

The Worst Appears Over For North American Auto Suppliers, But Competition Remains Tough

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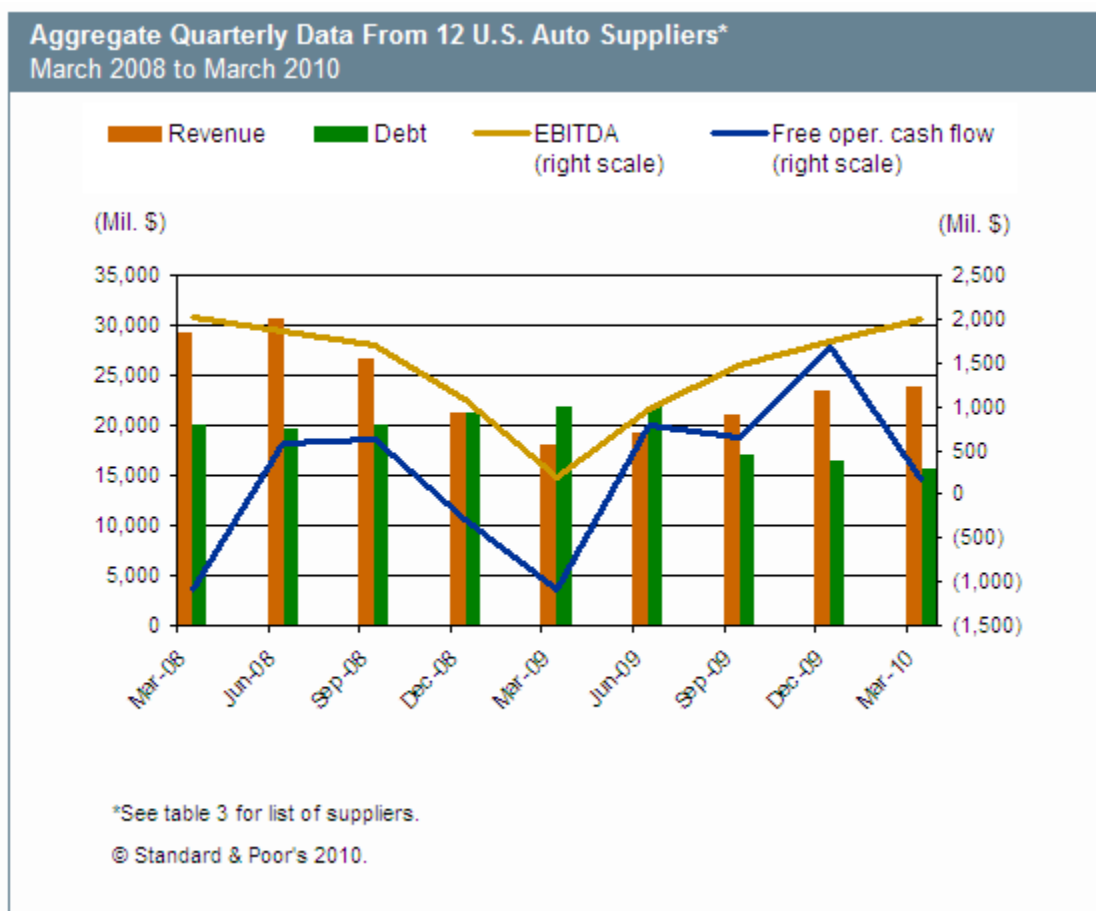
The Prospects For Financial Improvement Are Uncertain

The Worst Appears Over For North American Auto Suppliers, But Competition Remains Tough

In just one year, the financial performance of the rated North American auto suppliers has improved dramatically. In the first half of 2009, a number of industry participants and analysts expressed concern about the risk of a systemic collapse of the sector. But recently, the sector has returned to profitability and, in most cases, companies have reported positive free operating cash flow and improved liquidity.

Revenues, EBITDA, and cash flow of these suppliers dropped sharply during the downturn until hitting what we believe was the bottom of the cycle for them in the first and second quarters of 2009. But debt stayed fairly level through the downturn (aggregate debt reduction since the September 2009 quarter was mostly a function of Lear Corp.'s reduction in debt during bankruptcy).

The turnaround in financial performance for these suppliers is demonstrated by their reported results: Revenues have risen since the low point of the downturn in March 2009. Free operating cash flow and EBITDA have also recovered and have been higher year over year each quarter since the second quarter of 2009 (see chart).



Standard & Poor's Ratings Services believes much of this improvement stems from higher vehicle production and reduced supplier costs. Despite continued economic uncertainty, including the risk of a double-dip recession, we believe the worst period of financial performance during the downturn is over for the rated North American auto suppliers.

No major North American auto supplier has filed for bankruptcy protection since the parent company of Cooper-Standard Automotive Inc. filed in August 2009. And with the exception of Visteon Corp. (unrated), all the large suppliers have now emerged from bankruptcy or been sold, including Delphi Corp., which had a four-year stay under bankruptcy protection (see table 1).

Table 1

Status Of Selected Auto Supplier Bankruptcies	
Emerg ed	Have not yet emerg ed
Dana Corp.	Visteon Corp.
Date filed: March 2006	Date filed: May 2009
Bankruptcy status: Emerg ed February 2008	Bankruptcy status: Seeking to emerge; Johnson Controls expressed interest in some assets
Dura Automotive Systems Inc.	Will not emerge
Date filed: October 2006	Collins & Aikman Corp.
Bankruptcy status: Emerg ed June 2008	Date filed: May 2005
Delphi Corp.	Plastech Engineered Products Inc.
Date filed: October 2005	Date filed: February 2008
Bankruptcy status: Emerg ed October 2009	
Lear Corp.	
Date filed: July 2009	
Bankruptcy status: Emerg ed November 2009	
Mark IV LLC	
Date filed: April 2009	
Bankruptcy status: Emerg ed November 2009	
Hayes Lemmerz International Inc.	
Date filed: May 2009	
Bankruptcy status: Emerg ed December 2009	
Cooper-Standard Automotive Inc.	
Date filed: August 2009	
Bankruptcy status: Emerg ed May 2010	
Metaldyne Corp.	
Date filed: May 2009	
Bankruptcy status: Majority of assets sold in Section 363 sales to Metaldyne LLC or other operators in 2009-2010	

Even though we believe 2010 will be a much better year for the North American auto suppliers, we also believe the sector will continue to grapple with significant risks. We remain cautious about long-term credit quality, even though we have taken almost exclusively positive rating actions this year. In most cases, these actions were upgrades or outlook changes on very low-rated suppliers and reflected their improved prospects for avoiding financial distress (see table 2).

Table 2

Summary of Selected Recent Rating Actions On Auto OE Suppliers*

Company	Rating as of June 17, 2010	Summary of actions
American Axle & Manufacturing Holdings Inc.	B-/Stable/--	We took a series of positive rating actions on American Axle between the fall of 2009 and early 2010 reflecting our view of improvements in the company's liquidity and better visibility into progress by its main customer, General Motors Co.
ArvinMeritor Inc.	B-/Stable/--	Between early 2009 and mid-2010, we lowered ArvinMeritor's rating into the 'CCC' category as the heavy-truck market declined. We subsequently raised ratings as prospects improved, in our view reducing near-term default risk.
BorgWarner Inc.	BBB/Stable/--	In March 2010, we revised the outlook reflecting our view that BorgWarner will be able to continue improving its profitability and cash flow in 2010 following four consecutive quarters of sequential improvement.
Cooper-Standard Automotive Inc.	B+/Stable/--	In January 2009, we lowered the ratings when the company announced that it planned to repurchase term loan debt at a discount from par. Subsequent adverse market conditions led the company to file for bankruptcy in mid-2009. We assigned a 'B+' rating upon the company's emergence from bankruptcy.
Dana Holding Corp.	B+/Stable/--	We lowered Dana's rating in May 2009 when the company pursued a distressed exchange. Subsequent positive rating actions reflected our assumption that Dana's recent earnings and cash flow improvement will be sustainable into 2010, despite weak auto production that we expect for both light and commercial vehicles.
Federal-Mogul Corp.	B+/Stable/--	We lowered the rating on FMO in mid-2009 reflecting our view that lower auto production and weak consumer spending would pressure revenues and profitability and prevent it from achieving credit measures appropriate for the previous rating. We revised the outlook to stable in early 2010 reflecting our view of stabilizing performance as demand improved.
Harman International Industries Inc.	B+/Positive/--	We lowered Harman's ratings in early 2009 as the global auto markets worsened. We revised the outlook to positive in April 2010 as markets and the company's performance improved, in our view.
Hayes Lemmerz International Inc.	B-/Stable/--	We lowered the rating on Hayes in early 2009 from 'B-' as auto production declined sharply. Subsequently, the company filed for Chapter 11. Upon emergence, we rated Hayes 'B-' in late 2009.
Lear Corp.	B/Positive/--	We lowered Lear's rating to 'CCC+' in early 2009 on weak markets and performance. In the summer of 2009, the company filed for bankruptcy and emerged in November 2009. We revised the outlook to positive in early 2010 as the company's performance exceeded our earlier expectations.
Mark IV LLC	B/Negative/--	Mark IV filed for bankruptcy in April 2009. We rated it 'B' upon emergence in late 2009.
MetoKote Corp.	CCC+/Positive/--	We lowered the ratings to the 'CCC' category in April 2009. We revised the outlook to positive in April 2010, reflecting the potential benefit to its credit profile if auto production recovers sufficiently.
Shiloh Industries Inc.	B/Positive/--	The downgrade in 2009 was based on our assumption that liquidity would be very tight. The outlook revision to positive was prompted by our view of improving liquidity.
Tenneco Inc.	B/Positive/--	Downgrades in 2009 reflected the effect of declining light-vehicle production in North America and especially in Europe. Our upgrade in 2010 was based on our view of improving financial performance.
TRW Automotive Inc.	BB-/Stable/--	We lowered TRW's ratings and then raised them between early 2009 and mid-2010. The decline and then recovery in the global auto markets and our view of the company's progress in improving liquidity and cash flow were the primary reasons for the rating actions.

*Not exhaustive.

Current rating levels, even after the recent upgrades, indicate that we believe cumulative default risk remains high. The principal reasons for our view are the sector's traditional catalysts for default: volatility of auto production and raw material costs, the uncertain economic outlook, and eventual substantial refinancing needs. We believe profitability will remain constrained and that the supply base is still relatively vulnerable to any relapse in the recovery, which we believe is taking place gradually. In 2010, we expect U.S. light-vehicle sales to rise 12.5%, to 11.7 million units, from what we viewed as the long-term, unsustainable level of 10.4 million units in 2009. We expect 2011 sales to rise further, to 13.4 million units, or just above 2008's weak 13.2 million.

Our view of the vulnerability to future defaults, as well as the improvement since the bottom of the downturn, is demonstrated by a comparison of our ratings in mid-June 2010 to those in July 2009. Currently, only about 18% of

the rated companies have a rating of 'B-' or lower. In July 2009, nearly half of the suppliers were rated 'B-' or lower, and about 17% were in the 'CCC' category.

Even With Cost Improvements And Higher Production, Better Profitability Will Be Difficult

In our view, all rated U.S. auto suppliers improved their operating cost structures and lowered their breakeven rate of sales during the downturn. Several also reduced financial leverage--in some cases by distressed debt exchanges or bankruptcy reorganizations. These changes can be measured by the much-improved year-over-year results most suppliers are reporting. We expect similar results from the second quarter of the year.

Still, the sector consists mainly of low-rated companies. We believe it will be well into next year before credit profiles recover enough to warrant upgrades to around pre-crisis rating levels because we are evaluating the pace of the recovery in light of economic uncertainty. Many of our recent rating actions reflected suppliers' improved liquidity rather than better business risk profiles. We believe many of these suppliers need to improve both their business risk and financial risk profiles before we would consider the 'BB' category appropriate. Profitability, excluding the effect of financial leverage, is a key factor in our business risk assessment, and the level of profitability that the sector can sustain will be a key rating consideration in 2010 and 2011.

For the first quarter of 2008 through the first quarter of 2010, no rated original equipment (OE) auto supplier reported EBITDA margins in the high single digits (see table 3). The low point in the downturn was also not surprisingly the low point in supplier profitability; the aggregate EBITDA margin was 1%, versus almost 7% in the first quarter of 2008. Even in the first quarter of 2010, when auto production was relatively high, EBITDA margins for about half of the rated OE suppliers were still below those reported in the first quarter of 2008. We currently expect few suppliers to be able to achieve EBITDA margins in the double digits consistently. For the first quarter of 2010, only BorgWarner Inc., TRW Automotive Inc., and American Axle & Manufacturing Holdings Inc. did so.

Table 3

EBITDA Margin % Of 12 U.S. Auto Suppliers*									
March 2008 to March 2010									
	--2008--				--2009--				--2010--
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March
Johnson Controls Inc.	6.5	8.2	8.3	2.0	1.1	6.4	5.3	6.3	7.3
BorgWarner Inc.	13.3	13.2	10.5	4.8	8.4	7.0	8.9	11.5	13.2
Harman International Industries Inc.	6.2	8.9	9.2	2.0	(6.6)	0.6	5.6	10.3	8.1
Federal-Mogul Corp.	7.0	12.4	9.5	6.5	3.1	7.4	7.9	9.7	9.3
Stoneridge Inc.	11.5	9.4	5.7	2.4	(2.1)	(7.1)	7.8	5.2	6.1
TRW Automotive Inc.	8.4	9.2	5.0	3.8	1.5	7.3	9.4	10.2	11.7
Dana Holding Corp.	4.8	4.9	1.3	(1.1)	(1.2)	7.1	7.4	5.9	6.9
Exide Technologies	7.5	7.1	7.0	8.9	5.4	3.5	6.8	9.8	6.7
Lear Corp.	6.2	4.6	2.4	1.3	(5.6)	(0.8)	7.9	3.9	6.1
Tenneco Inc.	6.2	8.4	5.9	4.1	4.2	7.3	7.5	8.9	8.8
ArvinMeritor Inc.	5.5	5.2	4.8	0.4	3.5	2.5	5.5	4.2	4.6
American Axle & Manufacturing Holdings Inc.	3.4	(105.4)	5.8	104.6	8.7	(13.1)	9.8	14.3	14.1

Table 3

EBITDA Margin % Of 12 U.S. Auto Suppliers* (cont.)									
Aggregate	6.9	6.1	6.4	5.0	1.0	5.1	7.0	7.5	8.3
<small>*As reported, not including Standard & Poor's adjustments.</small>									

We calculate that for the other companies, EBITDA would have to be between 7% and more than 100% higher than that in the first quarter of 2010 to reach an EBITDA margin of 10%. For several companies, the range of improvement would have to be 25% to 59%. Because we believe most companies' cost-reduction benefits were in place during the first quarter of 2010, production increases would in our view be the most likely source of future margin improvement. A potential risk to margin improvement would be if increases in raw material costs cannot be recovered from customers, which could reduce the benefits of increased production.

Auto suppliers based in Europe and Asia have experienced relatively less credit deterioration in recent years, but the plunge in demand did affect their financial performance. We expect vehicle registrations to be about 10% lower in Europe year over year. Still, we believe European suppliers benefit from broader customer diversity and have less exposure to their key customers' ongoing market share losses than their North American counterparts face. Also, customer shifts in vehicle preference have generally been less pronounced in Europe than in the U.S.

Japanese suppliers, which make up the majority of the rated Asian auto suppliers, benefit in our view from their relationships with stronger-rated automakers, have a historically more collaborative relationship with those customers than North American suppliers have had with the U.S. automakers, and typically have what we consider to be conservative financial policies. At the same time, trends favoring smaller vehicles--especially volatile gas prices--have not had as pronounced an effect in Asia as they have in the U.S., given that SUVs and pickups have never been as popular in Asia.

The Prospects For Financial Improvement Are Uncertain

In our view, the financial performance of the auto supply sector so far in 2010 has materially improved from the weak levels during the recent downturn. But we believe the industry financial recovery remains exposed to a number of risks, and a fair degree of caution about future financial performance is warranted--along with recognition of fundamental improvements in credit quality. We believe several fundamental factors will be key in our evaluation of the extent of further credit improvement among rated North American auto suppliers.

The economic outlook

So far in 2010, improving economic conditions are leading to higher vehicle production and sales. Dealers are restocking inventories after they reached very low levels last year. In our view, future production levels will be the most important factor for improved credit quality, but we believe this is also the most uncertain factor. For suppliers to gain greater operational and financial stability, we believe the economy must show measurable and sustainable recovery, and light-vehicle sales in the U.S. and Europe must improve to levels well above those we are witnessing currently.

The evolving structure of the automaker sector globally

We expect competition among global automakers to remain fierce and that most automakers are working to increase so-called "global platforms" and alliances. In our view, this will affect supplier credit quality--favorably for those that can meet demand for global platforms, for example, but unfavorably for companies that do not have the

resources to continue developing key technologies.

In addition, we do not expect demand to improve enough in the next few years to close the gap in automaker capacity utilization. Accordingly, we expect competition to remain fierce and price pressures on suppliers to continue. We also expect more automaker alliances and trends toward alternative powertrains and smaller vehicles, which will raise demands on suppliers, benefiting some.

Accessibility of the capital markets

Even though many suppliers have completed refinancing actions since mid-2009, recent less favorable market conditions have led to postponements or cancellations of pending deals. Also, we expect interest rates to rise at some point during the intermediate to longer term. Currently, many companies are benefiting from very low base borrowing rates and contractual spreads that were set in more favorable times. The eventual repricing of supplier debt will raise costs, in some cases significantly.

Raw material prices

Auto supplier margins and cash flow are vulnerable in the short run to volatile swings in raw material prices, even if they have some mechanism for recovering these costs. Working capital financing needs tend to increase, and in some cases, we believe lack of effective pass-through of costs has caused financial distress.

Customer concentration

Most rated U.S. auto suppliers have substantial exposure to the domestic automakers. Extensive government involvement when General Motors Co. and Chrysler LLC (both unrated) filed for bankruptcy last year prevented severe consequences for the supply base, in our view. And both companies' post-bankruptcy long-term paths to financial recovery still may be evolving, in our view. But most U.S.-based suppliers remain exposed to their large automaker customers and product mixes, and to about the same extent as they were before the economic crisis in many cases. We believe the financial performance of suppliers with high exposure to these companies and to Ford Motor Co. will remain closely tied to their main customers' success for the next few years.

Excess supplier capacity

We believe excess capacity remains, even though we believe capacity utilization is likely to rise this year because of the increase in production. In addition to the emergence from bankruptcy of several suppliers (Delphi, Cooper-Standard, Lear, and Hayes Lemmerz International Inc.), competitors have been formed from so-called "section 363" sales of assets in bankruptcy proceedings (HHI Holdings LLC and the new Metaldyne). We also believe this revived capacity tends to have a low cost basis and reduced legacy liabilities, and that some attempts by large competitors to rationalize capacity have been less successful. For example, bankrupt Visteon Corp. has so far declined Johnson Controls Inc.'s recent offer to acquire certain of its assets.

We summarize our view of the key threats and opportunities facing the North American-based OE suppliers below (see table 4). Although many of the main threats are not new developments and stem from the 2008-2009 downturn, we believe the probability of their occurrence will vary. For example, we view the volatility of capital markets as a fairly consistent threat. On the side of opportunities, we believe we are better able to judge the prospects that sales will recover this year and next than we were in 2009.

Table 4

Threats And Opportunities For North American-Based Auto Suppliers

	Probability	Time frame	Effect	Auto suppliers affected	Comments
Threats					
Weak U.S. economy prevents gradual recovery in U.S. light-vehicle sales	Moderate	Near term	Severe	All	We expect sales to be 11.7 million units in 2010, an increase of 12.5% from the very weak levels of 2009. The automakers are now increasing production, but if sales fail to continue recovering, production could fall. We believe suppliers have reduced capacity but have still sized their businesses for a multiyear recovery in sales.
Sales in Western Europe decline more than we expect; other international markets weaken	Moderate	Near term	Severe	Large global suppliers	Currently, we expect sales, but perhaps not production, to fall about 10% in Western Europe in 2010. We expect major developing markets such as China and Brazil to remain in a growth mode, even if the rate of growth slows. Scenarios worse than these would hurt credit quality in our view.
Volatile capital market sentiment toward the sector	High	Upon us	Moderate	All	Capital markets remain volatile in our view and this has potential ramifications for all rated auto suppliers. Although many suppliers have refinanced, the lack of consistently available financing means there is much less room for error in liquidity. At least for now, however, the availability of debtor-in-possession and bankruptcy emergence financing seems to have improved.
Shifts in customer demand away from most profitable products	High	Upon us	Significant	All	The automakers' transition to reduced demand for pickups, SUVs, and minivans is a major challenge for many in the supply base, especially if this occurs in a short time frame. Smaller vehicles have fewer rows of seats, for example. The question is where long-term demand for these larger vehicles will stabilize. Demand for pickups has some correlation to housing and construction.
Volatile raw material prices	Moderate	Near term	Moderate	All	Prices of many key raw materials, such as steel, aluminum, and copper, declined because of the weak economy, but prices for some have started rising again. We expect prices to remain volatile for the long term. Suppliers have varying abilities to recover raw material price spikes from their automaker customers. In some cases, near-term cash flows can be affected because of working capital increases.
U.S. dollar fluctuations	High	Varies	Significant for some	Large global suppliers	Most vehicles are produced where they are sold, so the foreign exchange effect on suppliers is typically a translation issue rather than a revenue/cost currency mismatch. Still, many suppliers may see lower earnings in 2010 because of adverse translation caused by the weaker euro, and those with substantial dollar-denominated debt may see leverage increase--which could even affect covenant calculations.
Potential for automaker bankruptcy	Reduced for now	Intermediate to long term	Potentially severe	Most	The 2009 bankruptcies of General Motors and Chrysler did not affect the supply base because of government efforts to prevent a ripple effect, including providing substantial indirect funding. We do not believe the same level of government support would be a given in any future failures, so suppliers, especially those with thin liquidity, would be hurt by additional automaker bankruptcies.

Table 4

Threats And Opportunities For North American-Based Auto Suppliers (cont.)

Opportunities					
U.S. auto demand returns to more than 13 million vehicles per year	High	2011 onward	Significant	All	Unlikely until at least 2011 while the economy remains weak and the housing market stays under pressure. Also, improved vehicle quality and fewer miles driven will slow the natural replacement cycle, in our view. However, the average vehicle age continues to increase, and automakers are raising production in 2010.
Rising vehicle sales in developing markets	High	Upon us	Moderate	Large global suppliers	Even if growth slows in some markets in 2010, long-term demand trends should be positive, exceeding those in developed markets. Still, many competitors and overcapacity are risks.
New product introductions	High	Near term	Moderate	All	All automakers are focusing on the new consumer reality: fuel-efficiency in all car segments. More hybrid vehicles and eventually electric vehicles will mean content opportunities for some suppliers. As usual, the high and low of product-cycle swings vary by automaker, and less-diversified suppliers will be vulnerable if their main customer is at the nadir of its current product cycle.
Possibility of government support	Reduced for now	Intermediate to long term	Possibly significant	Varies	We believe the government views the auto supply sector as important to the U.S. auto industry, as demonstrated by the indirect support provided during last year's automaker bankruptcies. However, the extent of any future support is difficult to gauge, in our view. Separately, some suppliers may obtain loans to support fuel-efficiency projects, and for those, this money may arrive only in stages over several years.

We currently expect rating actions on the mostly low-rated U.S. auto suppliers this year to be more positive than negative. We believe these actions would likely include relatively minor rating or outlook improvements, however, because we are cautious about the strength of the recovery in developed markets, given ongoing mixed economic news and our view that production will remain volatile for several more years. A double-dip recession and a reversal in production could lead us to lower ratings, especially if liquidity tightens. But we believe most suppliers and automakers have improved their cost structures such that they are adequately positioned to weather a recovery that is more gradual than what we currently assume.

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