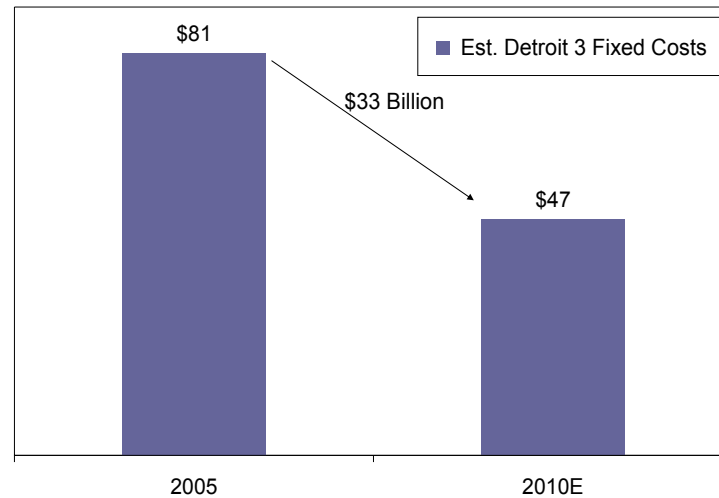
Crisis Breeds Opportunity – Has a New Industry Been Formed?

- U.S. Sales Downturn Accelerated an Inevitable Industry Restructuring
- Necessary Capacity Cuts & Painful Labor Sacrifices Ensued
- Government Support Greatly Facilitated the Transition

Necessary Capacity Reductions & Labor Sacrifices....



...Helped Eliminate Burdensome Fixed Costs



Source: CSM, Ward's, Company Reports and CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 4. Slide Presentation



Automotive

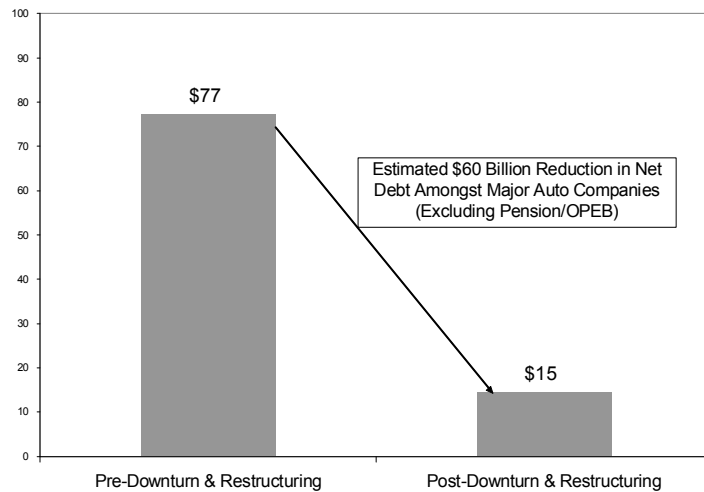
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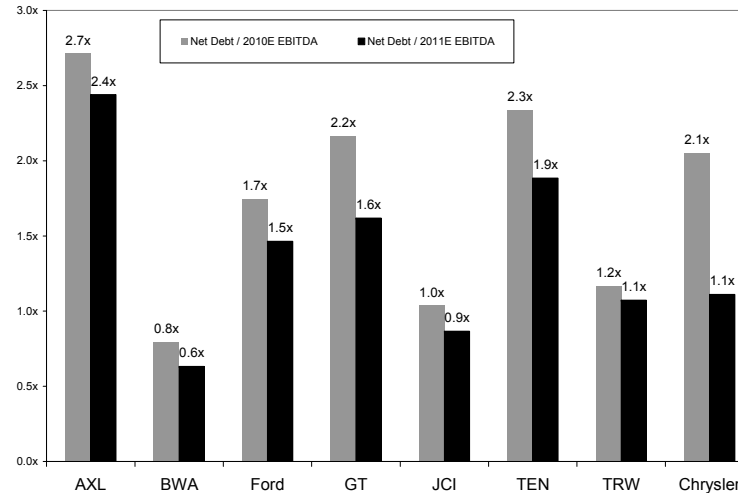
- Restructuring Slashed >\$60 Billion in Net Debt
- Today, A Handful of Auto Companies Sport Net Cash Positions
- Amongst Those Still Carrying Net Debt, Leverage Appears More Manageable (<3x)

The Result?

Estimated Net Debt Reduction for Select Auto Companies...



...And Even Remaining Levered Companies Aren't Overly Levered



Source: Company Reports, BEA & CIRA Estimates

Source: Citi Investment Research and Analysis

Figure 5. Slide Presentation



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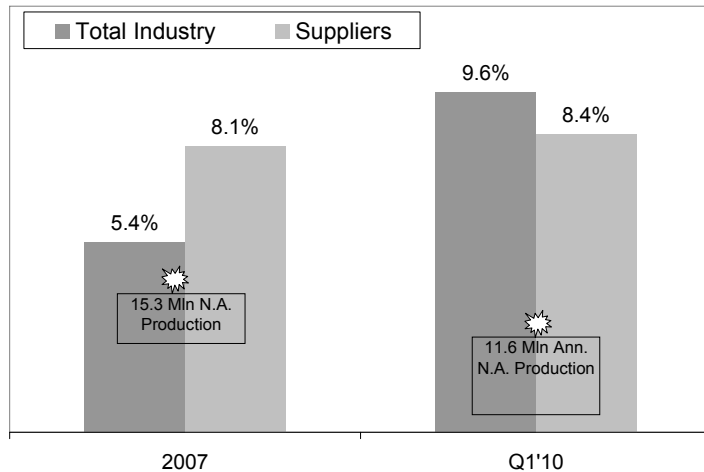
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Crisis Breeds Opportunity – Has a New Industry Been Formed?

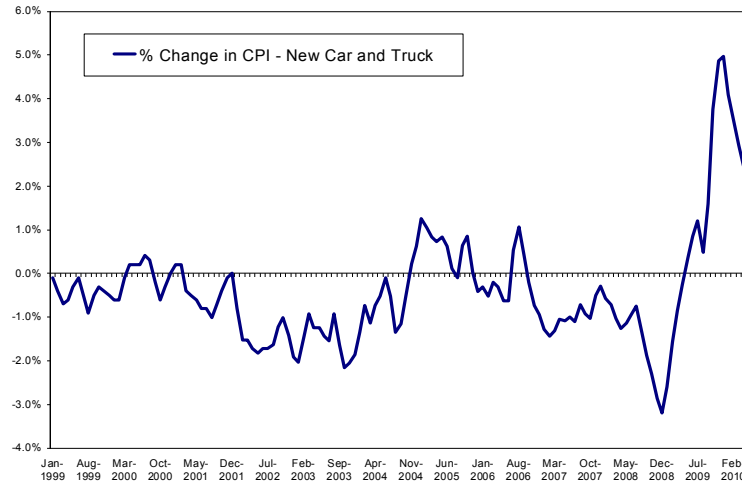
- Profit Margins Returned/Exceeded 2007 Levels
- 2011 Profit Margins Could Reach or Break 1999-2000 Peak Levels
- Automakers Showing Rare Incentive Discipline

So, Are We Out of the Woods?

Profit Margins Have Soared on Lower Volume...



...Creating Rarely Observed Pricing Gains



Source: Company Reports, BEA & CIRA Estimates

Source: Citi Investment Research and Analysis

Figure 6. Slide Presentation



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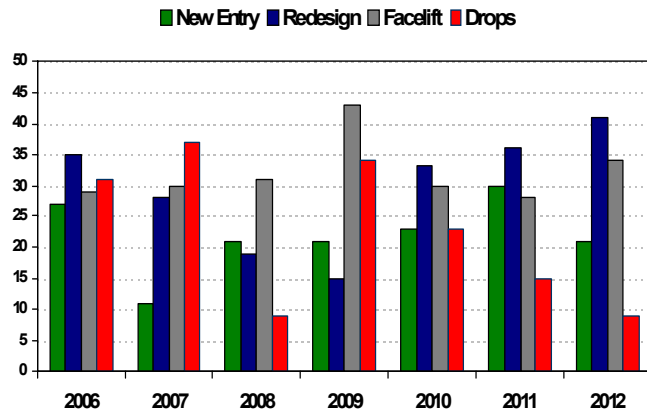
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Pieces Yet to Be Picked Up...

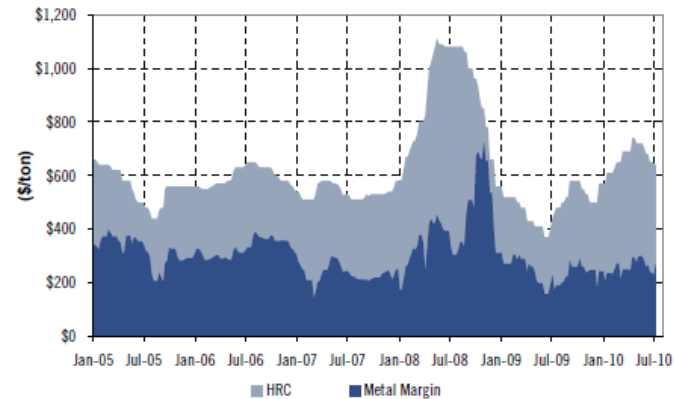
- Capacity Still Elevated & Competitive Conditions Forecasted to Intensify
- Raw Material & Fixed Cost Inflation Likely Begin to Pressure Break-Even Points
- Regulatory Cost Headwinds Expected to Intensify (CAFÉ)
- Jury Still Out on Industry Pricing Outlook
- Pension Plans Still Underfunded, A Risk for Several Stakeholders

Conclusion: Prosperity Still Requires Healthy Recovery to 14-15mIn SAAR

Competitive Landscape in the U.S.



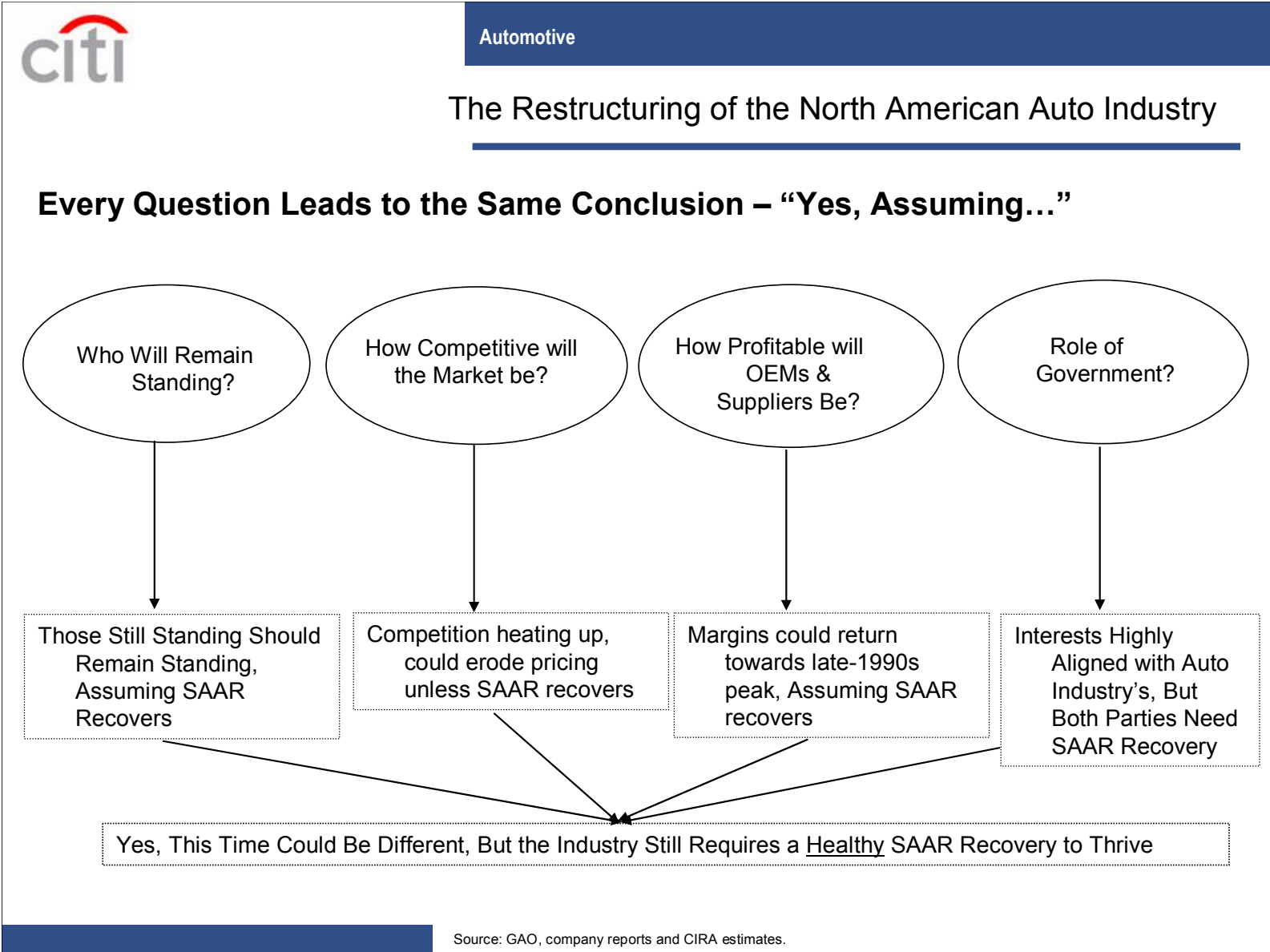
Steel Costs



Source: JD Power, Bloomberg, Company reports and CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 7. Slide Presentation



Source: Citi Investment Research and Analysis

Figure 8. Slide Presentation



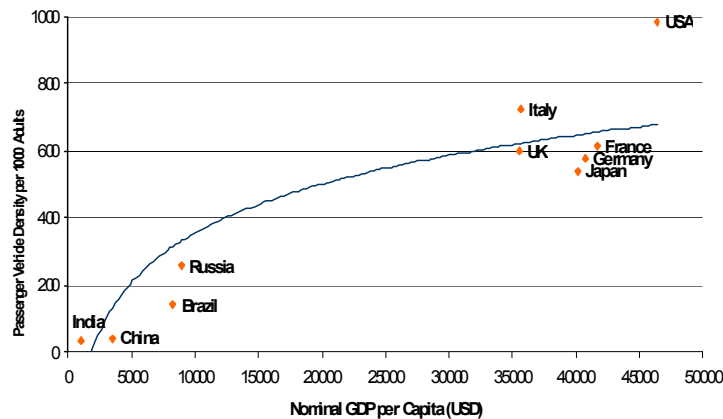
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Sales Cycle Cannot Be Overlooked – What Was the Scariest Event of 2009?

- The Tendency to “Wait” for the Economy Fails to Appreciate the Deeper Risk Here...
- ...U.S. Vehicle Density Has Increased in Recent Years and Ranks #1 in the World...
- ...Scrap Exceeded Sales in 2009 Despite Resilient “Desire to Buy” Surveys...
- ...A Stagnant Economy Could Cause Consumers to Abandon Purchase Plans and Destock
- Return to 1990s Vehicle Density Would Threaten the Industry’s Recovery!
- Confidence Crisis Could Cause Permanent Damage if Left Untreated!

U.S. Already a Highly Saturated Market...

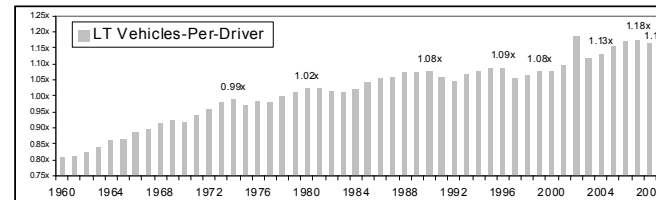


...What Happens if we Return to Late-1990s Saturation?

Smoothed SAAR over 3 Years **10.7**

SAAR Sensitivity (Scrap Rate on Y, Vehicle/Driver on X)

	1.09	1.13	1.16
5.0%	8.4	11.2	13.2
6.0%	10.8	13.6	15.6
6.5%	12.0	14.7	16.8



Source: JD Power, Ward's, FHWA, CSM, company reports and CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 9. Slide Presentation



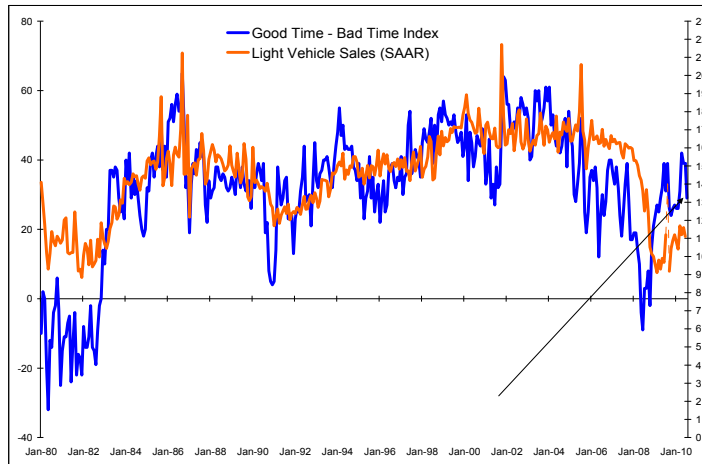
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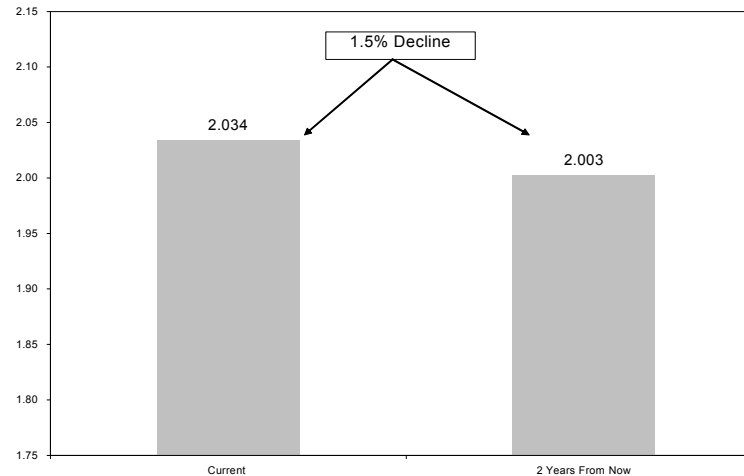
There's Some (Very) Good News...

- Underlying Demand Indicators Inconsistent with Low-11mIn SAAR
- Aging Fleet + Rising Utilization Offer Significant Replacement Opportunity...
- ...But the Opportunity Must be Embraced Before De-Stocking Potentially Occurs
- Citi Vehicle Saturation Survey Suggests Limited De-Stocking for Now
- Americans Still Want to Drive, But Fear & Anxiety Precluding Higher Sales
- Low Confidence = Who Wants Fixed Costs? We Call This the "Confidence Gap"

Auto Buying Sentiment vs. SAAR



Citi Vehicle Saturation Survey (Vehicles per Household Outlook)



Source: University of Michigan and CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 10. Slide Presentation

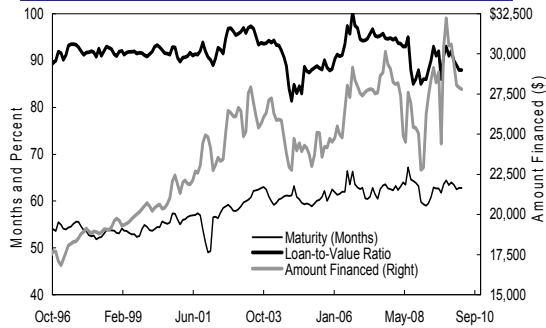


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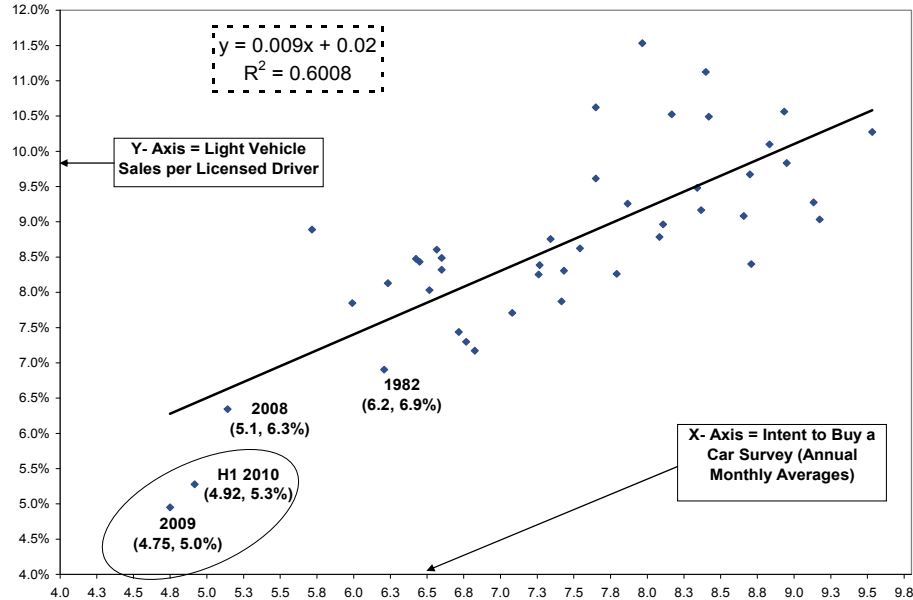
The Restructuring of the North American Auto Industry

A Few Things to Keep in Mind...

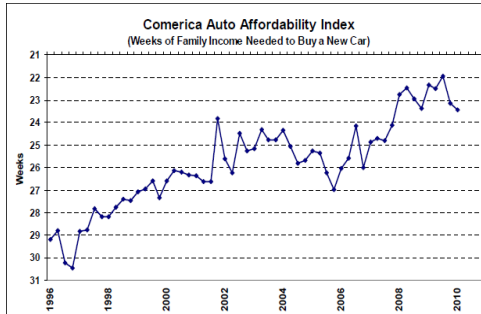
Credit Conditions Stabilized



The Economy is Bad, But Sales Should Still Be Somewhat Higher



Affordability Not the Problem



Sources: Comerica, Manheim, FRB, Ward's and CIRA

Source: Citi Investment Research and Analysis

Figure 11. Slide Presentation



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The Restructuring of the North American Auto Industry

3 Scenarios By Which This Can All Unfold

“Confidence Gap” Between Demand Surveys & SAAR Will Collapse in 1 of 3 Ways:

- (1) Good-Old Fashioned Economic Recovery – But When?
- (2) Stagnant Economy Causes Consumers to De-Stock – Biggest Threat to Industry!
- (3) Establishment of Powerful & Cost Effective Stimulus – Yes, A Solution Exists!

Time Matters: Vehicle Density Must be Preserved Before it Slips Away. If a Credit Worthy Consumer Wishes to Purchase a Vehicle, There’s No Reason Fear Should Prevent it!

What Will the History Books Say 5 Years From Now?

If Vehicle Density Returns to 1990s Levels



Auto Industry Spent 2001-07 Selling Cars at Little Profit Only to Lose the Replacement Opportunity of Those Cars in 2010-15

If Vehicle Density is Preserved



Auto Industry Restructured Just in Time to Embrace Replacement Demand Borne Out of 1999-07 Sales Boom, Helping Transform the Industry

Source: CIRA estimates.

Source: Citi Investment Research and Analysis

Figure 12. Slide Presentation



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The Restructuring of the North American Auto Industry

Option # 3: If the Economy Won't Pitch In; Will Others?

Imagine the Following...

- An Auto Incentive that Not Only Avoids Corrupting Price, But Promotes Trading-Up
- An Auto Incentive that Costs \$0 at Time of Sale
- An Auto Incentive that Consumers Won't Miss When the Economy Recovers
- An Auto Incentive that Directly Addresses Why Consumers are Reluctant to Commit
- An Auto Incentive that Could Jump Start SAAR by 2mln Units Overnight (Literally)

...A Blueprint Already Exists...

- Hyundai's Assurance Program is a Blueprint for the Ideal Industry Solution
- Simple Concept: Customer Can Return Recently Purchased Vehicle Upon Job Loss
- Takes Anxiety & Fear Out of the Equation
- Perfect for a Highly Saturated Auto Market Where Vehicle Purchase More Discretionary

...And Could Easily Be Applied by Industry...

- Easy to Communicate & Implement
- We Estimate Minimal Costs & High Returns
- Scalable and Eventually Won't Be Missed
- Good for Consumer, Industry & Economy – A True Win-Win

Source: CIRA estimates.

Figure 13. Slide Presentation



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The Restructuring of the North American Auto Industry

Option # 3: If the Economy Won't Pitch In; Will Others?

- Hyundai Saw Significant Share Gains Post Assurance Program
- CNW Surveys in 2009 Found 53% of Intenders Considered the Program as Key
- Confidence Crisis Can Have Long-Term Implications if Left Untreated
- Existence of Such Solutions Keeps us Positive on Demand Potential

What if This?...
(Hyundai U.S. Market Share Pre and Post Assurance Program)

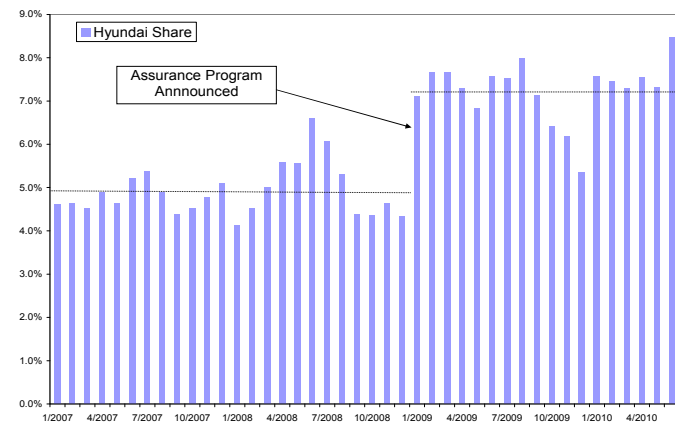


Figure 14. Slide Presentation



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The Restructuring of the North American Auto Industry

Summarizing Our Thoughts:

- Industry is Indeed Healthier on Many Fronts Today
- But Achieving Prosperity Still Requires a Healthy SAAR Recovery to 14-15 Million
- “Waiting” for the Economy Risks Leaking Further Density (Vehicles/Household)
- Decline in Density Poses Biggest Threat to U.S. Auto Industry
- “Confidence Gap” Exists and Will Collapse in 1 of 3 Ways: Recovery/Destock/Stimulus
- Wide Adaptation of Job Assurance Solutions Could Change the Course of this Cycle
- We are Bullish on the Industry and the Prospects for a SAAR Recovery...
- ... But if the Economy Doesn’t Carry Us, Job Assurance Should be Embraced...
- A Healthy Return Towards 14-15mln SAAR Could Truly Redefine the U.S. Auto Industry

Source: CIRA estimates.

Source: Citi Investment Research and Analysis

Appendix A-1

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