Capital Account

Special Situations and Value-Based Investing Opportunities

April 2013

General Motors

Despite a checkered history today's General Motors offers prospects for a substantial returns over the coming 3 years bolstered by capital restructuring, margin improvements and recovery in North American auto volumes

General Motors

Situation: Business emerging from bankruptcy under new management

Key Data:

Market Cap: $39bn

HQ: Detroit, Michigan

TTM Sales: $152bn

TTM EBITDA: $12.3b

Dividend Yield: 0%

PE Ratio: 7.4x ('14E)

EV/Sales: 0.19x

Net Debt to Ebitda: net cash

Recent Price: $28

General Motors combines some of our favorite investing characteristics…

a) a business that has emerged from bankruptcy,
b) new management with a mandate for change
c) multiple ways of winning… namely i) improvement in capital structure, ii) margin upside from cost actions and iii) the potential for volumes to surprise on the upside in their key North American market.

Much has been written on the past practices at GM and how they found themselves in bankruptcy, our concern here though is how they've emerged from the crisis and potential upside scenarios for an equity investor. The following points summarize the main achievements at the company over the past 3-4 years with the company relisting their equity in November 2010.

1) offloading much of the retirement benefit obligations to the UAW and fundamentally restructuring the balance sheet, has seen interest-bearing debt decline from $27bn pre-bankruptcy to around $5bn in 2012. Further GM's pension plan is today 90% funded and they have reached a four year labor agreement with the UAW on wages which keep fixed costs down but provide bonus incentives geared to profitability and product quality.

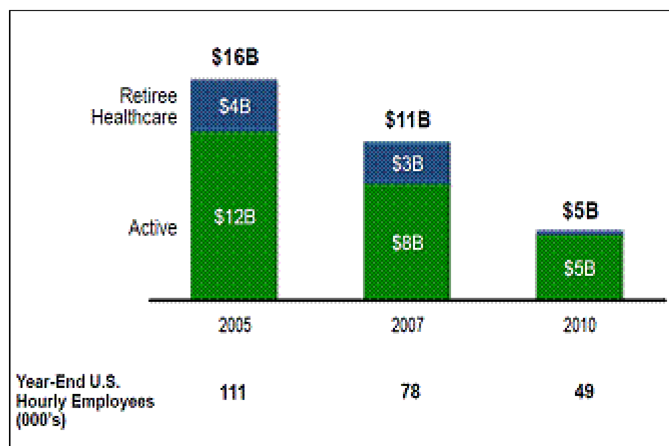
2) a headcount reduction in their North American business from 117k in '06 to 55k today.

3) reducing the number of GM brands from 8 to 4 (closed were Saturn, Pontiac, Oldsmobile and SAAB), as well as setting themselves on a path to halving the number of platform by 2020. This consolidation in brands will allow them to be

much more aggressive with each marketing dollar on new vehicles.

4) replacing prior GM management with a new unencumbered management team, 50% of whom are new to the business.

5) a reduction in operating costs in North American from run rates of $15bn in 2005 to $5bn in 2012. Prior to the restructuring the company were paying away close to $5bn/year just in retiree benefits. See chart below:



6) A significant reduction in the operating breakeven level of unit sales. Historically GM broke even at a SAAR of 16mln and market share of 23%. Post restructuring, this has been reduced to 11mln and 18.5%.

7) Much tighter integration of their engineering and purchasing, which will see their suppliers brought into the design and engineering phases much earlier. This should help to alleviate last minute design alterations which more often than not led to very expensive retooling, and crimped profitability

8) GM's dealer network has been slimmed and today is 90% profitable versus only 50% for most of the 2000's.

9) North American passenger vehicle sales capacity has been reduced by about 25% since the crisis, hence much more rational competition

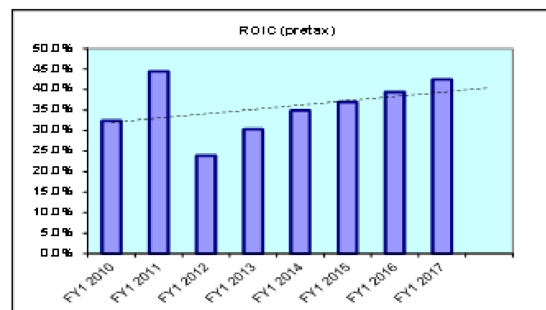
10) GM are on the cusp of their strongest new product cycle in many years. Over the course of 2012/13, 70% of all nameplates will be new models, positioning the company well to regain market share at a time when industry demand is now recovering.

As well as the operational improvements that flow from all of these achievements, GM's capital structure offers upside to equity investors. Like many bankrupt and near bankrupt entities in the crises GM took out expensive funding to bridge the gap in their balance sheet. In 2012 GM paid away $1.3bn in dividends and income attributable to preference holders on two series of Preferred Shares with a face value of around $10bn. This resulted in annual EPS leakage to common equity holders of around 81c/share which at a multiple of 9x, would be worth 26% more the equity. Each of these tranches of capital become redeemable through the next 24 months and with GM's gross cash balance ($27bn) and free cashflow ($10bn over 2013/14) the company have ample scope to rectify this capital structure anomaly.

The US Government stake now at 300mln shares is also for sale. The stigma of government ownership is clearly something management would like to remove, and their purchase of 200mln UST shares at the end of 2012 signifies their intent. There are various scenarios here depending on timing and priorities for cashflow. The following chart lays out the potential upside to EPS combining different levels of buyback with the 77c/share[1] benefit from the Preference Share redemption.

[1] The 77c is lower than the 81c mentioned above to account for interest foregone should said Pref's be redeemed

% Buy back	Shares	EPS	Add preference share tender benefit	New EPS	Target Mulitple	Target Price
0%	1366	4.84	0.77	5.61		
20%	1306	5.05	0.77	5.83	9	$ 52.45
40%	1246	5.29	0.77	6.06	9	$ 54.57
60%	1186	5.55	0.77	6.32	9	$ 56.91
80%	1126	5.84	0.77	6.61	9	$ 59.50
100%	1066	6.16	0.77	6.93	9	$ 62.38



Based on modest operational and market trends over the coming 3 years I have EPS at GM compounding at 20% with returns on capital comfortably getting into the 30's. Much will depend on their discipline around capex and obviously their success with new model introductions, however with the US auto fleet at its oldest in a generation, a river of latent demand awaits those who have correctly pitched the portfolio over the coming years. The potential for this to drive EPS upside and re-rating makes GM the stock a most compelling purchase.

Gold

I penned this short essay several years ago now, but given the take down in gold over the last 18 months thought its reappearance had some relevance

Gold: What is it Good For?

I think the most important thing to recognise with Gold is that it is a unique asset. Clearly it's not an equity or debt instrument, it is not an industrial commodity, nor is it obviously a paper currency. As Warren Buffet says, gold is this absurd metal that we spend billions of dollars a year digging up, only to have it melted down and stored again beneath the ground. Apart from its ornamental value it doesn't serve any useful purpose he says. It's typically never wise to argue with Warren Buffett. It also has to be said that gold hasn't necessarily outperformed equities over the long haul… though when we say that we're talking about the equity markets that have survived, which excludes more than a few markets (which have gone to zero at various times – Germany, Argentina, Austria, Hungary, Zimbabwe)

More than anything Gold is a currency, and along with Silver the oldest currency in circulation today. But unlike what we have come to know as traditional currencies issued by central banks under the authority of the state, it is not something that can be created by decree. It is obviously a naturally occurring metal that has several unique properties that have led to it becoming the oldest and most widely used unit of account that we have.

Nobody sat down 5,000 years ago and decided that Gold would "be" what today it has become. It is the ultimate example of survivorship bias. But clearly this survivorship bias did not happen without reason, these include the following:

1) Gold is rare…. All of the gold mined through history could be put into 2 Olympic sized swimming pools.
2) Gold supply has over the very long term grown at roughly the rate of the global population.
3) Gold doesn't degrade, so can be kept generation after generation without impairment
4) Gold is divisible and portable which sets it apart from land for example.
5) Gold can't be debased, although gold coins have frequently been debased by Monarchs in pursuit of expenditures.
6) Gold is nobody's obligation, it represents no promise to pay or redeem.

Primarily for these reasons gold has simply stood the test of time that other units of exchange have not. Silver too has many of the same characteristics, but its high industrial usage and smaller base has made a much more volatile metal than gold.

Another important and more subtle concept to consider when thinking about gold is that it is a constant. This is where the idea of gold being a store of value comes from. We are used to each day measuring the price of gold in US dollars, but in reality it is the value of a US dollar that is moving all about relative to an ounce of gold.

The concept of constant can be drawn from the writings of Irving Fisher, perhaps the greatest economist you've never heard of. Writing in 1928 Fisher talked about our conception of the sun rising and setting each day. In the early morning one might stand looking at horizon and watch the sun come up and at days end watch it gradually disappear over the western horizon. Although it has the appearance of moving up and down each day, the sun is a constant. It is the Earth's rotation on its axis that gives the appearance of the sun's movement. Although I'm sure it feels like it in Washington and Wall Street, we aren't the centre of the Universe.

Like the sun in Fishers analogy we can say that gold is a constant. I mean this in the sense that an ounce of gold today buys you roughly what it did a hundred years ago. Its real value is relatively (though not totally) constant. If your Great, Great Grandmother had left you two boxes that she sealed in 1909, one with an ounce of gold in it and the other with a $20 note, the box with $20 would have lost some 97% of its purchasing power by the time you opened it in 2009. The ounce of gold on the other hand would buy you today, approximately what it bought your great, great grandmother in 1909.

Coming back to Australia in early in 2009 was a nice little real life experience to draw on. In the ten years I was away, I estimate that my daily cost of living has approximately doubled over that period. Whether it's a 425ml glass of beer, a morning latte, loaf of bread, electricity to cool the house, the fuel that goes in my car or a basket of groceries. Granted some things are cheaper… LCD TV's, cell phones, internet connectivity. But roughly I guess that my weekly cost of sustaining myself has doubled over that time. The key point here though is that the value I derive from these goods is the same as it was ten years ago, and I venture to say was roughly the same ten years prior to that. By value, I mean utility. That ice-cold glass of beer at the end of a hot day gives me the same pleasure as it did ten years ago and probably the same pleasure that it gave my Father 30 years before that. My morning cereal gives me roughly the

same units of energy necessary to sustain me through to lunch time. Electricity to power my air conditioning provides the same relief this summer is it did in the summer of 1998/9.

So if the "value" of the goods hasn't changed but they "cost" twice as much, something else has changed. That something is the value of my paper money. Sneakily, year by year, over a ten year period, my paper money is worth only half what it used to be. Yes this is inflation, but it might also be known as paper money debasement. Inflation captures the phenomenon of higher prices for goods and services, and all kinds of things go into making this happen. Bread is obviously impacted by the cost of wheat today compared with a decade ago. But the cost of any item in an economy is also a function of the amount of money in circulation. Consider the following example of how this works.

Imagine a simple one product subsistence economy producing only rice, governed by an overlord who controls the money supply. They also have a stable population and fixed amount of land on which to cultivate their rice crop. Rainfall every year is the same, as are their crop yields. The market clearing price for rice in this economy is $100/ton. As demand and supply of rice are stable, the price is the same in any given year as it was the last. One morning the overlord decides on a whim that he is going to double the amount of money in circulation. As people in this economy don't save, they spend all of their earnings on rice to sustain themselves, beginning immediately the price of rice must rise as the increased circulation of money, against a fixed annual crop of rice has increased. We now have twice the amount of money buying the same fixed amount of rice. By definition the market clearing price will increase to $200/tonne and then stop. This short sharp burst in inflation happens very quickly as the velocity of money is 1 (no savings). Like my glass of beer example above, rice has the same "real value" at $200/tonne as it did at $100/tonne. The value of my money though has halved through a doubling of the money supply. In the real world we know that the price of rice will also be affected by rainfall, available land, crop science and changing demand patterns. All of these factors obviously going into determining the market clearing price for the commodity.

We can use lots of different ways to measure changes in relative value through time. For example the average house in Sydney ten year ago used to buy you about 10 new cars. In 20008 the average house would have bought you 23.3 new cars. The value of houses relative to cars has increased. Our most common denominator though in measuring value is money, paper money. If the amount of money in circulation rises (or falls), the price of all goods and services in this economy will also naturally rise (or fall), ceteris paribus. Houses have risen more than cars because land is fixed and global auto-manufacturing is not.

Gold is important because it is a time honoured way of measuring value. Time-honoured for the reasons I mention in the first paragraph. So if we think about the value of all goods and services denominated in gold rather than paper money, this is just another way of expressing value. If the amount of paper money in circulation increases relative to the amount of gold, then the price of gold must rise (as in the case of rice above). Under a standard where paper money is directly linked to the amount gold held, the value of paper money relative to gold is by definition stable. A paper money system that is not linked to hard assets is subject to wanton debasement for reasons most often driven by politics and popularity. America

(and anyone linked to the USD) went off the gold standard in August 1971, and today we live in a totally paper money world. It needs to be said however, that no paper (non hard-asset backed) money system has ever survived though history. Some paper currencies in fact have gone to zero (Zimbabwe, Weimer Germany, Hungary, Austria, Argentina), with most having ultimately gone back to some form of backing or linkage to a perceived stable unit of account. It remains to be seen how long this current (now almost 40 year) cycle of paper money experimentation will last. Several American States are already moving to accept cold coin as legal tender of merchandise transactions.

It also has to be said that Gold in the context that we have been talking is not alone in exhibiting many of the characteristics relative to paper money. Oil for example is also rare, has limited annual growth, is global and cannot be debased. Similarly with copper, palladium and nickel. One can rightly make the argument that any analysis of gold versus paper money can be made for any real commodity, and I agree with this. Gold simply has history on its side and is not subject to the same supply/demand vagaries as industrial metals and commodities, which tend to drive wide cycles around the equilibrium clearing price.

So-called "Gold Bugs", as far as I can tell hold the view that gold is good at any price. I don't think this is true either. In 1980 when gold exceeded $800/ounce, the value of known gold at that time exceeded the value of all the paper money in circulation, clearly a point of overvaluation. Measured against other commodities in 1980, Gold also looked very expensive in an historical context. Clearly as in any market, gold prices can get overdone to the upside as to make them poor investments.

Valuing gold is I agree very difficult. But directionally we can I think make a pretty good guess at where it is heading. As we survey the global landscape today for answers as to where the price of gold is headed I think it is helpful to look at the fiscal and debt situation that exists amongst G20 countries.

Very simply today the G20 is drowning in debt. Over the past decade global credit has grown at a compound annual rate of 12% against real GDP growth of 3.5%. Broadly defined, global credit today is running at levels never before seen in history relative to GDP. An increasingly it looks as though pay-day has arrived. It has certainly arrived in Europe. It is very likely to arrive in Japan quite soon, and the US and UK will not be spared if such a contagion takes hold.

Reported inflation today is apparently well contained, but the dramatic expansion in the balance sheets of the Fed, BoE, ECB and very likely the BoJ, means the seeds of widespread and accelerating inflation are being sown. The broken transmission mechanism within the banking sector, appears to be the only thing keeping these excess reserves from spreading into the real economy, thus mitigating the efficacy of central bank balance sheet expansion.

Reagan made the notion that debt doesn't matter popular, and convenient. Very simply though, there comes a point where debt does matter. Critically when Government debt as a percentage of GDP crosses 100%, an economy needs to grow by at least its rate of interest in order to keep their nominal debt balance in check. It's not apparent this is happening anywhere in the world. At some point creditors must ultimately demand additional returns to bear the risk to extending credit in such a situation. When the

creditors back away, or the cost of procuring credit becomes unpalatable, it will fall to the central bank to monetise the debt. This is precisely what is happening in debtor nations at present. The currency by definition is being debased and our old friend Gold, but just standing still by is worth more.

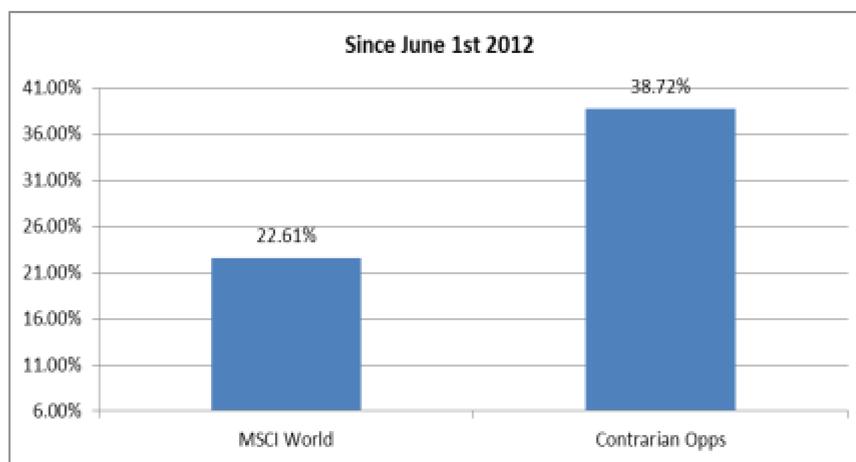
The real world is a more complex picture, with all types of investors driven my fear, greed, institutional factors and like, determining prices on a given day, but the big picture remains as clear as ever as it pertains to the global monetary system, and that is surely supportive of the trends we have seen in the past 8 years.

A word or two on Japan

It is one thing to trash your currency, a decision that can be taken by a small group individuals, sufficiently motivated, and with the appropriate policy *tools*. Kuroda-san's one chance to make a first impression has been a good one. The real test though of the longevity of the rally in Japan will be the preparedness of the population and CEO's of corporations to confront the changes that Abe is hinting at in his written and spoken communications. Embracing change is not something the Japanese have done well, but we should at least acknowledge that in 2013 there is a genuine (I believe) recognition that it is change that must be embraced. That is potentially great news for investors, and even better news for foreign private equity, for the first true test of Abe's language will surely be when the next private equity attempt is made on a cash-rich, undermanaged, lowly rated Japanese company. These efforts failed miserably in the mid 2000's when it was all the rage in the West, but it will surely come again. We added a number of Japanese names to the model portfolio following a visit there with so far positive results. Even absent the reforms, it appears that the long drawn out bear market in Japan has left many very good quality businesses overlooked, something we'll always try to take advantage of.

Model Portfolio Update

Running since June 2012 the model portfolio is a way of capturing ideas in a portfolio setting and benchmarking these against the broader market. It is actively managed with returns in local currency.



Name	Country	Sector	Weight	Return
GANNETT CO	US	Consumer Discretionary	4.1%	55.4%
GENERAL MOTORS C	US	Consumer Discretionary	3.7%	39.8%
SAFEWAY INC	US	Consumer Staples	3.8%	67.2%
SUSSER HOLDINGS	US	Consumer Staples	4.2%	56.0%
JAPAN TOBACCO	JP	Consumer Staples	3.2%	15.4%
ENI SPA	IT	Energy	3.1%	14.7%
OLD REPUB INTL	US	Financials	4.1%	43.9%
WR BERKLEY CORP	US	Financials	3.1%	15.7%
GSW IMMOBILIEN A	DE	Financials	3.2%	-8.7%
ZENKOKU HOSHO	JP	Financials	4.9%	42.8%
LEUCADIA NATL	US	Financials	8.2%	17.6%
CENTRAL JAPAN RL	JP	Industrials	5.2%	21.1%
ROCKY MOUNTAIN D	CA	Industrials	4.8%	2.8%
ESTERLINE TECH	US	Industrials	4.7%	22.2%
HYSTER-YALE	US	Industrials	4.1%	23.7%
FIAT INDUSTRIAL	IT	Industrials	2.9%	7.9%
ADT CORP/THE	US	Industrials	3.8%	14.7%
CSX CORP	US	Industrials	2.7%	5.7%
MICROSOFT CORP	US	Information Technology	7.2%	-0.7%
CAP GEMINI	FR	Information Technology	4.0%	2.7%
NETAPP INC	US	Information Technology	3.1%	17.4%
COMPUTER SCIENCE	US	Information Technology	3.6%	20.3%
ALENT PLC	GB	Materials	4.1%	8.5%
FRANCE TELECOM	FR	Telecoms	4.0%	2.3%
Market Cap (avge)	--			**$22.3bn**
PE Ratio (fwd)	--			**11.4**
Dividend Yield	--			**2.4%**

And finally… Charlie Ergin's surprise bid for Sprint seems to have plenty of industrial logic. Assuming the fine print reads well, it will be difficult for Sprint's board to reject such a proposal versus falling into the arms of a Japanese player who, while interesting, don't appear to have a roadmap for world of converged communications. Our thoughts thereafter turn immediately to DirecTV, who as a standalone Pay TV operator appear increasingly isolated. DirecTV do extremely well in their core market but with a maturing US base, programming cost inflation and lack of broadband, voice or mobile offering, seem cast adrift from the industry. Our work suggest their Latin American assets which include 41% of Sky Mexico as well as pay TV assets in Brazil, Colombia, Venezuala, Argentina Chile, Ecuador and others could be worth as much as $23bn (10x trailing ebitda), leaving the US business with 20mln subscribers paying each $100/month worth only 4.3x trailing ebitda. DirecTV is a very high quality business earning a 20%+ spread on its cost of capital. Sustaining that spread may only be achievable in another guise. With the industry evolving rapidly around them, might management be tempted to put their hand up to a larger sponsor who could ensure there is a path to sustained prosperity. Our work suggests AT&T could digest such a deal at a price in the mid-70's and it still be accretive to their current EPS. Net of the Latin American assets, such a deal would amount to only a single years worth of AT&T's free cashflow. No doubt WB and JM would agree.

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Sydney, April 2013