

93/11-Detroit's Comeback

While the Japanese downshift, investors can hitch a ride on the recovering U.S. automobile industry

By Peter Lynch

After a couple of years of improved car sales, a lot of people expected the party to be over, but as we've seen in the showrooms, the party continues, in spite of a sluggish economy that has added 2 million workers to the unemployment rolls since 1990. The public may not be buying new suits or dresses at the moment, but it is buying new cars.

In the car business, there are long stretches of poor sales, which create a so-called pent-up demand, followed by equally long stretches of excitement when the pent-up demand gets satisfied. These cycles of automotive boom and bust may be slightly out of sync with the economy at large.

One indication of how much pent-up demand exists at any given moment is the number of clunkers on the road. Right now, the average age of a car in the U.S. is 7.9 years, the highest it's been since 1948, when GIs home from the war had no money for anything but rent, diapers, and groceries.

Until somebody improves the bus service or invents a strap-on personal helicopter, most people will not tolerate living without a car. So as the clunkers conk out, they'll have to be replaced, and this means a steady supply of customers for car dealers and manufacturers.

This is happening at a time when the entire sad story of the U.S. auto industry in the late 1970s and early 1980s (inefficient, inept, insensitive to customers' needs) has been rewritten. Detroit is making good cars that people want to drive and that don't break down any more often than Japanese cars do. It's producing them in efficient factories that pay competitive wages.

The Japanese story (omniscient, omnipotent, omnivorous) has also been rewritten. When their economy was booming and their factories were running at top speed, the Japanese could sell their extra cars abroad at a very low cost per car. Today, with their factories running at half speed, the cost per car is much higher. Now it is Ford and not Toyota or Honda that is producing at full capacity. Now it is Japan and not Detroit that has to worry about losing its share of the U.S. market.

The financial press treats the decline in Japanese auto sales in the U.S. as though it's all to do with the rising yen and the falling dollar, which makes Japanese cars too pricey. This situation will reverse itself as soon as the yen falls and the dollar rises. I think more profound changes are at work here. The remarkable efforts of U.S. carmakers to correct their prior mistakes are likely to pay off for years to come.

In September 1992, I recommended Chrysler on Wall Street Week With Louis Rukeyser. Chrysler is doing okay selling cars and making a fortune on Jeeps and minivans. The minivan has replaced the station wagon as the suburbanite's favorite conveyance: It's roomier and also a better value. In the

government's dictionary, a minivan is defined as a truck, whereas a station wagon is a car. Being a truck exempts the minivan from certain emission-control requirements that add to the sticker price of cars.

Chrysler flirted with insolvency in the early 1980s, but today it is generating so much cash that the rating on its bonds is being raised from junk to investment grade. This would reduce its cost of borrowing and add further to its profits. Chrysler's Jeeps are selling well, and Chrysler has managed to hold on to a 50 percent share of the minivan market against a horde of competitors. The company has produced an exciting new line of cars (the LH series) in the \$17,000 to \$30,000 range and the first redesign of a full-size truck in 22 years. The Chrysler Neon, a lower-priced car that will appear at dealerships in 1994, has the potential appeal of GM's Saturn.

So it's easy to make a positive case for Chrysler, but with the stock having quadrupled in 24 months, it's not the buy it once was.

Three of the top auto analysts with whom I recently spoke (Wendy Beale- Needham at Smith Barney Shearson, Don DeScenza at DeScenza & Co., and David Bradley at J.P. Morgan Securities) like Chrysler, but they like < wam-co NYSE:GM>General Motors even better.

GM has long been the dunce of the industry--it took years for the company to figure out that customers actually want air bags in their cars--but lately GM has gotten smarter. It is installing air bags in all but three of its 1994 models. After noticing that many of its loyal Cadillac customers were getting too old to pass a driver's test, GM jazzed up the Caddy with a bigger engine to appeal to a younger crowd.

The main reason to prefer GM (and also Ford) over Chrysler is that GM and Ford have big overseas markets and will benefit when Europe shakes out of its recession, whereas Chrysler is essentially a domestic operation.

Elsewhere, I've noted that GM does so well with its non-automotive divisions, including GMAC, Hughes, and Electronic Data Systems (a canny acquisition it made from Ross Perot), that if it manages to break even on its U.S. auto business, it will make a fine profit. David Bradley thinks that before the end of the current upswing in car buying, GM can earn between \$5 and \$7 a share on U.S. car and truck sales alone. If that happens, the company's overall earnings would be \$10 to \$15 a share. He sees GM as a potential \$100 stock.

GM may also benefit from the curious way Wall Street appraises the earnings of cyclical companies. Chrysler is doing better than GM at present, so let's say Chrysler earns \$8, then \$10, then \$12 a share in the next three years, and in the fourth year it slips back to \$10. Meanwhile, GM earns \$4, \$6, \$8, and then the same \$10 as Chrysler. At that point, investors are likely to pay more for GM's \$10 than Chrysler's \$10. That's because Chrysler will appear to have reached its peak, while GM will look like it's still climbing.

Supply-Side Investing: Besides the carmakers themselves, there are an estimated 2,500 additional companies whose principal products are parts of cars. Many of these are publicly traded, and they also stand to benefit from the surge in auto and truck sales. GM, Chrysler, Ford, and even the Japanese carmakers are manufacturing fewer parts in-house, and this "outsourcing" makes the parts industry more important than in any previous cycle.

Somewhere on a car or truck, there's always a part or two that will make investors happier than if they'd invested in the sum of the parts. The catalytic converter, antiskid brakes, and the air bag all have created big winners in the stock market, and so has the aluminum wheel.

The main supplier of aluminum wheels is Superior Industries, whose stock has enjoyed a modest 40-fold gain in a decade. It didn't take a Nostradamus to see this one coming. Carmakers had to reduce the weight of their cars to improve gas mileage to meet EPA standards, and they could drop an easy few pounds with aluminum wheels. The percentage of new cars and trucks with aluminum wheels has increased from zero 20 years ago to 37 at present count. Someday, it may be 100 percent.

There's a certain amount of protection in investing in an established supplier such as Superior. When a car part fails, it's the carmaker that gets the bad publicity and not the part maker, so carmakers are very careful about who gets the contract. A competitor might arrive with the best-looking aluminum wheel ever, but unless that competitor has a track record, carmakers aren't likely to give up on what already works.

Superior may have a prosperous future ahead of it, but the problem is that its price-to-earnings ratio of 34 already reflects that probability. If you want to invest in wheels, Wendy Beale-Needham suggests Hayes Wheels, a company that came public in 1992. Hayes is the largest supplier in Europe, and in North America it's number two, behind Superior. Varsity, which sold the Hayes shares in the stock offering, still owns a sizable stake.

Don't Forget Spare Parts: The fact that 37 percent of the vehicles on the road are at least ten years old augurs well for the spare-parts business, also known as the aftermarket. The aftermarket has suffered in recent years because there were too many new cars on the road from the last big spurt in auto sales from 1983 to 1988.

In addition to normal cyclical blahs, two other factors added to the woes of the spare-parts market: Automakers insisted on making high-quality cars and trucks that refused to break down, and longer warranty periods meant that more repairs were being handled by dealers. But sooner or later, the warranties had to expire and the parts had to wear out. Millions of vehicles bought between 1983 and '88 have reached that age when they have to spend time in the shop.

So we can expect the aftermarket to become a very busy place--even busier if and when the other states follow California's lead in adopting stringent pollution-control standards. In addition, it's estimated that one third of all older cars will fail the EPA tests that go into effect in 1995.

Some of the best-known companies in this industry (Echlin, Standard Motor Products) have already seen their stocks rise in anticipation of better days ahead. Others have gone sideways, such as Genuine Parts, which went from \$30 in 1987 to a recent \$36. This company has increased earnings for 32 straight years, which puts it in the Lynch Hall of Fame. Even in the recent recession, Genuine Parts managed to boost its earnings. Lately, it's been cutting costs and upgrading the 700 NAPA parts stores it owns outright--it also supplies parts to 6,000 independent dealers. Don DeScenza has made Genuine Parts his number one pick in this sector.

Except for retailing and restaurants, there isn't another area of the stock market where more people have more of a chance to follow what's happening than in cars, trucks, and assorted parts. We'll eventually have an electric car, and once the initial confusion is sorted out, some company will emerge as the champion of that business, and we'll all realize who it is. Then there will be several champion suppliers of batteries and so forth, and we'll know who they are, too. And even though the news is out, there will be plenty of time to invest, because if Wall Street is true to form, it will be slow on the uptake.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, *Beating the Street*, is published by Simon & Schuster.;

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