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CARNAGE IN THE AUTO INDUSTRY – MAKING A SHOPPING LIST

It seems that one of the few areas of the stock market where clear signs of distress are beginning to be factored into stock prices is the automotive sector. Structural issues with the Big Three automakers such as enormous healthcare and pension obligations, as well as expensive unionized workforces and bloated layers of management have combined with uninspiring product lines (think gas-guzzling SUVs) and strengthening foreign competition to create a lethal mix for any equity even remotely related to the U.S. auto sector.

GM and Ford have made matters worse as they have morphed into overly-aggressive banks, so desperate to move cars off lots, that they offer silly 0% financing, employee pricing, and other heavily discounted financing plans which have done nothing more than steal from future years' sales to keep factory lines running today and avoid production cutbacks and market share loss. Well, now we find out that if you dangle cheap financing for long enough, then eventually all the fence-sitters looking to buy a car will have bought and the marginal buyer will go away as recent sales weakness and production cutbacks indicate. Regression to the long-term trend-line of car sales seems inevitable. Before this is all over we expect car sales could collapse in North America to not much more than 13.5-14 million units, which is barely above the industry scrap rate for old and damaged cars. This type of 20-30% unit contraction has often been seen in past auto recessions. Sub-14 million cars sold in a year would be a far cry from the slightly under 16 million light vehicle units expected to be sold in 2006 by industry group CSM.

The beginnings of such dramatic auto industry slowing have not gone unnoticed by the ratings agencies. S&P, Moody's, and Fitch have all cut Ford and GM to "junk" status. These companies' credit spreads in the bond market are now pricing in default as a very real possibility. Even Wall Street has started to wake up and smell the reality as both GM and Ford's stock prices have been pummeled to multi-decade lows as shown below:



Make no mistake about it, we think that the North American auto industry (and its suppliers) will get far worse before it gets better, but we think now is the time to make a shopping list. We think the blood will soon be spilled in the streets and that people will flee the sector in an even greater mass exodus making it possible for value investors to scoop at shares at very depressed prices. The Big Three and most major foreign car manufactures hold little appeal to us with the exception of perhaps Kia, but that is a story for another day. What we are most excited about in terms of trying to play the eventual auto industry rationalization and recovery in North America is a handful of well run auto suppliers.

Supplying parts to the Big Three North American auto manufacturers is about as difficult a task as one could ask for. You see, GM, Ford, and DaimlerChrysler, thanks to their tremendous clout, can (and do) without hesitation demand continuous annual cost savings from their suppliers, which dig deep into the already meager margins that most auto suppliers sport. Making matters worse is that since the late 90s, the threat of the Big Three sourcing parts from overseas, namely China and other low cost geographies, is now a reality. The game has changed for many auto suppliers. In many respects, their business models and capital structures have become obsolete nearly overnight.

Automobile manufacturing is a very capital intensive business and, for the suppliers in most cases, it is very expensive to own and maintain the heavy machinery and tooling required to churn out the parts the Big Three need for their cars and trucks. Hence, the return on assets (ROA), which is simply net income divided by the total cost of the assets one deploys, is appallingly low for the auto industry. ROAs through the cycle of 3-5% are quite common if not generous. To boost returns, most auto suppliers must reach for that four letter word "debt." By leveraging the balance sheet and effectively letting its bankers and creditors finance a great deal of their capital expenditures, 3-5% ROAs can be turned into a 10-15% returns to equity (ROEs) and everyone is happy. Unless, of course, the industry faces a downturn and margins are under severe pressure at the same time one's fixed cost structure has just gone up a great deal due to interest expense. The rash of bankruptcies from major North American auto suppliers such as Delphi, Tower Automotive, Collins & Aikman, J.L. French, and Dana is just the tip of the iceberg in our opinion. Levered time bombs (like Dura, Visteon, Exide, Hayes Lemmerz, and others) appear as possible candidates to help bankruptcy lawyers collect more of their outrageous fees.

The beauty of the continued carnage in the automotive supplier industry is that the good companies will likely be taken out and shot with the bad, irrespective of their better businesses. Sure, if the auto industry totally melts down, as we fear, then the lowering tide will lower all ships, but automobiles in the U.S. are not going away and though a greater portion of parts and supplies will come from Asia going forward, we think a select group of North American suppliers will be well positioned to grow after the industry shakeout. And should Mr. Market continue to beat their stocks with an ugly stick, we expect at some point to become large buyers of certain auto supplier shares.

The two fairly liquid auto suppliers we will talk about are Superior Industries (ticker: SUP) and Gentex Corp. (ticker: GNTX). The reasons we like these two companies over most of the other auto suppliers are 1) great balance sheets, 2) strong competitive positionings (high historical ROAs), and 3) quality managements with a history of making money. Below, we have presented snapshots of Superior and Gentex and why we would love to own them at the right price.



Superior Industries (ticker: SUP)

Stock Price:	\$19.46	Shares Outstanding:	26.610 mil
Market Cap:	\$517.9 mil	Dividend Yield:	3.3%
Net Cash and Investments:	\$107.3 mil	Net Cash / Mkt Cap:	20.7%
Net Cash per Share:	\$4.03		

Superior - 10 Year Summary

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Sales	504.2	549.1	539.4	571.8	644.9	643.4	782.6	840.3	901.8	844.9
Net Income	46.9	55.4	52.3	70.8	79.9	55.4	78.3	73.7	44.7	-7.1
EPS	\$ 1.63	\$ 1.96	\$ 1.88	\$2.62	\$3.01	\$2.10	\$2.91	\$0.73	\$1.67	\$(0.27)

Insider Ownership: 22.0%

Business Description:

Superior supplies aluminum wheels to Ford, General Motors, DaimlerChrysler, Audi, BMW, Isuzu, Jaguar, Land Rover, Mazda, MG Rover, Mitsubishi, Nissan, Subaru, Toyota, and Volkswagen. Aluminum wheels are roughly 60% of the OEM market with steel wheels being the other 40%. Aluminum wheel sales on the back of Superior's results have been taking share from steel over the last decade though the gains have been more subdued of late. Big Three sales are still the vast majority of Superior's sales, but they have carved out the dominant niche in high end aluminum wheels seen on many luxury cars. Superior is exiting its unprofitable start-up aluminum components business and after some delay is rapidly moving more of its production to low cost geographies in Mexico and eastern Europe. Its chief competitor is Hayes Lemmerz, which focuses on steel wheels. Hayes is again under severe financial pressure as its 2 buck stock price will attest. Unlike Superior, Hayes is struggling to scrape together the cash needed to move its production to low cost geographies. Superior has been very conservatively and profitably run by its founder, Louis Borick, for many decades. His son recently took over as CEO with Lou Borick now chairman. The Borick family owns a little over 20% of Superior's stock.

Investment Thesis/Risks:

Starting with the balance sheet, we see that Superior has \$107.3 million in net cash and investments (no debt) on its balance sheet. Finding an auto supplier with no debt is a rare feat, but finding a historically very profitable auto supplier with over 20% of its market cap in net cash is rarer still. On a \$19.46 stock price the company has \$4.03/share in cash backing, which is not too shabby. CEO, Steven Borick, noted last week in his Q4 2005 results commentary that, "We have the financial power to stay the course." We would whole-heartedly agree with that statement, especially with its largest competitor Hayes Lemmerz looking like it may file bankruptcy for a second time in less than 5 years. Superior is currently at a 52-week low and Street analysts are tripping all over themselves to cut their ratings on the company - a nice contrarian indicator.

The closer Superior trades to its net cash per share balance, the less and less Wall Street is assigning in value to the operating business and the higher one's margin of safety. We think the business clearly has



some value given its demonstrated track record of profitability and leading position in the aluminum wheel business. Precisely gauging what the company will earn going forward is likely not possible. Will Superior get back to making 3 bucks a share anytime soon? We doubt it. Will earnings more likely shake out somewhere between 1-2 bucks per share per annum? Sounds more reasonable. Will the company's 2005 losses continue indefinitely? While there is, of course, some remote possibility, we think it is unlikely. Marginal players and those that are thought to be accepting unprofitable contracts in the hopes of avoiding bankruptcy will have their day of reckoning. The company has a great balance sheet to ride out the downturn, in the meantime an even higher percentage of the company's production capacity is being moved to low cost geographies in Mexico and eastern Europe, and it maintains the dominant aluminum wheel share.

Gentex (ticker: GNTX)

Stock Price:	\$16.96	Shares Outstanding:	157.031mil
Market Cap:	\$ 2,663 mil	Dividend Yield:	2.1%
Net Cash and Investments:	\$ 639.5 mil	Net Cash / Mkt Cap:	24.0%
Net Cash per Share:	\$4.07		

Gentex - 10 Year Summary

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Sales	148.7	186.3	222.3	262.2	297.4	310.3	395.3	469	505.7	536.5
Net Income	24	35.2	50.3	64.9	70.5	65.2	85.8	106.8	112.7	109.5
EPS	\$ 0.17	\$ 0.25	\$ 0.34	\$ 0.43	\$ 0.47	\$ 0.43	\$ 0.56	\$ 0.69	\$ 0.72	\$ 0.70

Insider Ownership: 5.9%

Business Description:

Gentex has the dominant share (78%) in high-end rear-view mirrors that automatically dim to reduce glare. Secondary and tertiary businesses for the company include LED turn signals and fire protection alarms. If we are to believe the stats, just 18% of the 59 million vehicles produced annually around the world have an interior electrochromic mirror and just 5% have an auto-dimming exterior mirror. Gentex believes that its target market may reach \$2.5-\$3.0 billion in sales annually with the company having the lion's share of those sales.

Investment Thesis/Risks:

Gentex is the market leader in dimming rear-view mirrors commanding over 75% of the market. The next closest competitor is Magna Donnelly at 20%. Though, like all auto suppliers their margins have been pressured by OEM production cutbacks, they have still held up very nicely. Despite being a down year in terms of EPS growth, the fiscal year 2005 still sported a greater than 20% net margin which speaks to Gentex's wide moat around their mirror technology. Competition does exist, but to date has proved pretty lacking. Gentex's technology is not easily duplicated and cost savings overseas are not really as great an issue as with other automotive suppliers given the high tech content of mirrors and the minimal tooling. Likewise, Gentex has done a better job than most domestic suppliers of penetrating foreign car manufacturers. Some 51% of GNTX's sales come from Asia-Pacific and Europe and the company is largely in bed with the foreign manufacturers that annually take share from the Big Three.



Gentex's balance sheet is pristine with over 24% of the \$2.66 billion market cap residing in cash and investments. The company has used excess free cash flow to buy back stock, increase dividends, and expand into other markets like LED turn signals all the while driving mirror R&D. Management pay is fairly reasonable and though we would prefer a Superior-like 22% insider ownership, GNTX's 5.9% is adequate.

Gentex seems to have flat-lined around 70 cents in earnings which, along with 4 bucks a share in cash, support a \$17 stock price. But it doesn't argue that GNTX's stock is tremendously cheap at these levels; rather, GNTX is fairly valued. Over time, we would expect auto-dimming mirrors to make their way onto higher and higher percentages of interiors and exteriors. GNTX's moat seems wider than perhaps any other auto supplier we have come across and we await a sell-off to scoop up shares of this high quality company at a bargain price. The nice thing about all their cash is if the stock were to get hit more with the rest of the sector, the company can step up their buybacks great deal.

We suggest you put Superior and Gentex on your radar screen and watch the auto sector with a close eye.

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