ANDERSON ECONOMIC GROUP

Memorandum

Date: November 25, 2008

To: Auto Crisis Advisory Clients of Anderson Economic Group LLC

From: Patrick L. Anderson, Principal & CEO
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Re: Short-term Scenarios for Detroit 3 Automakers;
Rationalization Options including Mergers, Chapter 11, and Liquidation;
Opportunities for Competitors and Investors;
Possibilities and Risks of Federal Gov't Involvement

November 25 Report

I. Executive Summary

a. Introduction

The US automakers have been restructuring their operations over the past two years at a pace much faster than at any time in recent history. However, events moved against them very quickly in the fall of this year. Although the metaphor has been abused recently, it is indeed the worst crisis since the Great Depression for the domestic industry.

Although the industry crisis became front-page news in November, we concluded that the Detroit 3 could not survive in their current form much earlier in the year. Our October report on the proposed GM-Chrysler merger, issued before the election, before the dramatic reduction in fall-season sales became public knowledge, and before the recent Congressional hearings, outlined the dwindling options available to the Detroit 3, particularly Chrysler LLC.

This report updates our analysis using information that has since become available. It discusses in some detail the likely scenarios for the Detroit 3 Automakers; their available options, including mergers, Chapter 11 bankruptcy and Chapter 7 liquidation; the likely impact on employment and earnings in selected areas of the US; the opportunities the situation presents to competitors and investors; and the possibilities and risks of Federal government involvement.

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b. Cause of the Crisis; Magnitude Worsening

While domestic automakers have been struggling and losing market share for several years, the current economic crisis has sent vehicle sales plummeting. Based on the first three quarters of 2008 sales, AEG projects annual sales will be less than 13.5 million units, down from 16 million units in 2007 and from a post-2001 trend of 17 million vehicles per year. Per capita sales are at their lowest levels since World War II. However, the trigger for the crisis is the prohibitively damaging rate of sales that has persisted since September: approximately 10.5 million units per year. That is roughly a 40% reduction in sales—a reduction that cannot be accommodated alongside the survival of all OEMs in operation today.

The magnitude of the crisis was publicized by two events.

- On November 7, GM announced that its cash reserves could fall below the minimum required to satisfy covenants with key lenders, and that the "minimum" cash position could be breached early in 2009. This was language that no one in the current generation could recall being used by GM executives. Subsequently, the company confirmed that the GM board had discussed bankruptcy, although had rejected it.
- The Detroit 3 CEOs, along with the UAW President, went to Capitol Hill to lobby Congress for Federal assistance in the week of November 20. The harsh reception they received—including repeated tongue-lashing about such topics as the use of private planes, their failure to improve fuel economy fast enough, the apparently poor service received on a Congressional spouse's car, and other matters both trivial and momentous—was a stunning rejection of that plea, and a rude awakening to the lack of political capital the industry had in Washington.

By the close of this disastrous week, the Detroit 3 were given, in effect, an ultimatum: "submit" restructuring plans that satisfied the House and Senate leaders, or forget about any aid. All three have indicated they would submit such plans to Senate Banking Committee Chairman Christopher Dodd and Financial Services Committee Chairman Barney Frank by December 2. As of this writing, House and Senate hearings on these plans are scheduled for the first week of December; with the possibility that Congress would be called back into session to consider legislation aiding the following week.

These events cannot have a positive effect on consumer confidence in the automakers, let along creditors, suppliers, and others. In short, the political events have worsened the already bad financial conditions the automakers face.

c. Possible Scenarios

In October, we stated that no *status quo ante* scenario was available. The worsening conditions in November have made this more clear. We believe there are now essentially six possible scenarios, half of which depend on a commitment to Federal financing made before the end of January:

Scenarios with Commitment to Federal Assistance by January 2009

1. *Federal bridge loan and a GM-Chrysler merger*
2. *Federal bridge loan and radical restructuring outside of bankruptcy*
3. *Federal bridge loan and radical restructuring outside of bankruptcy for GM and Ford; Chrysler assets purchased by competitors.*

Scenarios without Commitment to Federal Assistance by January 2009

4. *Chrysler files for Chapter 11 bankruptcy; GM & Ford restructure outside bankruptcy*
5. *Both GM & Chrysler file for Chapter 11 bankruptcy*
6. *All Detroit 3 file Chapter 11, along with major suppliers*

Note that none of these scenarios avoid radical restructuring of the automakers. Although it is difficult to predict how Congress will act in December, we do believe the Federal government will ultimately come to the conclusion that federal financing of a restructuring of the domestic automobile industry (such as financing the merger of GM and Chrysler) would be much less costly to the taxpayer than a series of bankruptcies.

d. Specific Conclusions

1. *There remains no status quo ante scenario—even with Federal financing*

   The primary trigger for this crisis is a drop in sales demand, not credit conditions. The US economy could barely support the Detroit 3 when it was consuming 15 million units per year; it cannot support three Detroit-based automakers with demand below 12 million. Current demand is closer to 10 million units.

   Although it has largely been absent from news reports, the current rate of sales will probably push one or two non-Detroit brands out of the marketplace as well.

2. *Bankruptcy is a real possibility*

   There has been some conjecture that bankruptcy was not a real option. Unfortunately, bankruptcy for Chrysler and GM are not only options, they are probabilities without some type of Federal financing assistance in the near term.

3. *A successful Chapter 11 bankruptcy for the automakers requires three unusual elements*

   Some of the most critical statements by the CEOs to Congress were on technical matters involving bankruptcy. In particular, Mr. Wagoner stated that he expected a GM bankruptcy would become a Chapter 7 (liquidation) event, not a Chapter 11 (reorganization) process. Mr. Nardelli said that Chrysler had already rejected the idea of a "prepackaged" bankruptcy. Mr. Mullaly said that Ford had "rejected" the notion of bankruptcy.

   Our analysis is consistent with Nardelli's observation that a "prepackaged" bankruptcy would be a failure. Indeed, we see no available "package" for such a huge bankruptcy. Instead, we recognize three key elements for a successful Chapter 11 reorganization of any of the automakers:

   i. A warranty fund for consumers, both current owners and prospective buyers

   ii. Support for payments to dealers for warranty work and incentives

   iii. Support for key Tier I and Tier II suppliers

   We disagree with analysts that compare a GM bankruptcy with, say, one involving an airline. The franchise and warranty nature of the automobile industry makes continued business relationships much more important than for an industry that largely sells one-time purchases.

4. *Federal financing carries real dangers*

   The December 2 submission of "plans" by the automakers carries serious risks. A simple examination of the rhetoric used at the Congressional hearings reveals many of these risks: the executives were pilloried about service on a spouse's used car; their use of planes; minority dealer support; environmental consciousness; and other issues. The planes are the smallest of these concerns.

   Any restructuring plan with a chance of success must include all the items listed under "elements of a successful Chapter 11 reorganization," and a restructuring that will require the elimination of many plants, brands, and employees. Few of these will be considered politically acceptable to a Democratic-dominated Congress.

5. *The bankruptcy of one Detroit Automakers could allow the others to survive*

   It is clear that the network of suppliers, and the "just in time" production system adopted in the 1980s, will place huge stress on the supplier network if just one OEM went bankrupt. However, we believe that a single bankruptcy, if it was accompanied by the elements listed above, would not pull down the other two OEMs.

6. *One or two surviving Detroit-based OEMs could prosper in the future*

   The situation is dire for the automakers, but we disagree with the notion that the entire industry is a herd of "dinosaurs" or that the Detroit 3 do not produce vehicles Americans want. In fact, they produce lots of vehicles Americans (and, particularly for GM, others in the world) want. One or two surviving Detroit-based automakers, with a significant restructuring, could become quite profitable companies producing a smaller set of vehicles through a streamlined dealer network.

   Indeed, investors should be aware of opportunities that will arise over the next 18 months in this industry. After the current recession passes, it is likely that the American consumer will again purchase 15 and even 16 million units of vehicles again. We expect many of these to be produced by profitable companies, some of which are headquartered in or around Detroit.

e. About Anderson Economic Group

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