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BARRON'S COVER

Buy GM

By VITO RACANELLI

General Motors' turnaround could accelerate in coming years, driving handsome gains for bold stockholders. Needed: A jolt from the hybrid Chevrolet Volt. (Video)

IT'S NOT EASY BEING 100. JOINTS HURT, BONES ACHE and the funeral director's eyes brighten when he sees you. Just look at General Motors, which will hit the century mark in September.

Last week, it announced that it's downsizing its labor force by 19,000 workers. Many believe that even that won't be enough to keep the auto giant from the grave. In fact, GM (ticker: GM) now has a stock-market value of less than $10 billion, a mere 1/16th the size of Toyota's.

GM

Its shares, once a classic orphan-and-widow haven, have become favorites of short sellers aiming to profit as each spasm of bad economic news -- rising oil prices, higher unemployment, credit downgrades, depressed housing prices -- piles more downward pressure on the stock.

On the long side, General Motors now seems suited mainly for one group -- bold investors who hope to eventually double their money but can afford to lose it all if their wager goes awry. The good news for GM fans: Despite the misery that the car maker is experiencing and might endure for another 12 to 18 months, such a wager ultimately should pay off.

The litany of problems facing GM is daunting. Its SUV-heavy North American operation, its biggest unit, is bleeding red ink, as light trucks sink in popularity. And should the U.S. economic slowdown turn into a long, nasty recession, General Motors' $31 billion liquidity cushion could shrink dramatically before 2010, when the full impact of $4 billion-to-$5 billion in annual savings from a new United Auto Workers contract kicks in. And GM, which this year almost certainly will lose its mantle as the globe's No. 1 car maker to its Japanese arch rival Toyota (TM), continues to see its U.S. market share erode. At its annual meeting in Delaware this Tuesday, CEO Rick Wagoner is expected to disclose production cuts and other measures meant to conserve cash.

These worries, plus short-term issues such as the problems at GMAC Financial Services, GM's 49%-owned financing unit, have savaged the stock. At its recent price around 17, it had lost about 60% of its value since hitting 43 in October, when investors' hopes for a turnaround swelled.

BUT THE THICK GLOOM obscures improvements already evident and the prospect that GM's turnaround will accelerate over the next two to three years, even if the U.S. cyclical downturn dims the outlook for the next 12 months.

The shares could rise to at least 30 and maybe as much as 45 once those big cost reductions drop to the bottom line in 2010. And if the stars align perfectly -- the economy enjoys a second-half uptick and the housing market and consumer confidence turn for the better sooner than expected -- the stock's rebound could be quicker. Even a small improvement in sentiment could bring a disproportionate rise in the stock.

GM's junk-rated bonds, less risky than its equity, haven't slid as badly. Its short-duration notes due in 2011-13, for example, sell at about 85 to 93 cents on the dollar. Long-rated GM paper, like the senior note maturing July 15, 2041 (XGM), trades around 60 cents on the dollar, yielding about 12.35%. But, as with the stock, the Wall Street consensus view is mainly gloomy here, too.

Last fall's historic pact with the UAW deservedly made the headlines. Yet before that game-changing deal was announced, GM already had cut its global structural costs to less than 30% of revenue from 34% in 2005, although industrywide U.S. auto sales had dropped to an annual rate of 16.1 million from 2005's nearly 17 million. With the labor agreement, GM's target of trimming costs to 23% of revenue in 2012 looks achievable, despite higher material costs.

GM's problems stem almost entirely from North America, where its costs are still high and too many of its plants build gas-guzzling sport-utilities. But the labor deal essentially will level the playing field within 19 months. And GM is shifting its production mix toward smaller, more fuel-efficient cars while globalizing its stable of "platforms" -- the basic structures on which vehicles are built -- to increase its flexibility and react more quickly to changing consumer preferences.

OVERSEAS, WHERE MANY economies are still robust, the American car maker is faring well. In the first quarter, GM had an adjusted pretax loss of $611 million in North America, but pretax profits of about $1 billion in the rest of the world. Its sales are rising sharply in China, Russia and Latin America. Even a flat showing in North America would boost the stock. GM's first-quarter loss of $3.3 billion, or $5.74 a share, chiefly resulted from $2.9 billion in mostly non-cash special charges. Excluding them, its net deficit of 62 cents a share easily beat expectations by about $1.

Significantly, after losing a generation of consumers to better-engineered offerings from Asia and Europe, GM is designing quality cars again. Over the past 12 months, it's won a sackful of prestigious industry and media awards for vehicles like the hot-selling Chevrolet Malibu, which auto writers voted the 2008 North American Car of the Year, and the Cadillac CTS, Motor Trend's 2008 Car of the Year. Some GM marquees also did well on the latest J.D. Power ratings of dependability over three years, with Buick tying Lexus for first place, and next-best Cadillac coming in on their bumpers. Better cars can be sold with smaller incentives.

Another long-term plus is GM's growing embrace of green technology.

Nothing is more symbolic of this than the Chevrolet Volt, which GM is feverishly promoting (and lobbying for in Washington, to get a consumer tax break) -- two years before its scheduled debut.

CEO WAGONER HAS PLEDGED THAT the Volt, designed to challenge Toyota's primacy in hybrids, will debut in late 2010 and go at least 40 miles on a single charge without using its gasoline engine, which could make it an attractive commuter vehicle for many people.

GM also is introducing more non-plug-in hybrid cars and trucks. Some are "mild" versions that simply shut off the engine at stoplights and automatically restart it when the accelerator is pressed. Others are full-blown, advanced models, like the 2008 Chevrolet Tahoe and GMC Yukon, whose city mileage is 21 miles per gallon -- the same as a four-cylinder, manual-transmission Toyota Camry.

Table: GM's Woes

Developing such vehicles is costly, however, and some bears fear that GM's current problems could leave it without enough cash to survive until 2010. And there are lots of potential calls on GM's wallet. For example, GMAC, the vehicle- and home-loan financier in which it retains the 49% stake, owns deeply troubled Residential Capital, a mortgage lender. ResCap is trying to get a new $3.5 billion credit line from GMAC. GM and Cerberus Capital Management, the private-equity group that owns the rest of GMAC (as well as most of Chrysler), could finalize a guarantee of $750 million of that as early as this week. GM is also exposed to Delphi (DPHIQ), a parts supplier it spun off in 1999, which is trying to exit bankruptcy. The car maker already has written off $8.3 billion for Delphi, and has agreed to advance it up to $650 million this year as the supplier battles back from insolvency.

Meanwhile, GM faces higher costs for steel, plastic and other materials. In addition, it has been hit by sporadic local strikes, including one at a Kansas plant that makes the Malibu, and a longer, more serious walkout at key supplier American Axle & Manufacturing (AXL), which GM says cost it about $800 million in North American operating profits in the first quarter. GM agreed to provide up to $215 million to help end the American Axle strike, which will bash its results by an estimated $1.8 billion this quarter. Both labor disputes have ended, and the lower costs that American Axle will have under its new contract ultimately will help GM trim its own outlays.

AT THE SAME TIME, the U.S. economic slowdown isn't helping anyone. April's industry numbers suggest that U.S. light-vehicle sales will be as low as 14.4 million this year -- which would be the worst level since 1995. Still, "you've got to look beyond the recession, beyond the next 18 months," says Stephen Simmons, director of research for institutional investor Flippin, Bruce & Porter, which has been buying GM shares during the downdraft and now owns 1.8 million. Though the big labor-cost reduction won't come until 2010, GM has the wherewithal to get to the other side of the recession, he maintains, and the stock "is a compelling story that's nowhere near reflected in the price."

Simmons also declares that "GM is relevant again for consumers, thanks to the new models out over the past two years, and their high design quality....Between the [lower] cost structure and improving products, the margins are bottoming and will start moving up."

The buyout and retirement offers that GM said last week had been accepted by 19,000 employees -- about 25% of its full-pay UAW workforce -- will result in a huge one-time charge that Wagoner is likely to disclose at the annual meeting. But they also will result in lasting cost reductions of perhaps $2 billion annually, beginning next year. A JPMorgan report estimates that the financial benefits may begin phasing in as soon as this August, and that 15,000 of the positions won't be filled and that the other 4,000 will go to tier-2 employees.

The program will also significantly trim the average age of GM's workforce for the first time in many years.

General Motors says that its spending on pension and health care will drop to $1 billion annually in 2010 from an average $7 billion over the past 15 years.

The UAW agreement allows the car maker to transfer about $46.7 billion in its future retiree health-care liabilities -- a huge albatross -- from its balance sheet to an independent GM-funded trust on Jan. 1, 2010. (There are legal challenges to this, but they're unlikely to prevail.)

This should provide $3 billion of the annual savings GM foresees. (The car maker long ago cut the costs of its white-collar workforce.) The rest will come from the more than 50% reduction in hourly wages and benefits for new hires in positions not directly related to manufacturing, such as cleaning factory floors.

Hourly wages and benefits for most of these "Tier-2" employees will be in the mid-$20s, versus up to $78 for traditional UAW workers. This should trim GM's across-the-board hourly labor average to about $55 from about $72 now, says Trust Company of the West analyst Carol Moreno. "Lower labor costs are probably the biggest advantage foreign-car companies have," she adds. "The labor deal is transformational." TCW has fattened its GM stake as the stock has slid. As of March 31, it had about 16 million shares.

The deal would narrow the gap with Toyota, whose hourly labor costs average about $47.50 to $55. Over all, it could save GM up to roughly $1,540 per vehicle, estimates Sean McAlinden, an economist for the nonprofit Center for Automotive Research in Ann Arbor, Mich.

What do these future cost cuts mean for profits and GM's stock valuation?

Not all of the savings will drop to the bottom line, of course, but Trust Company of the West analyst Moreno figures they're worth about $2.50-$3 a share. (GM has 566 million shares outstanding.) If the industry environment in 2010 is better than the current one, net could hit $5-to-$6 a share.

Flippin's Simmons has a $5-to-$7-a-share estimate for GM when the North American unit hits break-even, which is likely by 2010. Applying an eight multiple to $6, his estimate's midpoint, he sees the stock going as high as $45.

Both Moreno's and Simmons' forecasts are higher than the Wall Street consensus of $4 a share for 2010. Based on the consensus figure, GM's two-year forward price-earnings ratio is about four; an eight multiple is more typical for car makers. If GM makes it over the bridge of troubles to 2010, investors are likely to award it a traditional multiple, boosting its stock to $30.

GENERAL MOTORS IS mounting an engineering turnaround, too. As noted, the company intends to launch the Volt in late 2010 and is increasing its roster of conventional hybrids. In fact, contends R. Brent Byrne, CEO of Divi-Vest Advisors in Wayne, Pa., an improving "green" image is "the No. 1 reason to own GM." Says Byrne: "No other car company is running down the green highway as fast as GM."

With its popular Prius hybrid, Toyota leads the pack in its ability to make at least some money from relatively eco-friendly cars. But if the Volt succeeds -- and, yes, Wagoner's stated delivery deadline won't be easy to meet -- GM will steal a march on its big Japanese competitor.

Table: GM's Hopes

And, says Elizabeth Lowery, GM's vice president of environment, energy and safety policy: "The Volt is just a piece of it." She says that the company is launching eight hybrids this year -- more than any other company -- and 16 over the next four years.

If the Volt works as advertised, that could be a coup for a company that hasn't had one in a while. Consumers, particularly young ones, "want to get off fossil fuels," Divi-Vest's Byrne observes, arguing that a green image could raise GM's revenues substantially. Byrne has been buying GM stock as the price has fallen. Divi-Vest owns about 147,000 shares.

Ron Harbour, partner in charge of auto manufacturing at consultant Oliver Wyman, calls the company's quality improvement over the past five years or so "the most significant in history....There's no more quality gap to competitors."

In part this improvement owes to the huge styling gains the company has made under its vice chairman, Robert Lutz, and chief of design, Ed Wellburn. Rather than assign a new vehicle to one studio, GM now has several teams around the world come up with competing designs. Ironically, this has speeded up the design process, Wellburn tells *Barron's*, giving the engineers more time to focus on quality.

"Enormous" is the word that Csaba Csere, editor-in-chief of Car and Driver magazine, uses to describe GM's progress. "Their cars look good on the outside, have a luxurious sense inside and drive well," says Csere, whose publication used to routinely blast the General's vehicles. "Look at the new Malibu. It's selling well and for a much higher transaction price than the previous edition," he says, adding that GM's improving products will "absolutely" make a difference against competitors.

The Malibu's sharply rising sales -- 59,123 were sold in 2008's first four months, 22.5% above the total a year earlier -- are helping to shift GM's mix toward cars. In April, cars accounted for 47% of sales, versus 39% a year earlier, as SUV sales fell 17%, to 608,000 units, while auto sales dropped just 4%, to 450,000. At this week's annual meeting, Wagoner probably will announce that the company is accelerating that shift by curbing production of slow-selling trucks and boosting car output.

At the same time, GM seems to have realized that even a relatively modest engineering investment can pay off nicely. It spent 18 months modifying the base engine of the manual-transmission Chevrolet Cobalt, so that it now gets a class-best 25 miles per gallon in the city and 36 on the highway -- up from 24/33 previously, without any loss of horsepower. That should help sales of that compact car.

Right now, the shift in mix -- which GM President Fritz Henderson says sped up in May -- hurts because cars produce lower profits than sport-utility vehicles. Long-term, however, capitalizing on the shift is crucial for the company to survive, attract new customers and meet tougher fuel-economy and emission standards, particularly if oil prices really do soar toward $200 a barrel.

As for market share, Tom Libby, senior director of industry analysis at J.D. Power and Associates, expects GM to boost its domestic figure in 2010 to about 23% from around 22% now. (At its peak four decades ago, GM had almost 50%.) Better vehicles, like the coming Chevy Traverse crossover (a mechanical cousin of the elegant, popular Buick Enclave) are making GM more competitive, he says, at a time when there are virtually no new segments of the U.S. market for Asian manufacturers to enter. His controversial prediction: "The Asians have made all the gains they are going to make."

GM is growing strongly outside the U.S., where it now sells more vehicles than it does at home. Last year, its worldwide sales rose 3.1%, to 9,370,000, giving it 13.3% of the global car market.

David Kudla, the chief investment strategist of Mainstay Capital Management, which oversees some 401(k) accounts for GM employees, says that the Detroit giant's "real opportunity is abroad and particularly in emerging markets....It's truly phenomenal." In the first quarter, he notes, 64% of the company's unit sales came from outside the U.S., and pretax profits in Latin America, Africa and the Middle East doubled to $517 million. China and Brazil are now, respectively, General Motors' second- and third-biggest markets.

Henderson says that unit volume outside the U.S. will be "consistent" with the good showing seen in the first quarter.

Sean McAlinden, the economist from the Center for Automotive Research, says that GM "has finally gotten the message" about employing its global scale and using common vehicle platforms around the world. Its "potential for growth [in the rest of the world] is better than Microsoft's," he quips, referring to the hundreds of millions of potential buyers in emerging lands.

TO KEEP GROWING ABROAD, GM must weather its domestic problems. In the first quarter, it burned through $3.4 billion of its cash reserves -- $2.1 billion of which it attributes to the American Axle strike -- to end with $23.9 billion, down from $27.3 billion on Dec. 31. GM also has $7 billion in undrawn lines of credit, giving it about $31 billion in liquidity. Two or three similar quarters would bring back bankruptcy worries. It's crucial that GM keep its cash pile above $18 billion or so, at least until mid-2009, when the coming labor cost cuts will become more visible to the market.

Barron's Online Editor Rich Rescigno says GM's battered stock is finally worth investors' attention. (May 30)

Admittedly, analysts have a hard time projecting GM's cash levels at the end of 2008 because of all the uncertainties, but the company is likely to finish the year with at least $20 billion.

John Casesa of Casesa Shapiro Group, an industry advisory firm, says that GM's liquidity appears adequate for the next two years or so. But he warns that if 2008 industry sales are as weak as indicated by April's figures, the shift to cars from SUVs accelerates and GM's results don't soon improve, the company might be forced to raise more capital.

GM could raise more cash through the equity or credit markets. With the credit crunch having eased a bit, a bond convertible to equity is doable, Casesa says. But selling stock would dilute existing shareholders' interests, and peddling bonds would add to the company's $110 billion long-term debt burden (including $47 billion that will be eliminated after the health-care trust is formed). General Motors could also close more plants, eliminate some slow-selling models, sell assets and cut its $1-a-share dividend, which costs it $566 million annually. (Some analysts expect this to happen soon.)

AS FOR GMAC, though it lost $589 million in the first quarter thanks to ResCap's woes, it still earned $258 million on auto financing and has about $19 billion in liquidity. ResCap is in serious trouble, but won't hurt GM's auto results. Says Shelly Lombard, a credit analyst with Gimme Credit: "If ResCap goes away today or tomorrow, it doesn't have any effect on GM besides forgone profits and the loss of GMAC value. GM isn't going down with ResCap."

Nonetheless, for every potential positive for General Motors, there's a potential negative. That's what makes the stock so risky. Anyone contemplating betting on it should realize that results may get worse before they get better next year. Soon-to-be released May U.S. auto sales numbers will be ugly, and might push the stock below the current 17 and change, providing an attractive buying point.

But picking an exact turning point in the economy or a stock is a rube's game. The short-term factors are out of GM's control, but 12 months from now, the economy should be past the hump. More important, "looking three to five years down the line," argues Casesa, "the factors GM can control -- labor costs, global scale and brands, and improved products -- will win out."

So while GM's 100th birthday party might not be particularly festive, its 102nd could be quite a bash.

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