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Kicking the tires on GM's IPO

It's still at least a few months away, but selling shares again will be a major step in the automaker's remarkable recovery. Should you buy General Motors' stock?

By Michael Brush
MSN Money

When General Motors rolls out as a public company in an initial public offering -- possibly in just a few months -- investors are going to find a brand-new carmaker that is definitely not their fathers' GM.

Shocked into facing reality by an extended timeout in bankruptcy after the economic downturn exposed serious flaws, including serial design misses and bloated costs, General Motors has gone through some big changes.

GM has corrected several of its old problems, making it potentially a very attractive investment in the IPO.

"I'm very bullish on them. It is a very positive story," says Sean McAlinden, the head of research and chief economist at the Center for Automotive Research, or CAR.

The carmaker's CEO and chairman, Edward Whitacre Jr., boldly told analysts at a full-day June 29 meeting that he was introducing a new GM to the world. "We are a new and a much different company than we were 12 months ago," Whitacre said.

Refreshingly, this isn't just the usual corner-office hype. And that's why this IPO -- details of which are expected any day now -- is the most intriguing and potentially the biggest of the past several years.

A year in the shop

Just a year ago, the car company that had dominated the industry during much of the post-World War II era was reduced to a shadow of itself by a cumbersome bureaucratic structure and a tendency to "overthink even the smallest decisions," Whitacre says.

GM suffered from high costs, an inflexible work force and a portfolio of vehicles that left buyers yawning. These shortcomings were glaringly obvious in an inability to keep up with Toyota Motor (TM, news, msgs) in "green" vehicles while GM continued to crank out SUVs and trucks.

"Now the company is leaner, meaner and greener," McAlinden says.

To be sure, challenges remain. Competition is tough and getting tougher in emerging markets, where GM pins much of its hopes. Europe remains weak. A new management team hasn't really been tested through the typical three- to five-year car design cycle. And most of all, a potentially sluggish economy has consumers moving back into hunker-down mode, avoiding big-ticket purchases.

But as the company, which is now 60% owned by U.S. taxpayers, prepares to hit the market again, consider the bright side: The company has paid back a government bailout, cleaned up its balance sheet and, maybe most importantly, seen strong sales in models such as the Chevrolet Equinox and Camaro and the Cadillac SRX. Strong demand has remaining U.S. factories humming at an impressive 85% of capacity. Most of them won't even close down for the usual two-week midsummer break, a sure sign that things have turned around at a company recently ridiculed as Government Motors. "Factories open this summer -- that's a real change for them," says David Thomas, a senior editor at Cars.com.

Maybe most surprisingly, the turnaround nudged GM into profitability in the first quarter for the first time since 2007. It announced net income of \$865 million on \$31.5 billion in sales, which were up 40% from a year before.

"There's no question the company is emerging from the dark times it faced not that long ago. Led by the Chevy Silverado and Malibu -- second and ninth in overall U.S. sales so far this year -- GM has seen six straight months of increased sales numbers compared to last year," says Perry Stern, a senior editor at MSN Autos.

Does all this mean GM will be a must-have stock when its IPO hits the market? That's still a tricky call. The fundamentals look good, but we don't know the price at which shares will enter the market -- a thorny issue that the brightest inside underwriters, JPMorgan Chase (JPM, news, msgs) and Morgan Stanley (MS, news, msgs), are no doubt grappling with now. Reuters suggests an IPO that would raise as much as \$20 billion and put GM's total value at \$80 billion to \$90 billion, more than the company's 2000 peak and above Ford Motor (F, news, msgs), but that's very unofficial.

Here's my rule of thumb for now: If GM shares carry a valuation at or meaningfully below that of Ford, the stock is a buy as a long-term bet that the economy will eventually improve. The revamped GM has prospects at least as good as Ford's, if not better.

Treasury Secretary Timothy Geithner has said the IPO would come in the fourth quarter or early next year. There's a political imperative at work here. "We think the Obama administration wants GM's IPO to happen well before the president starts campaigning for re-election, and we suspect

GM is closer to being ready than it publicly admits," Morningstar auto-sector analyst David Whiston says.

Let's kick the tires on the new GM and look at the pros and cons.

Cost cuts

GM has done an impressive job of cutting costs, and a painful one. It has slimmed down to around 103,000 employees in North America, from about 150,000 two years ago, says CAR's McAlinden. It has also negotiated more flexibility from workers, which helps by improving plant efficiency.

GM is phasing out or selling nameplates Saab, Saturn, Pontiac and Hummer to focus on four core brands: Chevrolet, GMC, Buick and Cadillac. This has helped the company shed less-efficient plants. It is cutting dealerships to 4,500 from 6,150 before bankruptcy.

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U.S. labor costs are now down to \$58 an hour, including the cost of benefits, from \$78 an hour before the bankruptcy, McAlinden estimates. That compares favorably to the \$60 an hour at Ford and \$52 to \$56 an hour at Toyota. All told, cost savings currently work out to about \$10 billion a year.

At these new cost levels and with a 20% share of the 11 million vehicles now sold in the U.S. per year, GM is slightly profitable. If GM can keep its 20% share as overall annual sales return to a more-normal 15 million a year in an improving economy, "they will print a lot of money," says Van Conway, a turnaround specialist with Conway MacKenzie.

Debt reduction

Though GM may have to contribute \$12 billion or so to shore up a pension shortfall that stands at \$27 billion, the company got rid of lots of debt in bankruptcy. Besides taking long-term debt down to \$5.4 billion, it paid off the government bailout.

"Once they start generating cash, this gives them tremendous borrowing power, which other companies are frightened about," McAlinden says. "As long as they don't get giddy about trying to grow too fast, I see a pretty good road ahead for them."

New, popular cars

More importantly, the company once again is rolling out cars that people like. One example is the Cadillac SRX, an SUV crossover built on a lighter frame, says Dave Thomas, who has the enviable job of test-driving cars for a living at Cars.com. "The styling there made a huge difference. It's just a looker," Thomas says.

Other examples include the latest version of the Camaro muscle car, the Buick LaCrosse luxury sedan and the Chevrolet Equinox.

Bing

"I think the bellwether model that really signifies the shift is the Chevy Equinox," Thomas says. "It's one of those cars, when you get into it, you're impressed." Strong demand for the Equinox helps explain why one Canadian plant is working at full capacity this summer.

"A car company can't survive without good product, and GM has a number of successes in its lineup," Stern says. "Cars like the Chevrolet Malibu, Buick LaCrosse and Cadillac CTS have helped redefine those brands, and the company has embraced the popular crossover segment with models ranging from the compact Equinox to the eight-passenger GMC Acadia to the stylish Cadillac SRX. GM reports its crossover sales are up 81% year to date."

Cars going on sale soon that should also be hits include the Chevrolet Cruze, due out later this summer to replace the Cobalt in the compact-car segment. The Cruze boasts an optional leather interior and up to 40 miles a gallon. GM will also soon release its battery-gasoline hybrid, the Chevrolet Volt.

Challenges ahead

Despite all these victories, potential GM investors have some worries. Perhaps the biggest is an untested management. Whitacre gave pink slips to 17 of GM's 18 top managers. They were replaced from within by middle managers who appear untested in more-senior positions.

"There's a lot of mystery with the new management team. . . . We don't know what they can handle," McAlinden says.

Though GM has rolled out a series of successful cars, none of them can be attributed to the new management team. All the popular new models originated under the old regime, says Steve Spear, an auto-sector expert who is a senior lecturer at the Massachusetts Institute of Technology. Though plenty of designers and managers who had a role in these models are still at the company, Spear says it is still too early to see what new management will be "kicking out of design to production. It's not clear that GM has changed enough to keep up with Toyota and Ford. The evidence is still out."

Next, Europe looks weak and will remain weak for a while. Besides the sluggish economy, GM has been carrying out a big restructuring there with lots of job cuts. This is likely to sustain negative sentiment toward the company for some time.

And while GM is rightly proud of its position as the largest car producer in the BRIC countries -- Brazil, Russia, India and China -- it's not all a smooth ride there either.

GM has a 13.3% market share in China via joint ventures, including a 49% stake in Shanghai Automotive Industry Corp. That's a great position to have, because China surpassed the U.S. as the world's largest vehicle market last year.

But problems could emerge. Many economists believe China's economy is in a bubble. The risk here is that competitors build up too much inventory in an overheated economy. This would put

downward pressure on car prices, which are already in steady decline as the market shifts to smaller, cheaper vehicles. On the cost side, the Chinese government may well pressure GM to increase wages sharply. Honda Motor (HMC, news, msgs) doubled wages in China last week because of government pressure, McAlinden says.

In Brazil and other Latin American countries, where Chevrolet is a prestige brand, GM does well because it commands premium prices. But GM comes up short in low-cost vehicles, as competitors such as Fiat, Volkswagen, Renault and Peugeot enter this growing segment of the market. GM is also weak in commercial vehicles.

Back in the U.S., GM now lacks its own financial arm to support car loans, and banks are still wary of making car loans.

That brings us to perhaps the biggest risk of all in buying into GM's IPO -- at least apart from getting in. (Unless you have a big-enough account with your broker to get in on the IPO at a favorable price, you'll have to buy in the regular market, minding the details and being careful of first-day jitters and price swings.)

Here's the big risk: What once looked like a promising economic recovery in the U.S. now seems to be sputtering. The signs are all around, even in the car market. Sales in May for both the industry and GM were strong. But in June, GM car sales slipped by 13% from the month before. With job growth so anemic, consumers still appear to be delaying big-ticket purchases.

If that continues, it's a problem not even Whitacre and the rest of the new management team at GM will be able to deal with.