McDonald Investments

MORNING CALL DAILY

Automotive Industry — *Why Now Is the Time to Start Buying Auto Stocks*

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Investment Summary

- Earlier this year we warned of a 'round trip' for auto stocks suggesting that while they may rise near term, we believed they would fall again later in the year due to concerns about auto sales and profitably. Subsequently auto stocks did rise driven primarily by interest rate cuts and stronger than expected auto sales. Then they fell. First, as a result of Ford Motor Company's announcement on August 17, 2001 that essentially they wouldn't be as profitable. Secondly, as a result of the significant rise in unemployment reported on September 7, 2001, pointing to a weaker economy, which increased concerns about the sustainability of auto sales. Even prior to the events of September 11, 2001 the stocks had effectively returned to the levels they were at when we wrote our first report…a round trip.

- The good news is this has clearly created a buying opportunity for investors, since historically the best time to buy auto stocks is when economic conditions are deteriorating and valuations are low. In order to demonstrate how auto stocks perform over a cycle, we have charted the performance of our NAASCAR auto parts supplier index vs. nineteen economic factors during the periods from January 1980-December 1982 and January 1990-December 1991, which mark the last two significant declines in auto sales. For comparison purposes, we have also included charts for the period from January 1999-Present. What is clearly evident in these charts is that auto stocks consistently declined in the face of significantly deteriorating economic conditions.

- So why start buying auto stocks now? Because, despite worsening economic conditions, auto stock prices have also historically rebounded prior to an economic recovery in anticipation of better economic conditions in the future. Here again we have used the previously mentioned charts, which clearly show that during both downturns that auto stocks 'bottomed' and began to rebound some one to six months before these nineteen factors 'bottomed.' In other words, as 'early cycle' stocks they began to move up while economic conditions continued to deteriorate in anticipation of the eventual economic recovery.

- That said, given today's valuations, it's difficult to tell if today's investors are looking beyond the sales trough early or simply optimistic about auto sales. Why? Because on a valuation basis, many of the auto stocks are still a ways above what we estimate to be their 'lowest stock price', suggesting that significant downside risk still exists for some stocks. Why are some stocks hanging in there? Frankly were not sure. It could be because the market is choosing to look 'across the trough' and is, therefore, already discounting a recovery. On the other hand, the market could simply be optimistic about auto sales. While uncertain, we tend to believe the later is the case, and as such also believe there will be another 'leg down' for many of these stocks since we also believe that auto sales over the next several months will be worse than most investors truly anticipate.

- Regardless of current valuations, it's clearly the right time in the cycle for longer-term investors to begin considering buying auto stocks. So what should investors do? In our opinion, they should begin by making the easy decisions

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first, like narrowing the down the choices by simply eliminating those stocks which don't meet their investment criteria based on market capitalization, financial leverage, dividend yield, etc. Secondly, we would recommend determining the valuation or, more specifically, price levels at which each of the remaining stocks becomes attractive. Finally, we would be looking entry points to begin building a position in these stocks over the next several months.

- Why not buy it all now? In the real world, portfolio managers must not only decide when to buy or sell stocks, but also determine how much to buy or sell. Given our bearish outlook, we believe there is a good possibility that valuations will decline further. That being said, there is no guarantee this will happen, nor is it a certainty that investors won't simply look past a 'rougher near term ride' causing valuations to remain unchanged, or even rise. Therefore, we believe the prudent investment strategy would be to build a position over the next several months taking advantage of any weakness over that time.

- So what looks attractive today? While there is clearly a difference in the quality of companies out there, in order to answer this question we have focused our attention primarily on two factors: valuation and liquidity.

- **Valuation.** From a valuation perspective, we are primarily concerned with 'How low or high could the stock go?' Our approach has been to first estimate probable low and high stock prices based on the historical range, 1989 to present, of a variety of valuation metrics focusing primarily on Price/Operating Cash Flow, Price/Book Value and Enterprise Value/Sales. The result of this analysis is an approximate low and high stock price for each company that can be used to evaluate the downside risk and upside potential. Could a stock go lower or higher? Of course, but it would also be setting a new or 'record' high or low on a valuation basis.

- **Liquidity.** It's often said that cash is king and based on our conversations with various debt and commercial lending officials, it's very clear that one of the most important things a company facing an industry downturn can have is ample liquidity. We define liquidity as access to capital or cash and, given our bearish outlook, liquidity is of paramount importance for auto companies at this time. Having access to cash is necessary, not only to fund working capital needs, but also to launch new products and sustain research and development efforts that should benefit a company coming out of the down cycle.

- Using this combination of valuation (i.e. downside risk vs. upside potential) while screening out those companies with notably higher financial risk (i.e. potential liquidity concerns during a significant downturn) we believe four stocks look particularly attractive today. **We are, therefore, upgrading three of these stocks, SUP, TRW and DCN, to BUY (2) from HOLD (3)** today as well as initiating coverage on DPH with a BUY (2) rating, for which a separate note has been published today.

- Given our bearish outlook we believe that the fundamentals for this group will continue to deteriorate for the next quarter or two at least and will most likely be worse than the market anticipates. As such, we believe there is a good possibility that valuations will decline further. If valuations were to decline further there are clearly a number of other stocks, namely ARM, BWA, GNTX, JCI and LEA, which could begin to look attractive based on our valuation work. However, at this time we have a difficult time recommending these stocks primarily based on the level of downside risk we estimate exists for these stocks.

Detailed Report

- **Section 1. Earlier This Year We Warned Of A 'Round Trip' For Auto Stocks Suggesting That While They May Rise Near Term, We Believed They Would Fall Again Later In The Year Due To Concerns About Auto Sales And Profitably…** Earlier this year we wrote two reports titled "Why We Wouldn't Buy Auto Stocks Just Yet. Parts 1 &

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2." Without going into great detail these reports sited two primary reasons why we believed auto stocks would be a 'round trip' ride for investors this year as follows:

- **Part 1 – Declining Auto Sales.** Our first piece titled "Why We Wouldn't Buy Auto Stocks Just Yet. Part 1" was initially published on March 8, 2001. In it, the first section began by pointing out the relationship between auto stock performance and the rise and fall of interest rates. Specifically, the annualized return of our NAASCAR Auto Parts Supplier Index was up 23% during periods in which the Fed was easing, and down 12% during periods when the Fed was tightening. Section two sited the major exception to this general rule, which is that a significant decline in auto sales has historically caused valuations to bottom for the group, regardless of the Fed easing. Section three presented our rationale for why we anticipated a significant decline in auto sales later in the year siting a number of economic indicators. At that time we very loosely thought we would begin to see signs of weakening sales by August 2001. Section 4 summed things up by suggesting that as long as auto sales remained strong, and the Fed kept easing, auto stocks would perform well. However, we also believed that the 'run' as it were would come to a sudden end when investors became skittish about auto sales.

- **Part 2 – Deteriorating Profitability.** Our second piece titled "Why We Wouldn't Buy Auto Stocks Just Yet. Part 2" was initially published on May 31, 2001. In this piece, we began by sighting what we believed to be one of the primary reasons for the dramatic rise in sport utility vehicle (SUV) sales – affordability. Simply put, higher residual values for SUVs resulted in lower monthly lease payments enabling the average mid-size car buyer, for example, to lease a more expensive SUV for the same monthly payment. Section two showed the dramatic impact that higher SUV sales have had on automaker profitability estimating that the segment alone contributed nearly 50% of the automakers variable profits in 2000. Section three noted that the picture was changing. Specifically, that Automotive Lease Guide (ALG), after years of maintaining higher residual values, was finally lowering residual values due to the significant decline in used SUV prices as off-lease volumes rose. Section four points out that lessors, who have been shellacked by residual losses in recent years, in effect 'subsidized' SUV purchases and consequently automaker profitability. We also speculated that many would exit the business. Section five suggested that the combination of lower residual values and the decline in the number of lessors (i.e. aggressive competition) would have a significant impact on automaker profitability resulting from either 1) lower SUV volumes or 2) higher incentives in order to keep monthly payments affordable. On the supplier side of the equation, a decline in volumes would clearly impact them directly, while an increase in incentive spending and subsequent decline in profitability would raise investor concerns about industry profitability negatively and increased pricing pressure.

- So what's happened? Auto stocks initially rose in the early part of the year as auto sales remained stronger than expected. Then, on August 17th, 2001, Ford Motor Company essentially announced they weren't going to be as profitable as they thought they would be causing auto stocks to take their first major hit…hence "Why We Wouldn't Buy Auto Stocks Just Yet. Part 2." The second shoe fell on September 7th, 2001, as the monthly unemployment number surged to 4.9% raising investors concerns about a decline in auto sales…hence "Why We Wouldn't Buy Auto Stocks Just Yet. Part 1." All of this took place prior to the events of September 11th, 2001, causing auto stock prices to decline from their summer highs back to where they were in March…i.e. a round trip.

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Table 1. Auto Parts Supplier Stock Prices

Company	Ticker	Stock Price Mar 8, 2001	High	Sep 10, 2001	% Chg. Mar 8 to Sep 10
ArvinMeritor	ARM	$15.28	$21.87	$16.10	5%
BorgWarner	BWA	$45.81	$55.19	$48.58	6%
Dana	DCN	$19.95	$26.57	$18.24	-9%
Gentex	GNTX	$27.25	$34.23	$28.00	3%
Johnson Controls	JCI	$70.19	$81.70	$70.05	0%
Lear	LEA	$34.49	$42.40	$33.85	-2%
Superior Industries	SUP	$37.20	$44.85	$36.80	-1%
TRW	TRW	$40.20	$45.45	$33.89	-16%
Average					**-2%**

Source: ADP; McDonald Investments estimates.

- **Section 2. …Creating A Buying Opportunity For Investors, Since Historically The Best Time To Buy Auto Stocks Is When Economic Conditions Are Deteriorating And Valuations Are Low…** So why look at auto stocks today when the United States economy is most likely in a recession and auto sales seem to be heading South, possibly in a big way, in the near term? Because, historically, the ideal time to buy auto stocks is when economic conditions are deteriorating and valuations are low.

- **Deteriorating Economic Conditions.** In order to demonstrate how auto stocks perform over a cycle, we have charted the performance of our NAASCAR auto parts supplier index vs. nineteen economic factors during the periods from January 1980-December 1982 and January 1990-December 1991, which mark the last two significant declines in auto sales. For comparison purposes, we have also included charts for the period from January 1999-Present. What is clearly evident in these charts is that auto stocks consistently declined in the face of significantly deteriorating economic conditions. We have organized these nineteen economic factors into six categories: Consumer, Employment, Stock Market, GDP Growth, Consumer Price Index and Interest Rates.

- **Consumer.** The consumer factors include consumer confidence, consumer expectations, consumer sentiment, new vehicle SAAR, housing starts, new home sales and existing home sales. The charts of each of these factors suggest a close relationship between the NAASCAR index and the performance of these factors during a downturn. Simply put, as these factors deteriorated, auto stock prices headed down.

- **Employment.** Employment factors include average workweek hours, manufacturing workweek hours, initial unemployment claims, the unemployment rate and The Conference Board's Help Wanted Index. Here again the story is consistent. As economic conditions deteriorated (i.e. lower hours, higher unemployment, etc.) so did auto parts stock prices.

- **Stock Market.** The comparison here is simply with the S&P 500, whose performance looks strikingly similar to that of the NAASCAR index during the last two downturns with the market declining along with the economy.

- **GDP Growth.** The GDP Growth category compares quarterly GDP Growth vs. the NAASCAR index and while quarterly GDP Growth bounces around some, the two bottomed within months of each other.

- **Consumer Price Index.** This category includes the year-over-year change in CPI as well as gasoline and used vehicle prices (CPI) charted against the NAASCAR index. While there does not appear to be a strong relationship vs.

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either gasoline or used vehicle prices and the NAASCAR index, the year-over-year change in CPI was rising while stock prices declined in both periods.

- **Interest Rates.** This category includes both the Federal Funds Target Rate and the spread between the 1-year and 10 year treasury yields vs. the NAASCAR index. In these two instances there is little discernable relationship between auto stock performance and these factors during a downturn.

- **Valuation.** What the above charts also show is the fact that historically auto stock prices not only declined in the face of significantly deteriorating economic conditions, they also fell to historically low valuation levels. In our report titled "Why We Wouldn't Buy Auto Stocks Just Yet. Part 1" published on March 8, 2001, we go into a great deal more detail to demonstrate this fact. Suffice it to say here, that since 1980 auto stock valuations bottomed in the early 1980s and 1990s in conjunction with the significant decline in economic conditions and automotive sales.

- **Section 3. …Because, Despite Worsening Economic Conditions, Auto Stock Prices Have Historically Rebounded Prior To A Recovery In Anticipation Of Better Economic Conditions In The Future…** Great, so auto stocks have historically declined to their lowest valuation levels in the face of significantly deteriorating economic conditions, so why start buying now? Because while the above is true, auto stocks have also historically started to rebound prior to any improvement in these same economic conditions.

- **Consumer.** While the consumer factors appear to be tied pretty close to the NAASCAR index in general, they often lagged the parts supplier index bottoming either the same month or within one to three months after the parts supplier index bottomed and began to move up.

- **Employment.** Here there are two distinct stories. With regards to average workweek hours, manufacturing workweek hours and initial unemployment claims each of these indicators continued to decline after the NAASCAR index began to move up with each bottoming some two to six months after the parts supplier index. The unemployment rate and help wanted index, on the other hand, continued to deteriorate for a year or two after the NAASCAR index started to rebound.

- **Stock Market.** As mentioned previously, the S&P 500 appeared to most closely resemble the NAASCAR index effectively rebounding in the same month as the parts supplier index. Therefore, historically, if you were able to pick the bottom of the S&P 500, you also picked the bottom of the auto parts index.

- **GDP Growth.** Unfortunately, with respect to GDP Growth, since it is only reported on a quarterly basis, it does not make for a great indicator. In both the early 1980s and 1990s GDP Growth bottomed one month after the NAASCAR index began to recover.

- **Consumer Price Index.** Hear again, gasoline and used vehicle prices (CPI) are of little use. However, the year-over-year change appears to be helpful in that it peaked at same time the NAASCAR parts index bottomed in both 1980 and 1990.

Interest Rates. Sorry, no help here, folks.

- **Section 4. …However, Given Today's Valuations, It's Difficult To Tell If Today's Investors Are Looking Beyond The Sales Trough Early Or Simply Optimistic About Auto Sales…** So where are we at today? Tough to say exactly. Clearly this has not been a 'classic' post war downturn, which is typically consumer lead followed by a decline in the industrial side of the economy. Instead we have seen the reverse. That said, we are seeing a decline in consumer spending in general, the notable exception being auto sales…for now (See our October 29, 2001, note

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titled ‘Buyer Beware: Rising Used Car Inventories Will Hurt Future New Car Sales’). Auto stocks themselves were clearly on the decline prior to the September 11, 2001 terrorist attacks, falling significantly immediately after the attacks, then regaining some of the lost ground by mid October.

- Still, on a valuation basis, many of the auto stocks are still a ways above what we estimate to be their ‘lowest stock price’, suggesting that significant downside risk still exists for some stocks. Why are some of these stocks hanging in there? Frankly were not sure. It could be because the market is choosing to look ‘across the trough’ and is, therefore, already discounting a recovery. On the other hand, the market could simply be optimistic about auto sales. While uncertain, we tend to believe the later is the case, and as such also believe there will be another ‘leg down’ for many of these stocks since we also believe that auto sales over the next several months will be worse than most investors truly anticipate.

- **Section 5. …Regardless, It’s The Right Time In The Cycle For Longer-Term Investors To Begin Buying Auto Stocks And Valuations Currently Look Compelling For SUP, DPH, TRW and DCN In Particular...** Regardless of current valuations, it’s clearly the right time in the cycle for longer-term investors to begin considering buying auto stocks. So what should investors do? In our opinion, they should begin by making the easy decisions first, like narrowing the down the choices by simply eliminating those stocks which don’t meet their investment criteria based on market capitalization, financial leverage, dividend yield, etc. Secondly, we would recommend determining the valuation or, more specifically, price levels at which each of the remaining stocks becomes attractive. Finally, we would be looking entry points to begin building a position in these stocks over the next several months.

- Why not buy it all now? Unfortunately, as sell side analysts, we are somewhat restricted by the rating systems. Like a light switch it’s either on or off…buy or sell. In the real world, portfolio managers must not only decide when to buy or sell stocks, but also determine how much to buy or sell. It is our opinion that the fundamentals for this group will continue to deteriorate for the next quarter or two at least. Further, we also believe that things will most likely generally be worse than the market anticipates…i.e. lower auto sales, production and earnings. As such, we believe there is a good possibility that valuations will decline further. That being said, there is no guarantee this will happen, nor is it a certainty that investors won’t simply look past a ‘rougher near term ride’ causing valuations to remain unchanged, or even rise. As we saw earlier this year, for example, when investors overlooked mediocre fundamentals and temporarily bid up stock prices. Therefore, we believe the prudent investment strategy would be to build a position over the next several months taking advantage of any weakness over that time.

- So what looks attractive today? While there is clearly a difference in the quality of companies out there, in order to answer this question we have focused our attention primarily on two factors: valuation and liquidity.

- **Valuation.** Our primary consideration here is ‘How low or high could the stock go?’ The point here is to compare your possible downside risk vs. your upside potential. Our approach has been to first estimate probable low and high stock prices based on the historical range, 1989 to present, of a variety of valuation metrics including Price/Earnings, Enterprise Value/EBITDA, Price/Operating Cash Flow, Price/Book Value and Enterprise Value/Sales. Unfortunately, for many of the companies the combination of high operating leverage and lower auto production has essentially made the income-based metrics essentially useless. Therefore, for most of the stocks we focused primarily on Price/OCF, Price/Book Value and Enterprise Value/Sales. The result of this analysis is an approximate low and high stock price for each company that can be used to evaluate the downside risk and upside potential. Could a stock go lower or higher? Of course, but if one did would have to set a new high or low on a valuation basis.

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Table 2. Auto Parts Supplier Stock Prices vs. McDonald Investments Estimated Low/High

Company	Ticker	Current Price	Stock Price Estimated Lowest	Downside Risk	Stock Price Estimated Highest	Upside Potential
ArvinMeritor	ARM	$15.59	$8.00	-49%	$25.00	60%
BorgWarner	BWA	$42.80	$26.00	-39%	$75.00	75%
Dana	DCN	$10.55	$9.00	-15%	$44.00	317%
Delphi	DPH	$11.90	$8.50	-29%	$20.00	68%
Gentex	GNTX	$24.20	$14.00	-42%	$42.00	74%
Intermet	INMT	$2.90	$2.50	-14%	$24.00	728%
Johnson Controls	JCI	$74.00	$40.00	-46%	$99.00	34%
Lear	LEA	$31.19	$17.00	-45%	$70.00	124%
Superior Industries	SUP	$34.32	$24.00	-30%	$53.00	54%
TRW	TRW	$34.81	$24.00	-31%	$73.00	110%

Source: ADP; McDonald Investments estimates.

- A second, and much simpler, way of evaluating downside risk and upside potential is to simply look at a stocks recent performance. For our purposes we decided to look at both the 52-week low/high. The 52-week performance is useful because it captures both December low prices when valuations were near recession levels as well as recent highs. We view this as a useful double check of our valuation analysis.

Table 3. Auto Parts Supplier Stock Prices vs. 52-Week Low/High

Company	Ticker	Current Price	52-Week Low	Downside Risk	52-Week High	Upside Potential
ArvinMeritor	ARM	$15.59	$8.87	-43%	$21.87	40%
BorgWarner	BWA	$42.80	$33.50	-22%	$55.19	29%
Dana	DCN	$10.55	$10.25	-3%	$26.90	155%
Delphi	DPH	$11.90	$9.50	-20%	$17.50	47%
Gentex	GNTX	$24.20	$16.18	-33%	$34.23	41%
Intermet	INMT	$2.90	$2.50	-14%	$7.87	171%
Johnson Controls	JCI	$74.00	$46.44	-37%	$81.70	10%
Lear	LEA	$31.19	$20.18	-35%	$42.40	36%
Superior Industries	SUP	$34.32	$28.00	-18%	$44.85	31%
TRW	TRW	$34.81	$27.43	-21%	$45.45	31%

Source: ADP; McDonald Investments estimates.

- **Liquidity.** It's often said that cash is king and based on our conversations with various debt and commercial lending officials, it's very clear that one of the most important things a company facing an industry downturn can have is ample liquidity. We define liquidity as access to capital or cash and, given our bearish outlook, liquidity is of paramount importance for auto companies at this time. Having access to cash is necessary, not only to fund working capital needs, but also to launch new products and sustain research and development efforts that should benefit a company coming out of the down cycle. There are three primary sources for the liquidity:

- **Cash/Marketable Securities & Cash Flow.** This is the most basic source of funds for a company. It is simply cash or liquid marketable securities found on the balance sheet as well as the generation of cash through normal operations.

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- **Banks.** Another common method by which companies will obtain financing is by taking loans from commercial banks. The most common lending facilities provided by banks to companies are in the form of revolving lines of credit where the borrower may access cash as needed without a fixed payment schedule, or term loans that typically have fixed repayment schedules.

- **Corporate Debt Markets.** In this segment a company obtains financing by issuing either public or private debt. Here the company is assigned an issuer rating, usually by Moody's or Standard & Poor's based upon their creditworthiness.

- Two good examples are General Motors and Ford, companies that may not have the best cash flow at present, but have ample liquidity. Both were able to access the corporate debt markets and obtain substantial amounts of funding within the past two weeks. In fact, the demand was so great for the two companies' debt that GM increased the size of its offering several times and raised $6 billion after originally looking for $4 billion. Ford was able to raise $9.3 billion after originally seeking only $3 billion, even after having its debt ratings lowered and hemorrhaging cash over the past few quarters due to expensive tire recalls and quality problems. Why have these companies been able to do this? Because they are large, and well established companies that have solid debt ratings that are above investment grade.

- Using this combination of valuation (i.e. downside risk vs. upside potential) while screening out those companies with notably higher financial risk (i.e. potential liquidity concerns during a significant downturn) we believe four stocks look particularly attractive today**. We are, therefore, upgrading three of these stocks (SUP, TRW and DCN) to BUY (2) from HOLD (3)** today as well as initiating coverage on DPH with a BUY (2) rating, for which a separate note has been published as follows:

- **SUP.** Overall, SUP is the most conservative pick of the four from both liquidity and risk and return perspective. However, in our opinion, the stock is attractive for longer-term investors and, therefore, we are upgrading to **BUY (2)** from Hold (3) and establishing a price target of $44. Our price target is 12.6x our 2002 operating cash flow estimate, 2.7x 2001 book value estimate and 1.6x on an enterprise value to sales basis. While the P/OCF ratio is at the high end of the company's historical range, understandably so given the market outlook, the later two are in-line with the company's historical average valuation.

- **Liquidity.** Looking at the balance sheet and cash flow of SUP, we find that the company has a large cash hoard of over $100 million, and they generate substantial free cash flow. On an annual basis, we estimate that the company will generate in excess of $52 million, $46 million, and $53 million of free cash flow in 2001, 2002 and 2003 respectively. Furthermore, examining the capitalization structure of SUP you will find they have no debt, but could likely obtain financing from banks if they desired. Therefore, because of the companies significant cash on hand, the ability to generate cash from operations and access to bank debt if needed, liquidity is not high on the list of concerns for the company.

- **Valuation.** On the other hand, while the valuation is attractive for longer-term investors, it is the least attractive amongst the four. Our current estimate for the low and high stock price for SUP is $24 and $53 respectively implying downside risk of 30% and upside potential of 54%. By comparison, the 52-week low and high of $28.00 and $44.85 suggest downside of 18% and upside of 31%.

- **DPH.** Amongst the four stocks we find attractive, DPH is the second most conservative pick with a higher degree of financial risk, yet still low, offset by a more favorable risk and return relationship. We are, therefore, initiating coverage of DPH (our full initiation report is available separately) with a **BUY (2)** rating and a price target of $16. Our price target is 6.4x our 2002 operating cash flow estimate, 2.6x 2001 book value estimate and 0.5x on an enterprise

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value to sales basis. While the P/OCF ratio is at the upper-end of the company's historical range, understandably so, the later two are in-line with the company's historical average valuation.

- **Liquidity.** The balance sheet of DPH has over $750 million of cash and equivalents. Also, we estimate that the company will generate $132 million, $262 million, and $288 million of free cash flow in 2001, 2002 and 2003 respectively. It is important to note that our free cash flow includes continuance of DPH's large $1.1 billion annual capital expenditures, which we believe could be throttled back if necessary to free up additional cash. From a balance sheet perspective, DPH's debt-to-cap stands at 52% and we estimate it will decline slightly through next year ending 2002 at about 51%, as DPH uses its free cash flow to reduce debt. The company has well balanced the maturity of their $3.5 billion debt portfolio, with it about $1.4 billion of short-term debt, the bulk of which is commercial paper. The remaining debt mostly is in the form of corporate bonds, which were issued in $500 million increments maturing in 2004, 2006, 2009 and 2029. From an immediate liquidity standpoint, DPH has ample access to cash with over $2 billion available either on in the form of commercial paper or through committed bank credit facilities. Additionally, DPH has a solid Baa2/BBB investment grade rating with a stable outlook. The company routinely issues commercial paper and as recently as June 2001, DPH accessed the longer-term debt markets by issuing $500 million of 5-year notes. With its strong corporate debt ratings, we believe if necessary they could continue to access the debt markets for long term liquidity.

- **Valuation.** The valuation picture for DPH is very attractive for longer-term investors in our opinion. Our current estimate for the low and high stock price for DPH is $8.50 and $20 respectively implying downside risk of 29% and upside potential of 68%. By comparison, the 52-week low and high of $9.50 and $17.50 suggest downside of 20% and upside of 47%.

- **TRW.** TRW is also very attractive with modestly higher, yet comfortable, financial risk and a comparable risk and return relationship to DPH. We also like the added benefit of the defense side of the business. We are, therefore, upgrading TRW to **BUY (2)** from Hold (3) and establishing a price target of $45. Our price target is 6.0x our 2002 operating cash flow estimate, 1.9x 2001 book value estimate and 0.7x on an enterprise value to sales basis. All three of these measures are in-line with the company's historical average valuation.

- **Liquidity.** From a balance sheet perspective, TRW had $242 million in cash on hand at the end of 3Q01. Also, we estimate the company will generate approximately $188 million, $164 million, and $131 million of free cash flow in 2001, 2002 and 2003 respectively. Additionally, TRW still owns over 11 million shares of RFMD stock that they have been actively liquidating to retire debt. At present, the stake is worth roughly $230 million. At the end of 3Q01, TRW's debt-to-cap was a lofty 72%, however the company is using free cash flow, and proceeds from RFMD stock sales and divestitures to reduce the debt burden. We estimate that debt-to-cap will decline to 70%, 68% and 65% by the ends of 2001, 2002 and 2003 respectively. Currently TRW's $6.5 billion in debt is structured such that $1.5 billion is short term, mostly Commercial Paper (about $1.1 billion), $4.5 billion is in notes and bonds maturing in various years between 2002 and 2029, and the remaining $900 million is bank debt. From an immediate liquidity standpoint, we estimate that the company has access to $800 million, either in the form of commercial paper or backing revolving bank lines. Additionally, TRW has a solid Baa2/BBB investment grade rating with a stable outlook. They are active in the commercial paper markets and in 1Q01 accessed the longer term debt markets by issuing $500 million of 5-year notes. Furthermore, TRW has an outstanding shelf registration that would enable them to issue an additional$1.2 billion of notes or bonds if desired. Hence by virtue of its strong corporate debt rating, we believe they could quickly access the debt markets for long term liquidity.

- **Valuation.** The valuation picture for TRW is also attractive for longer-term investors in our opinion. Our current estimate for the low and high stock price for TRW is $24 and $73 respectively implying downside risk of 31% and

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upside potential of 110%. By comparison, the 52-week low and high of $27.43 and $45.45 suggest downside of 21% and upside of 31%.

- **DCN.** DCN is clearly the most risky name on our list. In part because of greater financial risk as well as concerns about asbestos liability. That said, current valuations make the stock very attractive. In our opinion, while the company is in for a rough ride, both the liquidity and asbestos issues are manageable. We are, therefore, upgrading DCN to **BUY (2)** from Hold (3) and establishing a price target of $20. Our price target is 10.2x our 2002 operating cash flow estimate, 1.4x 2001 book value estimate and 0.5x on an enterprise value to sales basis. While the P/OCF ratio is at the higher end of the company's historical range, understandably so given the market outlook, the later two are in-line with the company's historical average valuation.

- **Liquidity.** As of the close of 3Q01 DCN had $186 million of cash and a 56% debt-to-cap. We estimate that debt-to-cap will not stay fairly steady at 57%, 57% and 55% for 2001, 2002 and 2003 respectively. Of note, DCN recently announced intentions sell the Dana Commercial Credit (DCC) division, although we believe the unit is saleable we have not factored any debt reduction into our estimates associated with such a divestiture. Looking at free cash flow, DCN generated $426 million in 2000, and we estimate they will generate $32 million, $15 million and $113 million in 2001, 2002 and 2003, respectively. We believe that DCN's nearly $3 billion of debt is favorably structured from a maturity standpoint, such that less than $450 comes due by the end of 2002. Specifically, about $100 million is out on a $1 billion bank line, $210 million due in other domestic bank agreements, and about $120 million out at various foreign banks where DCN has operations. The remaining debt is longer term, maturing beyond 2002, in the form of notes and bonds. From the standpoint of immediately liquidity, we believe DCN has about $900 million available on their bank revolver, although restrictive credit covenants could modestly limit that amount. Interestingly, the company presently has a split investment rating. Moody's presently rates DCN at Ba1, which is the highest junk rating, while S&P has a BBB- rating, the lowest notch that is still investment grade. It is important to note was that following the company's 3Q01 dividend cut and restructuring announcement, DCN has been placed under review for possible downgrade. Despite the split rating, DCN was able to raise over $750 million in 10 year bonds in early August. In fact, the company had planned to offer $500 million of bonds, but demand for the issue was so large that the offering was increased to just over $750 million. More importantly, the bonds were priced 25 basis points lower than anticipated. The bottom line is that in spite of debt ratings, declining market conditions, and asbestos liability concerns, DCN was able to increase the size if its credit facility with the bank group, put in place an accounts receivables securitization program, and raise over $750 million in an oversubscribed debt offering. Hence, we believe DCN has demonstrated they have ample liquidity.

- **Valuation.** The valuation picture for DCN is very attractive for longer-term investors in our opinion. Our current estimate for the low and high stock price for DCN is $9 and $44 respectively implying downside risk of 15% and upside potential of 317%. By comparison, the 52-week low and high of $10.25 and $26.90 suggest downside of 3% and upside of 155%.

- **Asbestos.** DCN has asbestos liabilities. A concern? Not a major one in our opinion. Why? Primarily because there are two basic types of asbestos, the fibrous type that most people associate with insulation in buildings, and the encapsulated kind that is imbedded into flat sheeting. The mining of fibrous asbestos was one of the final nails in the coffin for Federal Mogul that pushed that company to bankruptcy. For a period of time, DCN used the encapsulated variety of asbestos to make certain gaskets, clutches and brake components. The encapsulated variety poses significantly less risk, since it is buried within an sheet and would only be harmful if the sheet is were crumbled and the fibers were able to become airborne.

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- That said, DCN has been dealing with claims for more than just the past few years. Specifically, as of 3Q01 there were 73,000 cases outstanding, down from 82,000 at the end of 1999, but up from 71,000 at the end of 1Q01. Of the 73,000 cases there are 32,000 cases settled but awaiting payment. Management estimates total liabilities, including both the 32,000 settled and 41,000 non-settled cases, are $98 million of which $85 million are covered by insurance. In total, DCN's total expense, net of insurance, for 2000 was $5 million and management estimates 2001 will be roughly the same amount.

- Five million a year doesn't sound like much, but what might investors be concerned about going forward? The primary concern would be that DCN's liabilities would spike up exhausting the company's insurance coverage. So the chief investment questions are 1) 'Will the liability grow significantly?' and 2) 'Does DCN have adequate insurance coverage?'

- **Will The Liability Grow Significantly?** With respect to the first question, it's important to recognize that in February DCN began handling claims for asbestos on their own, separately from the Center for Claims Resolution (CCR), an organization which aggregated and settled claims for a number of companies. As a result of this change, management anticipates that the number of claims will rise since plaintiff's attorneys are now citing a laundry list of companies in their lawsuits. However, it's important to note that fewer than 5% of these claims actually name a DCN product in the suit. It is also worth noting that DCN has never had a claim from an employee. Also as a result of the decision to handle claims separately, DCN anticipates litigation costs will rise. Offsetting these two increases, management is seeing an increase in the number of cases being dismissed as well as a reduction in the settlements per claim. In fact, the net of these three factors, according to management, means that DCN's gross liability will likely stay flat or could possibly even decline in the near term.

- As importantly, is it possible that DCN would see a significant increase in the number of claims and amount of the liability? Sure, anything is possible. However, in addition to our first point concerning the difference in asbestos types, we would add three thoughts. First, according to management the yield per case in the auto industry is much lower that that of the 'housing industry' making it a significantly less profitably target. Second, given the types of products concerned (i.e. gasket, clutch & brake components) it is notably more difficult to aggregate a list of clients, therefore, it's less profitable again. Finally, an 'all out' assault on the auto industry would include companies using the components like General Motors and Ford Motor Company. Given their visibility and strong lobbying efforts in Washington, D.C. it is unlikely such an assault would be carried out as 'unencumbered' by government legislation as it has to this point.

- **Does DCN Have Adequate Insurance?** This is clearly a more difficult question to address because the company has not disclosed the amount other than to say that it is more than adequate to consider the entire issue 'immaterial.' Why not? Management is concerned that, if disclosed, it could attract additional claims. Three additional thoughts here. First, it's worth noting that in January of this year, DCN was effectively pushed out of the commercial paper market at the same time asbestos concerns were at their peak. So what? Well during that same time period the company's bank group was willing to increase DCN's bank line $250 million to $1.25 billion. A clear vote of confidence. Second, as previously noted DCN recently completed a $750 million bond offering in August…oversubscribed by $250 million…a second vote of confidence. Finally, quite simply there are significant legal ramifications for a management, or auditor, to knowingly fraudulently misrepresent a liability as 'immaterial.' Given we know that the current liability level was at $98 million in 3Q01, combined with management's contention that issue was 'immaterial' in large part due to the fact that the company has 'more than adequate insurance' implies that the level of coverage is significant. How significant? Impossible to say really, but given that management recognizes that this issue has and will continue to exist for a number of years, to use the word 'immaterial' would imply to us insurance coverage of two to three times the current liability.

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- **Section 6. …While A Further Decline In Valuations For Others Could Make Them Attractive.** Given our bearish outlook we believe that the fundamentals for this group will continue to deteriorate for the next quarter or two at least. Further, we also believe that things will most likely generally be worse than the market anticipates…i.e. lower auto sales, production and earnings. As such, we believe there is a good possibility that valuations will decline further. If valuations were to decline further there are clearly a number of other stocks, namely ARM, BWA, GNTX, JCI and LEA, which could begin to look attractive based on our valuation work. However, at this time we have a difficult time recommending these stocks primarily based on the level of downside risk we estimate exists for these stocks. – *Brett Hoselton*

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