

European Autos: Why a GM Bankruptcy Can Raise European and Japanese Auto Industry Returns

Ticker	Rating	CUR	31/03/2009 Closing Price	Target Price	YTD Rel. Perf.	EPS			P/E			Yield
						2008A	2009E	2010E	2008A	2009E	2010E	
BMW.GR	O	EUR	21.70	30.00	15.3%	0.49	0.40	1.42	43.9	53.8	15.2	1.4%
DAI.GR	M	EUR	19.41	25.00	-12.9%	2.99	-0.65	0.73	6.4	NM	26.2	3.1%
F.IM	M	EUR	5.27	5.00	29.9%	1.29	-0.68	0.05	4.1	NM	NM	NA
PAH3.GR	M	EUR	36.08	60.00	-16.5%	24.10	3.30	5.99	1.5	11.1	6.1	NA
UG.FP	O	EUR	14.24	25.00	32.3%	-1.51	-6.72	-0.57	NM	NM	NM	NA
RNO.FP	M	EUR	15.49	20.00	-1.4%	2.23	-4.17	0.96	6.9	NM	16.1	NA
VOW3.GR	O	EUR	43.34	55.00	27.5%	11.89	1.45	2.99	3.5	28.5	13.8	NA
MSDLE15			773.84			92.72	83.16	95.66	8.3	9.3	8.1	6.3%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

Highlights

- The dramatic downsizing of GM will be good for industry returns.** European and Japanese auto stocks got hit hard earlier this week on concerns of the systematic impacts of a GM and Chrysler bankruptcy. We recognize that a chaotic bankruptcy would have serious near-term implications due to supplier failures and could also affect dealer networks, financing, consumer confidence and potentially the Mid-West and wider US economy. However, the US administration is intent on restructuring GM (and probably Chrysler) in an orderly fashion (probably with a "pre-packaged" bankruptcy). Furthermore, a down-sizing of GM (and Chrysler) is, in our view, a major positive for wider industry returns going forward.
- A downsized GM and Chrysler could be worth over €18bn of EBIT to the rest of the industry.** "What is good for GM is good for America", as the old cliché goes (actually a statement by GM's CEO in 1955). A bankruptcy may not be good for GM's employees or bondholders – and may not be good for America, at least initially. But we believe it will be good for Europe and Japan. We are often asked "can the auto industry ever become rational?". It is clear that at last such a moment is drawing near. It is rather rare to find a global industry where the 2nd largest producer goes bankrupt – a producer that has been acting, for at least two decades, in a way that is negative for industry returns. If GM and Chrysler are radically downsized – with large parts of their capacity and product offering eliminated – it has to be good for global auto industry returns. We estimate that if GM/Chrysler surrender 30% of their US market share, it could be worth US\$14.5bn (€11bn) of EBIT for other OEMs who can ramp up utilisation. If Opel exits Europe (e.g. is not nationalized) its market share could be worth €7.5bn of EBIT.
- GM has been a deflationary force for decades.** GM has been a deflationary force on pricing – both in the US and Europe – for many years. Having historically refused to reduce manufacturing capacity, product offering and dealer density, GM has always resorted to aggressive pricing. GM has been the leading exponent of oversupply, cheap financing and deflationary strategies. GM's post-September 2001 0% financing strategy pulled forward demand and structurally lowered industry ARPUs. GM has been selling hundreds of thousand of "brand new second hand cars" each year – vehicles for which there is no

real consumer demand but that go quickly to second hand via daily rental fleets, employee discounts and other routes. Cutting this behavior would be enormously positive for industry returns.

- **A restructured GM will not lower prices – GM has been pricing below cash costs in recent years.** We've heard it argued that if the US industry is restructured and made more competitive, it will close the cost gap with the Japanese, allow GM and Chrysler (and probably Ford) to price lower – and damage Japanese and German profits in the US. We believe this conclusion is wrong – GM has already been selling vehicles far below breakeven cost for years – and probably below marginal (cash) cost. That is why the company has been hemorrhaging cash and is heading for Chapter 11.
- **GM vehicles sell for US\$3k to US\$10k below Toyota's – depending on segment.** In this report we show data on the massive price disadvantage that GM and Chrysler suffer – with their small cars selling at US\$3,000 below Honda/Toyota levels, their midsize SUVs US\$6,000 below and their large cars selling for US\$10,000 less. GM and Chrysler have a price problem more than a cost problem. This is a brand issue – and the brands won't be fixed by Chapter 11. But a bankruptcy and slimming down will reduce the fixed cost and volume hunger of GM and Chrysler – and therefore we'd expect industry prices to rise, not fall.
- **The US autos task force will force a proper restructuring and slimming down of GM.** Almost all of the reports we hear from industry contacts about the US Administration's Auto Panel are positive. Led by former investment banker Steve Rattner, it has rejected both GM and Chrysler's turnaround plans and application for aid. A panel member reportedly stated that "we have unfortunately concluded that neither plans submitted by either company represents viability and therefore does not warrant the substantial additional investments that they requested". Instead, the panel has given GM 60 days of funding (and time) to come up with a more detailed and realistic plan – and Chrysler just 30 days to prove a deal with Fiat will work. We believe it would be more logical for the US government to recommend folding Chrysler into GM, rather than letting Chrysler continue.
- **What does "new GM" look like?** In this report we outline our view on what "new GM" needs to look like – with reduced financial and post-retirement liabilities, fewer employees and with a radically downsized production footprint, fewer dealers and a much narrower product range. As the task force looks closely at how to return GM to viability, it will likely conclude that GM must focus on those vehicles that US consumers will buy from a US brand at a viable, cash generative price.
- **The US government needs to save Detroit first, and save the planet later.** We believe GM needs to focus on profitable vehicles at first, with environmental efforts left until easier times – even if this does not fit with the Obama administration's broader political (environmental) agenda. That inevitably means larger vehicles – mainly pick-ups, SUVs and larger cars. In this report we look at the most realistic product and platform plan for GM (and GM with Chrysler).
- **Who will take the large market share gains available in the US? A close look at "cross-shopping".** We expect the US administration to restructure GM (and Chrysler) into smaller entities with much lower market share. For the purposes of this research, we have assumed GM and Chrysler shed 30% of their product lines and market share, falling from 33% market share in 2008 (22% and 11% respectively) to 23%. Who will pick up the share that is made available? In this report we show data on "cross-shopping" patterns – what other vehicles the current buyers of GM and Chrysler vehicles consider before making a purchase. The reality is that GM and Chrysler buyers are most likely to defect to Ford, followed by Japanese and then European cars. This varies by product and segment – with the greatest opportunity for the Japanese in Minivans and small SUVs and for the Europeans in medium sedans. The biggest European beneficiaries will be Renault (via Nissan) and VW. In the near to medium term, there will be few benefits for BMW and Mercedes. We estimate the EBIT value of the US market share available to the other OEMs at US\$14.5bn.

- **Share gains also available in Europe.** The biggest opportunity for the Europeans is in domestic markets, where the fate of GM's Opel business will determine how much market share is up for grabs. The appetite for M&A in Europe appears weak (Daimler and BMW turning down the opportunity to take on Opel and Renault admitting the attractions, but unable to afford it). The willingness of the German government to save/nationalize Opel remains unclear. Were Opel to fail, with its leading position in the UK and large market shares in Germany and Spain, it would offer excellent market share opportunities for VW, Ford, PSA and Renault. We estimate the EBIT value of the market share available to other OEMs in Europe at €7.5bn.
- **Near-term supply chain disruption is a big risk.** While we are optimistic on the medium and long-term benefits of a GM/Chrysler bankruptcy and restructuring, there are obvious near-term risks. The impacts on the Europeans might not be limited to North America. Large scale supply chain disruption and failure – even in the event of a pre-packaged bankruptcy – may be inevitable. The contagion may spread to Europe. Ford and GM Europe could be forced to suspend production near-term in the event of a filing by their US parents – and/or could be impacted by the failure (or non-payment) of common suppliers operating on both sides of the Atlantic. European OEM production in Europe could be impacted directly by supplier distress (North Americans Magna, JCI and Lear are all Top 10 suppliers in Europe).

Investment Conclusion

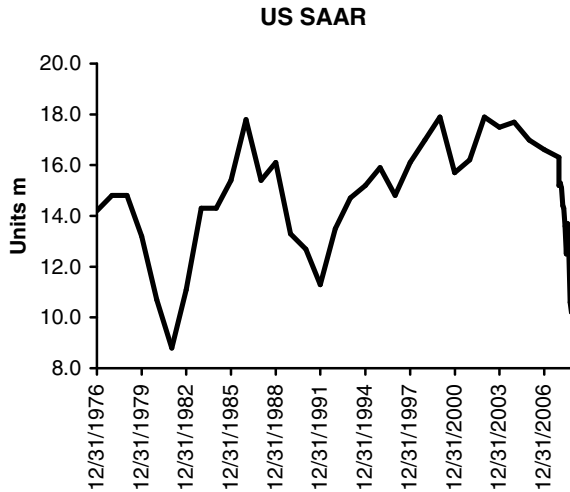
We continue to maintain our positive sector stance. When we launched sector coverage in October 2008, we took a positive view on the sector. We argued that we were close to the “classic” point where it makes sense to buy auto stocks and argued that on a 12 month view, there was every chance stocks could outperform. Some of our major concerns have been allayed: financial services funding now looks more reliable – either via capital markets or via government guarantees for the banking system. Volumes do look to be stabilising in Europe. The next move in US volumes must surely be up. Raw material costs are plummeting. GM's decline – both in the US and in Europe – will eventually be good for industry returns.

The challenges remain monumental. Although we continue to believe our positive view is realistic, we must attach some major caveats. The extent of the sales decline has been far greater than we anticipated back in October. The balance sheets are already in much worse shape than we forecast. The current “stabilisation” in European volumes appears highly reliant on (temporary) scrappage incentives. Mix is an issue for the volume OEMs and a severe challenge for the premium automakers. Truck markets are in freefall and will take longer to stabilise than car markets. Global consumer de-leveraging may have much further to go and have complex implications for car demand. But the stock market knows that, doesn't it?

Details

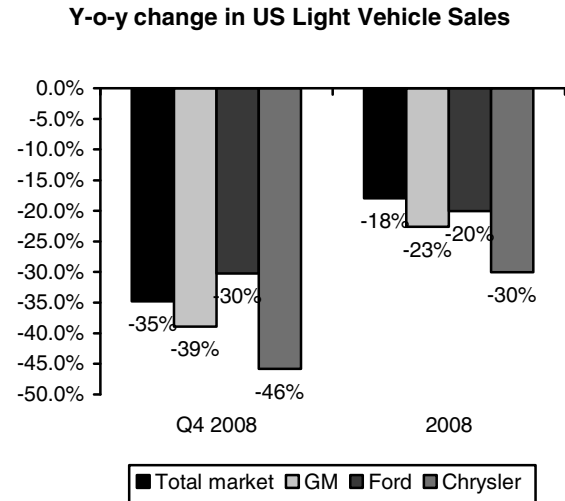
The end may be nigh for GM and Chrysler (or at least a radical downsizing). While some believe the Obama administration is simply attempting to place pressure on the UAW and bondholders with its talk of bankruptcy, we believe the US government is quite serious about putting these companies into a Chapter 11 process (or similar) and radically downsizing them. Such a move is probably overdue. The American industry has been in decline for decades – but after a recovery in profitability in the late 1990s (driven by SUV and pick-up profits), its deterioration began again after 2000 and has become particularly acute in recent years. The businesses have not looked viable in their current form for a number of years – but only in the last 12 months, with the collapsing US market, have they been pushed to the brink.

Exhibit 1
US SAAR has collapsed to early 1980s levels



Source: Bloomberg, Bernstein Analysis

Exhibit 2
GM, Ford and Chrysler sales in severe decline



Source: Autodata, Bernstein Analysis

What happens next for GM and Chrysler?

The US Administration's approach to Detroit's problems appears impressive. The process is being run by a White House autos panel, headed by former investment banker Steve Rattner, and has rejected both GM and Chrysler's turnaround plans and application for aid. A panel member reportedly stated that "we have unfortunately concluded that neither plan submitted by either company represents viability and therefore does not warrant the substantial additional investments that they requested". Instead, the panel has given GM 60 days of funding (and time) to come up with a more detailed and realistic plan – and Chrysler just 30 days to prove a deal with Fiat will work. The panel said Chrysler's assumptions under the business plan it had submitted to the U.S. Treasury were "unrealistic or overly optimistic."

It looks like the government may sanction an official bankruptcy process for both. It is not clear if this will be Chapter 11, Chapter 7 or some other specialist arrangement. The press reports that the US administration has not ruled out a structured, quick bankruptcy process for either GM or Chrysler. Reuters reported an official saying "think of it as a quick rinse...it would be very, very short. Potentially as little as 30 days. The companies would emerge from the other side very quickly."

GM and Chrysler could be stripped of debt obligations and labour contracts. But those measures alone would not make the businesses viable. GM and Chrysler also need to become radically smaller – and probably one entity (if Chrysler's deal with Fiat does not come off). We would assume that either inside or outside bankruptcy proceedings, GM and Chrysler will be required to exit large parts of their product line and close large parts of their manufacturing and product development capacity.

Unless Fiat convinces, GM and Chrysler may be forced together by the US administration. The timing of current deadlines is interesting – Chrysler has 30 days of funding to prove it is viable, while GM has been given 60 days. If Chrysler-Fiat is not seen a realistic salvation, we would assume the autos task force will either let Chrysler fail or will force it together with GM in a bankruptcy process. We'd then expect GM (with or without Chrysler) to emerge from bankruptcy with greatly reduced financial and post-retirement

liabilities, fewer employees and with a radically downsized production footprint, fewer dealers and a much narrower product range.

What does a smaller "new GM" look like?

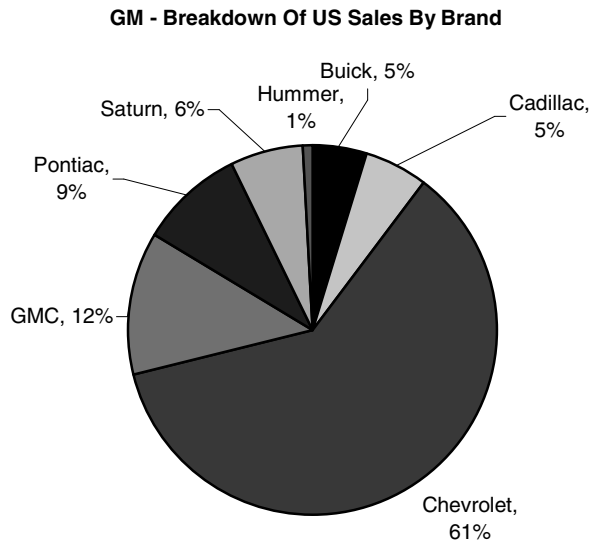
Cash generative model lines only. To be viable, GM must focus on those vehicles that US consumers will buy from a US brand at a cash generative price. That means larger vehicles – mainly pick-ups, SUVs and larger cars. We believe the logical approach would be to look at which products and brands have the potential to be profitable – and organize the industrial structure around that (e.g. cut assembly plants, headcount and development centres and the dealer network accordingly). Simplistically, we believe Detroit might benefit from focusing on 4 product types:

- **Pick-ups.** We would assume that, as a group, Detroit's pick up products should still be viable – at least in a normal economy. Individually, contribution margins on GM's T800 and Chrysler's Dodge Ram may be poor at present – but in a normal economy, especially with shared platforms and powertrain – they should be profitable.
- **Mid-size SUV.** Detroit should also still be able to make some money in mid-size SUV – although volumes have collapsed, monocoque (e.g. car type chassis) products like Grand Cherokee should still be viable going forward.
- **Minivans and crossovers.** Detroit has an array of product that can be defined as "crossover", but this encompasses all sorts of different vehicle types. Collectively, putting all sorts of US\$25,000 and above minivan/SUV-lite and passenger car based utility vehicles onto one platform may allow volumes to reach economic levels.
- **Rear-wheel drive cars.** Detroit has lost money in passenger cars for a long time. If it is to hope to ever be profitable in a car segment, it is likely that large cars have the best hope. Chrysler's 300C and some of the Cadillac product may be viable going forward – particularly if placed on a common platform.

Save Detroit first, then save the planet later. We believe GM needs to focus on profitable larger vehicles at first, with environmental efforts left until easier times – even if this does not fit with the Obama administration's broader political (environmental) agenda. The list of mainly large cars above would suggest that Detroit would abandon between 30% and 50% of its current volume – and shed perhaps 30-50% of its 240,000 direct workers.

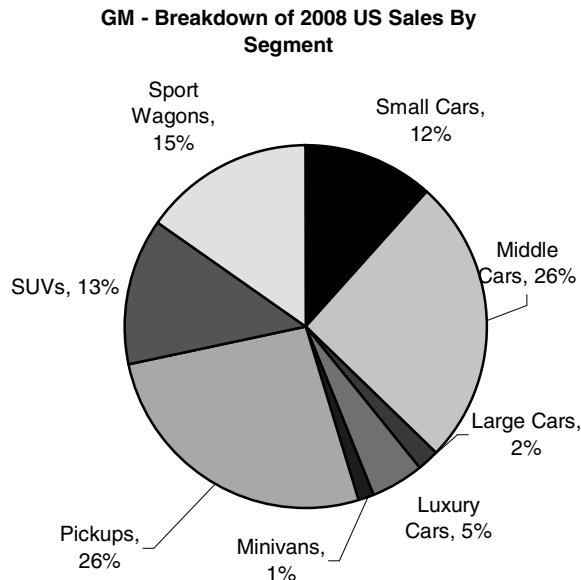
A slimmed down Detroit may focus on just a few product types. If GM and Chrysler exit large parts of the market – small and medium cars, certain SUV segments and perhaps Minivans, then there will be far less pressure on pricing, far less competition to push volumes, market share opportunities and a healthier industry structure. For the purposes of this research, we have assumed GM and Chrysler shed 30% of their product lines and market share, falling from 33% market share in 2008 (22% and 11% respectively) to 23%. This is based on the assumption that much of Chrysler is closed (Minivan stays) and GM closes Saturn, Pontiac and exits part of its Chevrolet small car business and parts of its Chevrolet and GMC truck business.

Exhibit 3
GM product line by brand – Chevrolet "carries" GM, with pick-ups the only real profit centre



Source: Autodata, Bernstein Analysis

Exhibit 4
GM product line by segment – time to get out of many car lines?

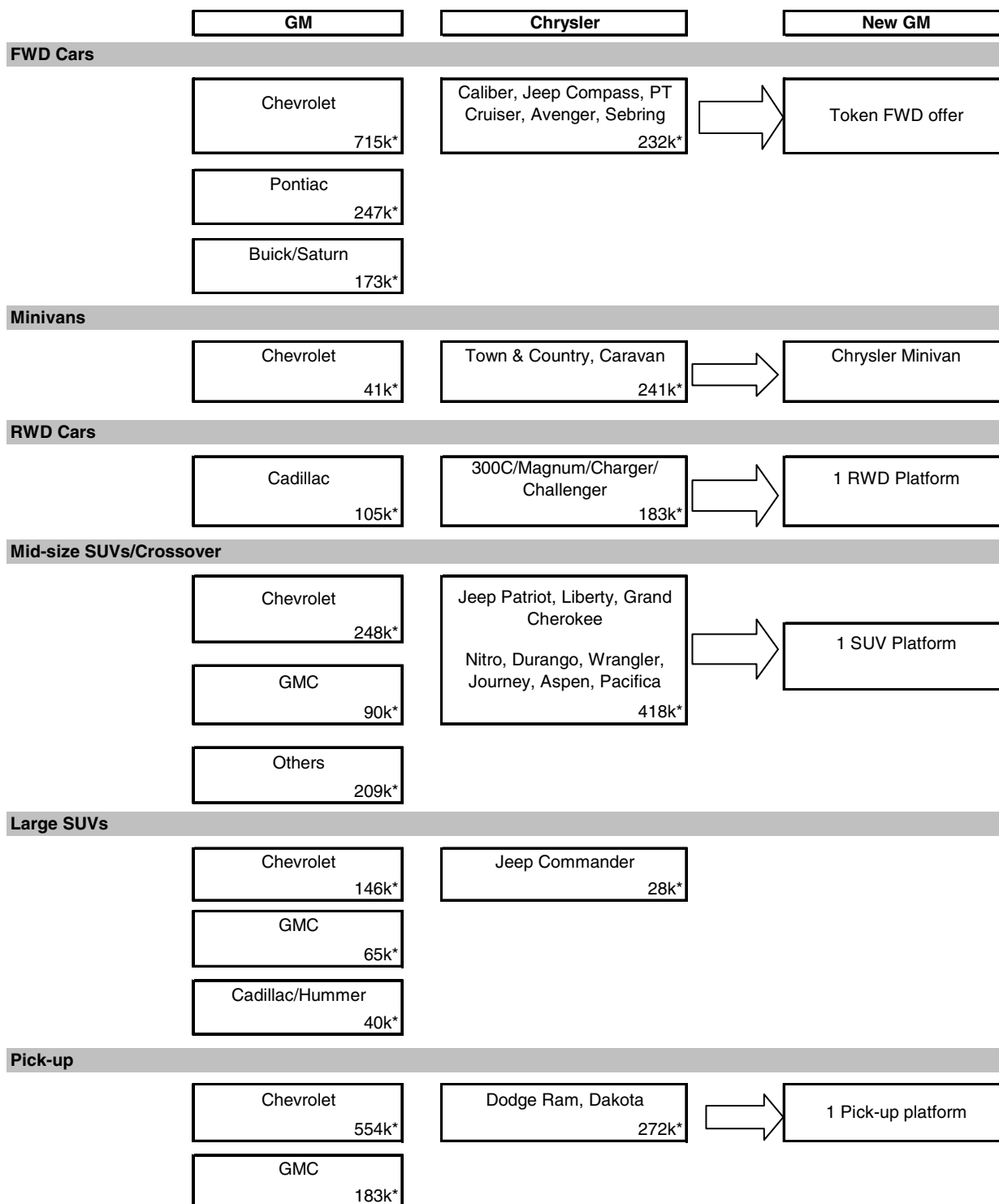


Source: Autodata, Bernstein Analysis

What might a merged GM and Chrysler look like, post restructuring?

If the Fiat deal doesn't work out (and our suspicion is that the US task force would rather not recommend that Detroit continues with 3 automakers), we would assume that Chrysler will be dramatically downsized and probably integrated into new GM. There is so much product overlap – and geographical and functional overlap (e.g. design and engineering centres within 30 miles of one another) that big capacity reductions would be inevitable. We would forecast that Chrysler will slim down to become only a minivan producer (where it is an industry leader), with its pick-up and rear-wheel drive products merged with GM's similar operations. We show a possible GM-Chrysler product and platform strategy, for a slimmed down combined entity, in **Exhibit 5**.

Exhibit 5
GM-Chrysler if pushed together could slim down to a limited number of products and platforms



* figures in box are 2008 volumes

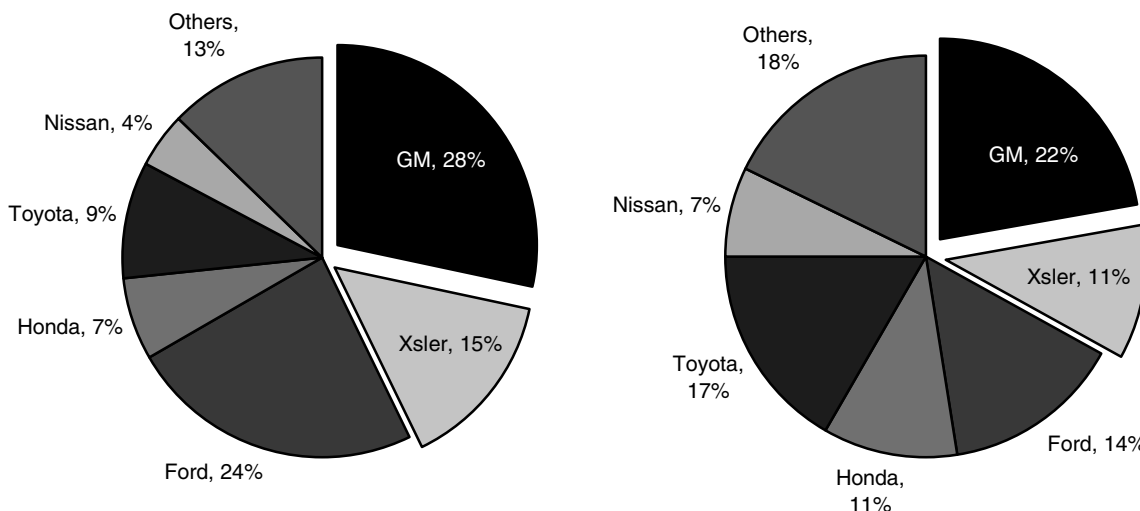
Source: Bernstein Analysis

European Autos

Who gains US share if GM and Chrysler slim down?

It is a common misperception that the American Big 3 have customers directly to the Japanese. While this is superficially true (Big 3 'share down, Japanese 'share up), the reality is more complex. Big 3 buyers rarely move directly to Japanese brands. GM buyers typically cross shop Ford and Chrysler. Toyota buyers typically cross shop Honda and Nissan. What is more common is that older consumers continue to buy American cars, but eventually leave the new car market (due to old age/death), while younger consumers buy Japanese cars – and are an expanding part of the demographic group that buy new cars. Over time, market share shifts to the Japanese and Europeans as younger consumers come of age and move from the used car to the new car market.

Exhibit 6
GM and Chrysler have been using share fast this decade – comparing U.S. Market Share in 2000 and 2008. Bankruptcy and slimming down may mean large parts of the current market share is abandoned too

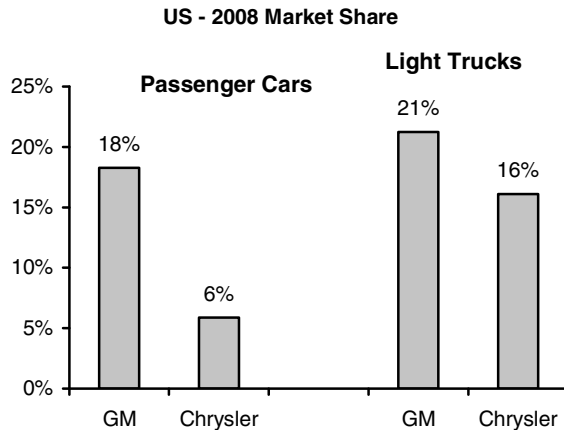


Source: Auto Insight, Bernstein Analysis

Who will pick up the share that is made available? GM and Chrysler are really light truck companies (see **Exhibit 7**) so this is the main market share that is available on paper. But a "new GM" may move out of (severely loss making) cars and focus on (potentially still profitable) trucks.

In event of a sudden decline in the size of GM and Chrysler, we would expect a more rapid and direct move to the Japanese ("honey, I can't buy a Lincoln anymore, they don't exist") but cross shopping patterns suggest the shift will be complex. The reality is that GM and Chrysler buyers are most likely to defect to Ford, followed by Japanese and then European cars. This varies by product and segment – with the greatest opportunity for the Japanese in Minivans and small SUVs and for the Europeans in medium sedans. The biggest European beneficiaries will be Renault (via Nissan) and VW. In the near to medium term, there will be few benefits for BMW and Mercedes.

Exhibit 7
GM and Chrysler are more focused on light-truck – and to be viable, may need to reduce, not increase, car exposure



Source: Auto Insight, Bernstein Analysis

A close look at cross-shopping – consumers will move to Ford and the Japanese

We refer to a study by Edmunds published recently that looked at cross shopping habits of Chrysler buyers. What other vehicles do they consider? The study concluded that GM is the most "cross shopped" automaker by Chrysler buyers, with very similar customer preferences. Were GM and Chrysler both to be restructured and slimmed down (an outcome we see as likely), then we'd suggest that the non-GM products featured in the Edmunds study are the most likely to benefit from market share changes. Edmunds data would suggest that Ford will benefit most from a smaller GM and Chrysler, followed by Honda, Toyota and – at a distance – Nissan.

Nissan really does look like a laggard amongst the Japanese. We believe Nissan would gain some share – but the Edmunds data suggests it would do far less well (even accounting for its smaller size) than Toyota or Honda. Edmunds reports that "Nissan [was] the least cross-shopped by Chrysler shoppers of the largest automakers selling in the US". Nissan's Titan pick-up is cross shopped against Dodge Ram and GM pick-ups less than Toyota's Tundra.

The Japanese have the most to gain in Minivan, mid-size SUV and small SUV. Cross shopping habits suggest the Japanese have the most to gain in minivans (where Chrysler is heavily compared to Toyota and Honda product – see **Exhibit 8** and **Exhibit 9**) and mid-size SUV (where Jeep Grand Cherokee is widely compared to Honda Pilot, Ford Explorer and Toyota 4Runner – see **Exhibit 10**) and small SUV – where Chrysler products are most often compared with one another but after that with Honda and Toyota (see **Exhibit 11** to **Exhibit 13**). These segments are where the Japanese have gained most share in recent years (having already dominated in cars) and it seems likely their gains would advance if GM and Chrysler are slimmed down.

Exhibit 8
The Japanese could gain big market share from Chrysler in Minivans

Chrysler Town & Country	
1. Honda Odyssey	43%
2. Dodge Grand Caravan	33%
3. Toyota Sienna	33%
4. Nissan Quest	12%
5. Hyundai Entourage	12%
6. Volkswagen Routan*	9%

*based on Chrysler minivan platform

Source: Edmunds, Bernstein Analysis

Exhibit 9
Honda compares better than Toyota in Minivans

Dodge Grand Caravan	
1. Honda Odyssey	50%
2. Chrysler Town & Country	31%
3. Toyota Sienna	26%
4. Hyundai Entourage	13%
5. Nissan Quest	11%
6. Kia Sedona	10%

Source: Edmunds, Bernstein Analysis

Exhibit 10
Honda and Toyota may gain some share – but less – in SUVs

Jeep Grand Cherokee	
1. Honda Pilot	8%
2. Ford Explorer	8%
3. Toyota 4Runner,	7%
4. GMC Acadia	7%

Source: Edmunds, Bernstein Analysis

Exhibit 11
The Japanese share gain in smaller SUVs would likely continue...

Jeep Patriot	
1. Honda CR-V	17%
2. Jeep Compass	15%
3. Jeep Liberty	13%
4. Ford Escape	12%
5. Saturn Vue, Toyota RAV4	11%

Source: Edmunds, Bernstein Analysis

Exhibit 12
....with Honda, Ford and Toyota most often compared

Jeep Liberty	
1. Jeep Patriot	23%
2. Honda CR-V,	14%
3. Jeep Grand Cherokee	14%
4. Ford Escape	13%
5. Toyota RAV4	10%
6. Jeep Compass	10%
7. Jeep Wrangler	10%
8. Dodge Nitro	9%

Source: Edmunds, Bernstein Analysis

Exhibit 13
Nissan makes fewer appearances than Honda or Toyota in small SUV

Jeep Compass	
1. Jeep Patriot	35%
2. Honda CR-V	17%
3. Jeep Liberty	13%
4. Nissan Rogue	12%
5. Ford Escape	12%

Source: Edmunds, Bernstein Analysis

The Japanese may gain some share in pick-ups – but Ford would be the big winner. American patriotism is very evident in the Pick-Up market, where Japanese product struggles to get recognized (see **Exhibit 14** and **Exhibit 15**). Toyota Tundra and Nissan Titan might gain a few sales – but not many. Ford would be the big winner. Given we would expect "new GM" or "new GM-Chrysler" to remain big in pick-ups, the share gains may be limited once the company emerges from bankruptcy protection.

European Autos

Exhibit 14
Buyers of large pick-ups only look at other American brands...

Dodge Ram 2500/3500	
1. Ford F-250/F-350	35%
2. Chevrolet Silverado 2500/3500	31%
3. Dodge Ram 1500	24%
4. GMC Sierra 2500/3500	16%

Source: Edmunds, Bernstein Analysis

Exhibit 15
...although Toyota and Nissan get some recognition at the lighter end

Dodge Ram 1500	
1. Chevrolet Silverado 1500	32%
2. Ford F-150	30%
3. Toyota Tundra	21%
4. GMC Sierra 1500	15%
5. Nissan Titan	10%

Source: Edmunds, Bernstein Analysis

Exhibit 16
GM and Chrysler's large SUVs do not have Japanese competition

Dodge Durango	
1. Chrysler Aspen	16%
2. Chevrolet Tahoe	13%
3. Ford Explorer	10%

Source: Edmunds, Bernstein Analysis

Cross shopping habits in cars reveal there are 2 different car markets in the US. Edmunds data on cross shopping in medium and small car reveals the degree to which buyers of American brands only really cross shop other American brands, while it seems buyers of Japanese brands look mainly (only?) at other Japanese brands. The data show in **Exhibit 17** to **Exhibit 22** suggest that Ford will be the big winner but we would assume the Japanese and probably European would also gain. In mid-size cars, Chrysler products are compared mostly to US products, followed at a distance by Honda Accord, Nissan Altima and Toyota Camry – in that order). In smaller cars, the Japanese feature, but again at a distance. This may be opportunity that European brands looking to enter the US market have identified.

**Exhibit 17
Dodge Charger buyers don't look at Japanese cars...**

Dodge Charger	
1. Dodge Challenger	24%
2. Chrysler 300	13%
3. Pontiac G8	10%
4. Ford Mustang	10%

Source: Edmunds, Bernstein Analysis

**Exhibit 18
...nor do Dodge Magnum buyers**

Dodge Magnum	
1. Dodge Charger	17%
2. Chrysler 300	10%
3. Dodge Challenger	8%
4. Chrysler Pacifica	7%
5. Dodge Caliber, Chevrolet HHR	7%
6. Dodge Nitro, Ford Flex	6%

Source: Edmunds, Bernstein Analysis

**Exhibit 19
Chrysler 300 and Cadillac buyers may compare the Honda Accord**

Chrysler 300	
1. Dodge Charger	14%
2. Cadillac CTS	10%
3. Honda Accord	10%

Source: Edmunds, Bernstein Analysis

**Exhibit 20
Sebring and Malibu buyers will look at Japanese sedans...**

Chrysler Sebring	
1. Pontiac G6	13%
2. Chevrolet Malibu	12%
3. Honda Accord	11%
4. Nissan Altima	10%
5. Toyota Camry Solara	10%
6. Dodge Avenger	9%

Source: Edmunds, Bernstein Analysis

**Exhibit 21
...but Caliber and Cobalt buyers don't...**

Dodge Caliber	
1. Pontiac Vibe	14%
2. Chevrolet Cobalt	10%
3. Chevrolet HHR	9%

Source: Edmunds, Bernstein Analysis

**Exhibit 22
...and nor do PT Cruiser buyers**

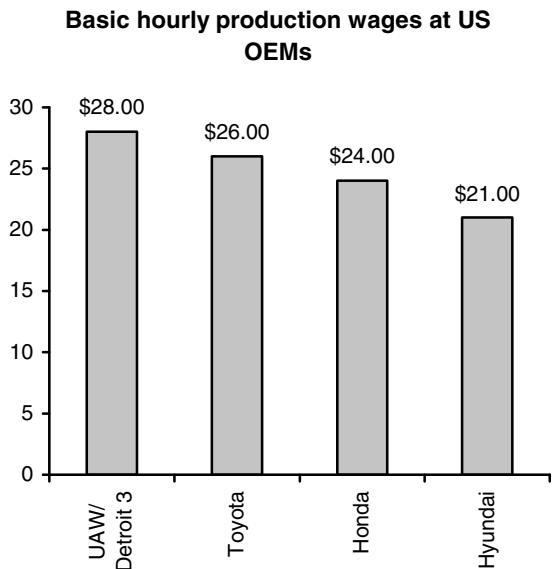
Chrysler PT Cruiser	
1. Chevrolet HHR	26%
2. Dodge Caliber	12%
3. Pontiac Vibe	9%

Source: Edmunds, Bernstein Analysis

GM and Chrysler will have lower costs

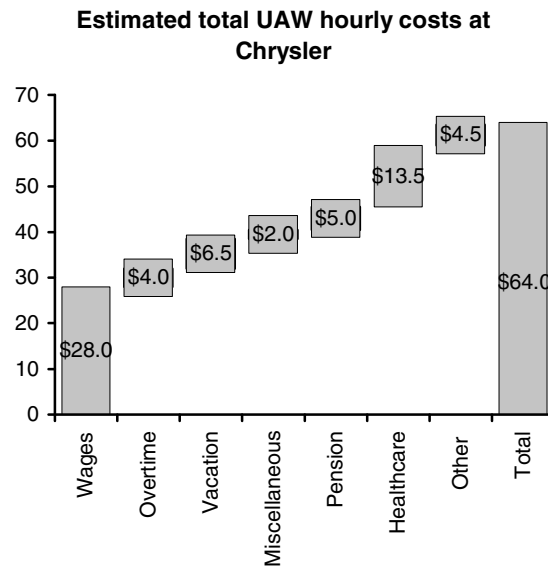
A surgical bankruptcy of GM and/or Chrysler may allow the companies to shed part or all of their high structural legacy costs. Clearly, this will be politically difficult for the Obama administration and/or expensive (it is not clear if the liabilities would be abandoned, cut down or passed onto some government body). GM and Chrysler (and probably Ford) need to take wage costs down to Japanese transplant levels, as a minimum (see **Exhibit 23**) and reduce post-retirement costs (see **Exhibit 24**).

Exhibit 23
UAW hourly rates at GM and Chrysler are only slightly above Japanese



Source: CAR

Exhibit 24
But total costs including benefits and healthcare are high – we assume these will be slashed



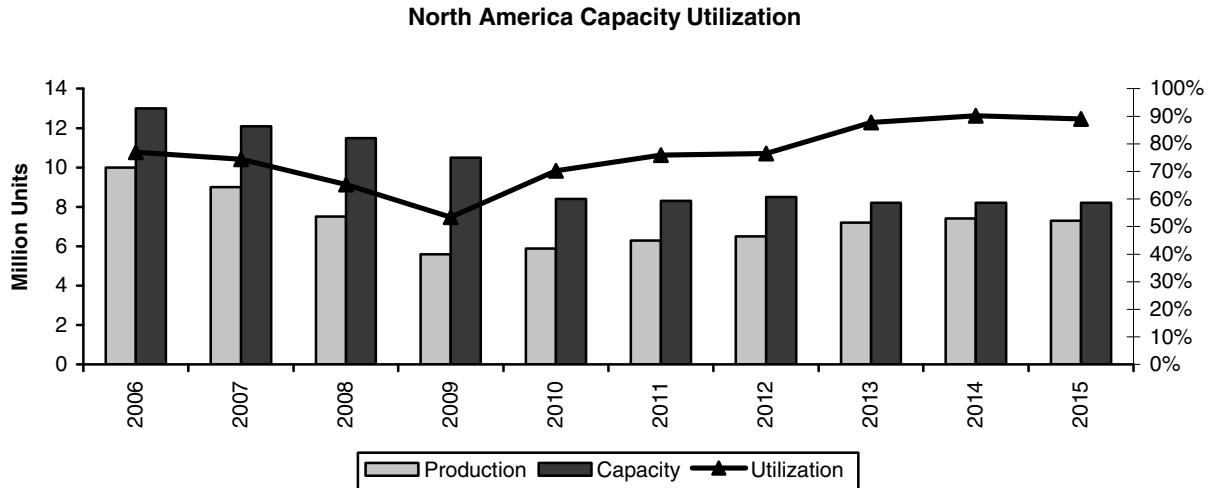
Source: Glenn Mercer Automotive LLC

Capacity utilization will improve

If GM and Chrysler are radically downsized, clearly capacity utilization will be substantially improved – these companies having spent the last 5 years in an unsuccessful race to cut capacity faster than market share declined. In bankruptcy protection, it might be possible to cut capacity finally – and exit many product lines. If GM and Chrysler were to close multiple plants to reduce their output to just the 4 or 5 product lines we suggest above, then North American utilization would improve massively (assuming a rebound from current distressed SAAR levels). In **Exhibit 25** we show an estimate from specialists CSM of what Detroit 3 utilisation could look like at a 16mn SAAR if "Chrysler dissolves, GM sheds brands and Ford rightsizes". CSM estimates Detroit utilization could climb back towards 90% levels (although the market share basis of this is not clear).

Exhibit 25

Capacity utilization would improve substantially if GM is slimmed down and Chrysler "dissolved"



Source: CSM Worldwide, Bernstein Analysis

A more competitive GM and Chrysler does NOT mean lower pricing

We've heard it argued that if the US industry is restructured and made more competitive, it will close the cost gap with the Japanese, allow GM and Chrysler (and probably Ford) to price lower – and damage Japanese and German profits in the US. We believe this conclusion is wrong – GM has already been selling vehicles far below breakeven cost for years – and probably below marginal (cash) cost. That's why the company has been hemorrhaging cash and is heading for Chapter 11.

GM has been a deflationary force on pricing – both in the US and Europe – for many years. Having historically refused to reduce manufacturing capacity, product offering and dealer density, GM has always resorted to aggressive pricing. GM has been the leading exponent of oversupply, cheap financing and deflationary strategies. GM's post-September 2001 0% financing strategy pulled forward demand and structurally lowered industry ARPUs. GM has been selling hundreds of thousand of "brand new second hand cars" each year – vehicles for which there is no real consumer demand but that go quickly to second hand via daily rental fleets, employee discounts and other routes. Cutting this behavior would be enormously positive for industry returns.

GM vehicles sell for US\$3k to US\$10k below Toyota's – depending on segment. We show PIN data below (see **Exhibit 26**) on the massive price disadvantage that GM and Chrysler suffer – with their small cars selling at US\$3,000 below Honda/Toyota levels, their midsize SUVs US\$6,000 below and their large cars selling for US\$ 10,000 less.

Exhibit 26

GM, Chrysler and Ford have a price problem more than a cost problem – they already sell small cars at a massive discount to Honda and have destroyed their profitability and balance sheets as a consequence

Key data for compact cars from the first 10 months of 2008:

Vehicle	Customer Cash Rebate	Days to Turn	Vehicle Price Less Customer Cash Rebate	Median Household Income	Customer (Buyer) Age	Deficit to Civic
Chevrolet Cobalt	\$1,664	40	\$15,652	\$56,846	50	\$3,638
Dodge Caliber	\$981	66	\$17,106	\$58,929	49	\$2,184
Ford Focus	\$2,119	39	\$15,617	\$56,875	49	\$3,673
Honda Civic	0	24	\$19,290	\$63,918	44	N/A
Average for Compact Car	\$1,295	34	\$19,063	\$63,503	47	\$227

Note: Civic data do not include hybrid model

Source: Power Information Network, Bernstein Analysis

GM and Chrysler have a price problem more than a cost problem. GM, Ford and Chrysler sell their vehicles at a lower price than Toyota in virtually every segment, as we show in Edmunds data below in **Exhibit 27**. This is a brand issue – and the brands won't be fixed by Chapter 11. But a bankruptcy and slimming down will reduce the fixed cost and volume hunger of GM and Chrysler – and therefore we'd expect industry prices to rise, not fall.

Exhibit 27

The Detroit 3 sell vehicles in virtually every segment at prices below Toyota

US- Transaction Prices by Segment (January-May 2008)

Category	GM	Ford	Chrysler	Toyota
Compact Car	\$15,025	\$15,031	\$16,721	\$18,418
Compact SUV	\$21,688	\$22,028	\$21,833	-
Compact Truck	\$19,516	\$17,338	\$21,960	\$23,147
Large Car	\$21,518	\$23,047	\$25,342	\$31,753
Large SUV	\$37,087	\$35,425	\$30,084	\$44,971
Large Truck	\$28,442	\$28,555	\$30,137	\$29,222
Luxury Car	\$37,650	\$32,346	-	\$41,728
Luxury Sport Car	\$63,879	\$64,394	-	\$45,974
Luxury SUV	\$45,525	\$45,820	-	\$46,032
Midsize Car	\$19,127	\$18,707	\$20,754	\$23,169
Midsize SUV	\$23,707	\$27,394	\$25,790	\$29,285
Minivan	\$23,940	-	\$25,070	\$26,930
Van	\$23,242	\$22,639	\$38,259	-

Source: Edmunds, Bernstein Analysis

A closer look at potential US market share gains – what are they worth?

We believe the contraction of GM and Chrysler will not be negative for industry pricing but will see these Detroit companies exit large parts of the US car market, putting market share up for grabs. It is complex to forecast how much market share will become available and how it will be allocated. Given GM and Chrysler build and sell so many "brand new second hand cars", it is possible that the total size of the US market has been over-inflated for years and sales will therefore run at a structurally lower level.

We have estimated the approximate market share gains for the rest of the industry. We have done this in a very simple way, assuming that GM and Chrysler are slimmed down in a way that seems them abandon 30% of their combined market share. Another way of looking at this is to assume Chrysler effectively ceases to exist.

We estimate that this additional market share may be worth US\$14.5bn to the rest of the industry. Again, this is a very simple calculation, but if assume a US\$4,000 contribution margin (variable profit) on every standard vehicle sold and US\$8,000 for every premium car sold, assuming market share is spilt as per 2008's (non GM and Chrysler) market share, then we arrive at a total profit boost of US\$14.5bn. We assume this flows to the operating line of the other auto companies in full (probably a naïve conclusion).

GM and Chrysler's market share exit could "save" Ford. In reality, we believe Ford would be the biggest winner in the event of GM and Chrysler exiting parts of the US auto market. We have simply allocated the newly available market share equally and this alone gives Ford a US\$3bn EBIT boost. It would probably be greater in reality – with the caveat that Ford might have margin issues if it did not get its labour costs down to GM and Chrysler's new levels.

Exhibit 28

A shrinking of GM and Chrysler would benefit the Japanese OEMs and Ford – worth US\$14.5bn of additional EBIT

Impact of GM and Chrysler Restructuring on OEM's Volumes, Market Share and Profitability

	2007 Units	2008 Units	2008 Share	2009E Share	2009E	2009E	Contribution	% of EBIT
	000	000		Post-GM & Chrysler Restructuring	(10m SAAR)	(16m SAAR)	US\$m	2007
							Margin*	
GM	3,790	2,933	22.2%	15.5%	1,551	2,481		
Chrysler	2,077	1,453	11.0%	7.7%	768	1,229		
Total	5,867	4,387	33.1%	23.2%	2,319	3,710		
Toyota	2,621	2,218	16.7%	19.2%	1,923	3,078	3,440	17%
Ford	2,387	1,908	14.4%	16.5%	1,655	2,648	2,959	n.a.
Honda	1,552	1,429	10.8%	12.4%	1,239	1,983	2,216	28%
Nissan	1,068	951	7.2%	8.3%	825	1,320	1,476	21%
Hyundai	467	402	3.0%	3.5%	348	558	623	29%
Kia	305	273	2.1%	2.4%	237	379	424	n.a.
Mazda	296	264	2.0%	2.3%	229	366	409	28%
BMW	294	249	1.9%	2.2%	216	346	773	13%
Mercedes	253	225	1.7%	2.0%	195	312	698	6%
VW	231	223	1.7%	1.9%	194	310	346	4%
Others	809	714	5.4%	6.2%	619	991	1,108	n.a.
Total	16,150	13,243	66.9%	76.8%	10,000	16,000	14,471	n.a.

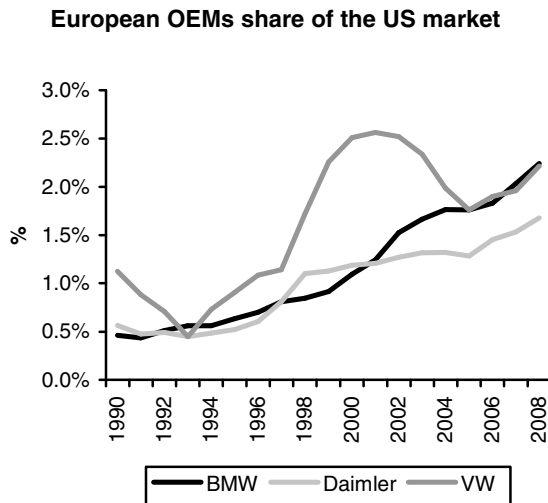
*on additional units vs 2008

Source: Auto Insight, Bernstein Analysis and Estimates

A US opportunity for the Europeans? A look at cross-shopping behaviour suggests the near-term opportunity for the Europeans will be limited. But there may be some longer term opportunities:

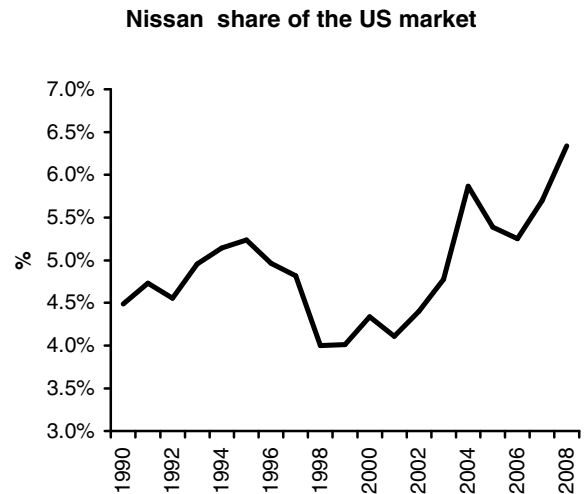
- **The Germans have been growing for many years in the US.** Most of the market share has been taken by premium vehicles. But the success of VW's diesel offering suggests that there may be a role for fuel efficient European vehicles in the US – particularly given very aggressive new fuel economy regulations (CAFE 2015). If Detroit is forced to exit from large parts of the US market, it should be possible for the Germans to accelerate their market share gains in the US.
- **It might also be time for the French to consider a re-entry into the US market.** They have relevant small car and diesel expertise and could pick-up a distribution network (and possibly capacity) very cheaply. However, we acknowledge that they have very weak brands – last available in the US in the late 1980s - and unproven quality (how would Renault and PSA fare in the face of JD Power studies?). Fiat's Chrysler strategy is clearly driven by similar objectives.

Exhibit 29
European market share gains in the US since 1990 (%)



Source: Global Insight, Bernstein Analysis

Exhibit 30
Nissan market share in the US since 1990



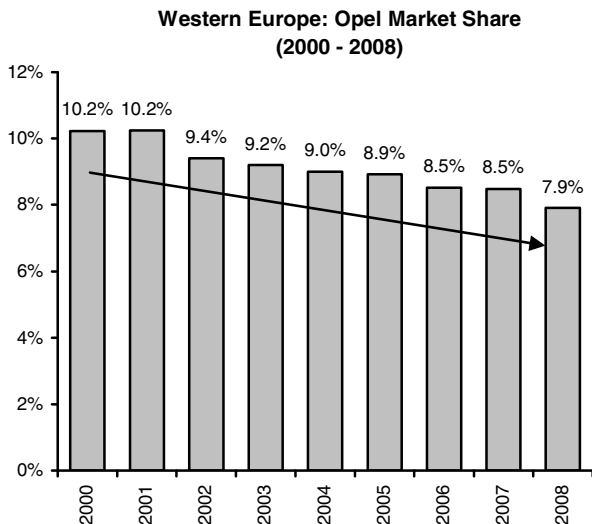
Source: Global Insight, Bernstein Analysis

Who gains share in Europe if Opel fails?

A more direct benefit for the automakers within our coverage will come in Europe. Almost irrespective of what happens with GM in the US, it looks likely that GM's European business, Opel, will be cast adrift. There do not appear to be any industrial buyers (Daimler ruling it out). Unless a last minute saviour comes along (Renault, Fiat?), then the German state must decide whether to take control or let it fail. While we continue to assume the German state will take effective ownership, it is worth considering what the benefits for the other Europeans might be if Opel simply failed. We would assume that GM's other European business – branded as Chevrolet but based on Daewoo in Korea, might find a buyer.

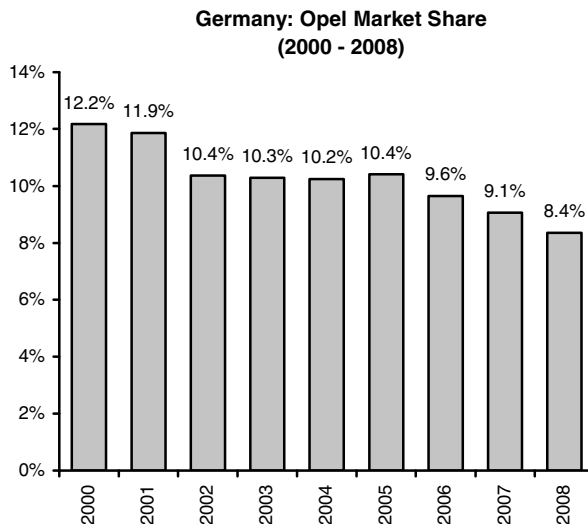
Opel controls 8% of the West European market. Market share trends show that the decline of Opel/Vauxhall has slowed versus the steep falls seen in the late 1990s, but market share continues to slide in the face of VW's ongoing success, a resurgent Ford Europe (arguably a more successful turnaround than Opel), Fiat and premium brand expansion. In Western Europe, market share fell to 8% in 2008 (see **Exhibit 31**). In Opel's "home" market, Germany, share is little better. The UK, "home" of Vauxhall, looks to be the business's strongest market – but not necessarily an attractive one given volume and currency trends.

Exhibit 31
Opel share loss has slowed – but has not stopped



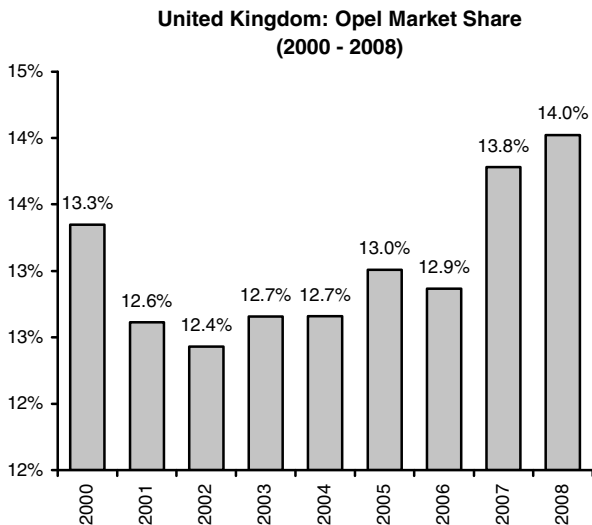
Source: Global Insight and Bernstein analysis.

Exhibit 32
Germany is a big problem for Opel: a damaged brand?



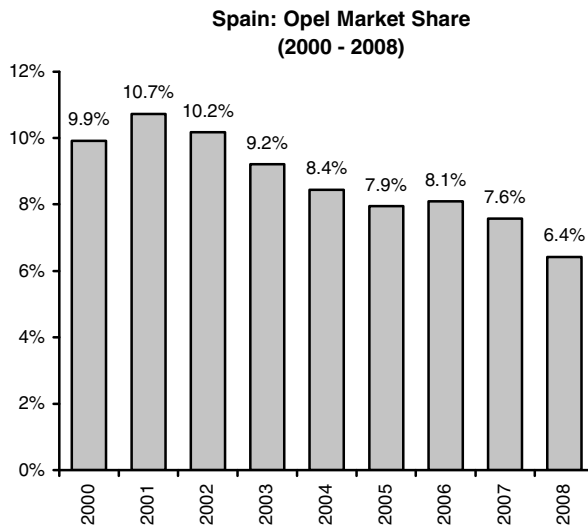
Source: Global Insight and Bernstein analysis.

Exhibit 33
Opel (Vauxhall) continues has actually been gaining UK market share on the back of Corsa and diesel engines



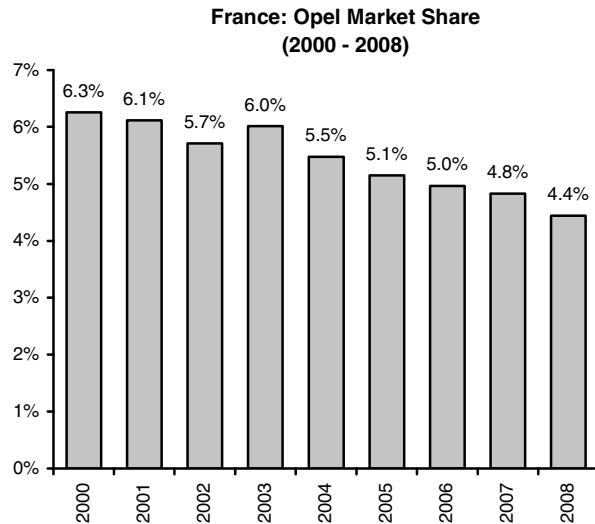
Source: Global Insight and Bernstein analysis.

Exhibit 34
Opel used to be strong in Spain but has lost share to VW and the Asians in recent years



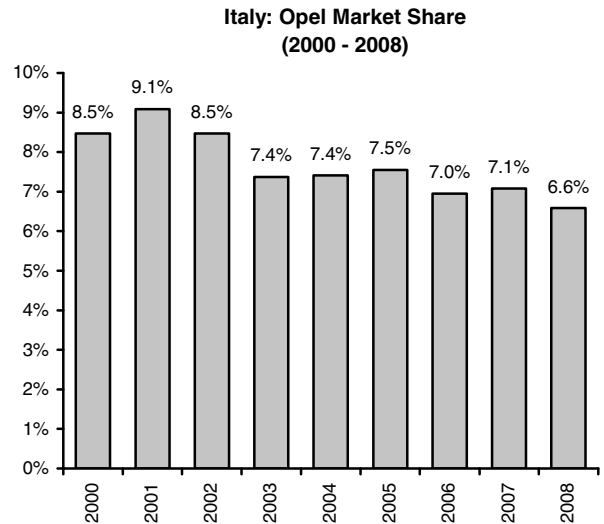
Source: Global Insight and Bernstein analysis.

Exhibit 35
Opel has suffered big losses in France despite PSA and RNO waning: VW and Fiat have been the big aggressors



Source: Global Insight and Bernstein analysis.

Exhibit 36
Opel has stabilised its losses in Italy thanks to the Corsa (the basis of the Fiat Punto incidentally)



Source: Global Insight and Bernstein analysis.

Quantifying the potential benefits of an Opel failure

The perpetual problem of poor returns in European Autos might be eased by an Opel failure. We are often asked "can the auto industry ever become rational?" and "when will we see capacity cuts or rationalization?". In the event that Opel goes, it would free up 8% of the European market and remove the most problematic capacity – since Opel has been one of the most deflationary forces on European pricing in the last decade.

This additional market share may be worth €7.5bn to the rest of the European industry. We go through the same exercise as that undertaken for the US market. We have done this in a very simple way, assuming that Opel's share is split as per 2008's (non Opel) market share. Again, this is a very simple calculation, but if assume a €3,000 contribution margin (variable profit) on every standard vehicle sold and €7,000 for every premium car sold, we arrive at a total profit boost of €7.5bn. We assume this flows to the operating line of the other auto companies in full.

Exhibit 37

An Opel bankruptcy would benefit mostly VW and PSA – worth €7.5bn of additional EBIT

Impact of Opel Bankruptcy on Other OEMs' Market Share, Volumes and Profitability

	2008 Units 000	2008 Share	2009E Share ex Opel*	2009E (11m SAAR)	2009E (14.8m SAAR)	Contribution Margin (€m)	% of EBIT 2007
Opel	1,069	8%					
VW	2,759	20%	22%	2,432	3,271	1,535	25%
PSA	1,765	13%	14%	1,556	2,092	982	96%
Ford	1,360	10%	11%	1,199	1,612	757	n.a.
Renault	1,123	8%	9%	990	1,332	625	50%
Fiat	1,117	8%	9%	985	1,324	621	19%
BMW	803	6%	6%	708	952	1,042	25%
DAI	756	6%	6%	666	896	981	11%
Toyota	701	5%	6%	649	873	514	3%
Nissan	314	2%	3%	277	372	175	3%
Honda	232	2%	2%	212	286	159	3%
Others	1,548	11%	12%	1,327	1,784		
Total	13,549			11,000	14,794	7,392	

* Allocated proportionally

Source: ACEA, Bernstein Analysis

The big near-term risk - US supply base failure

What happens to the supply chain if GM and Chrysler suffer a sudden shutdown? The exact consequences are difficult to model but simplistically, we'd assume the financial impacts on the suppliers would force many into Chapter 11 – and for a period of time, they would be unable to produce components for non-Detroit companies. We base this on the assumption that up to 50% of revenues for some suppliers come from the Detroit 3 – production stoppages by Detroit would mean this revenues suddenly stops, forcing many suppliers into liquidity difficulty. In addition, credit availability from banks to suppliers may be withdrawn if lenders fear the impacts of a Detroit failure – which would expedite problems. We show a CSM estimate of the supplier overlap in Exhibit 38.

Exhibit 38

Supply is Interlinked – many Detroit suppliers ship to the Asian and European OEMs

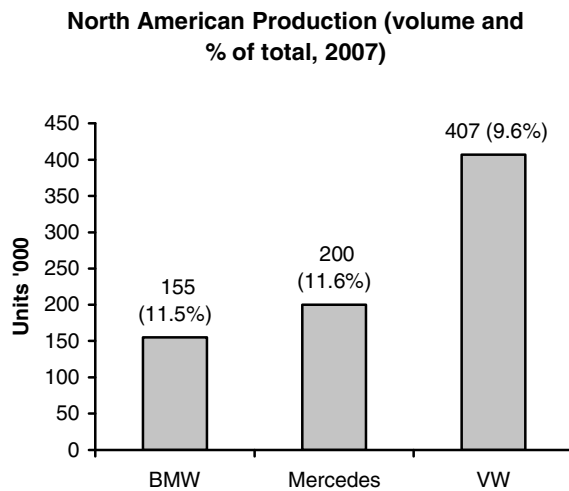
Percentage of Detroit's 3 Suppliers that Supply Other Manufacturers

	Chrysler	Ford	GM	Asian OEMs	European OEMs
GM	56%	51%	100%	58%	37%
Ford	64%	100%	70%	65%	46%
Chrysler	100%	54%	66%	59%	44%

Source: CSM Worldwide, Bernstein Analysis

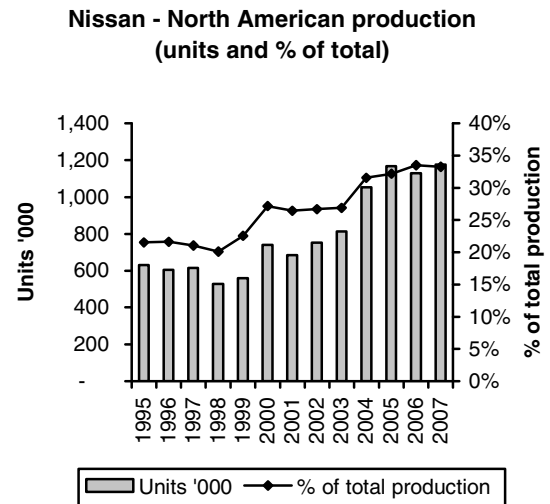
Given these inter-linkages, the Europeans in North America could find it difficult to build vehicles for a period of time. BMW, Mercedes, VW and Nissan (Renault) all build vehicles in North America – as we show in **Exhibit 39** and **Exhibit 40**.

Exhibit 39
BMW, Mercedes and VW production in N.America



Source: Global Insight, Bernstein Analysis

Exhibit 40
Nissan production in North America



Source: Global Insight, Bernstein Analysis

The Europeans and Japanese building in North American all share suppliers with the Detroit 3. Would these common suppliers be able to still produce components for (solvent) European and Japanese OEMs? In preparation for this call, we asked the view of a leading automotive consultant, working on supplier restructuring in North America. He commented that:

"actually, perhaps naively, I think that would not happen. Recall that every supplier's production lines are set up by each OEM... except for generic parts like some fasteners I guess. So if GM went bust certainly suppliers would feel pain and many additional ones would go bust, but I am not sure their ability to supply other OEMs would instantly vanish. Close the GM line, lay off all the people on that line, run the rest. No one would be happy but the physical production lines are generally separable. There would certainly be a lot of "chicken" played, as in supplier X serving Toyota and GM might try to raise prices to Toyota if GM fizzled in order to stay solvent. But even in receivership the bank would probably want to run as much volume as it could".

This seems like a pragmatic view – but we would assume that the sheer magnitude of revenues due from the Detroit 3 would mean that any supplier facing a stoppage of GM or Ford production, would struggle to keep building parts for other customers in the near-term. We would expect a Detroit 3 bankruptcy to cause at least a few weeks or months of production stoppages at other automakers in North America.

European implications: what would an Opel bankruptcy mean for EU suppliers?

In indirect terms, suppliers' financial problems or insolvency in North America could affect their ability to continue production and shipments in Europe. If we look at the Top 10 suppliers in Europe, 3 of them are North American (Magna, JCI and Lear). If they hit serious trouble in the US, it could prevent production in

Europe. We think there is a meaningful risk that European OEMs may need to inject cash into the supply base to keep it viable in 2009.

Valuation Methodology

In a "normal" economy, we value stocks on the basis of their returns on capital, using the calculation "EV/IC = (ROIC-g)/(WACC-g)" where g accounts for growth. We believe that over time, even in the momentum-driven auto sector, valuations will be driven by the ability of a company to generate a return on its capital base, and grow its business. In a "normal" economy, we also look at EV/EBITDA and P/E to gauge relative valuations and peak stock price potential.

In today's more challenging times, when earnings look set to collapse and as stocks derate, we look at valuations versus historic troughs on metrics such as EV/IC and EV/sales and look at balance sheet strength. Our price targets are based on trough multiples.

Risks

The risks to our view on European Autos are straightforward and are mainly macroeconomic in nature. Earnings, liquidity and equity value could be severely tested if the recession proves even deeper and longer than we forecast and if auto and truck sales fall far below our assumptions, putting our price targets for the European Autos stocks at risk. The ability of the financial services businesses to remain viable is at risk if the financial system deteriorates further and capital market access becomes impossible.

We believe state support will be forthcoming in a severe economic scenario for Europe. We assume this will take the form of help with labor costs and job-cut programs plus financial subsidies, rather than equity investments; but if governments do demand equity issuance, it will clearly dilute current shareholder value.

Our forecasts are also sensitive to moves in the euro versus the U.S. dollar and the U.K. sterling as well as Latin American and Asian currencies.

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12-Month Rating History as of 03/31/2009

Ticker Rating Changes

BMW.GR	O (IC) 10/13/08	O (DC) 02/08/08
DAI.GR	M (RC) 02/24/09	O (IC) 10/13/08 M (DC) 02/08/08
F.IM	M (IC) 10/13/08	U (DC) 02/08/08
PAH3.GR	M (IC) 10/13/08	M (DC) 02/08/08
RNO.FP	M (IC) 10/13/08	M (DC) 02/08/08
UG.FP	O (IC) 10/13/08	O (DC) 02/08/08
VOW3.GR	O (RC) 12/11/08	U (IC) 10/13/08

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