

# Special Update

## The Auto Sector – An Investment Outlook

NOVEMBER 2008 FOR PROFESSIONAL INTERMEDIARIES ONLY

# BLACKROCK

### Recent developments across the auto sector

Concerns about the viability of various auto manufacturers have become more prominent recently as investor unease has shifted from the financial system to the wider economy.

As one of the largest manufacturing industries, accounting for more than 10% of global GDP (taking the supply chain, distribution and aftermarket into account), the auto sector's future is becoming a subject not just of economic commentary but also of political significance, particularly in the US. Some form of state aid to Detroit is under consideration from President-elect Obama's administration-in-waiting.

The industry is characterised by very capital intensive production processes. Vertical integration has diminished – i.e. manufacturers do not tend to have the same degree of ownership of (and therefore capital tied up in) either parts supply or retail inventory and distribution as has historically been the case. However, they still face a series of obstacles to making consistent returns on capital over the cycle.

These obstacles include the high ticket nature of the product to consumers (still the largest purchase after homes), which often requires significant credit provision to facilitate purchase. In a hostile credit environment, this poses issues for new car sales and for the residual values of second-hand cars.

Clearly, for those companies with previously robust credit subsidiaries, the ability to finance their own credit arms has also become challenged. Add to this the need for very long-range model and production planning, a likely 10% to 20% drop in demand over the next 12 months in an industry already facing excess capacity, and continuing competitive pressure from more fuel efficient, cheaper and more reliable Japanese and European models, and it is easy to see how the US companies face difficulties. And that's before the US manufacturers' legacy workforce pensions and healthcare benefit costs are added into the equation.

### Exposure to the auto sector across BlackRock portfolios

As cyclical industries go, therefore, auto manufacturers offer us few reasons to get excited. Indeed, generally, the shares have not provided many opportunities for long-term performance.

At present, we have very little exposure to Detroit through the manufacturers or suppliers to them in our US, Global, European or Japanese equity products. We have a small exposure to some elements of corporate debt in some of our US and Global fixed income portfolios, particularly those investing in the high yield space since the auto sector comprises a significant proportion of the high yield universe.

Elsewhere, to the extent that valuations are low relative to strong balance sheets and there may be some consolidation to remove excess capacity worldwide, we have some exposure to the Japanese names Toyota, Nissan and Honda in our Japanese and global equity portfolios, and to some special situations such as Peugeot and Daimler in Europe, though we are underweight benchmarks in the industry.

In the UK, there is only a small opportunity to gain exposure through suppliers to the industry such as Tomkins and GKN and we are steering clear at present.

### Outlook from here

2009 is likely to see a severe industry-wide demand decline, while seeds of recovery may be sown by the forced removal of capacity. It seems unlikely that the low probability of even modestly improved returns will attract investors yet. These become more visible much later in the recovery phase of the cycle; the exception may be that specific company developments, such as mergers, offer such great cost savings (production, servicing, parts procurement, sales outlets, advertising) as to catalyse value for shareholders. Demand from the developing world is already key (this year, auto sales in Brazil, Russia, India and China are expected, for the first time, to surpass those in the US) and is likely to account for much of the auto makers' growth from here. This implies some grounds for optimism on a longer-term view. But, for now, we're not holding our breath!

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