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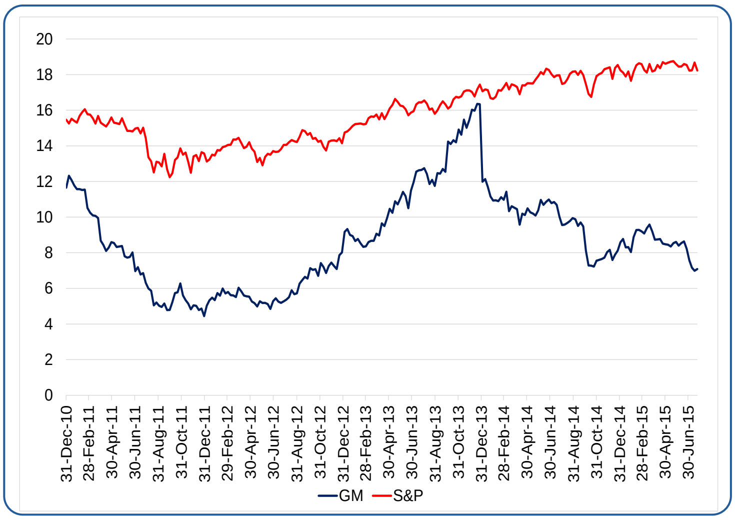
General Motors: 2Q15 results feedback

General Motors (GM) reported 2Q15 EPS of USc0.67/share and adjusted diluted EPS of $1.29, the latter up 122% on the prior quarter, thus putting the company on a trailing P/E of c. 7x. That rating is less than half the P/E of the S&P 500 Index, currently at about 18x, and is thus apparently very attractive. However, we note there are a number of provisos which tarnish this appearance, which we discuss further below. It seems that the company raises the classic question of whether to buy an excellent company at a good price or a good company at an excellent price, GM apparently falling into the latter category. In summary, our view is that, despite the provisos, the stock offers decent value and could be bought at current levels.

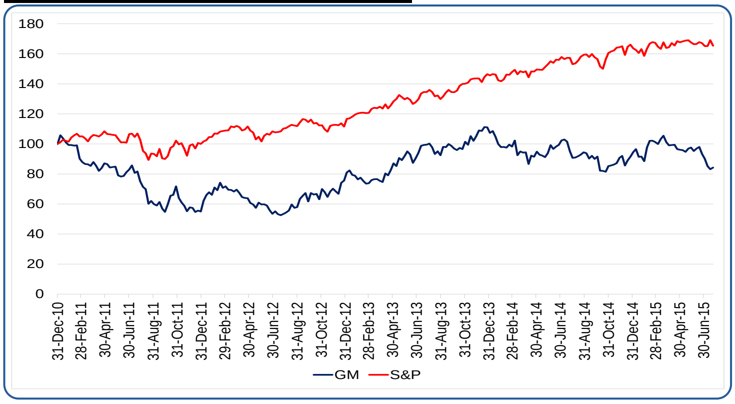
Figure 1: P/E multiple, GM vs S&P 500: Note the extreme divergence



Source: Bloomberg, Anchor Capital

Earnings for the automakers are rarely high quality and periodically hit ‘air pockets’. This can be seen in GM’s EPS record *vis-à-vis* the S&P 500, in which the former delivered less growth, with more volatility, than the broader market (see chart below entitled *Earnings performance, GM vs. S&P 500*). Furthermore, automakers generally have weak pricing power associated with low levels of customer loyalty, a plethora of product alternatives, and the fact that the industry is mature and highly (perhaps over) capitalised. Thus, there is a general concern about the quality of industry earnings. We further note a concern about GM’s adjustments to get from accounting earnings to diluted adjusted earnings. In each of the past five quarters, the special items adjustment, which is added to accounting earnings to get adjusted diluted earnings, has been very material (over 100%, on average, over the past five quarters). Therefore the apparently very cheap P/E of 7x rises to 11.5x if these adjustments are ignored; although this is still cheap (not identical with good value, though), when compared to the S&P. In our opinion the real “core” earnings number is somewhere in the middle of these extremes.

Figure 2: Relative price performance, GM vs S&P 500 (December 2010 rebased to 100)



Source: Bloomberg, Anchor Capital

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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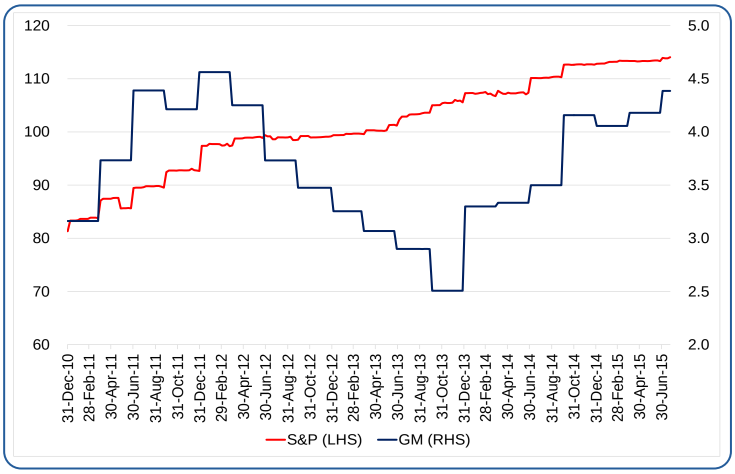
Figure 3: EPS performance, GM vs S&P 500:



Source: Bloomberg, Anchor Capital

GM's results showed the effects of two themes that are quite pervasive amongst S&P companies, as well as two broader global economic themes. On the level of company themes, GM shows US dollar strength putting downward pressure on earnings and a large share buyback programme supporting EPS. So, while GM's revenues were down by 4% QoQ, if the effect of the strong US dollar is stripped out, revenues would have actually been 2% higher QoQ. For the year to 21 July, GM has bought back $2.1bn worth of shares (c. 4% of its market capitalisation), of a $5bn buyback programme. As far as the macro themes go, the company's results suggest a booming US economy (eight straight quarters of YoY margin expansion in North America) but also confirm the softening of the Chinese economy seen this year.

GM revenue is still overwhelmingly dominated by North America:

		2Q15	
Revenue	**$mn**	**38 180**	**100%**
- GM North America	**$mn**	26 481	**69%**
- GM Europe	**$mn**	4 987	**13%**
- GM International operations	**$mn**	3 053	**8%**
- GM South America	**$mn**	2 109	**6%**
- GM Financial	**$mn**	1 515	**4%**
- corporate & eliminations	**$mn**	35	**0%**

Source: Bloomberg, Anchor Capital

GM Europe was effectively breakeven (vs loss making in 2Q14) and could be ascribed some option value – this should be borne in mind when interpreting GM's P/E multiple. We note, however, that GM is only targeting a breakeven performance in FY16 in this region. GM South America reported a loss of $0.1bn (EBIT-adjusted); again this business probably has some option value and its distorting effect on the Group P/E multiple should be borne in mind. The quarter had strong cash flows with adjusted automotive free cash flow (FCF) of $3.3bn (vs $1.9bn in 2Q14). On the balance sheet, cash and marketable securities were $22.8bn, 46% of market capitalisation, and quite a substantial cash pile. The company plans to reduce this to $20bn through buybacks. Consonant with an apparently stronger balance sheet, Fitch raised GM and GM Financial to investment grade during the quarter.

China is, according to management, "by far the biggest concern being raised by our investors," particularly in relation to the potential growth moderation and increased price competition. "We expect a more volatile market in China as growth moderates." This, however, hasn't changed GM's long-term view on China and the company continues to expect strong growth in the medium to longer term. They stated that "at the beginning of the year we had already planned for some industry moderation and increased price competition. Initial assumptions heading into 2015 were 6%-8% industry growth overall and 3% price deterioration on a YoY basis. It has been clear to us for some time that the moderation is stronger and the price environment more challenging than we had anticipated." So, while there has been a softening in China, we do note that, year to date, GM's Chinese SUV sales are actually up 83% vs 2014. Management now expects the industry in China, for the full year, to grow in the low single-digit range.

Management also expect Chinese price reductions in the 5%-6% range but didn't give guidance as to the profit sensitivity on these general price reductions. They did however disclose the approximate price sensitivity in Shanghai General Motors (SGM; GM's Chinese volumes are roughly 50/50 SGM/GM-Wuling), which is that a 1% carry-over price reduction (not the same as YoY price reduction), results in a $100mn reduction in GM equity income, emphasising, however, that this is "absent any mitigating factors." They plan to offset headwinds, to some degree, through increased mix and cost efficiency. Management expect Chinese equity income to be flat in 2H on 1H, thus in the range of c. $2bn for the full year. They continue to expect 9% - 10% net margins in China for the medium and longer term.

For what it's worth, management clearly think their share is underpriced, having stated, in relation to share buybacks, that "we're going to continue to aggressively and prudently act because clearly our stock is undervalued."

As far as the outlook goes, management reaffirmed their guidance for improved adjusted EBIT in 2015 vs 2014. They expect 2H15 to be "even better" than 1H15. On an EPS level, that implies EPS higher than $4.30 (i.e. double 1H15's adjusted diluted EPS), therefore a P/E multiple lower than 7x on CY15 earnings. Management also expect FY15 EBIT-adjusted north of $10bn for the company. We do note that the company has significant launches for the remainder of the year.

Blake Allen*

** note Blake Allen owns GM shares*

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