McDonald Investments

MORNING CALL DAILY

Delphi Automotive — DPH: *Initiating Coverage with a BUY Rating*

McDonald Investments Inc., A KeyCorp Company
Automotive Industry
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Rating	*BUY (2)*	*Next Quarter*	*December*
Price	*$11.83*		*$0.07*
52-Wk Low	*$9*	*vs.*	*$0.36*
52-Wk High	*$17*	*Reporting Date*	*1/17/02*
12-Month Price Target	*$16*	*Dividend*	*$0.28*
2002E	*$0.44*	*Yield*	*2.4%*
2001E	*$0.37*	*Market Cap.*	*$6,577.5*
2000A	*$1.94*	*Book Value*	*$5.87*
2002 P/E	*26.9x*	*Estimated Growth*	*NA*
2001 P/E	*32.0x*	*Trading Volume*	*NA*
EV/EBITDA 2001E	*6.1x*	*Fiscal Year*	*December*

Summary & Recommendation

- On November 5, 2001, we are initiating coverage of DPH with a **BUY (2)** rating at a price of $11.83 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 value to sales basis. DPH is the world's largest automotive parts supplier and sells its products and system integration skills to the major vehicle manufacturers in every world region through its global network of manufacturing sites, technical centers, sales offices and joint ventures. We rate DPH a **BUY (2)** for three primary reasons. First, because now is the right time to begin buying auto stocks in our opinion, which we outline in detail in our November 5th report titled 'Why Now Is The Time To Start Buying Auto Stocks.' Second, DPH's current valuation is compelling. Based on a number of historical valuation metrics, our current estimate for the low and high stock price for DPH is $9 and $21 respectively implying downside risk of 24% and upside potential of 78%. By comparison, the 52-week low and high of $9.50 and $17.50 suggest downside of 20% and upside of 48%. Finally, the Company has strong financial liquidity, which gives it the financial flexibility to weather a downturn without significantly impairing future profitability and growth. **Our earnings estimates are $0.37 for 2001, $0.27 for 2002 and $0.58 for 2003. Adjusting for the upcoming FASB 142 change for goodwill accounting, our estimates are $0.44 and $0.75 for 2002 and 2003, respectively.**

Investment Strengths

- **Right Time In The Cycle To Begin Buying Auto Stocks.** The first reason to considering buying DPH is because now is the right time to begin buying auto stocks in our opinion. Simply put, auto stocks are early cycle stocks and while they historically have declined in the face of deteriorating economic news, they also rebound prior to 'the bottom' in anticipation of the inevitable recovery. A more detailed discussion of our view can be found in our November 5th report titled 'Why Now Is The Time To Start Buying Auto Stocks.'

- **Compelling 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 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 DPH the combination of high operating leverage and lower auto production has essentially made the income-based metrics essentially useless. Therefore, we have focused primarily on Price/OCF, Price/Book Value and Enterprise Value/Sales. Based on a number of historical valuation metrics, our current estimate for the low and high stock price for DPH is $9 and $21 respectively implying downside risk of 24% and upside potential of 78%. By comparison, the 52-week low and high of $9.50 and $17.50 suggest downside of 20% and upside of 48%.

- Could a stock go lower or higher? Of course, but in doing so it would also be setting a new high or low on a valuation basis. While this is more likely for a stock like with limited historical data, like DPH, we would suggest that the historical low set in December 2000 is a reasonable low-end estimate since auto stocks in general were selling at recession levels at that time. Hence, it seems reasonable to believe that the valuation levels we saw for DPH in December 2000 were representative of 'the bottom.'

- **Strong 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: 1) The company may have cash on the balance sheet and/or generate substantial cash from operations; 2) Banks can provide liquidity in the form of committed revolving credit facilities or term loans; and 3) Companies could go to the debt markets and issue short term debt (commercial paper) or longer term debt (notes and bonds).

- 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.

- **Market Position.** DPH is the world's largest automotive component supplier. As such, the company is among the very few automotive suppliers with the breadth and technology to be capable of entire electronics integration. DPH has both the products and ability to combine electronic steering, shifting, suspension and telematics in one package that make them distinctive to OEM's. Furthermore its vast size affords the company significant purchasing leverage over many of its peers.

- **Technology.** With in excess of 6000 granted patents and roughly 16,000 engineers (6000 of whom are dedicated to automotive software and electronics), DPH's technological wherewithal is unmatched in the automotive industry. This great breath of technology is enabling the company to move up the value chain, and better position itself in the more profitable segments of the market.

- **Lean Manufacturing.** Incorporating the principals of lean manufacturing are providing an advantage for DPH. The Delphi Manufacturing System (DMS) is enabling the company to remove substantial fixed and overhead costs, which make them more competitive and efficient. It ultimately can help to improve return on capital.

- **Management.** We believe DPH has assembled one of the strongest management teams in the automotive industry. Even more significant, the team has been intact and working together prior to the company having gone public in February 1999.

- **Global Presence.** With the increasing globalization of the automotive marketplace, DPH is well positioned with roughly 200,000 people working in 190 manufacturing sites located in 42 countries throughout the world.

Investment Weaknesses

- **Continued Weakening For North American Production.** We estimate that sales to automakers (light vehicle original equipment) represent roughly 90% of DPH's overall revenues, the bulk of which is in North America to one customer…General Motors. In 1999 and 2000, North American light vehicle production reached record levels of 17.0 and 17.2 million units respectively, but we estimate production will fall 10.9% to 15.3 million units in 2001 and then decline 7.1% further to 14.2 million in 2002. These figures, however, include transplants and we estimate that light vehicle production by the former "Big 3" will retrench 13.2% in 2001, and 7.4% in 2002, both more than the overall build declines. More importantly focusing only on DPH's primary customer GM, we expect production to decline 12.1% in 2001 and fall an additional 7.6% in 2002. On a positive note, we anticipate production levels for GM, the former 'Big 3', and North America will begin to rebound during 2H02 and be grow roughly 5% during 2003. Softening in light vehicle production will create a difficult operating environment for DPH, especially if the production declines are deeper and/or longer than we anticipate, or if cost reductions are not able to keep pace with the production slowdowns.

- **Potential For Downward Earnings Revisions.** A number of factors have negatively impacted earnings for nearly all of the automotive parts suppliers and caused downward earnings estimate revisions. For example, on October 16, 2001 DPH provided guidance during their 3Q01 earnings call that 4Q01 earnings would be in the range of $0.05 and $0.15, well short of the First Call mean estimate of $0.24 at the time. Given the uncertainty surrounding both vehicle sales/production and the U.S. economy it is conceivable we could see earning revisions fall further.

- **Pension Obligations.** When DPH went public, they assumed a pension program that was underfunded by nearly $2 billion. After completing adjustments for retirees of that belonged to GM and making collective contributions of $2.4 billion in 1999 and 2000, the pension plan ended 2000 with a small net surplus. It is likely that negative factors will cause the year 2001 to end at a net underfunded level. However, this is truly a long term obligation, and DPH will not be required to immediately contribute any excess amounts to the plan, but rather potentially add small incremental amounts over the next 10-15 years.

- **Significant Exposure To GM.** Created originally to be the principal parts supplier for GM, DPH naturally has relied upon GM to provide significant portion of its revenue. The company has moved to broaden its customer base over the past few years, but through 3Q01 still obtains about 68% of its revenues from GM. So in the near term at least, as GM goes, so does DPH.

- **Ability Divest Assets.** An integral portion of the plans to improve margins and returns on capital at DPH depends upon the successful execution of a portfolio restructuring (i.e. exiting the lower return businesses) or 'portfolio review' as DPH calls it. As a part of the review currently, DPH is seeking to fix, sell or close roughly $4-5 billion worth of annual revenue in 2001. Given today's difficult market conditions there are plenty of sellers and few buyers of auto assets, therefore, DPH is finding it more difficult to divest certain assets at acceptable values.

- **UAW At DPH.** The DPH workforce consists of about 34,000 UAW workers or just over 17% of their 198,000 workforce. The company and the UAW have thus far successfully worked through initiatives that have closed, relocated and/or divested operations. However if the relationship were to deteriorate, current and future restructuring plans could be foiled or delayed. – *Brett Hoselton*