

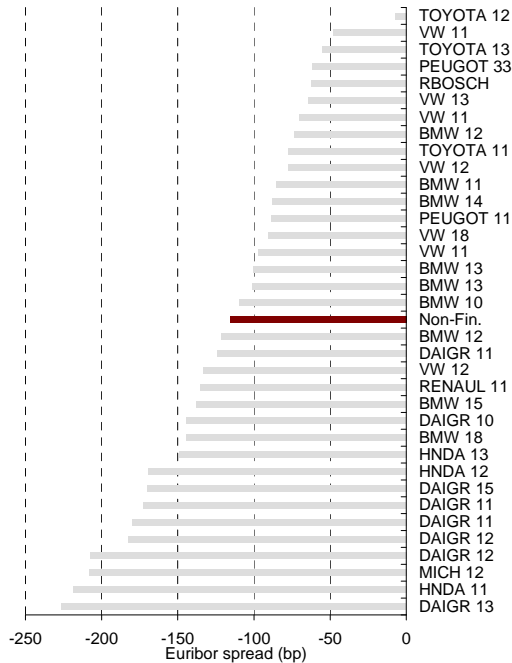
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## Q309 Update

### Auto iBoxx bonds change since 2 January



### No rebound in credit metrics

#### ■ Sentiment to remain affected by still-declining credit metrics

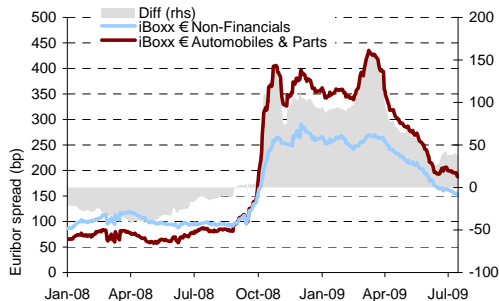
The boost to demand through scrapping and green incentives is mainly positive for mass-market carmakers short term. The volume winners in Europe so far are Fiat, through its 41% share of the A and B segments, and Volkswagen due to its size and cash pile. We estimate the pull-forward of demand in Europe at around 2m vehicles in 2009, but part of this will have to be given back next year. We expect that demand will slide just 8.5% this year but then drop again by and estimated 8% in 2010. In our view, the disruption in the second-hand market, due to massive incentives, will take a while to stabilise and transaction prices will remain under pressure well after such incentives expire. Premium carmakers alone (Daimler, BMW, Porsche) will be immune, as they are not taking part in the feast.

Weaker cash flow generation from the industrial division of automakers, combined with rising leverage to fund capex and R&D, is likely to keep credit ratings under pressure going into 2012 when new fuel efficient vehicle technology will be released. We do not rule out the outsourcing of captive financing (eg, Fiat's Fidis), notably for mass-market carmakers that are in or close to high yield territory such as Renault and Peugeot.

#### YTD Autos bond supply above average full-year levels

For the remaining part of 2009, we expect new bond supply for the auto/ truck makers/suppliers in our coverage to be USD20bn across all currencies, of which we estimate EUR7bn to be in EUR. DAI, Toyota, Renault, Fiat and Porsche are still potential issuers this year in our view.

### Auto iBoxx vs Non-Financials



#### ■ Sector recommendations:

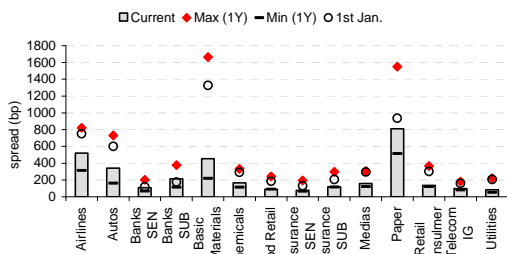
**CDS recommendation:** We are Underperform Autos CDS in general vs CDS indices with a more negative stance on Peugeot, Renault and Valeo. We maintain our CDS compression trade between Fiat and Peugeot/Renault.

**Cash recommendation:** Sectorperform cash bonds for auto companies rated BBB+ and higher up to 3Y maturity and Underweight the rest.

#### ■ What to expect from Q2 earnings releases?

The Q2/H1 earnings season is likely to show further operating losses. That said government scrapping vehicle incentives have reduced the pace of decline in demand in Europe. As a result European auto sales are down 11% in H109 while production is down about 30%. In the US auto sales are down about 35% in H1. However, Q2 production is sequentially better than Q1, which should lead to positive swings in working capital. Free cash flows at industrial operations are likely to remain poor given that operating losses should be wide spread in Q2 due to weak volume/mix as sales have been more robust in the less profitable small A and B segments. Fiat and VW are likely to be the winners of this reporting season given that they benefited greatly from the scrapping vehicle incentives. BMW, Daimler and Volkswagen are the fittest in terms of liquidity/cash cushion for FY09.

### CDS per sector



Sources: Bloomberg, Calyon

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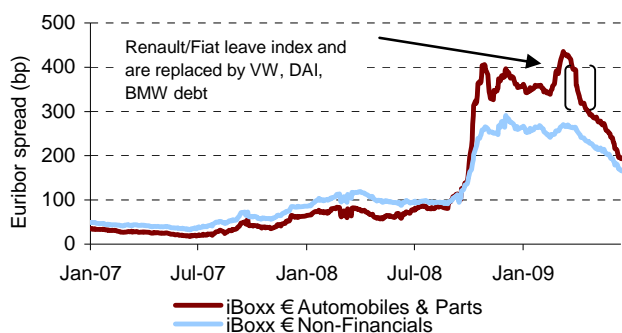
# Autos Credit valuations

## Credit valuations: too tight too fast?

As seen in the charts below credit spreads have rallied substantially year-to-date in line with the equity market. Yields on new bond issuance came at very generous levels compared with government bonds. For instance, the 5Y yield differential between Daimler (BBB+/A3) and the euro generic government bond stood at 5.6% at the beginning of FY09 compared with only 2.5% now. Overall the 5Y yield stood at about 7.7-7.8% for a 'low single A'-rated Auto company (DAI, BMW or VW) in January 2009 vs c.4.9% now.

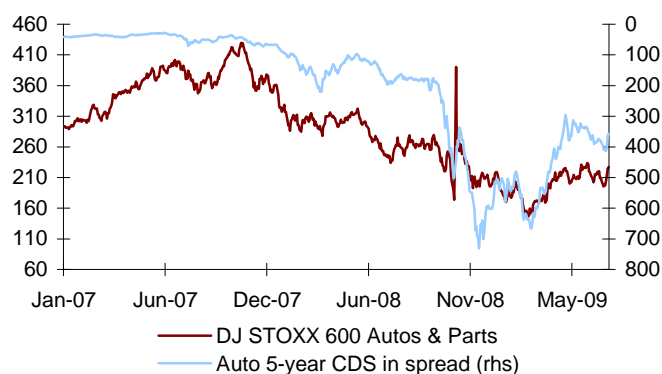
The large premium attached to the new bonds (ranging between 100bp and 200bp versus secondary cash spreads) combined with investors' cash inflows, wider valuations and an orderly execution of new deals, ie, highly rated and well-known companies coming to the market first, have enabled syndicate desks to keep the ball rolling since the beginning of the year.

Auto iBoxx performance vs Non-Financials



Sources: Calyon, Markit

Auto 5Y CDS versus Auto equity valuations



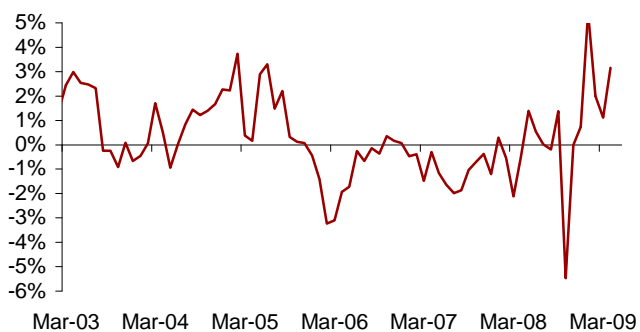
Sources: Calyon, Markit

## Cash inflows have supported buying of credit bonds

The main technical factor behind credit spread tightening since the beginning of the year has been the large increase in cash inflow into credit funds. The two charts below illustrate this trend in Europe and in the US investment-grade and high-yield markets.

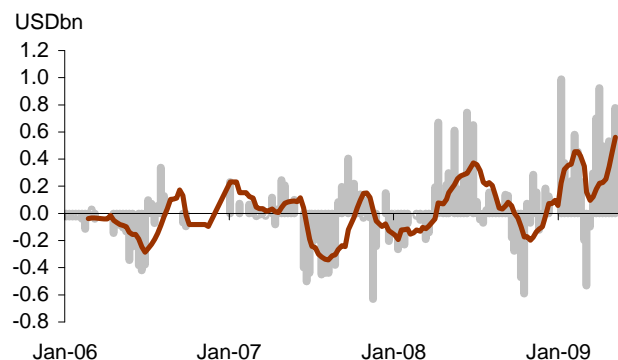
The rebound in size of assets under management (AUM) in credit funds has been very substantial given that in 2008 net redemption of AUM had reached the highest ever level for the investment-grade market in Europe.

Monthly ch. in European investment-grade funds



Sources: Calyon

Monthly change in US high-yield funds



Sources: AMG, Calyon

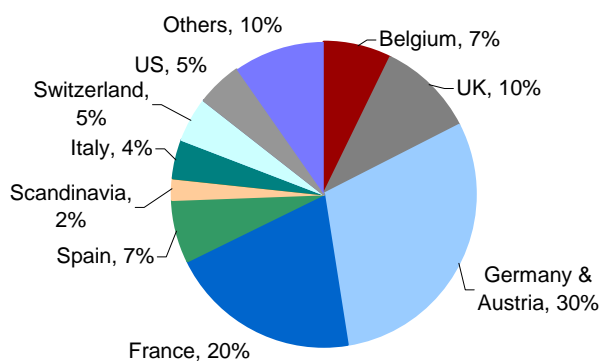
## Investors likely to be more risk averse

In addition, as seen in the charts below, placement of new corporate issuance has been strong with retail and insurance investors, accounting for more than 50% of total placement year-to-date. Both are total return investors. However, these investors are risk-averse and are likely to optimise the performance of their upcoming investment by extending duration in safe-haven sectors such as Utilities, Telecoms or government bonds rather than cyclicals given that credit ratings are likely to deteriorate further in 2010.

European automakers have been downgraded by one to two notches since the beginning of 2008 (see table below) and we expect one more notch of downgrade in 2010. Auto suppliers have been under greater rating pressure, down two notches and more depending on the degree of exposure to OEMs.

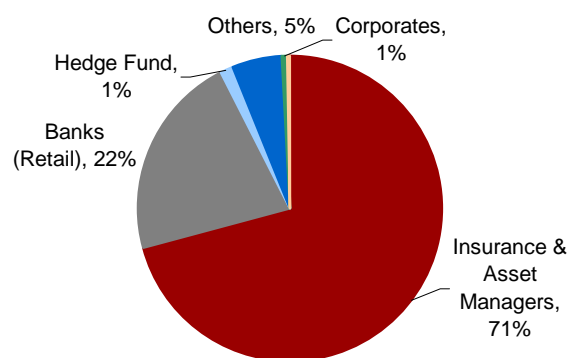
Despite a sharp cut in capex, free cash flows have been under pressure since the middle of 2008 due to the one-off adjustment of inventories and subsequent cuts in production and negative working capital swings. Going forward, as discussed later, the sector will suffer from reduced margins and increasing need for investments (capex and R&D), which in turn will lead to weaker credit metrics. For a detailed review of the fundamental drivers of the sector refer to page 13.

Geographical placement of corporate new issuance YTD



Sources: Calyon

Investor placement of corporate new issuance YTD



Sources: Calyon

Autos issue bond debt between 3Y and 5Y to finance similar maturities in new car loans. Client appetite for auto companies rated BBB+ and higher has been supported so far by large new issuance premiums. Appetite for lower-rated auto companies is very likely to fade away, barring any rebound in premiums, given current tight credit valuations and the fundamental risk embedded in their bonds.

We therefore believe that, when and if lower-rated auto companies access the bond market, they will have to come with a high risk premium on top of secondary spreads, potentially weighing on the performance of recent issuance, which in turn could limit client appetite.

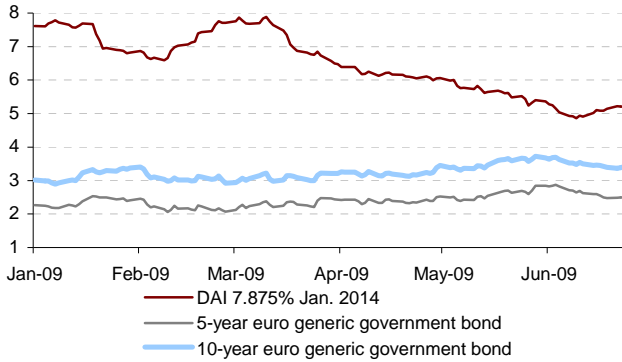
In addition, IG funds are reluctant to increase exposure to companies that are borderline sub-investment grade as they would become forced sellers once a company were to join the high-yield indices, which most of the time triggers a potential loss given the current poor liquidity of the secondary market. Indeed, the euro high-yield market is about 3 times smaller than the investment-grade market. The European high-yield market is relatively young and is dominated by leveraged investors with relatively short investment horizons, which leads to greater volatility and less liquid markets during times of uncertainty.

## Widening yield in govies and still low equity valuations could weigh on Autos credit valuations

As seen in the charts below, credit valuations, including autos, have been outperforming government bond valuations year-to-date. The large increase in government debt and subsequent refinancing needs has put pressure on government bond valuations, with investors favouring the short-end of the govies curve, which in turn is putting pressure on the long end of the curve.

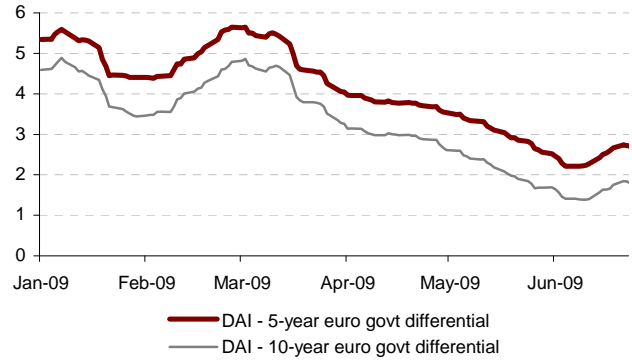
Our Fixed Income Strategy team expects government yield to increase going into next year, which will reduce further the risk-reward cushion embedded in credit valuations, and in turn is likely to lead investors to allocate future cash inflows more into government bonds, equities and/or less volatile credit sectors such as Utilities/Telecoms rather than cyclicals rated borderline to speculative-grade territory such as Fiat, Peugeot and Renault. We believe that BMW, DAI and VW should still enjoy good access to the bond market but at a premium to government bonds or through shorter durations.

Yield development of Daimler 5Y cash bond vs 5Y and 10Y euro government bond



Sources: Calyon

Yield differential between DAI 5Y cash bond and 5Y and 10Y euro government debt



Sources: Calyon

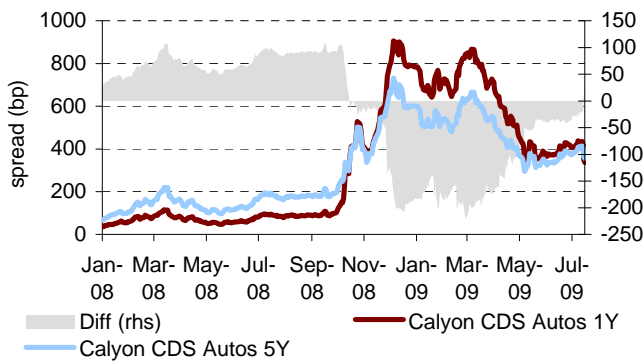
The secondary market for cyclical names remains very challenging, with little appetite for risk among dealers due to balance sheet de-leveraging and Basel II capital risk requirements. As a result, investors that are looking to reduce exposure to cyclicals will have to do it through the investment of new bond issuance in safe-haven sectors.

The recent tightening in CDS markets was directional and correlated to equity, and did not reflect any clear fundamental improvement for the sector, which should experience a further decline in credit metrics in 2010.

Cheaper valuations are likely to trigger: (1) a jump to default loan hedging; and (2) correlation desks reducing curve normalisation (steeper) trade, which could put some pressure on 1-2Y CDS of the weakest auto companies, especially towards Q4. The best Automakers such as VW, DAI or BMW are likely to see their CDS curves normalising further or stabilising given recent steepening of their curves.

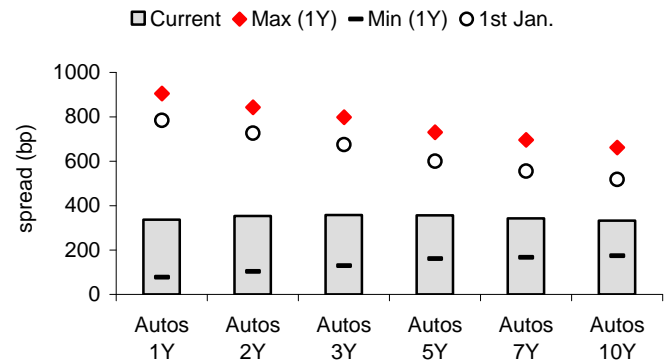
Finally dealers' cash bond inventories are currently low due to strong appetite for new issuance. However, any reduction in primary issuance appetite towards more cyclical sectors as issuance premiums decrease could lead to some profit taking by investors, which in turn could weigh on secondary cash valuation and CDS as trading desk will look to hedge their jump to default risk through short dated CDS.

1Y vs 5Y CDS Autos index since 02/01/09



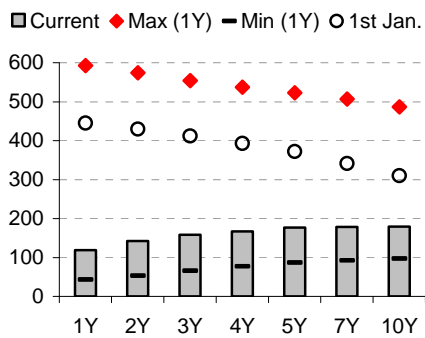
Sources: Calyon, Markit

Autos CDS index curve



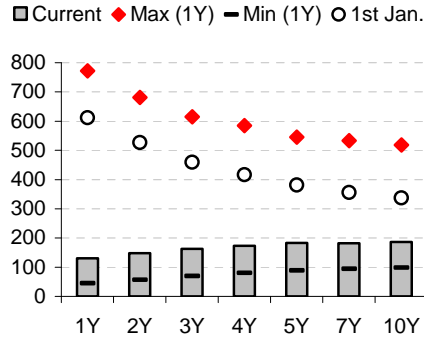
Sources: Calyon, Markit

BMW CDS curve (spread in bp)



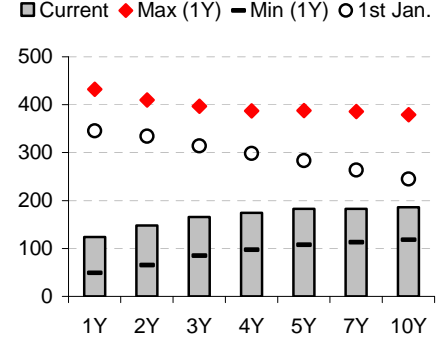
Source: Calyon, Markit

DAI CDS curve (spread in bp)



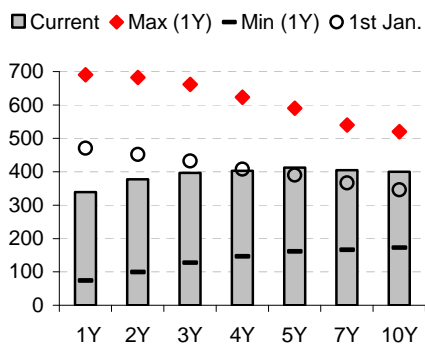
Source: Calyon, Markit

VW CDS curve (spread in bp)



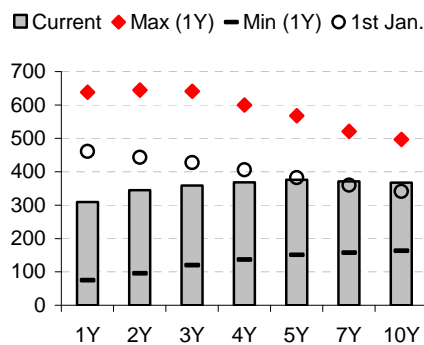
Source: Calyon, Markit

RNO CDS curve (spread in bp)



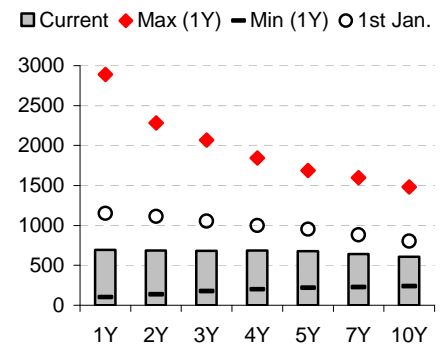
Source: Calyon, Markit

PSA CDS curve (spread in bp)



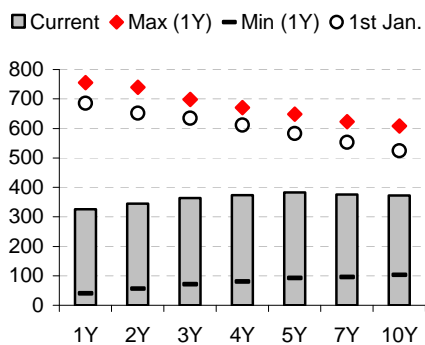
Source: Calyon, Markit

Fiat CDS curve (spread in bp)



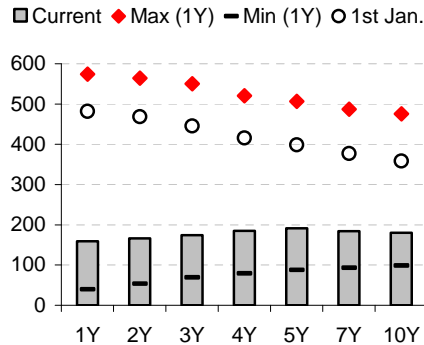
Source: Calyon, Markit

Volvo CDS curve (spread in bp)



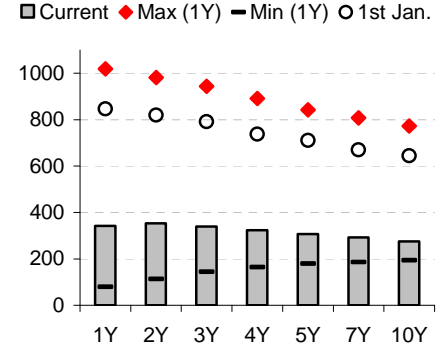
Source: Calyon, Markit

Scania CDS curve (spread in bp)



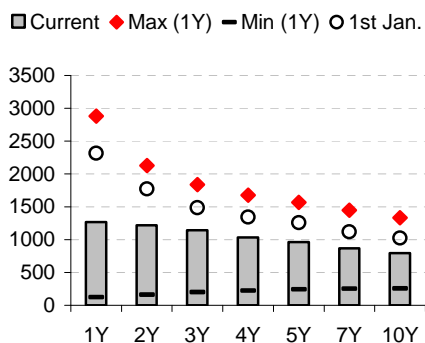
Source: Calyon, Markit

Porsche CDS curve (bp)



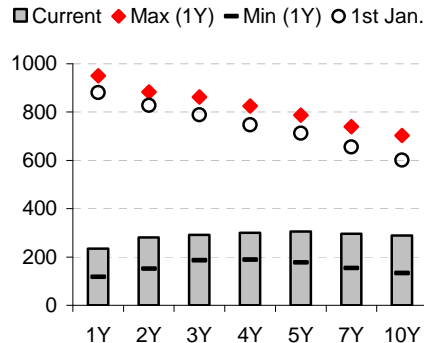
Source: Calyon, Markit

Conti CDS curve (spread in bp)



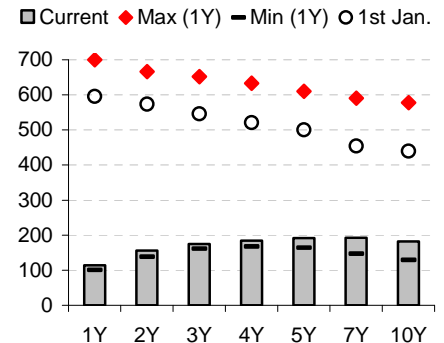
Source: Calyon, Markit

Valeo CDS curve (spread in bp)



Source: Calyon, Markit

Michelin CDS curve (spread in bp)



Source: Calyon, Markit

## Sector and issuer recommendations

### Cash recommendation – Marketweight from BBB+ and up to 3-year and Underweight the rest

We remain marketweight cash bonds of BBB+ and higher rated auto companies such as DAI, VW, BMW, Volvo, Toyota up to 3Y given little spread differential with maturities above 3Y. We are slightly underweight these names above 3Y. We are also marketweight the new Michelin 5Y given scarcity of bond in the name and recession resistant free cash flow due to flexible capex. We are underweight Renault SA and Peugeot SA, but we favour the recent 18-month bonds issue by RCI Banque and Banque PSA finance. With regards to Fiat we would look to participate (marketweight) in any new issuance given that we favour its volume mix in the current environment.

### CDS recommendation

We are Underperform Autos CDS in general vs CDS indices with a more negative stance on Peugeot, Renault, and Valeo. We also believe that the normalisation of the CDS curve has reached a fair level between 1-5Y, but could steepen further beyond 5Y given current flatness between 5-10Y.

#### CDS investment recommendation vs sector index

Issuer	S&P/Moody's	Calyon	Perf. Expectation vs Sector Index		
			Previous	Since	Current
BMW AG	A neg/A3 neg	Low-A	Sector perform	05/11/08	Sectorperform
Michelin	BBB neg/Baa2	Low-BBB	Sector perform	26/06/09	Sectorperform
Conti AG	BB CW neg/Ba3 neg	Low-BB	Sector perform	19/09/08	Sectorperform
Daimler	BBB+ neg/A3 neg	High-BBB	Sector perform	24/07/08	Sectorperform
Fiat SpA	BB+ CW neg/Ba1 neg	Mid-BB	Sector perform	17/12/08	Sectorperform
Peugeot SA	BBB- CW neg /Baa3 neg	High-BB	Underperform	17/12/08	Underperform
Porsche	NR	Mid-BBB	Sector perform	17/12/08	Sectorperform
Renault	BB/Ba1	High-BB	Underperform	17/12/08	Underperform
Scania	A- CW neg/NR	High-BBB	Sector perform	30/10/07	Sectorperform
Valeo	NR/Ba1 neg	Mid-BB	Underperform	19/03/09	Underperform
Volkswagen AG	A- CW neg/A3 CW neg	High-BBB	Sector perform	02/02/09	Sectorperform
Volvo	BBB+ neg/Baa1 neg	High-BBB	Sector perform	19/09/08	Sectorperform

Source: Calyon

### Review of existing trade recommendations

As seen in the table below, over the past quarter we took profit on two trade recommendations, the 5Y CDS spread compression between **Fiat** and **Valeo** and the 1Y-5Y curve steepener in **Daimler**, both trade generating c. 340bp and c.290bp of performance respectively.

We are maintaining our 1Y compression trade between **Fiat** and **Peugeot/Renault** initiated on 11 February 2009, given the large spread differential at the time of the recommendations of c. 1200bp, a level that is unlikely to resurface in our view given that Fiat, Renault and Peugeot credit metrics are very close. We also continue to favour Fiat versus Renault and Peugeot given its strong positioning in small vehicles, which provide a competitive advantage in the current environment

We also keep holding **Faurecia** 2010 bond. We recommended buying the bond at a cash price of 83 back in February 11. The bond has a put at par on the breach of one of the covenants (net debt/EBITDA of no more than 3.50 and EBITDA/net interest expense of more than 4.50). One of the covenants could be breached by year end. If not, we do not expect Faurecia to default by the time the bond mature (Oct. 2010) given that it is 71% owned by Peugeot a strategic partner.

## Autos CDS Trade ideas - 2009 track record

**Closed Strategies**

	Entry Date	P&L (€)	Selling Leg	Amount	Entry Spread	Last Spread	Buying Leg	Amount	Entry Spread	Last Spread	Closing Date
Sell CONGR CDS EUR SR 1Y - Buy PEUG CDS EUR SR 1Y	11/12/2008	717,968	CONGR	10M	2,378	1,462	PEUG	10M	496	360	26/01/2009
Sell CONGR CDS EUR SR 1Y - Buy VW CDS EUR SR 1Y	11/12/2008	650,224	CONGR	10M	2,378	1,462	VW	10M	378	161	26/01/2009
Sell CONGR CDS EUR SR 1Y - Buy RENAUL CDS EUR SR 1Y	11/12/2008	687,498	CONGR	10M	2,378	1,462	RENAUL	10M	536	383	26/01/2009
Sell BMWGR CDS EUR SR 5Y - Buy PEUG CDS EUR SR 5Y	17/12/2008	374,377	BMWGR	10M	413	174	PEUG	10M	412	405	26/01/2009
Sell BMWGR CDS EUR SR 5Y - Buy RENAUL CDS EUR SR 5Y	17/12/2008	95,276	BMWGR	10M	413	174	RENAUL	10M	406	415	26/01/2009
Sell DCX CDS EUR SR 5Y - Buy PEUG CDS EUR SR 5Y	17/12/2008	387,198	DCX	10M	418	178	PEUG	10M	412	405	26/01/2009
Sell DCX CDS EUR SR 5Y - Buy RENAUL CDS EUR SR 5Y	17/12/2008	155,443	DCX	10M	418	178	RENAUL	10M	406	415	26/01/2009
Sell BMWGR CDS EUR SR 5Y - Buy VW CDS EUR SR 5Y	17/12/2008	192,651	BMWGR	10M	413	174	VW	10M	297	201	04/02/2009
Sell DCX CDS EUR SR 5Y - Buy VW CDS EUR SR 5Y	17/12/2008	233,871	DCX	10M	418	178	VW	10M	297	201	04/02/2009
Sell FIAT SPA CDS EUR SR 5Y - Buy VLOF CDS EUR SR 5Y	05/03/2009	455,624	FIAT SPA	10M	1,410	887	VLOF	10M	545	364	05/04/2009
Sell DCX CDS EUR SR 1Y - Buy DCX CDS EUR SR 5Y	17/12/2008	922,889	DCX	10M	678	160	DCX	10M	418	184	26/06/2009
<b>Closed Strategies 2009 P&amp;L</b>		<b>4,873,020</b>									

**Open Strategies**

	Entry Date	P&L (€)	Selling Leg	Amount	Entry Spread	Last Spread	Buying Leg	Amount	Entry Spread	Last Spread	Closing Date	P&L at maturities if no default
Sell FIAT SPA CDS EUR SR 1Y - Buy PEUG CDS EUR SR 1Y	11/02/2009	725,581	FIAT SPA	10M	1,649	679	PEUG	10M	427	311	Open	995,085
Sell FIAT SPA CDS EUR SR 1Y - Buy RENAUL CDS EUR SR 1Y	11/02/2009	735,147	FIAT SPA	10M	1,649	679	RENAUL	10M	453	347	Open	971,641
<b>Open Strategies 2009 P&amp;L</b>		<b>1,460,728</b>										

**Total P&L 2009****6,333,748**

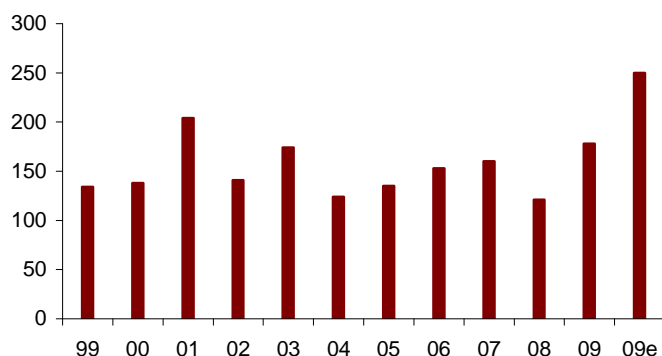
Source: Calyon

## New issuance at record high

### Non-financials bond issuance at a record-high

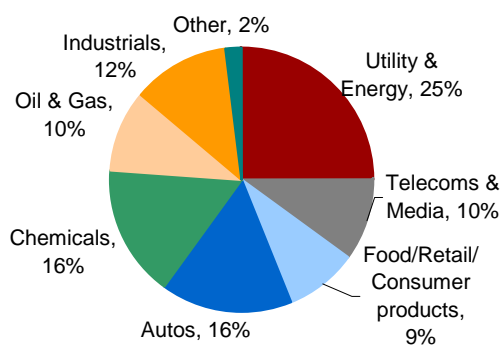
New bond issuance has been very strong year-to-date with EUR176bn issued in the non-financials euro market, ie, a 42% increase compared with FY08 issuance levels and a 10% increase vs FY07. We estimate that FY09 new issuance is likely to reach at least EUR250bn, an all-time record (previous highest point was in 2001 with EUR204bn) due to a catching-up effect of debt refinancing as the credit market was closed last year from mid-September to end-December. In addition, weaker cash generation on the back of the recession has increased funding needs leading to additional leverage of the more cyclical sectors.

Non-Financials euro market issues (EURbn)



Sources: Calyon, Bloomberg, ECB

2009 YTD euro bond issuance by sector excl. banks



Sources: Calyon, Bloomberg

As seen in the table below, 83% of YTD euro corporate new issuance has come from issuers rated BBB+ and above. For Autos it stands at 82% YTD for issuers rated at least A-. For the Auto sector the credit rating category is more than ever key for investors given that credit ratings are more volatile, which can affect liquidity and mark-to-market of auto bondholders especially if they are forced sellers on any downgrade to sub-investment grade category.

Any decision to invest in the sector therefore takes into account the cyclical nature of the industry and the near-term challenges it faces such as:

- Falling demand in a recessionary environment (increasing unemployment);
- To increase sales of more fuel-efficient but smaller and less profitable vehicles in segments A and B, which in turn affects volume mix and margins;
- Declining net pricing due to rising incentives by governments and automakers, which will affect pricing in the long run given the inelasticity of pricing for the sector;
- Increasingly, pressing demand and cash spending to adapt manufacturing, logistics, vehicles and R&D to meet consumer demand for fuel-efficient vehicles and to meet environment regulation

### Conclusion

Pressure on margins/cash flows and an increase in need for cash for capex and R&D is likely to slow down any de-leveraging efforts of the industry in the coming three years. Leverage is even likely to increase at the automakers that do not enjoy scale effects in R&D and industrial production with a high level of shared components across brands and common production platforms. Therefore, access to the bond market will become more and more selective given our view of still-deteriorating credit metrics and ratings in 2010. Recent tightening in credit spreads, while government yield is increasing, is likely to reduce investors' interest in the sector as risk-reward is evaporating at a fast pace. Going into next year we expect auto companies rated BBB+ and above (BMW, VW, DAI, Toyota, Volvo, Scania, MAN, Bosch) to maintain access to the bond market, though

*A boom in new issues in Q109 after a drought in 2008*

issuance premium versus secondary valuations will have to be attractive given recurring high issuance volumes for the sector. Automakers rated below BBB+ are likely to be limited in terms of issuance volumes, which in turn will lead them to look for alternative methods of funding including potential JVs with banks, something we discuss later (see *Credit rating de-linkage between parent and captive finance company*).

### 2009 YTD non-financials (NFN) euro bond Issuance by credit rating category

Rating	% of total NFN	Autos credit rating positioning (S&P)
AAA	5%	
AA+	0%	
AA	2%	Toyota
AA-	15%	
A+	5%	
A	16%	BMW, VW Bank
A-	22%	VW, DAI, Scania
BBB+	13%	Volvo
BBB	10%	RCI banque, Banque PSA, Michelin
BBB-	3%	Renault SA, Peugeot SA
High Yield or not rated	4%	Conti, Valeo, Fiat, Porsche

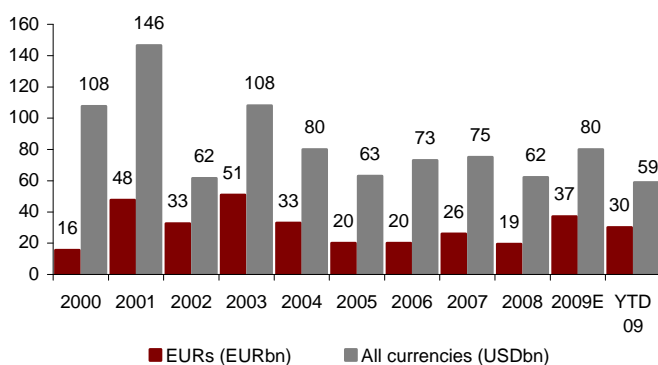
Source: Calyon, Bloomberg

### Oversupply from top-rated automakers

Euro-denominated bond supply for the top 11 auto/truckmakers (Ford Credit, GMAC, Toyota, BMW, Volkswagen, Porsche, Peugeot, Renault, Fiat, Volvo and Scania) and the main auto suppliers in our coverage (Continental AG, Valeo, Michelin, GKN) stands at EUR29.5bn 2009 year-to-date. Across all currencies 2009 year-to-date issuance stands at USD59bn.

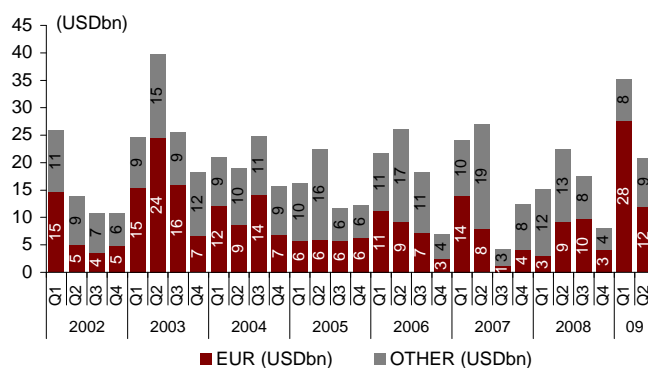
Following the bankruptcy of Lehman Brothers in mid-September 2008 and the subsequent waves of negative headlines surrounding the banking industry, Autos new issuance collapsed last year (see chart below). The delay in refinancing had reached such a high level that, once client appetite and cash inflows resurfaced, the better-rated carmakers came in force to the bond market.

#### Autos global bond issuance since 2000



Sources: Calyon, Bloomberg

#### Autos quarterly global bond issuance



Sources: Calyon, Bloomberg

In Q109 bond issuance from automotive companies was close to a 'normal' full year of issuance (see above charts). As seen in the chart above YTD euro issuance for the sector is already greater than the trend observed since 2005 when annual issuance ranged from EUR20bn to EUR26bn. However, this included euro-denominated issuance of Ford and GMAC, which accounted for about 25-35% of the total, while year-to-date neither carmaker has issued any bonds in euro.

Therefore, once adjusted for GM and Ford, we consider that the sector has so far issued the equivalent of slightly less than twice the issuance of a normal year, meaning that some carmakers have been over-conservative with regards to access to funding.

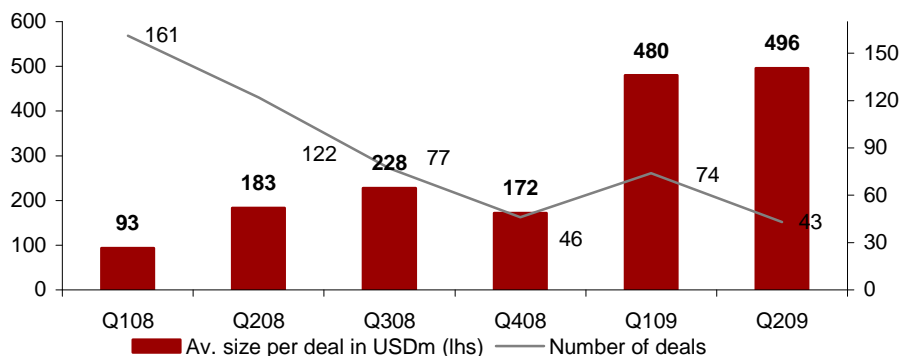
As seen in the table below it is clear that VW has been over-issuing YTD with bond issuance net of 2009 and 2010 redemption of USD0.6bn, which is a very conservative move given that VW's Q1 deliveries declined by 10.7% worldwide. This move reflects management's uncertainties with regards to the development of credit markets and fears over a 'W' shape for credit yields, something that we discuss later in the section *Credit valuations: too tight too fast?*

2009 and 2010 bond redemption net of YTD bond issuance across all currencies

(USDbn)	Ford	GMAC	DAI	Toyota	PSA	RNO	Volvo	Scania	BMW	VW	Fiat	Porsc.	Conti	Mich.	Valeo	GKN	Total
2009	-12.8	-6.9	-9.0	-7.4	1.7	-3.1	-0.4	-0.8	-0.4	7.0	-0.6	0.0	-0.1	0.5	0.0	0.0	-32.2
2009 and 2010	-20.2	-16.2	-17.7	-24.8	-1.0	-6.2	-2.1	-1.7	-3.9	0.6	-1.9	0.0	-0.1	0.5	0.0	0.0	-94.6

Source: Calyon

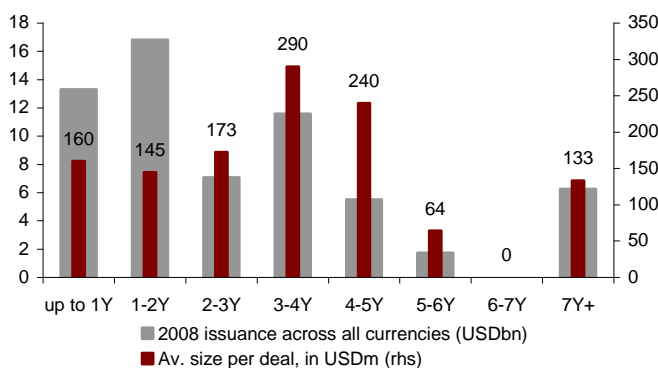
Autos quarterly average size of deals and no. of deals



Source: Calyon, Bloomberg

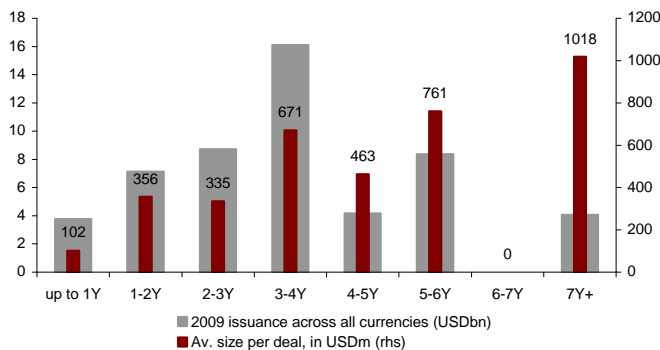
As seen in the charts above, in 2009 the average size per deal reached the highest level since Q108. Last year the bulk of the new issuance was made at the short end of the curve (up to 2Y) with smaller-sized deals (see chart below) due to net redemption of assets under management among investors, which triggered low client appetite. As seen in the chart below the bulk of the Autos new issuance came with a duration of 3Y-4Y, matching new car loan maturities, a sign of normalisation of the primary credit market for automakers.

2008 issuance and avg size per maturity bucket



Sources: Calyon, Bloomberg

2009 issuance and avg size per maturity bucket



Sources: Calyon, Bloomberg

In Q109 the trend reversed, with issuers coming to the realisation that the world economy had changed and so had the risk premium that had to be attached to it. As a result yields on new deals came at very generous levels compared with government bonds.

So far this year, new issues with large premiums

The large premium attached to the new bonds (ranging between 100bp and 200bp versus secondary cash spreads) combined with investors' cash inflows, wider valuations (5Y yield stood at about 7.7-7.8% for a 'low single A'-rated Auto company like DAI or BMW in January 2009 vs c.4.9% now) and the orderly execution of new deals, ie, highly rated and well-known companies coming to the

market first, have enabled syndicate desks to keep the ball rolling since the beginning of the year.

However, we highlighted earlier the risk of tightening valuations in the face of still-deteriorating credit metrics for the sector while government bonds yields continue to widen, which could push investors to allocate future cash inflows more into government bonds and/or less volatile credit sectors such as Utilities/Telecoms rather than cyclicals rated borderline to speculative grade territory. For instance, the 5Y yield differential between DAI and the euro generic government bond stood at 5.6% at the beginning of FY09 compared with 2% now.

## **Autos issuance likely to be moderate for the rest of 2009**

Given the amount of issuance that has been concentrated in such a small period of time and the likelihood that lower-rated companies will keep trying to access the bond market at a now cheaper cost of borrowing, we feel that client appetite with regard to the Autos sector could become more selective and discrimination of the highly rated automakers and lower-rated ones could increase.

*We expect the corporate bond market to tighten again*

We therefore believe that if lower-rated auto companies keep accessing the bond market, they will have to come with a high risk premium on top of secondary spreads, potentially weighing on the performance of recent issuance, which in turn could limit client appetite.

In addition, investment-grade funds are reluctant to increase exposure to companies that are borderline sub-investment grade as they would become forced sellers once a company were to join the high-yield indices, which most of the time triggers a potential loss given the current poor liquidity of the secondary market. Indeed, the euro high-yield market is about 3 times smaller than the investment-grade market. The European high-yield market is relatively young and is dominated by leveraged investors with relatively short investment horizons, which leads to greater volatility and less liquid markets during times of uncertainty.

### **Who are the potential issuers for the rest of 2009?**

New bond supply in the Autos sector typically comes from the captive finance operations of the automakers, in order to refinance the new car loans granted to the buyers of vehicles and to finance the car inventories at the dealerships. The captive finance operations are in turn influenced by a number of competing factors: strategic decisions to grow or shrink the size of the balance sheet (managed receivables); the level of vehicles sold by the parent; the vehicle incentives policy and the desire to pre-fund future maturities (on average 12 months before maturity, but it might be more now given fears over the future liquidity of the credit market).

In addition to these factors, the most significant, in our view, has been the use of other funding sources such as asset-backed securitisation (ABS), commercial paper (CP), asset-backed commercial paper (ABCP), floating rate notes (FRN), fixed rate notes, whole loan sales, retail bonds, bank facilities, intercompany loans from the industrial operations, and account deposits at the banking unit. In addition, new funding channels have surfaced with the credit crisis including refinancing through the ECB should the carmaker own a banking unit as well as senior unsecured debt backed by states (French SFEF and German Soffin).

During periods of economic growth and excluding the one-off period of commercial paper refinancing in 2001, the industry had generated per-year issuance of USD100-110bn across all currencies. This said, declining bond issuance from Ford, GM and Chrysler since 2004 has limited issuance across all currencies to USD75bn in 2007 and USD62bn in 2008.

## Autos bond issuance forecast across all currencies and in EUR

(USDbn)	Ford & GM	others	Total
<b>2009 issuance - Year-to-date</b>	<b>6</b>	<b>54</b>	<b>59</b>
<i>of which euros (in EURbn)</i>	<i>0</i>	<i>29.5</i>	<i>29.5</i>
<b>2009 issuance - low range estimate</b>	<b>10</b>	<b>50</b>	<b>60</b>
<i>of which euros (in EURbn)</i>	<i>0</i>	<i>25</i>	<i>25</i>
<b>2009 issuance - high range estimate</b>	<b>12</b>	<b>68</b>	<b>80</b>
<i>of which euros (in EURbn)</i>	<i>0</i>	<i>37</i>	<i>37</i>
<b>2008 issuance</b>	<b>4.1</b>	<b>58.1</b>	<b>62.2</b>
<i>of which euros (in EURbn)</i>	<i>0.7</i>	<i>18.7</i>	<i>19.4</i>
<b>2007 issuance</b>	<b>16</b>	<b>59</b>	<b>75</b>
<i>of which euros (in EURbn)</i>	<i>3</i>	<i>18</i>	<i>21</i>
<b>2009 redemption</b>	<b>25</b>	<b>66</b>	<b>91</b>
<i>of which euros (in EURbn)</i>	<i>5</i>	<i>19</i>	<i>24</i>
<b>2010 redemption</b>	<b>17</b>	<b>46</b>	<b>62</b>
<i>of which euros (in EURbn)</i>	<i>3</i>	<i>20</i>	<i>22</i>

Source: Calyon

For the remaining part of 2009, we expect new bond supply for the top 11 auto/truckmakers (FMCC, GMAC, Toyota, BMW, Volkswagen, Porsche, Peugeot, Renault, Fiat, Volvo and Scania) and the main auto suppliers in our coverage (Continental AG, Valeo, Michelin, GKN) to be USD20bn across all currencies, of which we estimate EUR7bn to be in EUR.

The breakdown by issuer can be seen in the table below. Fiat and Renault could look to tap the bond market should a window of opportunity arise. That said, any issuance from these low-rated automakers will be limited in size given that they are either in high-yield territory or borderline to it.

These estimates are based on sluggish global demand for new vehicles (Europe down 8.5% and the US down 23.5% in 2009), hardly any issuance from Ford Credit (FMCC), GMAC and Chrysler (which together accounted for about 20% of new issuance in 2007 and still 7% in 2008), and difficult access to the bond market for lower-rated autos companies that are borderline sub-investment grade.

## 2009 gross issuance and net issuance (redemption) per company

(USDbn)	Ford	GMAC	DAI	Toyota	PSA	RNO	Volvo	Scania	BMW	VW	Fiat	Porsc.	Conti	Mich.	Valeo	GKN	Total
<b>2009 issuance - low range est.</b>	4.4	5.6	7.9	15.6	2.4	2.8	2.0	0.7	7.0	10.9	0.0	0.0	0.0	0.5	0.0	0.0	<b>59.9</b>
<i>of which euros (in EURbn)</i>	0.0	0.0	4.6	4.5	1.9	2.0	1.0	0.2	3.4	7.6	0.0	0.0	0.0	0.4	0.0	0.0	<b>25.5</b>
<b>2009 issuance - high range est.</b>	5.2	6.5	8.7	17.4	2.7	3.1	2.8	0.7	10.5	15.7	1.1	4.0	0.0	1.1	0.0	0.0	<b>79.6</b>
<i>of which euros (in EURbn)</i>	0.0	0.0	5.1	6.0	2.1	2.2	1.4	0.2	5.1	10.2	0.9	3.0	0.0	0.8	0.0	0.0	<b>36.8</b>
<b>2009 Year-to-date</b>	1.1	4.5	5.7	14.3	4.1	2.2	2.4	0.2	8.3	15.4	0.0	0.0	0.0	1.1	0.0	0.0	<b>59.2</b>
<i>of which euros (in EURbn)</i>	0.0	0.0	3.5	4.2	2.8	1.5	1.2	0.0	5.2	10.3	0.0	0.0	0.0	0.75	0.0	0.0	<b>29.5</b>
<i>of which % of total euro</i>	0.0%	0.0%	11.9%	14.2%	9.6%	5.1%	4.1%	0.0%	17.6%	34.9%	0.0%	0.0%	0.0%	2.5%	0.0%	0.0%	<b>100%</b>
<b>2009 left from top estimate</b>	4.1	2.0	3.0	3.1	-1.4	0.9	0.4	0.5	2.2	0.3	1.1	4.0	0.0	0.0	0.0	0.0	<b>20.3</b>
<i>of which euros (in EURbn)</i>	0.0	0.0	1.6	1.8	-0.7	0.7	0.2	0.2	-0.1	-0.1	0.9	3.0	0.0	0.0	0.0	0.0	<b>7.3</b>
<b>2009 Gross redemption</b>	13.9	11.4	14.7	21.7	2.4	5.3	2.8	1.0	8.6	8.4	0.6	0.0	0.1	0.6	0.0	0.0	<b>91.4</b>
<i>of which euros (in EURbn)</i>	2.3	2.6	4.3	0.4	1.0	3.1	1.2	0.3	4.2	4.2	0.0	0.0	0.1	0.5	0.0	0.0	<b>24.2</b>
<b>2009 net redemption - low range est.</b>	-9.5	-5.8	-6.8	-6.0	0.1	-2.5	-0.8	-0.3	-1.6	2.5	-0.6	0.0	-0.1	-0.1	0.0	0.0	<b>-31.5</b>
<i>of which euros (in EURbn)</i>	-2.3	-2.6	0.3	4.2	0.9	-1.2	-0.2	-0.1	-0.8	3.4	0.0	0.0	-0.1	-0.1	0.0	0.0	<b>1.3</b>
<b>2009 net redemption - high range est.</b>	-8.7	-4.9	-5.9	-4.3	0.3	-2.1	0.0	-0.3	1.8	7.4	0.5	4.0	-0.1	0.5	0.0	0.0	<b>-11.9</b>
<i>of which euros (in EURbn)</i>	-2.3	-2.6	0.8	5.7	1.1	-1.0	0.1	-0.1	0.9	6.0	0.8	3.0	-0.1	0.3	0.0	0.0	<b>12.6</b>

Source: Calyon

## Credit trend

### Car demand is not likely to rebound to pre-crisis levels

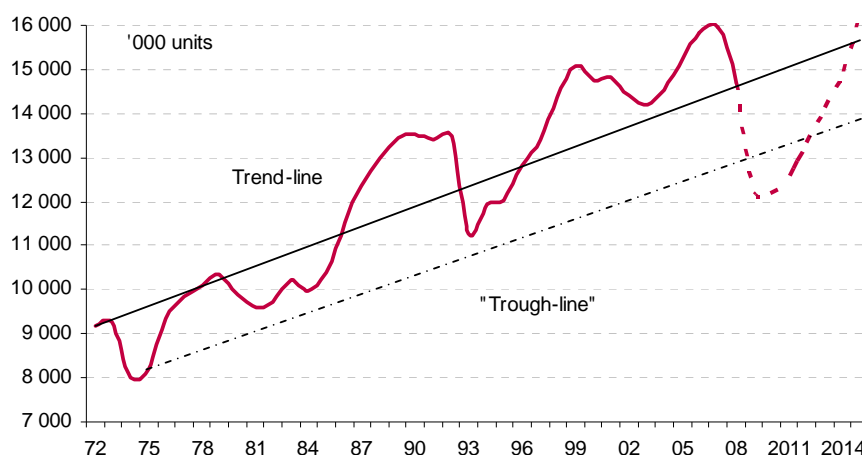
*Structural changes caused the deep recession*

The collapse in demand, which for the first time in history has occurred simultaneously in all markets in the world, is due to two different factors:

- **The end of a consumption cycle:** in essence this factor is not structurally disruptive for the sector, which remains fundamentally cyclical. If past trends are relevant, we argue that a 15% volume decline in two years (2008 and 2009) would indicate a normal cycle trough. In such a normal cyclical pattern, it would be logical to expect a material rebound in demand as from 2010. We argue that the sector has the financial resources to sustain such a trough without any major trouble and will not need to ask for State help.
- **A deleveraging of the economy:** the major disruption of normal patterns are: (1) the end of cheap credit; and (2) the rising aversion to indebtedness. We argue here that the main issue is not availability of credit but consumers' unwillingness to take on new debt. The collapse of car demand to a level far below the historical trend can, in our view, be attributed to this deleveraging of the real economy.

Therefore at the start of the year we were anticipating a 15-20% decline of the European car market, before potentially stabilisation next year. The recovery to pre crisis level was not expected before 2014 at the earliest, indicating a level of demand structurally lower than in the past.

Sharp drop up to 2010, recovery to pre-crisis level not before 2014



Source: ACEA, Cheuvreux, Industry

### The scrapping incentive phenomenon

France, Germany and Italy have introduced incentive programmes to stimulate car demand that declined up to 50% YoY in some months/regions before those subsidies were initiated. Some other EU countries, like the UK, are now launching their own programmes. Even the US government is on the verge of launching a scrapping plan, resembling the highly successful German scheme (voucher of up to USD4,500 for the scrapping of an old vehicle in exchange of a purchase of a new less polluting one – at least 22 miles per gallon for cars and 18 miles per gallon for light trucks; a measure expected to boost demand by 1m units in a full year).

*A EUR1,000 cash scrapping incentive in France*

**France:** the State is offering a EUR1,000 incentive for each car over 10-years old that is scrapped, in return for the purchase of a new one. This comes on top of the green incentive/tax scheme that cost the State around EUR280m last year. This scrapping incentive is most often matched by carmakers in order to boost volumes. Around 35% of new car sales have benefited from the scheme since the

start of the year, representing around 650,000 vehicles. The net effect of the incentives is expected to amount to around 300,000 vehicles in 2009 (15% of the new car market). Officially, the scheme is set up for one year, ie 2009. However, we believe it is very likely that the State will maintain the programme in 2010 in order to continue to support demand and smooth the end of the scheme. Therefore we anticipate a roughly stable market this year and a slight decline next year (by 5%). But the pull-forward effect will have to be offset probably in 2011 and through a material price decline.

*A EUR2,500 cash scrapping incentive in Germany*

**Germany:** the scrapping incentive initiative launched at the start of this year entitles every buyer of a car that is not older than one year to a EUR2,500 state subsidy if a car is traded in for one that is at least nine years old. Acceptance of the plan by car buyers has far exceeded all expectations. It is a massive help for carmakers to rid themselves of the huge number of new cars on their own or dealers' inventories. The fact that many Germans are trading in their old cars to benefit from the tax break even though the residual value of their cars exceeds the EUR2,500 tax incentive indicates there is a substantial positive psychological effect associated with the scrapping bonus. At the outset, the government had allocated a EUR1.5bn budget, leading to support for 600,000 vehicles (20% of the German new car market). Facing with such a massive success, the German State increased its dedicated budget to a maximum of EUR5bn, which could be used up by the end of the third quarter. The gross effect of the programme could amount to almost 2m vehicles, ie, about two third of 2008 German sales. Customers are only required to sign the contract for a new car in 2009 while delivery/registration could also happen latter, which is why we expect another distortion of registration levels in Q110. We base our calculations on 1.5m additional new registrations in 2009 through the subsidy scheme and an underlying market decline of 35%. All in all, German new registrations in 2009 are set to slightly exceed 3.5m units, equivalent to 23% growth or 800,000 units more than in 2008. The VW group believes that ~50% of applicants for the scheme are buyers that would traditionally purchase second-hand vehicles, which could limit the backlash on new car sales in 2010. Nevertheless, if no smoothing measures are taken, car sales could easily decline by ~20% vs 2009E to 2.8m units, depending on how many incentivised cars from the 2009 programme will distort Q1-10 registrations.

### Other European programmes

In the UK the government has launched in early May 2009 a GBP2,000 scrapping incentive per vehicle, shared between the State and dealers. Again the effect should be pretty massive in a market down as much as 25% in the first five months of 2009.

Italy and Spain also have incentive schemes but more related to CO<sub>2</sub> emission with less of a supporting effect in terms of demand. The Spanish plan has almost no positive effect, mainly as there is only an interest rate subsidy for new car purchases, but no cash transaction involved. Comparable programmes in Luxembourg, Portugal and Austria do not have much influence on car sales on a European scale.

### 2009 will definitely be better than feared

Undoubtedly, the most positive impact of those schemes, the German programme in particular, for the auto industry is that it helps clear inventories of new cars, including huge dealer inventories, display cars and self registration models. German dealers of basically all European volume makers have sold their entire fleet of pre-owned cars that are less than one year old. Industry order backlogs suggest the biggest positive impact of the scrapping schemes has yet to come.

*We estimate the European car market will be boosted by 2m vehicles in 2009*

We assume European car sales will be inflated by some 2m units in 2009, equivalent to 13% of normalised car sales and eventually 17% of 2009 sales without any subsidisation at all. Therefore we expect the European car market to decline only 8.5% this year to 12.4m vehicles.

### But a pull-back is to be expected next year

The pull-forward in demand this year leads to a backlash sooner or later. We argue that governments cannot afford, for obvious political and social reasons, to

let demand drop next year. We anticipate a somewhat stable market in 2010 still supported by incentives (even if the amounts involved could be reduced, notably in Germany).

The counter effect would then be felt the following year, ie in 2011. Arguably this would coincide with a macroeconomic recovery that could absorb this counter-impact, notably through an improvement in the mix after a sharp deterioration in previous years. This is precisely what the politicians will assume.

However, this tactic has a major flaw, which concerns pricing:

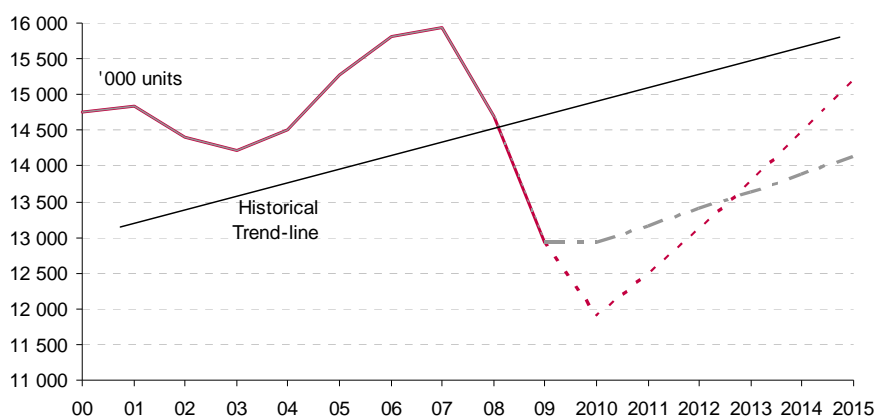
- Along with the State incentives, carmakers are offering their own discount, most often at least equivalent to the State subsidy. This is even embedded in the scheme in the UK where the State offers GBP1,000 per vehicle on the condition that the dealer/carmaker offers the same discount. These global massive discounts have a depressing impact on the mix as buyers are attracted by deals rather than the product itself and go for small vehicles.
- When the States will stop their schemes, it is highly likely that the pricing environment will not return to the previous level and that OEMs will have to compensate for the end of State help. The situation in the 1990s (scrapping scheme in 1994 and 1995 in many European countries) illustrates the lasting effects of this disruption on pricing positioning, and residual values in the second-hand car market.

*An 8% decline in demand in 2010E  
with lower incentive schemes*

All in all, we anticipate a slight 8% decline of the European market in 2010 and a gradual recovery in the next few years due to this pull-back impact. Should European governments maintain their incentives scheme next year, demand could remain stable albeit eating even more into the recovery trend (grey curve on chart below).

Note that the volume trend only tells part of the story. The revenue trend is meant to be affected for a long time by these push strategies.

**Less dramatic decline but volumes only tell a part of the story**



Source: CA Cheuvreux, Calyon

Ultimately, the only way out of the crisis will be through massive cost-cutting that might occur when markets recover. The drawback of this timing is that this cost-cutting wave might not be well understood and accepted by trade unions and politicians alike.

## European new registrations

('000 units)	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
Germany	3,342	3,253	3,237	3,267	3,342	3,468	3,148	3,090	3,509	2,781
France	2,255	2,145	2,009	2,014	2,068	2,001	2,065	2,050	2,030	1,930
Italy	2,413	2,280	2,247	2,259	2,237	2,326	2,491	2,160	2,080	1,940
UK	2,459	2,564	2,579	2,567	2,440	2,345	2,404	2,132	1,700	1,650
Spain	1,426	1,332	1,382	1,518	1,529	1,635	1,615	1,161	0,800	0,750
Major markets	11,922	11,565	11,454	11,624	11,616	11,771	11,722	10,593	10,119	9,051
Smaller markets	2,896	2,834	2,758	2,893	2,914	2,992	3,072	2,965	1,950	2,000
Western Europe	14,818	14,399	14,213	14,517	14,530	14,766	14,794	13,558	12,407	11,412
% Change										
Germany	-1.1%	-2.7%	-0.5%	0.9%	2.3%	3.8%	-9.2%	-1.8%	13.6%	-20.7%
France	5.7%	-4.9%	-6.3%	0.2%	2.7%	-3.3%	3.2%	-0.7%	-1.0%	-4.9%
Italy	-0.4%	-5.5%	-1.4%	0.5%	-0.9%	4.0%	7.1%	-13.3%	-3.7%	-6.7%
UK	10.7%	4.3%	0.6%	-0.5%	-5.0%	-3.9%	2.5%	-11.3%	-20.3%	-2.9%
Spain	3.2%	-6.6%	3.8%	9.8%	0.7%	6.9%	-1.2%	-28.1%	-31.1%	-6.3%
Major markets	3.4%	-3.0%	-1.0%	1.5%	-0.1%	1.4%	-0.4%	-9.6%	-4.5%	-10.6%
Smaller markets	-9.8%	-2.1%	-2.7%	4.9%	0.7%	2.7%	2.7%	-3.5%	-23.8%	260.0
Western Europe	0.5%	-2.8%	-1.3%	2.1%	0.1%	1.6%	0.2%	-8.4%	-8.5%	-8.0%
<b>Peak (2007) to trough (2010E) decline</b>									<b>-18%</b>	<b>-25%</b>

Source: ACEA, CA Cheuvreux

## Fiat, a clear winner, Volkswagen in for a killing

The good news of this incentive phenomenon relates to operating cash flow, which is not declining as deeply as feared, as the industry is using its capacity much better.

The bad news relates to profitability, which does not benefit from these volumes generated on a lower mix and particularly aggressive transaction prices. Marginal profitability remains poor if not negative for these models.

### Market share by segment in Europe 2008

(%)	A	B	C	D
Fiat	31.9%	9.6%	1.0%	5.5%
Renault	10.6%	18.5%	10.3%	10.8%
PSA	16.6%	18.6%	16.7%	15.6%
GM Europe	5.8%	16.4%	13.1%	8.9%
Ford Europe	4.5%	12.5%	13.2%	23.6%
Volkswagen	2.0%	15.0%	26.6%	24.6%
Toyota	8.1%	6.5%	6.7%	8.0%

Source: CA Cheuvreux

### Car registrations, Europe (EU 27 + EFTA)

(No. of units)	YTD June 09	YTD June 08	% Change, YoY
VW	1 591 138	1 641 545	-3.1%
Fiat	672 312	680 069	-1.1%
GM	676 949	825 678	-18%
PSA	947 893	1 079 177	-12.2%
Ford	764 092	830 433	-8.0%
Renault	644 171	740 147	-13%
BMW	355 758	458 083	-22.3%
DAI	354 689	435 903	-18.6%

Source: ACEA

The incentive game is obviously favourable for mass-market car makers as the incentives chiefly benefit small and low polluting vehicles. In the recent sector rally, Fiat, Peugeot and Renault were the main winners, while German players, notably premium car manufacturers, lagged behind.

We argue that this trend is set to continue as long as the incentives persist. However, a reversal of the trend in favour of premium carmakers is to be expected when incentives are dropped, as these groups did not benefit from them; this is a probable investment theme for 2010.

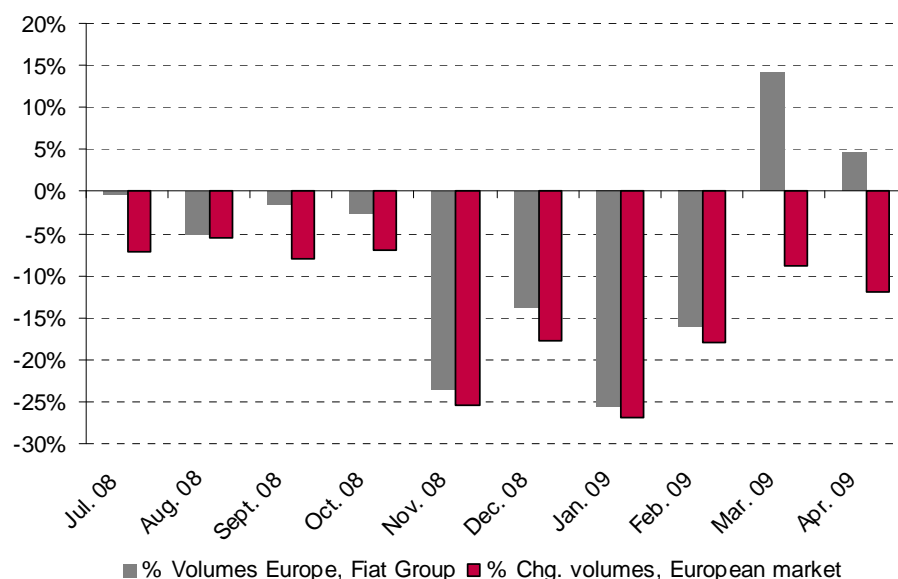
Over 60% of Fiat's sales in Europe benefit from the incentives scheme

## Fiat is an obvious winner

Fiat is the obvious winner of the incentive game. Over 60% of its volumes in Europe relate to small cars that are eligible to the schemes in many key markets. But above all, the Panda and the Cinquecento, the group's two fast-selling models are assembled in Poland at a cost that is now particularly attractive following the 26% depreciation of the Polish zloty versus the euro since 1 January 2009. Although Fiat Auto does not disclose profitability trends by region, it is common knowledge that it was barely profitable in Europe last year, with all the profits being generated in Mercosur. We argue that Fiat Auto is probably more profitable in Europe in 2009 thanks to the volume boost to small cars and to the currency impact, which brings in an additional EUR1,000 per car in value terms (based on a production cost of EUR4,000). All European rivals are in the red this year notably in their European businesses.

Fiat is the carmaker that has posted the smallest volume slide in Europe so far this year, with a limited decline of 3% after five months, in a market down 14%. Fiat is the also sole carmaker in positive territory since February, when incentives started to produced their impact: Fiat Auto sales were down 26% in January but up 2.4% over the past four months, in a market down 13%.

### Fiat sales in Europe benefit massively from scrapping incentives



Source: ACEA

## Volkswagen in for a killing

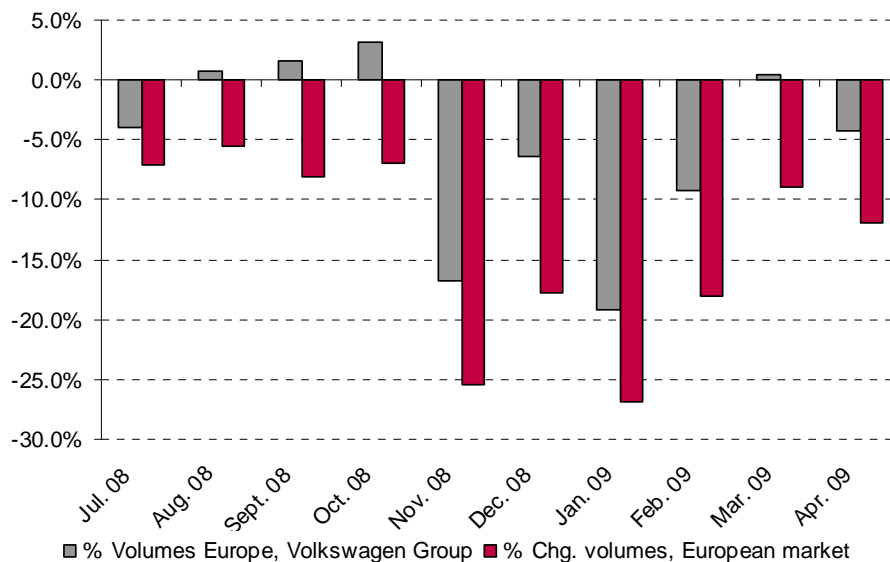
Volkswagen is probably the most aggressive carmaker in Europe at present despite constant official denials from the group. No need for a long explanation to be convinced of this strategy which we believe is deliberate: surprisingly volumes of the *Polo* are still up in a tough market, while the model dates from the early 1990s and will be replaced after the summer. With regard to the *Golf VI*, which reached the showroom at the end of 2008, the group has added up to EUR4,600 worth of discounts in Germany on top of the EUR2,500 offered by the State, which puts the entry-level transaction price for retail customers at less than EUR10,000, ie well below the list price of a *Polo*. There are also abundant examples for more ageing models like the *Touran* compact minivan, the *Transporter* LCV, etc.

Volkswagen has the cash and the flexibility to win the value proposition game

This strategy is deliberate in our view. Volkswagen is the European market leader and leader in terms of price. It had EUR10bn in net cash at the start of the crisis when many mass-market competitors were already indebted with limited room for manoeuvre. Volkswagen decided to push its advantage a little bit further by grabbing easy points of market share at a time when the competition was unable to follow this price / value proposition game.

Such a move explains the importance of the scale effect in this industry and the need for many carmakers to catch up in terms of size. Fiat Auto, PSA, Ford Europe, GM Europe are clearly sub-scale. Renault limits its handicap by means of its alliance with Nissan but such an aggressive strategy by Volkswagen can only push Renault's management to accelerate integration of the two groups in order to squeeze more synergies out of the alliance.

### Volkswagen is likely to be a market proxy



Source: ACEA

## Industrial liquidity under pressure

The good news of the scrapping incentives programme is that it alleviates the industry's cash constraints somewhat, as it supports volumes and helps clear inventory while avoiding overly sharp production cuts. Carmakers can better absorb fixed costs and burn less cash than feared in the trough of this recession, notably at a time when they tend to clear their inventory.

*Scrapping incentives help cash generation in the short term*

However, we would not expect operating profitability to change radically from levels expected at the start of the year, as the additional volumes sold involve a poor mix and low prices, leading to low marginal profitability, if any.

All in all, mass market carmakers are likely to end the year with lower-than-expected debt, though up YoY, and premium makers to end up with more net cash. The table below shows our current expectations based on conservative assumptions for volumes. 2009 FCF could end up better than expected depending on production levels in the very last months of the year.

We believe that the H1 season could surprise positively on this account, with better FCF than expected for many OEMs thanks to the rise in production on low inventories and stronger-than-expected effect from scrapping incentives.

## 2009 Industrial liquidity

Change in cash in FY09 EURbn	Peugeot	RNO	Fiat	BMW	VW	DAI	Volvo	Scania	Conti	Michelin	Valeo
							SEKbn	SEKbn			
Free cash flow	-3.8	1.1	0.5	0.4	3.8	-0.4	-7.1	2.5	0.5	0.3	-0.3
Debt repayment by end 2009	-1.7	-3.5	-1.5	-1.3	-2.9	0.0	-15.5	-4.6	-1.5	-0.8	-0.2
sub total (a)	-5.5	-2.4	-1.0	-0.9	0.9	-0.4	-22.5	-2.2	-1.0	-0.5	-0.5
<b>Available committed liquidity</b>											
Gross cash	3.3	1.1	2.6	5.1	9.5	4.7	16.7	4.3	1.6	1.2	0.3
Marketable securities	0.5	1.2	0.1	0.6	3.8	1.0	5.9	0.1	0.0	0.2	0.4
Bank facilities	6.4	7.1	3.4	5.9	7.8	6.8	26.7	26.8	2.2	1.4	1.2
sub total (b)	10.2	9.4	6.1	11.5	21.0	12.5	49.3	31.1	3.8	2.8	1.9
<b>Cushion (shortfall) (a+b)</b>	<b>4.7</b>	<b>7.0</b>	<b>5.1</b>	<b>10.6</b>	<b>22.0</b>	<b>12.1</b>	<b>26.7</b>	<b>29.0</b>	<b>2.8</b>	<b>2.3</b>	<b>1.4</b>
Cut in capex/R&D	0.0	0.6	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.3	0.0
Dividend payments	0.0	0.0	0.0	-0.2	-0.8	-0.6	-3.7	-2.0	0.0	-0.2	0.0
Share buyback/Right issue	0.0	0.0	0.0	0.0	0.0	2.0	0.0	0.0	0.0	0.0	0.0
Other <sup>1</sup>	0.0	0.0	0.0	0.0	0.0	-0.8	40.0	1.5	0.0	0.0	0.0
sub total (c)	0.0	0.6	0.0	0.1	-0.8	0.5	36.3	-0.5	0.0	0.1	0.0
<b>Cushion (shortfall) (a+b+c)</b>	<b>4.7</b>	<b>7.6</b>	<b>5.1</b>	<b>10.7</b>	<b>21.2</b>	<b>12.6</b>	<b>63.0</b>	<b>28.5</b>	<b>2.8</b>	<b>2.4</b>	<b>1.4</b>
<b>Cushion incl. stake holdings</b>	<b>5.2</b>	<b>18.4</b>	<b>5.1</b>	<b>10.7</b>	<b>25.5</b>	<b>12.6</b>	<b>63.0</b>	<b>28.5</b>	<b>2.8</b>	<b>2.4</b>	<b>1.4</b>

1- DAI's Chrysler exposure, new financing for Volvo and Scania

Source: Calyon

## Re-rating potential capped until end 2010, as mid-term risks still exist

We believe that the re-rating will most probably be capped from now on, as the mid term risks are still there. We still expect that the European car market will decline 8.5% next year (assuming the end/progressive phase out of the scrapping vehicle schemes), leaving little upside on FCF generation purely from operations. The only way carmakers can secure FCF or at least no cash burn will be through cost reduction. This cost cutting will have to be driven by radical changes in management style, with a more acute focus on cash and a trade-off in terms of future projects.

In the table below, we take the example of a typical mass-market carmaker in Europe with EUR50bn in revenues, and a negative operating margin in Europe in current market conditions. We assume two scenarios for the investment: one with an investment ratio of 8% (Volkswagen Group's ratio stands at 6.5% at present while PSA's is 8.4% and Renault 11.7%, with a target to reduce it to below 10%). This first scenario reflects the industry's current effort to prepare for the future under the current environment. The other scenario is based on an 11% investment ratio that reflects the required effort to prepare for the shift in powertrain technology under stricter regulations (notably CO<sub>2</sub>). We show that, excluding any cost-cutting measure, this car maker has little chance of generating a decent FCF in a foreseeable future.

All in all, it is difficult to see the industrial FCF/Net debt ratio improving rapidly for the sector over the period 2009–2012, for the mass-market OEMs at least.

Hence, we expect the question of refinancing of the industrial part of these OEMs to be raised again, probably later this year, and investors will then start to look ahead at 2010 prospects.

*Cash generation and financing to become tight again in 2010*

## Low FCF for a typical generalist in a foreseeable future unless there is drastic cost-cutting

(EUR m)	2008	2009	2010	2011	2012
Sales	50 000	44 000	40 480	42 504	44 629
% Change		-12%	-8%	5%	5%
EBIT	500	-1 000	-600	0	600
EBIT margin (%)	1.0%	-2.3%	-1.5%	0.0%	1.3%
Investment ratio at 8%					
Investment	4 000	3 520	3 238	3 400	3 570
As % of sales	8%	8%	8%	8%	8%
Change in WCR	-1 500	-1 500	0	0	0
FCF	-1 500	-1 020	682	438	430
Investment ratio at 11%					
Investment	5 500	4 840	4 453	4 675	4 909
As a % of sales	11%	11%	11%	11%	11%
Change in WCR	-1 500	-1 500	0	0	0
FCF	-1 500	-2 340	-533	-837	-909

Source: CA Cheuvreux

## Consolidation inevitable at last

### Europe is not NAFTA

Europe is not NAFTA. In the US, the federal government is paying for massive restructuring of the auto industry, implying capacity cuts and job losses notably at both GM and Chrysler. In Europe, governments seem more concerned about maintaining social stability at the expense of the necessary adjustment of the car industry to a new and probably lasting environment.

### A high level of interventionism in Europe

In every country in Europe, governments have launched support programmes for the auto industry. More or less all of them rely on two pillars: (1) financial support for the largest players, the carmakers, that in turn are asked to support their local suppliers as much as possible; and (2) incentives to boost demand and to avoid an excessive collapse in car markets.

**Incentives:** Germany leads the way here with a EUR2,500 scrapping incentive (for a car over nine years old), with a budget of up to EUR5bn that may be entirely used up by end of Q3. France offers EUR1,000 per car for vehicles more than ten years old. Even the UK has launched its plan with a GBP2,000 incentive, shared between the state and the carmaker or dealer.

→ We believe it highly likely that the numerous incentive schemes now in place in Europe will be maintained in 2010, although the amounts offered might be reduced, notably in Germany. Therefore, the pullback effect next year could be absorbed at least partially. However, the amount of cash put on the table to boost demand is significant enough to become a potential political issue in the event of an excessive re-rating in share prices.

**Financial help:** France offered a five-year EUR3bn loan to both French carmakers at slightly subsidised rates (from 6.5% to 9.5%). Furthermore, carmaker's captive finance divisions can refinance through the SFEEF, an arm that refinances banks in times of liquidity shortage. Germany is offering a guarantee on borrowings by carmakers. So far, only the captives of BMW, Daimler and Volkswagen have used the scheme. However, the German government will also be deeply involved in the bail-out of Opel, as it is ready to guarantee from EUR4bn to EUR7bn of the new company's debt, depending on the future owner of Opel.

**Flexibility measures:** Most of all, although it is not the most publicised measures, governments have strengthened flexibility measures to help the industry get through times of very weak volumes without being forced to take drastic actions on fixed costs. In Germany, the government has extended the benefit period for its partial employment scheme from 6 to 18 months. In 2009, around 6,000 companies in Germany are expected to use the scheme, which will affect 250,000 staff for a cost of EUR1.5bn for the government, five times the amount paid in 2008. In France, the government extended the temporary

*In Europe, governments pay to avoid restructuring and potential social unrest*

unemployment scheme from 600 hours a year to 1,000 hours, over 90% supported by state funds (ie, slightly more than 50% of working time per year per employee). In Italy, the Casa Integrazione system provides similar flexibility to that of the extended French scheme.

In our view, these are the most pernicious measures if the collapse in demand is not just temporary. On the one hand, it is massively positive from a cash perspective for the industry, as it allows a transfer to the states of huge amount of fixed costs. On the other hand, it lessens the urgency for adjusting the fixed cost base and gives the false impression that things are not that bad.

## Heavy restructuring in NAFTA

Unlike in Europe, the US government is finally tackling the issue of its own car industry, if only because two of its three players are nearly bankrupt.

All in all, the US government will have spent over USD80bn between 2008 and 2009 in bailing out GM and Chrysler. This enormous sum urged the government to force real and lasting restructuring at both carmakers. These measures encompass:

*In North America, governments are paying for a massive restructuring of capacity*

- A reorganisation of the legal entities of Chrysler, taken over by Fiat and going through a rapid Chapter 11 process, and of GM, which is now following the same path.
- Massive downsizing of both players in NAFTA: GM has already announced its intention to keep only four brands alive: Chevrolet, Cadillac, Buick and GMC, and cut its network by 2,600 dealers (out of 6,400 in NAFTA). We believe GM will cut around 30% of its capacity in NAFTA between 2008 and 2012, ie, a capacity cut of 2 million units. In our view, Chrysler under Fiat management could downsize its current capacity of 3.7 million vehicles (for 2m vehicles sold in 2008) by up to 40%, leading to a 1.3m unit capacity cut.

## Excess capacity issue addressed in NAFTA, not in Europe

(million units)	North America	Europe
New car market 2007 (reference year)	16.0	16
New car market 2009 (trough year)	9.5	13
Production capacity (reference year)	19.0	19.6
Estimated excess capacity within crisis	6.0	5.6
Adjustment of capacity	4.5	1
Estimated excess capacity at end of crisis	1.5	4.6

Source: *Automotive World, CA Cheuvreux*

➔ All in all, we believe that the process well under way in NAFTA could lead to a capacity cut of some 3.5m vehicles, ie, 37% of the market at its current trough, and 20% of the US market in a normal year (17m units). The main winners of this process would be the Japanese mass-market carmakers, as price aggressiveness from a restructured GM would definitely ease.

To quick-start demand that has collapsed below replacement level (contrary to Europe) with a car market at around 9m vehicles in 2009, the Federal government is working on a voucher scheme, similar to the European scrapping incentives. The measure (a USD4,500 voucher for the scrapping of an old vehicle in exchange for the purchase of a new less polluting one – at least 22 miles per gallon for cars and 18 miles per gallon for light trucks) is expected to boost demand by 1m units in a full year.

➔ The best European name to play these two themes is Renault, thanks to Nissan's exposure to the NAFTA market (6% market share). Note the leverage impact of Nissan's re-rating on Renault's share price linked to the sheer size of the Nissan stake in Renault's valuation.

## GM Europe, a hotly contested prey

Fiat and the Canadian Magna are fighting to take over Opel and possibly a larger part of GM Europe, with Magna being a clear favourite with its tentative agreement with GM.

Opel's survival basically depends on the injection of EUR6bn-7bn in state aid into the company to avoid bankruptcy. EUR3bn of those funds will be provided by the

German government. A core prerequisite for the German government to subsidise Opel is a guarantee by the contender to maintain all Opel plants and to limit job cuts to the absolute minimum, eg, offering an early retirement scheme or payments for voluntary departures to avoid any redundancies.

It is not clear at this stage whether FIAT's restructuring plans, which comprise at least a substantial downsizing of several plants – not only those of Opel but also several of FIAT – would survive heavy political lobbying by the governments involved.

*Opel rescue is not good news for the industry, which faces 35% excess capacity*

Representatives of the German government warmed up to Magna's proposals for the acquisition of a 25% stake in Opel. Magna would maintain Opel's headquarters in Germany. There are no overlaps with any existing automobile production. Klaus Franz, head of Opel's European works council, which represents the interest of around 55,000 Opel staff in Europe, already expressed his preference for Magna, which he considers to be more interested in Opel's innovative expertise than in size and scale effects, which is the main target of Fiat and – last but not least – an alliance between a German and a Canadian company with Austrian roots may prove to cause less friction than the German – Italian option.

To summarise: An Opel/Fiat alliance could be one of the few examples of a partnership that generates (some) synergies and makes sense from many different angles. However, given the financial weakness of both partners and the dependence on the goodwill of governments to make the alliance a reality, there are many obstacles to overcome that may contradict the pure industrial rationale, before Opel/Fiat is a done deal.

Finally, note that GM is still the owner of Opel and will ultimately make the choice. And from its point of view, Fiat is clearly not a favourite, as: (1) GM had to pay a high price of EUR1.5bn to exit its former joint venture with Fiat in 2005; and (2) selling Opel to Fiat would lead, sooner or later, to the reintroduction of GM technology into Chrysler in the US.

→ In our view, the Fiat share is not a buy, regardless of the outcome:

If it acquires GM Europe, it might well create one of the leaders in Europe, but synergies will take years to materialise. Furthermore, these synergies are needed to maintain the business's viability, as its own CEO has mentioned several times that it does not have the critical size; sell the news after playing the rumour.

If Fiat does not manage to acquire GM Europe, it is left alone at a critical time for its car business, which is openly subscale (as stated by its present CEO many times) and needs to develop new platforms. Sergio Marchionne's core strategy for the car business over the past few years had been to make the most out of the existing resources of Fiat Auto and to limit its investment with the underlying rationale that either Fiat Auto would be sold or that Fiat would take part in sector consolidation and therefore would tap into others' engineering capabilities at a cheaper cost. This strategy could ultimately backfire.

### **Fiat / GM Europe would change the landscape**

A Magna / Russian solution would change virtually nothing. Magna does not bring anything to the deal but cash (EUR500m) and comfort for politicians in Germany. Opel would remain subscale and would continue to fight for market share and volumes, which implies a still aggressive pricing strategy.

→ Such a solution is worse for the competition, as the price pressure would not ease and there would be little if no capacity cuts in Europe.

We question whether GM's choice in favour of Magna is not a tactical way to keep Opel in friendly hands for a few years while it is restructuring in NAFTA, before a repurchase in better times. We note that Boe Henderson, head of GM Group's purchasing, recently left his position to head the Russian group GAZ, which is GM's partner in Russian, while GAZ is Magna's partner in its bid for Opel. While Magna remains a favourite, we believe the case is far from finalised and Fiat is not out of the race.

The solution that will emerge for GM Europe will have a significant impact on the sector:

*A Fiat / GM Europe alliance, albeit not the favourite at this stage, would trigger more consolidation in the sector*

A merger of Fiat Auto and GM Europe would create the second player in Europe with a 17% market share, behind Volkswagen Group (21% market share), but well ahead of PSA (12% market share). In small car segments (A and B segments), the new company would hold a 25% market share, making it a clear leader, ahead of Volkswagen Group. On the crucial C segment for a mass market carmaker (the Golf segment), it would hold 12%. The resulting scale effect per platform that both groups could share is the main advantage of such an alliance, notably in terms of purchasing. A rule of thumb estimate gives savings of around 15% in cost of parts when volumes are doubled. Sergio Marchionne mentioned between EUR1bn and EUR1.4bn in potential synergies between the two groups. This compares with EBIT for Fiat Auto of EUR803m last year.

→ Other mass-market OEMs would have to adapt to the new landscape, looking also for a larger scale effect. In our view, the players most affected would be Ford Europe, PSA and to a lesser extent Renault.

### **Other mass-market carmakers would have to move**

We have endeavoured to determine the possible reaction of the OEMs most affected by a Fiat/GM Europe deal, namely Ford Europe, Renault and PSA. We believe other European names, notably Volkswagen, BMW, Daimler and Porsche, are not affected at all, either because they are active on different segments (in the case of Daimler, BMW and Porsche) or because they are already far ahead of the pack in terms of scale (the case of Volkswagen).

#### **Ford Europe: accelerating its globalisation**

Ford Europe currently enjoys a successful line-up (*Mondeo, Fiesta, Galaxy, S Max*), is recovering some market share lost in the past few years (10.5% year to date versus 8.6% in 2008 and 8.3% in 2001) and generated EUR1,060m in profit last year. However, it lacks scale with just 1.8m units sold in 2008.

The solution so far has been to globalise its platform strategy as much as possible. This limits the scope of further alliances. The D segment platform, on which the *Mondeo, Galaxy* and *S Max* are based, is global, used in NAFTA but also by its former Japanese partner Mazda. The C segment platform (*Focus, C Max*) is also global and is used on the three main world markets. A new alliance would raise two questions: (1) the timing of expected synergies, which would necessarily take a long time to materialise (convergence

of product lifecycles before any possible synergies); and (2) who would be in charge of running the alliance. The Ford family owns 3% of Ford but controls over 40% of voting rights (through class B shares).

#### **Renault Nissan: the only solution is to boost integration**

Both Renault and Nissan have been trapped by the depth of the crisis with rising cash burn and high debt (in the case of Renault). The alliance, while in theory open to potential partners, does not have the financial means to participate in the consolidation of the sector today. We do not expect Carlos Ghosn, either through Nissan or through Renault, to undertake a deal in the short term.

However, the alliance has enough potential in itself. So far the alliance has been driven on a consensus basis. Each new project was to be a win-win cooperation with a minimum of 5% operating margin for both partners within the project. This process worked well at the beginning to pick low-hanging fruit, but has proven ill adapted as time went by.

The crisis forced the alliance's management to rework its process, going from what the CEO of both companies calls soft synergies to hard synergies. This process of looking for systematic savings and synergies is now mandatory and a team of 11 senior managers within the alliance is responsible for its implementation, reporting directly to Carlos Ghosn. The alliance targets EUR1.5bn in cash savings this year, of which 45% for Renault and 55% for Nissan. For the first year, two-thirds of the savings are linked to investment spending, and only a small portion from purchasing. We believe that this part will grow with time once Renault and Nissan share more standardised modules and parts. The overall savings will also grow from this first-year target of EUR1.5bn.

*PSA: new management with a wider mandate to increase scale and accelerate globalisation*

→ Play the only existing and proven alliance that, backed by its ten-year experience curve, is accelerating its synergy process and delivering valuable cash savings to shareholders rapidly.

### **PSA: many options... in theory**

PSA is the odd man out. This does not come as a surprise. It results from the Peugeot family's long-standing strategy to keep tight control over the group. At the AGM, while the new CEO Philip Varin was presenting his initial view for the group, the chairman of the board, Thierry Peugeot, reiterated that the three strategic targets given to the executive board were growth, profitability and independence.

In essence, the family is not opposed to a deal to accelerate its globalisation and to achieve critical size, even if this implies a certain dilution of its 30% stake (45% of voting rights), provided that it remains the group's core shareholder. For example, when PSA acquired Chrysler Europe in the late 1970s, its stake declined to 21% but enough to retain control over the group.

The most obvious partners for PSA are the carmakers already in cooperation with the group, namely Ford, BMW, Fiat and Mitsubishi.

**BMW:** In our view, while some preliminary work has probably been carried out in the recent past, a deal with BMW is unlikely: (1) it does not fit the target of the new CEO to boost the group's exposure to emerging markets; (2) the Quandt family, which controls BMW, would by far lead such an alliance (48% stake for equity currently worth EUR17.2bn, while the Peugeot family weighs only EUR1.6bn).

→ No major alliance, but deepening cooperation is possible

**Fiat:** This is the most logical partner, in our view: (1) It fits perfectly with Philip Varin's target, ie, achieving critical size per platform (in Europe this would definitely be the case on small and mid-size vehicle segments) and increase exposure to emerging markets (Fiat Auto is the market leader in Mercosur and has strong positions in eastern Europe). (2) The Peugeot family could retain its core shareholding position with a stake twice the level of Exor, in our view, at around 20% in the event the deal is carried out at the Fiat Auto level.

We estimate synergies at EUR1.5bn, 75% of which from purchasing and 25% from production efficiency (after restructuring). Valuing these cost synergies is always delicate as the industry history shows that little can be seen on the bottom line in the long run due to the level of competition. We see these synergies as mostly defensive, ie, required to maintain the competitiveness of both players. At best, we would assume no more than 50% of these gross savings as value creation for shareholders (ie, between EUR12 and EUR15 per share).

The most valuable synergies for shareholders, however, are growth synergies in the long run, ie, accelerating the growth of one partner using the strength of the other. PSA could accelerate its development outside Europe thanks to the strong presence of Fiat in Mercosur and its know-how in low cost operations.

→ However, such a deal implies a level of confidence between the groups which is probably lacking for the time being. Such a move would require restructuring and we understand that PSA does not want to get involved in a restructuring process in Italy. Therefore, we see a low probability of a deal at this stage.

**Mitsubishi Motors:** MMC is the easiest solution for the Peugeot family and would fit the CEO's strategy. (1) It could be rapidly integrated with a very limited risk of control for the family, as MMC is a small player, with fewer than 900,000 units sold in 2008. (2) Over 50% of its volumes are generated in emerging markets, ie, outside the Japan, NAFTA and Europe triad, where PSA could develop a presence. (3) It is present in almost every segment of the market, allowing PSA to gain access to a wide range of technology, platforms, etc. PSA is already buying a version of its SUV Outlander, rebadged Peugeot, and Citroën and will start to sell its full electric car as from end 2010 in Europe.

**Ford Europe:** Ford Europe (8% market share in Europe) would be a perfect answer to PSA's scale issue but offers little help with the emerging markets strategy. Such a deal also requires a sharing of power to ensure that both families keep control over their own business. Note that the Ford family owns just 3% of

Ford's equity but controls over 40% of voting rights. A solution could be a geographical sharing, with PSA taking care of the European operations while Ford controls NAFTA.

→ We would put a low probability on such a deal, as Ford has already implemented a global platform approach, reducing the need to look for a further scale effect. Moreover, synergies would be slow to be achieved, as they would require complete convergence of the product/platform cycle on a global basis.

### PSA: the family remains key in decision-making

In practical terms, no deal involving PSA can be achieved without the Peugeot family's approval. So far, the family has been reluctant to take the risk of external growth or a global alliance, and we would argue that it has been lagging the industry in an inevitable process.

The new CEO's mandate is obviously broader than that of Christian Streiff. His first comments suggest that he will: (1) continue the Cap 2010 plan in Europe with implementation of the lean cost approach; (2) accelerate the globalisation process, focusing on two of the group's weaknesses, the scale per platform and the low exposure to emerging markets. We believe two sets of deals can be expected that respect the condition of the Peugeot family maintaining a firm grip on the group:

Further strengthening project-by-project cooperation with other OEMs in Europe to compensate for the lack of scale. This approach allows shareholding ties, and thus potential dilution for the family, to be avoided. All options are possible here either with existing partners or new ones like GM Europe if a deal with Magna goes through.

A strategic deal, which could be designed along the lines of the Renault/Nissan alliance (once again to respect the independence of both parties) with an emerging player. Philippe Varin is well connected and respected in India after his deal on Chorus, which was sold to Tata Steel in 2006. No European name is present on a reasonable scale in India and this could become PSA's new frontier, ahead of the competition on this market.

### Potential deals

Potential deal	Cost synergies	Comments
Fiat / GM Europe	EUR1.5bn on purchasing and production costs within three years	GM unlikely to help Fiat rebuild Chrysler with Opel technology
GM Europe / Magna	No synergies as no complementary fit	In our view, a financial deal mostly, where Magna helps GM keep its European arm aside while it restructures in NAFTA
PSA / Fiat	EUR1.4bn on purchasing and restructuring within three years	More lasting synergies are related to growth but long-term timeframe
PSA / Ford Europe	EUR1.2bn on purchasing and restructuring within three years	More lasting synergies are related to growth but long-term timeframe
PSA / BMW	EUR1.4bn on purchasing by strictly pooling purchasing on shared platforms within five years	No restructuring as no sharing of production to be expected
PSA / MMC	EUR800m on purchasing within five years	More synergies on potential development of PSA using existing MMC platforms and technology
Renault / Nissan	EUR1.5bn cash synergies in 2009 set to increase further in next few years	Immediate cash synergies thanks to the alliance's ten-year experience
PSA / Fiat	EUR60bn revenues, EUR36bn purchasing	1.5% purchasing savings, ie, EUR900m gross before tax EUR500m on production costs after restructuring based on 10,000 staff cuts
PSA / Ford	EUR52bn sales, EUR31bn purchasing	1.5% purchasing savings, ie, EUR800m gross before tax EUR400m on production costs after restructuring based on 8,000 staff cuts
PSA / BMW	EUR89bn sales, EUR53bn purchasing	1.5% purchasing savings, ie, EUR1.34bn gross before tax No production cost savings as no sharing of production
PSA / MMC	EUR52bn sales, EUR31bn purchasing	1.5% purchasing savings, ie, EUR800m

Source: CA Cheuvreux

## Winners and losers of the crisis

Theme	Winners	Losers
US market: restructuring of capacity scrapping incentives	Renault through Nissan exposure	
European car market: scrapping incentives and clean vehicles	Fiat, Volkswagen, PSA, Renault	BMW, Daimler, Porsche
Scale effect	Ahead of M&A moves, Volkswagen, Renault/Nissan	PSA, Ford Europe
Financial flexibility through the crisis	Volkswagen, Daimler, BMW	PSA, Renault, Fiat, Porsche
M&A actions	Porsche, potentially PSA depending in family	

Source: CA Cheuvreux

## Credit rating delinkage between parent and captive

In all, 70% of global auto sales are financed through consumer loans. Carmakers' captive finance subsidiaries (CFS) are a strong marketing tool for the parent company as they provide financing to carmakers' clients, thus enabling the latter to sell more vehicles. Unlike a bank or a consumer-finance company, CFS view the financial part of a car purchase transaction as secondary in importance. A CFS is very effective at making financing available to both dealers (wholesale financing) and end-customers (retail financing) through economic cycles, and thus smoothing the sales curve. On average, 30% of cars sold are financed through loans from a CFS. The latter is generally speaking both wholly-owned by the parent company and profitable.

### Determination of captive companies' credit rating

As a matter of fact, the parent's creditworthiness is the starting point for the captive's credit rating. As long as the parent is financially viable, the captive cashes in on its support. Moody's lists "guarantees, support agreements, comfort letters or implicit support" as elements that may supplant the captive's metrics for evaluating credit risk. **Due to this close relationship, it appears normal for S&P and Moody's that most captive finance companies secure the same rating as their parent:**

- The parent's investment in the captive (in the form of equity and advances) may provide an economic incentive to maintain the captive's financial health.
- On the subsidiary's side, the captive should be able to demonstrate, through time, consistently prudent financial management.
- However, several CFS of major automotive groups benefit from a specific analytical approach which may lead to **a rating differential from the parent.**

### Criteria that may trigger delinkage



The captive demonstrates that it is a sound and relatively independent finance company (franchise strength, profitability, capitalization, asset quality, loss reserves among others)

The captive is a regulated entity

The parent is engaged or strongly motivated to maintain high the creditworthiness of its captive. The motivation is assessed based on the subsidiary's strategic importance to the parent company (contribution level to its sales)

A regulatory and legal framework restricts the parent's influence

The captive is positioned to operate as a viable and contributing stand-alone entity through various chains of stresses to the parent.

National insolvency laws limits the extension of bankruptcy proceedings from the parent company to the subsidiary

In case of a default of both of the parent and the captive, the latter's creditors have superior recovery prospects. In several cases, the captive's liquid and high-quality consumer receivables assets would generate higher recovery value for creditors than the own assets of the parent.

The captive's business risk profile and financial strength is better than its parent's.

Source: Moody's, S&P

## Assessing the independence

Rating agencies base themselves on the **history of independent decision-making** by the subsidiary and codification and disclosure of inter-company protocols. In case of a stress scenario upon the parent, to ensure that the captive's operations would continue to be valuable, it would need a **distinct viable funding strategy**.

*For instance, at the beginning of the 2000s and in the case of FMCC and GMAC, Moody's gave weight to the size and depth of the ABS market for prime auto loans, and concluded that these companies could continue to operate as securitisers, even with their respective parents being filed for bankruptcy.*

**Clear corporate separateness** matters a lot: The parent and the captive should maintain segregated and identifiable assets, records, employees in clear disclosure documents.

In the case of a bankruptcy, their separateness could thus be respected. **Intercompany obligations** could also have a bearing on the decision. Should the credit deterioration arise at the parent level, the parent's creditors might wish to include the captive in the bankruptcy in order to ensure perceiving a greater recovery value. That is why rating agencies appreciate the **absence of cross-default or cross-acceleration provisions**.

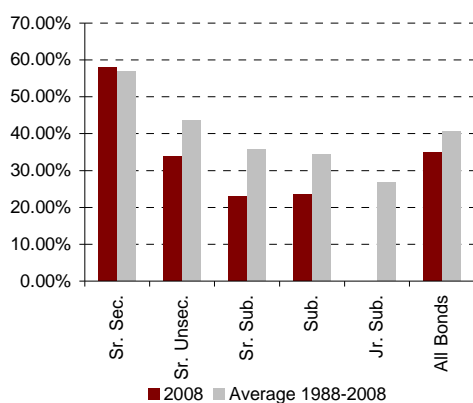
There may be value in preserving the captive finance company's market reputation by not filing into bankruptcy, and directors and parent creditors would thus face legal limits on pushing a distinct and solvent company into bankruptcy. Moreover, Moody's throws light on **the possibility for a US bankruptcy court to force a substantive consolidation of a parent and its captive**, thereby equalising the recoveries of their respective creditors.

A judge is likely to consider two points:

- Is there a substantial identity between the parent and its captive (see chart below)?
- Will the benefits of consolidation avoid some harm or realise some benefit? A very subjective area and likely to include the interests of current and retired healthcare obligations, which may be better off if assets are combined.

Agencies pay heed to this threat when differentiating the ratings and finalise the process only when forced consolidation prospects seem rare or impossible.

Annual average bond recovery rates, 1988-08



Source: Moody's

### Checklist

- 1 Does company have consolidated financial statements?
- 2 Is there sharing of interests and ownership between corporate entities?
- 3 Are there an intercompany guarantees or loans?
- 4 Is it difficult to separate the assets of parent and subsidiary?
- 5 Are assets transferred without following corporate rules?
- 6 Are there any commingling of assets and business functions?
- 7 Is it more profitable for parent and sub. to be at a single physical location?
- 8 Does the parent own a majority of the subsidiaries stock?
- 9 Do the entities have common officers or directors?
- 10 Is the subsidiary grossly undercapitalised?
- 11 Does subsidiary transact solely with the parent?
- 12 Do the parent and sub. disregard the legal requirements of the separate organisation?

Source: Jones Day

## Assessing the recovery prospects

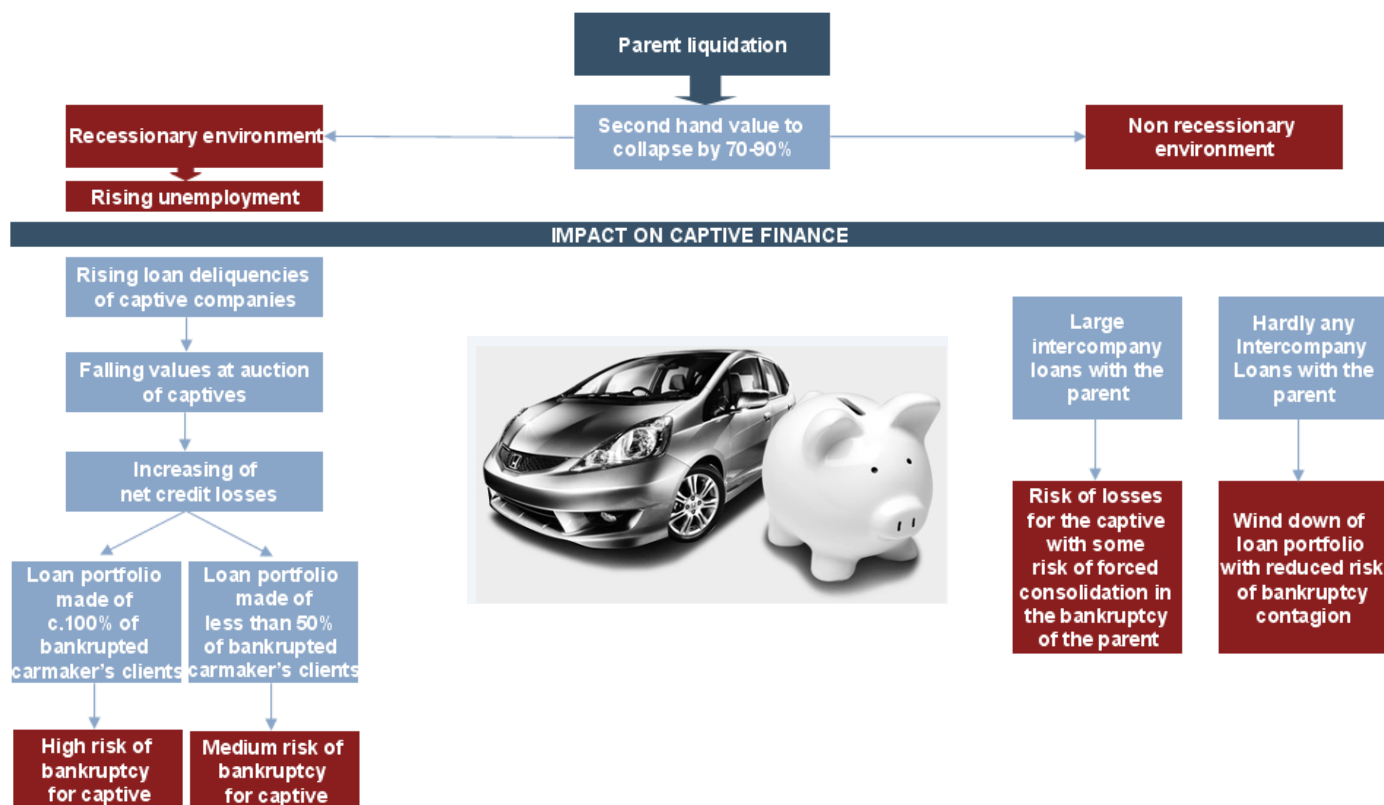
Moody's pays attention to the presence of **negative pledge covenants** in order to protect the captive's balance sheet against abuse. Although collateral value could decrease if the parent company is under strong stress, the automotive market is still sufficiently large to ensure that basic parts and services would be available for the cars, limiting the downside pressure on valuations.

**Do captive bondholders get better recovery?** Theoretically, yes. Speaking about asset quality, auto loans portfolios are generally short-lived, very liquid assets but also extremely diverse. Recovery prospects are highly correlated to the intrinsic characteristics of these portfolios. Run-off of receivables at CFS are often greater than maturing debt.

If the credit quality of the parent falls sharply, the CFS could dispose of all its non-auto businesses (ie, insurance & mortgage operations...). But, in this scenario, the captive's bondholders would be completely exposed to the Auto business.

**Calculation of recovery rate has too many moving parts and scenarios.** A recent Moody's study showed the 20Y average recovery rate for corporates stands at 40.6%.

### Stress scenario



Source: xxx chart needs inserting properly...

### RCI Banque (BBB- stable/A3 CW Neg) and PSA Finance (BBB Neg/A3 CW Neg)

Renault's (BBB- Neg/Ba1/BB Neg) and Peugeot's (BBB- Neg/Baa3 Neg/BB+ Neg) captive finance subsidiaries are fully owned by their respective parent companies and contribute a sizeable part of their EBIT (c.35% in 2007). Due to a certain number of key risk drivers that could put the parents under pressure in case of stress, the parent's ratings might go down, thereby questioning the ability of the CFS to refinance properly new credit car loans. Seeing the current trend of downgraded ratings and bad environment fundamentals, RCI Banque and Banque PSA Finance could face a major issue, with a sizeable increase in net credit losses.

Would the solution be structural? Ultimately, we believe that, in a worst-case scenario, both CFS would look at the Fiat/Fidis example, ie, secure a new shareholder, preferably a bank with high credit ratings, that could refinance new car loans through its own access to capital markets and other sources of funding. In the aforementioned case, Credit Agricole invested EUR1bn in Fidis to secure a 50% stake.

## Issuer snapshot

### BMW ind. liquidity (EURbn)

Change in cash in FY09	
Free cash flow	0.4
Debt repayment by end 2009	-1.3
sub total (a)	-0.9
Available committed liquidity	
Gross cash	5.1
Marketable securities	0.6
Bank facilities	5.9
sub total (b)	11.5
<b>Cushion (shortfall) (a+b)</b>	<b>10.6</b>
Cut in capex/R&D	0.3
Dividend payments	-0.2
share buyback	0.0
sub total (c)	0.1
<b>Cushion (shortfall) (a+b+c)</b>	<b>10.7</b>

Source: Calyon

### BMW (A neg/A3 neg/NR)

In Q109 BMW reported an EBIT loss of EUR55m due to weaker volume mix in the Automobile division (revenues down 21% YoY) as vehicle deliveries declined by 21.2% YoY (Europe down 22.7% YoY and North America down 23.9% YoY). More importantly the company did not increase reserves for residual value or non-performing loan risks but could not rule out further provisions by year-end given the weak pricing environment. We factored in a EUR0.3-0.5bn additional provision by year-end and a FY09 operating loss of EUR40m. According to the Manheim US used car price index, prices have started to recover over the past three months and were up c. 10% YoY in June 2009 for the luxury segment. If this trend is confirmed over the summer period we could see a reversal of the EUR1.6bn provision for residual values that was taken by BMW in 2008.

The credit loss rate rose from 0.46% in FY07 to 0.59% in FY08, which remains low compared to peers (close to 1%). Automobile free cash flow was positive EUR220m in Q109 due to a EUR1.4bn positive swing in working capital on the back of inventory reduction. We expect FY09 industrial FCF to reach EUR0.4bn. At end March 2009 the Automobile net cash position was standing at EUR9,165m up from EUR9,046m at end December 2008. All in all we expected the industrial committed gross cash position to stand at c. EUR10.6bn at end FY09, ie, a very strong liquidity cushion in the current challenging environment.

We favour the German OEMs given their stronger liquidity cushion, hence our Sectorperform stance on BMW within the sector. We also expect a potential one notch cut to Low-A with S&P by the end of the year.

**One year rating target: Low-A (maintained)**

**Relative value: Sectorperform (maintained since 05/11/08)**

### Continental (BB CW neg/Ba3 neg/BB CW neg)

Q1 revenues declined by 35.2% YoY on the back of a 35% decline in vehicle production at the OEMs in Europe. EBITDA was 71.8% down to EUR249.5. However, in Q109 sales have been improving month on month due to the positive impacts from government vehicle scrapping incentives on new vehicle sales. Operating cash flow was negative EUR295.3m due to a EUR297m negative swing in working capital. However, Q1 is seasonally the weakest point in terms of working capital and production at the OEMs should have increased quarter over quarter. Capex declined by EUR112m vs Q1 last year and is targeted to be cut by EUR0.6bn YoY in FY09 to EUR1bn, which should help the company to achieve its target of a positive free cash flow this year (we target EUR0.5bn).

Net debt rose EUR558m in Q109 to EUR11,041m (net gearing of 210%). However, the company did not breach its loan covenant (net debt to EBITDA of no more than 4.75x in Q209, 4.50x in Q309 and 4.0x in Q409), but remains at risk to do so by the end of the year in our view. Even if it does not breach the covenant this year, Conti will have to face a large cash payment in August 2010 of EUR3.5bn for the repayment of tranche B of the VDO loan. As seen in the table (left) we expect Conti's available committed gross liquidity to be EUR2.8bn at end FY09. As a result, Conti needs to raise at least EUR1.5bn in our view to cover EUR0.7bn of shortfall between tranche B repayment and available liquidity at end 2009, and EUR0.8bn of cash cushion for corporate purpose. This could be done through an extension of the loan, but given the size of it and the current exposure of the banks to Conti and Schaeffler it seems unlikely unless Conti reinforces its capital structure through a capital increase first.

The banks that are involved in the loan to Schaeffler for the acquisition of Conti and the banks that are involved in the loan to Conti for the acquisition of VDO are for a large part the same banks. We therefore believe that should Conti breach its loan covenants or fail to repay part of the VDO loan next year it is not in the interest of the banks to push the company into a distressed situation given that the bulk of the cash flow from the combined Schaeffler-Continental business is coming from Continental. There are a few options, which include: refinancing of

### Conti liquidity (EURbn)

Change in cash FY09	
Free cash flow	0.5
Debt repayment by end 2009	-1.5
sub total (a)	-1.0
Available committed liquidity	
Gross cash	1.6
Marketable securities	0.0
Bank facilities	2.2
sub total (b)	3.8
<b>Cushion (shortfall) (a+b)</b>	<b>2.8</b>
Cut in capex/R&D on top of FY09 est.	0.0
Dividend payments (FY08 level)	0.0
share buyback (FY08 level)	0.0
Other	0.0
sub total (c)	0.0
<b>Cushion (shortfall) (a+b+c)</b>	<b>2.8</b>

Source: Calyon

the VDO loan with the possibility to use the Tyre business (c.EUR4bn) as collateral since the current loan is unsecured; a reverse takeover by Continental as currently being reviewed by both companies (result to be released by end July 2009) followed by a capital increase and potentially bond issuance; financial aid from the states of Bavaria (Schaeffler) and Lower Saxony (Continental).

Q209 results will be released on 30 July and should show some QoQ improvement in terms of FCF, but above all management is likely to disclose its plan with regards to the combination of Continental with Schaeffler.

We keep our recommendation on Continental unchanged at Sectorperform given already the valuations and our belief that the end game will not be to the detriment of Continental given its strategic importance for the bank lenders.

**One year rating target: Low-BB (previously High-B since 20/06/09)**

**Relative value: Sectorperform (maintained since 19/09/08)**

## Daimler (BBB+ neg/A3 neg/BBB+ neg)

### Daimler ind. liquidity (EURbn)

Change in cash in FY09	
Free cash flow	-0.4
Debt repayment by end 2009	0.0
sub total (a)	-0.4
Available committed liquidity	
Gross cash	4.7
Marketable securities	1.0
Bank facilities	6.8
sub total (b)	12.5
<b>Cushion (shortfall) (a+b)</b>	<b>12.1</b>
Cut in capex/R&D	0.0
Dividend payments	-0.6
Rights issue	2.0
Chrysler cash exposure	-0.8
sub total (c)	0.5
<b>Cushion (shortfall) (a+b+c)</b>	<b>12.6</b>

Source: Calyon

Q109 group EBIT loss reached EUR1.4bn compared to EUR2bn profit in Q109. The decline in earnings was primarily related to the Mercedes-Benz car division, where EBIT was a loss of EUR1.1bn. The division was negatively impacted by weak volume/mix (the scrapping vehicle incentives in Germany, France and Italy led to higher sales of smaller less profitable and more fuel efficient vehicles) and also the changeover to the new E-Class (c. 18% of group sales).

Industrial free cash flow was negative EUR0.8bn in the quarter despite a 16% YoY cut in capex to EUR685m. However, the industrial net cash position improved in the quarter from EUR3.1bn in Q408 to EUR3.7bn in Q109 due to the EUR1.95bn capital increase underwritten by Aabar Investments representing 9.1% of the share capital of Daimler AG. We expect industrial committed gross liquidity to stand at EUR12.6bn at end FY09 including a negative FCF of EUR0.4bn, ie, recovery in FCF in H2.

Q209 unit sales declined by 14.3% at the Mercedes-Benz Cars unit of which a 13.6% YoY decline for Mercedes-Benz brand. This is a rebound from Q1 levels down 23.2% YoY and 25.4% YoY respectively. In addition, unit sales rose by 22.4% from Q109 levels due to the launch of the popular E-Class, which should have helped to reduce inventories further. H209 should see further recovery due to the full availability of the E-Class and the GLK (small M-Class) leading to a FY09 decline in unit sales of 8-10% in our view.

On 27 April 2009, Daimler, Chrysler, Cerberus and the US Pension Benefit Guaranty Corporation agreed on a binding term sheet, which requires Daimler to make a cash contribution of USD600m to Chrysler's pension plans in three annual instalments of USD200m beginning this year and to waive its fully impaired loans to Chrysler with a nominal amount of USD1.9bn, which were already written off in FY08. Additionally, Daimler's 19.9% interest in Chrysler Holding LLC has to be redeemed. Daimler's additional obligation, under a guarantee for payments to be made to the Chrysler pension plans if these plans terminate until August 2012, will be limited to a maximum of USD200m down from the previously agreed amount of USD1bn.

We therefore expect passenger car sales to benefit from new models and stabilisation in residual values while we believe that the heavy truck unit will reach the trough of its cycle in H209, with a recovery in order intakes from Q409 in line with the GDP cycle. We therefore remain Sectorperform.

**One year rating target: High-BBB (maintained)**

**Relative value: Sectorperform (maintained since 17/02/09)**

## Fiat (BB+ CW neg/Ba1 neg/BB+ neg)

### Fiat ind. liquidity (EURbn)

Fiat Change in ind. cash in FY09	
Free cash flow	0.5
Debt repayment by end 2009	-1.5
sub total (a)	-1.0
Available committed liquidity	
Gross cash	2.6
Marketable securities	0.1
Bank facilities	3.4
sub total (b)	6.1
<b>Cushion (shortfall) (a+b)</b>	<b>5.1</b>
Cushion (shortfall) (a+b) breakdown	
Cut in capex/R&D	0.0
Dividend payments	0.0
share buyback	0.0
Other	0.0
sub total (c)	0.0
<b>Cushion (shortfall) (a+b+c)</b>	<b>5.1</b>

Source: Calyon

Fiat has been outperforming other automakers year-to-date due to its leading market position in the popular small segments (A+B) that are currently most in demand due to their low price and fuel efficient profile. In Europe Fiat unit sales are down 1.1% in the first 6 months of the year while the market is down 11%, which has enabled it to gain 1 percentage point of market share to 9.1%. In Brazil the company maintained its leadership in a market up 3.7% YTD June. The Brazilian Automobile Association is now expecting a 6.4% rise from FY08 levels.

Q109 industrial free cash flow was negative EUR437m in the quarter including capex of EUR664m and industrial operating cash flow of EUR227m due to a EUR264m positive swing in working capital as production volumes rebounded from Q408 levels. As a result the industrial net debt rose from EUR5.9bn at end December 2008 to EUR6.6bn at end March 2009 including a negative impact of EUR0.2bn from mark-to-market of operational hedging items. The company guided EUR1bn in industrial cash generation in FY09 and an industrial net debt of less than EUR5bn (EUR5.9bn end-2008) at end-FY09. The company also targets to reduce capex by EUR1-1.3bn vs FY08. We target FCF to be EUR0.5bn as we see car incentives start to fade as we go in Q4. At end FY09 we expect industrial liquidity to stand at c. EUR5.1bn. We also point out that EUR1bn of bond debt will mature in February 2010, which should lead to some form of refinancing in order to maintain the current cash cushion that we regard as adequate.

We consider the partnership with Chrysler as positive due to the likely combination of engineering and R&D costs, even if the geographic footprint of both companies will not enable them to optimise their industrial production costs.

Our Sectorperform stance on the company within the sector, which we rate at Underperform, reflects the valuations that have already fully priced in the weakened credit profile of the company in our view, especially versus similarly rated peers such as Renault, Valeo or Peugeot.

**One year rating target: Mid-BB (previously High-BB since 23/10/08)**

**Relative value: Sectorperform (maintained since 17/12/08)**

### Michelin liquidity (EURbn)

Change in cash FY09	
Free cash flow	0.3
Debt repayment by end 2009	-0.8
sub total (a)	-0.5
Available committed liquidity	
Gross cash	1.2
Marketable securities	0.2
Bank facilities	1.4
sub total (b)	2.8
<b>Cushion (shortfall) (a+b)</b>	<b>2.3</b>
Cushion (shortfall) (a+b) breakdown	
Cut in capex/R&D	0.3
Dividend payments (FY08 level)	-0.2
share buyback (FY08 level)	0.0
Other	0.0
sub total (c)	0.1
<b>Cushion (shortfall) (a+b+c)</b>	<b>2.4</b>

Source: Calyon

## Michelin (BBB neg/Baa2/BBB- neg)

Michelin is likely to report a decline in revenues of around 15% for H109 due to a double digit decline in sales to OEMs on the back of large production cuts (we expect a cut of 25% in FY09) and large declines in the replacement market (c. 10%).

At the end FY08 the ratio of funds from operations to net debt was below the 25% threshold defined for a Mid-BBB. Consequently, risk of rating pressure (a one-notch cut to Low-BBB) cannot be ruled out in the next year should recovery in the replacement takes longer than currently expected.

However, we expect that H109 free cash flow could be very similar to H208 (EUR36m). The impact of falling raw-material prices (down c.50% since July 2008), such as natural rubber, will not have any positive impact on cost of goods sold before Q209 given the six-month lag between lower prices and the impact on the P&L. The company expects the tyre market (OEM and replacement) to remain well below prior-year levels in the first half, although no clear guidance has been provided for the full year. We expect free cash flow to be slightly positive (EUR0.3m) in FY09, as Michelin has cut by half its capex to EUR700m for FY09 (capex of EUR1.3bn in 2008).

Following the recent 5Y EUR750m bond issuance, liquidity has improved in our view and the cushion stands at about EUR2.4bn at end FY09 after debt repayment. We are marketweight the new bond given attractive valuations and coupon language (125bp coupon step-up on any downgrade from Moody's or S&P to high yield territory). We remain Underperform CDS.

**One year rating target: Low-BBB (maintained)**

**Relative value: Sectorperform (maintained since 26/06/09)**

## Peugeot SA (BBB- CW neg/Baa3 neg/BB+ neg)

### Peugeot ind. liquidity (EURbn)

#### Change in cash in FY09

Free cash flow	-3.8
Debt repayment by end 2009	-1.7
sub total (a)	-5.5

#### Available committed liquidity

Gross cash	3.3
Marketable securities	0.5
Bank facilities	6.4
sub total (b)	10.2

#### Cushion (shortfall) (a+b)

Cushion (shortfall) (a+b)	4.7
Cut in capex/R&D	0.0
Dividend payments	0.0
share buyback	0.0
sub total (c)	0.0

#### Cushion (shortfall) (a+b+c)

Cushion (shortfall) (a+b+c)	4.7
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Source: Calyon

H109 unit sales declined by 14% YoY despite the positive impact of government scrapping vehicle incentives in France, Germany and Italy. Volume mix should also weigh on H1 operating results given higher sales in less profitable A and B segments. The company is calling for a 12% decline in unit sales in Europe this year despite government incentive programmes. It also guided the market for a FY09 operating loss of EUR1bn to EUR2bn. We target a loss of EUR1.3bn. We also expect industrial free cash flow to be negative EUR3.8bn in FY09, which should increase industrial net debt from EUR2.9bn at end FY08 to EUR6.7bn at end FY09 and in turn lead Peugeot SA to sub-investment grade rating with S&P (currently under credit watch negative on the BBB- rating) pushing the company in high yield credit indices given that it is already rated at BB+ with Fitch. Year-to-date the company has been increasing its liquidity through EUR3bn of government loans, EUR0.4bn of EIB loan, EUR575m of convertible bond and EUR750m of bond debt. All in all we consider that the available committed gross cash at the industrial business should stand at c. EUR4.7bn at year-end.

However, increased leverage combined with weaker operating metrics on the back of a weaker volume mix could push the company to increase industrial partnerships and/or participate in the consolidation process (see section, Consolidation inevitable at last) in order to optimise capex/R&D costs as well as production cost. In the recent AGM, Philip Varin, the new CEO, set a strategic target to become a global carmaker with more presence in emerging markets. However, the Peugeot family confirms its intention to remain the core shareholder of the group despite being open to a limited dilution of its stake (30.3% of the capital and 45.1% of the voting right at end Dec 2008). The new strategy and financial targets will be announced on 29 July when reporting H1 results.

In our view the optimisation of the funding structure/cost of Banque PSA Finance can only be done through a partial disposal of the unit to a banking partner (Fiat/Fidis case). If not the Financial Services unit is likely to shrink its asset base as credit ratings remain linked to its ultimate parent company (see section on Credit rating delinkage).

In May 2009 Faurecia (auto supplier) raised EUR455m of cash through a right issue that was underwritten by Peugeot SA up to their 71% stake, ie c. EUR320m. We consider that European car production declined by at least 25% in H109, which should have resulted in a substantial decline in EBITDA; increasing the likelihood of a breach of the covenants on the EUR0.3bn bond maturing 2010. The bond has a put at par on the breach of one of the covenants (net debt/EBITDA of no more than 3.50 and EBITDA/net interest expense of more than 4.50). We recommended buying the 2010 bond at a cash price of 83 back on the 11 February.

**One year rating target: High-BB (maintained)**

**Relative value: Underperform (maintained since 17/12/08)**

**Renault ind. liquidity (EURbn)**

<b>Change in cash in FY09</b>	
Free cash flow	1.1
Debt repayment by end 2009	-3.5
sub total (a)	-2.4
<b>Available committed liquidity</b>	
Gross cash	1.1
Marketable securities	1.2
Bank facilities	7.2
sub total (b)	9.5
<b>Cushion (shortfall) (a+b)</b>	<b>7.1</b>
Cut in capex/R&D	0.6
Dividend payments	0.0
Share buyback	0.0
Other	0.0
sub total (c)	0.6
<b>Cushion (shortfall) (a+b+c)</b>	<b>7.7</b>

Source: Calyon

**Renault SA (BB stable/Ba1 stable/BB neg)**

In H109 worldwide unit sales at Renault declined by 16.5% while market share was stable at 3.7%. H1 results will be released on 30 July. In Q109 revenues stood at EUR7.1bn, down 30.8% YoY (EUR10.2bn in Q108) due to a depressed global demand for new vehicles. Renault's unit sales were down 22.4% YoY and production down 30%, which enabled the company to reduce inventories from 365k units at the end December 2008 to 323k units at end March 2009, ie, in line with its FY09 target to cut inventories by EUR1bn.

Although industrial net debt was not reported at end Q1, the company mentioned that it rose less than 10%, ie, less than EUR790m since it stood at EUR7.9bn at end FY08 (EUR5.9bn at end FY07). Demand in Q109 was primarily coming from the small less profitable vehicles of the A and B segments as a result of the positive impact of scrapping vehicle incentives in France, Germany and Italy. Order book was at similar levels to Q108 and given improving demand on the back of the government incentives inventories of small vehicles had to be rebuilt in Q2, increasing temporarily production by c. 45% vs Q1, which in turn should have triggered a positive swing in working capital during the quarter.

Late May Renault/Nissan announced combined cash saving of EUR1.5bn for FY09 through increased synergies in engineering, R&D, combined production platforms, purchasing. The cash saving and positive impact on free cash flow for Renault alone will amount to EUR678m. Unlike Peugeot Renault will benefit from its stake in Nissan (44.3%) and Volvo (20.9%) next year as both companies are likely to renew with profitability due to their exposure to North America. However, in FY09 Nissan will have a negative contribution of 1.2bn to Renault's earning in H1 (H1 results to be released on 30 July).

We target a positive free cash flow within the industrial operations of EUR1.1bn in FY09 (including real estate disposals of EUR300-400m), which should lower industrial net debt from EUR7.9bn to EUR6.8bn at end FY09, ie, a similar level to Peugeot SA. We do not know at this stage whether weakness in demand will resurface in Q4 as government incentives start fading away. We consider that the net cash cushion of the industrial operations at end FY09 should stand at c. EUR7.1bn including the EUR3bn loan from the French government and EUR0.4bn loan from the European Investment Bank. We do not expect further credit rating pressure at this stage and we do not see any trigger for Renault CDS to outperform its peers hence our Underperform stance.

As with Peugeot we consider that the best way to optimise the funding structure/cost of RCI Banque can only be done through a partial disposal of the unit to a banking partner (Fiat/Fidis case). If not the Financial Services unit is likely to shrink its asset base as credit ratings remain linked to its ultimate parent company (see section on Credit rating delinkage).

**One year rating target: High-BB (maintained)**

**Relative value: Underperform (maintained since 17/12/08)**

## Scania liquidity (SEKbn)

Change in cash FY09	
Free cash flow	2.5
Debt repayment by end 2009	- 4.6
sub total (a)	2.2
Available committed liquidity	
Gross cash	4.3
Marketable securities	0.1
Bank facilities	26.8
sub total (b)	31.1
<b>Cushion (shortfall) (a+b)</b>	<b>29.0</b>
Cut in capex/R&D on top of FY09 est.	
Dividend payments (FY09 level)	- 2.0
New financing in 2009	1.5
Other	0.0
sub total (c)	0.5
<b>Cushion (shortfall) (a+b+c)</b>	<b>28.5</b>

Source: Calyon

## Scania (A-CW neg/NR/NR)

Q209 results will be released on 23 July and are likely to show a further decline in operating metrics. Revenues are likely to be down 30% on the back of falling order intakes (est. down 67%). We expect operating profit to be down c. 80% YoY. Q109 operating profit was down 86% YoY on the back of lower volumes (trucks and buses deliveries down 43% YoY and 39% YoY respectively) and capacity utilisation as well as currency effects.

Industrial free cash flow was positive SEK874mm due to a positive working capital of SEK608m as the reduction in inventories was greater than payments of trade payables. In addition, net investments declined by 21% YoY. As a result the industrial net debt position stood at SEK7,404 (EUR675m) down from SEK8,364m (EUR764m) at end-December 2008 but up SEK10.9bn since (EUR1bn) Q108 when the company had a positive industrial net cash position of SEK3.5bn (EUR320m). The sharp increase in YoY net debt reflects the large decline in volume sales and production levels that triggered a negative swing in working capital last year. The negative swings in working capital were due to lower production, in order to adjust inventories to the depressed level of demand, and subsequent payments in trade payables that were built in previous quarters when production stood at a much higher level.

Scania's liquidity is adequate in our view, with cash & equivalents, plus available committed bank facilities totalling more than SEK30bn, ie, more than enough to meet 2009 needs. Nevertheless, rating pressure is not ruled out in line with its ultimate parent VW.

**One year rating target: High-BBB (maintained)**

**Relative value: Sectorperform (maintained since 30/10/07)**

## Valeo (NR/Ba1 neg/NR)

## Valeo liquidity (EURbn)

Change in cash FY'09	
Free cash flow	-0.3
Debt repayment by end 2009	-0.2
sub total (a)	-0.5
Available committed liquidity	
Gross cash	0.3
Marketable securities	0.4
Bank facilities	1.2
sub total (b)	1.9
<b>Cushion (shortfall) (a+b)</b>	<b>1.4</b>
Cut in capex/R&D on top of FY09 est.	
Dividend payments	0.0
Share buyback	0.0
Other	0.0
sub total (c)	0.0
<b>Cushion (shortfall) (a+b+c)</b>	<b>1.4</b>

Source: Calyon

Due to the large decline in automakers' production, Valeo reported a 33.4% decline in Q1 revenues and posted an operating loss of EUR83m (vs an operating profit of EUR86m in Q108). Free cash flow was negative EUR116m in the quarter and net debt increased by EUR112m YoY to EUR933m. For FY09 the company expects cash burn to "not significantly exceed restructuring cash out" that we see it at c. EUR250m. The one third reduction in expected capex will contribute to containing the cash burn that should reach its peak in Q309 according to the company.

The company expects a 30% decline in production in H109 leading to an operating loss and a 20% decline in production YoY in FY09. Liquidity risks are contained in our view, given available committed liquidity of EUR1.4bn at end Dec 2009, including EUR0.3bn of negative FCF.

The company has access to confirmed bank credit lines, provided by ten banks and available for an average period over two years, totalling EUR1.2bn. These bank lines have a covenant of a net gearing of no more than 120%, which is unlikely to be breached this year in our view. In addition, bank credit lines and the group's long-term debt include a cross-default clause that causes all long-term financial debts to be repaid should one financial debt be subject to early repayment. Long-term debt stood at EUR1.3bn at end-FY08 (we do not have the details yet at end Q109). Net gearing stood at 80% at end Q109 up from 63% at end-FY08.

The company also managed to move EUR541m of the EUR1.2bn credit lines to a new covenant based on net financial debt to EBITDA (excluding other income and expenses such as impairment, restructuring provisions...) of no more than 3.5 times (stood at c. 1-1.5 times at end FY08), though we do not know the level at end Q1. The company plans to move over time the rest of the credit lines under this new covenant, but they stressed that there was no urgency since they are still comfortable with the net gearing covenant.

Valeo's credit rating could be under further pressure in the next 12 months (more likely in H209) should negative free cash flows exceed EUR200m, according to Moody's, which is a real possibility given recent management comments.

**One year rating target: Mid-BB (maintained)**

**Relative value: Underperform (maintained since 19/03/09)**

## Volvo liquidity (SEKbn)

Change for FY09	
Free cash flow	-7.1
Debt repayment by end 2009	-15.5
sub total (a)	-22.5
Available committed liquidity	
Gross cash	16.7
Marketable securities	5.9
Bank facilities <sup>1</sup>	26.7
sub total (b)	49.3
Cushion (shortfall) (a+b)	
	26.7
Cut in capex/R&D on top of FY09 est.	
	0.0
Dividend payments (FY09 est. level)	
	-3.7
New financing in 2009	
	40.0
Other	
	0.0
sub total (c)	36.3
Cushion (shortfall) (a+b+c)	
	63.0

Source: Calyon

## Volvo (BBB+ neg/Baa1 neg/BBB+ neg)

Volvo truck deliveries declined by 55% YTD May. In Q109 the company reported an operating loss of SEK4.5bn. All divisions reported a loss except Volvo Aero. The sharpest declines were seen in the Trucks division (operating loss of SEK2.4bn) and the Construction Equipment (CE) division (operating loss of SEK1.4bn). In addition, the Financial Services division reported an operating loss of SEK0.4bn due to SEK780m of provision for non performing loans. Loans write-off stood at SEK439m in the quarter leading to an annualised write-off ratio of 1.51% vs 0.29% a year earlier. The credit reserve to loan portfolio ratio rose from 1.37% in December 2008 to 1.78% at end March 2009. Given that unemployment levels keep increasing in all regions where Volvo provides customer loans we expect this trend to continue this year.

According to Volvo, a marked slowdown in its core markets (Europe and North America), where the company generates 60% of its industrial revenues, and a significant increase in raw materials and components are the main reason for these weak results. The company expects the European truck market to decline by at least 50% this year while the North American market is set to decline by 30-40%.

In its recent Capital Market day update (mid-June), Volvo stated that the bottom of the cycle had been reached, which should lead to a recovery in truck and CE markets in 2010 in line with the recovery in GDP. Order intakes should first recover in the US and Japan. The company also reiterated that SEK21bn of cost savings will be achieved by year-end (SEK10bn in labour cost, SEK6bn in R&D/production and SEK5bn in SG&A). Manufacturing capacity has been cut by 50% but could be raised by 25% in 2 months and 50% in 5 months when order intakes recover next year.

Industrial net debt rose from EUR2.8bn at end-December 2008 to EUR4.2bn at end-March 2009 (the highest level since Volvo was rated at A-), due to negative free cash flow as the company suffered negative swings in working capital (SEK11.4bn, ie, EUR1bn) due to lower production in order to adjust inventories to the depressed level of demand and subsequent payments in trade payables when production stood at a much higher levels in previous quarters. This trend is likely to continue into Q209 and Q309.

In terms of financial flexibility the company has about SEK15bn of debt within the industrial operations that matures in 2009; however, its available committed liquidity within the industrial operations stands at c. SEK80bn (SEK24bn in liquid assets and SEK35bn of unused committed bank facilities including a new EUR775m 2Y revolving credit facility signed this month, new bond debt of c. SEK20bn).

Credit ratings have been cut by one notch to BBB+ in recent weeks in line with our credit rating target. We expect truck sales to reach the bottom of the cycle in Q3, hence our Sectorperform stance.

**One year rating target: High-BBB (lowered from High-BBB)**

**Relative value: Sectorperform (maintained since 19/09/08)**

**Volkswagen (A-CW neg/A3 CW neg/BBB+ CW neg):****VW ind. liquidity (EURbn)**

<b>Change in cash for FY 09</b>	
Free cash flow	3.8
Debt repayment by end 2009	-2.9
sub total (a)	0.9
<b>Available committed liquidity</b>	
Gross cash	9.5
Marketable securities	3.8
Bank facilities	7.8
sub total (b)	21.0
<b>Cushion (shortfall) (a+b)</b>	
	22.0
Cut in capex/R&D	0.0
Dividend payments	-0.8
share buyback	0.0
Other	0.0
sub total (c)	-0.8
<b>Cushion (shortfall) (a+b+c)</b>	
	21.2
<b>Cushion incl. Stake holdings</b>	
	25.5

Source: Calyon

VW has been outperforming its peers worldwide YTD in terms of market share, especially in Germany due to the positive impact of the vehicle-scraping incentive programme. VW's worldwide passenger car market share rose from 9.7% in Q108 to 11% in Q109. In Western Europe the company gained 1.7 percentage points of market share in H109 to 21.4%.

In Q1 operating profit declined by 76.2% to EUR312m, ie, a margin of 1.3% (4.9% in Q109) due to a decline in unit deliveries, negative currency effects and weaker mix as customer are buying smaller less profitable and more fuel efficient models. We expect FY09 EBIT to decline by 63% YoY to EUR2.3bn. The company is also expecting to return to a net profit in Q209.

At end March 2009 the net cash position within the automotive business stood at EUR10.7bn due to positive industrial free cash flow in Q1 (EUR1.8bn) and EUR1.3bn cash proceeds from the disposal of the Brazilian truck unit. We expect FY09 free cash flow to reach EUR3.8bn due to a rebound in production in H2, primarily for vehicles in the small segments A and B, and a positive contribution from the Chinese JV (VW expects the Chinese market to reach 6m units this year vs 5.5m in FY08).

Concerning the Porsche-VW merger both Porsche and VW will hold supervisory board meetings the week starting 20 July in order to reduce the leverage at Porsche. Following the acquisition of a 50.76% stake in VW, Porsche has increased its net debt to EUR9-10bn and will have to repay a EUR700m loan received from VW in September. The FT is reporting that a package of measures could be decided by the end of the month to reduce the leverage at Porsche "as completely as possible". These measures would include the disposal of Porsche car business to VW for as much as EUR4bn, a EUR5bn capital increase and the sale of equity options in VW. The Qatar Investment Authority and the Porsche families could inject cash and assets to strengthen the balance sheet, including the Porsche fully owned Salzburg Holding, a car dealership.

Last May S&P and Moody's placed the long term credit rating of Volkswagen AG and Volkswagen Financial Services, both rated at A-/A3, on review for possible downgrade. The A-2/P-2 short term ratings were affirmed. VW Bank A/A-1 ratings were also put on Watch negative by S&P. The actions reflected the announcement made early May that the Porsche and Piëch family shareholders plan to merge Porsche and VW and create an automotive group that will be comprised of 10 brands including Porsche. The final structure of the deal is likely to be decided before September when Porsche needs to repay the EUR700m loan to VW in our view. The decision will have to take into account the opinions of the workforce (IG Metal) and the State of Lower Saxony, which owns 20% of VW and still enjoys a right of veto within the board of VW known as the 'VW law'. We maintain our rating target on VW at High-BBB, ie one notch lower than current levels, with VW bank being still rated one notch higher than VW AG and VWFS. We remain Sectorperform for the time being and expect the convergence of CDS between Porsche and VW to continue.

**One year rating target: High-BBB (maintained)**

**Relative value: Sectorperform (maintained since 02/02/09)**

# Autos earnings calendar

## July

29	Monday	30	Tuesday	1	Wednesday US Auto Sales	2	Thursday	3	Friday
6	Monday	7	Tuesday	8	Wednesday	9	Thursday	10	Friday
13	Monday	14	Tuesday	15	Wednesday European Auto Sales	16	Thursday	17	Friday
20	Monday	21	Tuesday Volvo Q209 Results Faurecia H109 Results	22	Wednesday Fiat Q209 Results	23	Thursday Scania Q209 Results Ford Q209 Results	24	Friday
27	Monday	28	Tuesday	29	Wednesday Valeo Daimler PSA Q209 Results	30	Thursday Continental Q209 Results Renault H109 Results	31	Friday Michelin H109 Results

## August

3	Monday US Auto Sales	4	Tuesday BMW Q209 Results	5	Wednesday	6	Thursday	7	Friday
10	Monday	11	Tuesday	12	Wednesday	13	Thursday	14	Friday
17	Monday	18	Tuesday	19	Wednesday	20	Thursday	21	Friday
24	Monday	25	Tuesday	26	Wednesday	27	Thursday	28	Friday

## September

31	Monday	1	Tuesday US Auto Sales	2	Wednesday	3	Thursday	4	Friday
7	Monday	8	Tuesday	9	Wednesday	10	Thursday	11	Friday
14	Monday	15	Tuesday European Auto Sales	16	Wednesday	17	Thursday	18	Friday
21	Monday	22	Tuesday	23	Wednesday	24	Thursday	25	Friday
28	Monday	29	Tuesday	30	Wednesday	1	Thursday	2	Friday

## Appendix – Summary of CDS recommendations

Issuer	Ratings		Spot CDS	Variation			Expected Trend	Spot vs Index			Perf. Expectation vs Sector Index		
	S&P/Moody's	Calyon		1 Week	1 Month	YTD		Ratio	Fair Value	Spot-FV	Previous	Since	New
Issuer's Names							(1)		(2)			(3)	

### Expected trend

According to our quantitative model, this column indicates the expected trend for each single name (sector) relative to its sector index (the iTraxx Main):

↗ The single name (resp. sector) should underperform its sector (resp. iTraxx Main) in the month following. Indeed, the single name CDS over sector index ratio has tightened a lot in the past few days and so the model anticipates a trend reversal. This means that it is a good time to play the underperformance (but not necessarily the widening as we are in relative value)

→ No trend reversal is expected

↘ The single name (resp. sector) should outperform its sector (resp. iTraxx Main) in the month following. The ratio single names CDS/sector index has widened a lot in the past few days and so the model anticipates a trend reversal. This means that it is a good time to play the outperformance (but not necessarily the tightening as we are in relative value)

### Fair value model

**The ratio** corresponds to the single name spread divided by its sector index (or sector index divided by iTraxx Main).

The historical fair value model has been developed to enhance our recommendation on every issuer of the coverage list. Its principle is based on a historical observation of the positioning of the 5Y CDS spread over the sector index. The average between the 3M, 6M and 12M ratios is considered to be the fair positioning of the 5Y CDS over the sector index. Therefore, with the spot value of the index, we can compute the historical fair value of the CDS.

The calculation of the historical fair value is achieved in several steps.

- **Step 1:** Using Calyon prices, we compute the ratio: '5Y CDS spread/index' for every trading day. It is worth noting that the computation of the index takes into consideration the PV01 weighting method (the wider the name, the less impact it has upon the fair value calculation for the index).
- **Step 2:** Once step 1 has been achieved, we compute the average value of the ratios over three months (3M), six months (6M) and one year (12M).
- **Step 3:** The average between the 3M, 6M and 12M ratios is considered to be the fair positioning of the 5Y CDS over the sector index. Therefore, with the spot value of the index, we can compute the historical fair value of the CDS. Comparing the spot price of the CDS and its fair value according to our model gives the analyst a quantitative tool to appreciate the potential future performance of an issuer vs the sector.

### Performance expectation vs sector index

This represents the view of our analysts based on a fundamental analysis. It also indicates how long a particular recommendation has been held.

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**Christophe Boulanger**

**Recommendation System:**

**Fundamental credit assessment:** We evaluate the fundamental credit quality trend of an issuer for the next 12 months.

Calyon's Credit Research evaluates the potential changes of an issuer for the next 12 months and assigns a one year forward rating based on S&P's scale. This rating is to be compared with the average long-term rating assigned by S&P and Moody's.

**Internal credit rating:** We assign a rating to a company which reflects the assessment of the credit quality by the credit analyst. The timeframe for the rating is one year. As a rating scale we use a scale similar to the one of S&P and Fitch, however, we substitute the rating agencies plus or minus by high and low, ie. the Calyon scale uses AAA, High-AA, Mid-AA, Low-AA, High-A, Mid-A etc.

**Performance of credit instruments:** We express our expectation of how the 5 year CDS is going to perform vis-à-vis its sector. The timeframe of that recommendation is one month. When the analyst changes a recommendation he/she should indicate in the analysis when the last recommendation was made.

**Outperform:** CDS spreads should outperform the sector performance.

**Sectorperform:** CDS spreads should perform in line with the sector performance.

**Underperform:** CDS spreads should underperform the sector performance.

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(as of 17<sup>th</sup> Jul 2009)

	All covered companies		Companies where Calyon provided Investment Banking Services in past 12 months	
	Count	Percentage	Count	Percentage
Outperform	15	16%	6	40%
Sectorperform	42	45%	15	36%
Underperform	36	39%	4	11%

**Disclosures****Company Name Disclosure**

Company Name	Disclosure		
Aabar Investments	None	Magna	None
Banque PSA Finance	G	MAN	None
BMW	G	Michelin	G
Bosch	None	Mitsubishi	None
Chrysler	None	Nissan	None
Continental AG	None	Opel	None
Daimler	G	Peugeot	None
Faurecia	None	Porsche	None
Fiat	None	Qatar Investment Authority	
Fidis (Fiat financing)	None	RCI Banque	None
FMCC	None	Renault	None
Ford	None	Salzburg Holding	None
Ford Credit	None	Scania	None
GAZ	None	Toyota	None
GKN	None	Valeo	None
GM	None	Volkswagen	G
GMAC	None	Volvo	G
Lehman Brothers	None		

A	NOT IN USE
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