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INSIDE

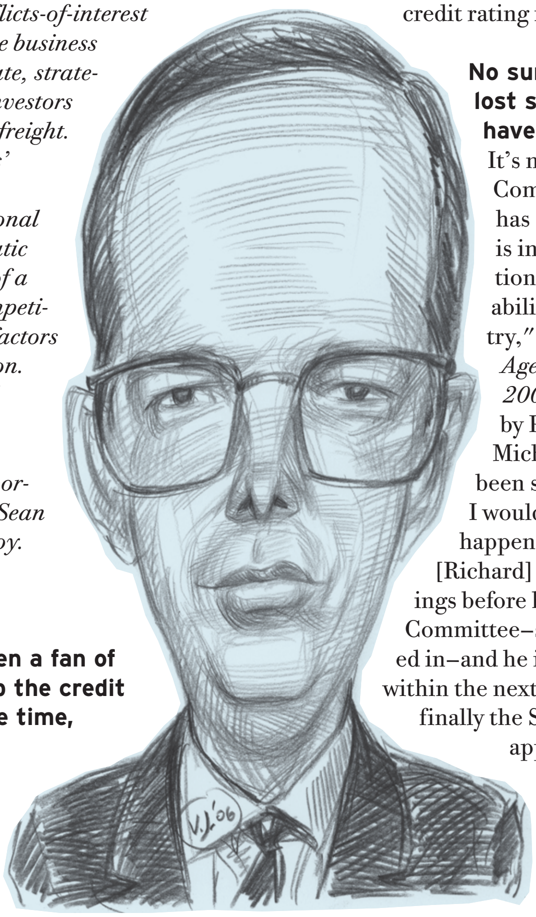
In Memoriam
Douglas R. Gillespie, Sr.
(1945 - 2006)

listeningin

Egad! Egan-Jones

Independent, Investor-Centric Credit Analysts Take Aim At Equities

***Sean Egan**, one half of the dynamic duo who (along with **Bruce Jones**) founded **Egan-Jones Ratings Co**. back in the early 1990s and has been a thorn in the side of the ratings industry's grand dames ever since, gave me a call the other day to bring me up to speed on the pair's latest venture. As it turns out, **Egan-Jones Performance Services** is as radical, and as obviously a good idea, today, in equities research as their independent, investor-funded credit rating business was back when they were just getting it started. What's so radical? Start with independence, an Egan-Jones trademark. They avoid conflicts-of-interest like the plague, with a simple business model: Selling timely, accurate, strategic long and short calls, to investors who are willing to pay their freight. It works because Egan-Jones' approach to credit research encompasses not just traditional ratio analysis, but a systematic and continuing assessment of a company's business and competitive position and any other factors that could influence valuation. Which has proven, time and again, to provide advance warning or disasters-in-the-making as well as profit opportunities. A number of which Sean shares in this interview. Enjoy. KMW*



I have to tell you, I've been a fan of the way you've shaken up the credit ratings business for some time, Sean.

Well, we are an irritant to S&P and Moody's and to a lesser extent, Fitch–

Irritants are good. I based my early career on being an irritant.

Still, Moody's and S&P would prefer that we go away. In fact, there's a story on *Bloomberg* this morning saying that they have upped their lobbying budget from $1.5 million per year to $1.9 million per year.

I guess that means it's getting more expensive to buy votes–

Let's say that I guess they believe in putting their money where their hopes and paychecks are–because they're trying to block the opening up of the credit rating industry.

No surprise there. But they've lost some ground in that battle, haven't they, lately?

It's not entirely clear. The House Committee on Financial Services has approved a bill that they say is intended to increase "competition, transparency, and accountability in the credit rating industry," the so-called *Credit Rating Agency Duopoly Relief Act of 2006*. It was introduced last year by Pennsylvania Republican Michael Fitzpatrick and now has been sent on to the full House. But I wouldn't begin to predict what will happen there. In the Senate, [Richard] Shelby has held several hearings before his Banking Committee–some of which I've participated in–and he is supposed to introduce a bill within the next 60 days. So perhaps, maybe, finally the SEC will do its job [and approve more NRSROs –or have that responsibility taken away from it.

You dreamer, you.

We have no problems with

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Victor Juhasz
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the current rules, as stated. The issue is that the SEC hasn't been following those rules. They say that you have to be a nationally recognized statistical research organization and a few other things, that's the main requirement. But you know, we have much more national recognition in the U.S. . And by the way, we have much more national recognition, in the United States, than **DBRS** [**Dominion Bond Rating Service Ltd.**]–yet when we point that out, they're completely silent. Anyway, we continue the fight. People in Washington are interested now because of all the **Enron**s and **WorldCom**s, etc. **Standard & Poors** and **Moody's Investor Services** stood up and tried to say there was no way they could have caught those problems–that the reason that they got Enron and WorldCom wrong was because there was fraud. But we stood up and said that there is always fraud when we have these debacles. The job of the credit analyst is to cut through that to see what is really going on. So we've become a poster boy for people who are trying to reform this industry.

Isn't the essential problem with the credit rating industry related to its disregard of a very simple principle we all learned–or should have–at our parents' knees: "Whose bread I eat, his song I sing."

Yes, exactly. You're right. As we all know, the SEC has forced a $1.4 billion settlement on the equity research analyst side of Wall Street for conflicts of interest during the internet bubble. Why in the world would the regulators not see that there is something similar on the fixed-income side? I can't imagine, but they don't see the connection there. So they're continuing to do what they've always done–at least, until they're forced to change. But we are hopeful that change will happen fairly soon.

You've been fighting that battle for a long time now, haven't you?

We've been at this, issuing credit ratings, since December of 1995 and it's worked out very well for us.

Didn't you actually start your company a couple of years before that?

Yes. We formed the firm in 1992. We started out doing consulting work for institutional money managers.We didn't start issuing credit ratings until December of '95. That was long ago enough, at this point, that there have actually been some studies done about the accuracy of our reports–one from the Federal Reserve Board of Kansas City–and even a skeptic like you has to know that we couldn't manipulate the Federal Reserve Board–

Heaven forbid!

Yes. We're lucky if we can even get the attention of our local congressman. We have no influence at the Fed! And there are other studies of our ratings, one from Stanford Journalism, one from Michigan, that have been done now–and have been helpful. One thing we've always done differently is look at the whole company, not just a specific bond issue, when we do our analysis. So as a result of our credit work we have been able to look at companies and even equities a little bit differently than other people do. We try to cut through the PR and find out what's really driving a company.

"As a result of our credit work, we have been able to look at companies and even equities a little bit differently. We try to cut through the PR and find out what's really driving a company. "

For instance?

We have been bearish on **General Motors** (GM) and **Ford** (F)for quite some time–and we continue to be so. Even though a lot of people are celebrating because it looks like **Delphi** might not go on strike now and a lot of autoworkers are accepting buyouts, but we still see too many fundamental problems remaining at GM and Ford to celebrate. people are accepting the buyouts, but we see some fundamental problems remaining with GM and Ford.

I want to pursue those with you. But before we go too far down that road, let's be clear. Isn't the essential difference in the way Egan-Jones approaches credit ratings that you aren't paid by the companies whose securities you analyze?

Well, if we an speak informally, it's that–and that we simply don't believe a lot of garbage.

You mean you approach your work with a modicum of skepticism?

I think it's well placed. A perfect example was the WorldCom case where S&P and Moody's used to claim that they were so close to the company, that they knew exactly what was going on. The problem is that being close to a company often times doesn't help them. They're blinded by the public relations garbage that companies are feeding to the investment community.

You're saying they were spellbound by Bernie Ebbers' line of bull, and got fooled?

Yes, exactly. In fact, Moody's now-retired chairman, Clifford Alexander, sat on the board of WorldCom for ten and a half years. He resigned, I think, about eight months before they filed before bankruptcy. So Moody's was right there, had a seat in WorldCom's boardroom, and yet they couldn't act. Either they didn't see the information or didn't want to see the information. But they failed to warn investors.

Your WorldCom reports, by contrast, did not make for pleasant reading in the Ebbers household?
No, they hate us, and rightly so. A lot of company managements hate us because we don't necessarily believe what a lot of those managers are saying. I have yet to meet a CFO or a Treasurer who doesn't believe that his company's shares are undervalued or that his debt is underrated. They all think that.

How right you are. And the bigger the bull market, the more they're convinced.
Exactly. But that's not to say that we're always bearish. Take **Nextel** as an example. We have been bullish on that company for a long time—were bullish. Obviously, they've been taken out now, with their merger with **Sprint,** creating **Sprint Nextel** (S). But our rating on Nextel at one point was six notches above S&P and Moody's.

Wow, six notches?
Yes, that's huge. And it's interesting: How, in the same basic industry, did we have one rating, on WorldCom, that was way below S&P and Moody's, and another rating, on Nextel, that was much, much higher than S&P and Moody's?

I assume you're going to tell me–
I think the explanation is that there is a bias on the part of S&P and Moody's in favor of the large important issuers. WorldCom, obviously, was a huge investment banking client. So we were cutting across the grain by saying that the company had significant problems. It was the same kind of thing with Enron, by the way. Whereas Nextel was big—there was no doubt about it—but it just didn't have the voice or presence in the investment community that WorldCom had.

Sure, one necessary step in creating a really big investment fraud is hitching your company's wagon to Wall Street's perpetual financing machine.
Yes. **Fannie Mae** (FNM) and **Freddie Mac** (FRE) are beautiful at that, by the way.

Aren't they?
Oh, they're the best at that. We don't rate them anywhere near AAA.

I have the sense that with Fannie and Freddie we're experiencing the investment equivalent of the *Night of the Living Dead.*
I like that analogy.

They're "living" proof that financial institutions can be too big to fail.
It's funny; we rate them at about A or A minus.

That highly?
Well, what we'd really like to rate them is probably about a single B+ or so. The reason why we don't is because—our credibility—our rating is low enough so that we wave a red flag. I mean, it's probably four or five notches away from S&P and Moody's AAA. Then too, you have to give some credence to the idea that the Government will probably step in. But on a stand-alone basis, or if you assume that it's only the $2.2 billion credit line that would be available from the Treasury, then they should be rated way down in the single-B or BB category.

Ah, the bond world is still so much more of a polite and genteel place than the equity markets.
I agree. Just think about it—Fannie and Freddie don't have to put up any margin with the brokers dealers, because they're rated AAA by S&P and Moody's. It's all so incestuous.

That alone must must be worth zillions–
Imagine what would happen if they didn't have even a portion of their supposed portfolio profits to report. We doubt that they actually have those profits; we doubt that real capital is there. And it seems like every couple of months another accounting fiasco surfaces either at Fannie or Freddie.

They're still finding the corpses.
Our other major issue with them is that we question whether any-

one really can effectively hedge a trillion-dollar-plus portfolio.

I'm sure they have hired somebody from MIT who thinks they've got it done.
Right, except when it comes down to it, there is no one on the other side of all those trades.

Either that, or everyone is on the other side of those trades, which is the same thing.
That's a good way of putting it. You and I and every other taxpayer are actually on the other side.

Let's turn to a less dismal topic. You and your partners have just started offering equities research, as an offshoot of your credit work, under the Egan-Jones Performance Services banner. Was that to assist analysts and PMs who forgot how to read balance sheets during the bull market?
I'm not touching that! It was more of a natural progression, since we were looking at the whole companies, anyway, for our credit ratings service. Because we were getting the credit calls right, we knew we had the data, the methodology and an ability to identify likely changes in equity prices–long term, not short term–because changes in credit pricing generally precede changes in equity pricing. Still, until recently the demands of building the Ratings Company, kept us so busy that we just never got around to actually producing an equity performance product. We always had the technology, but for all those years, we just never did it. Undoubtedly we had (and still have) a tiger by the tail, and we probably left some money on the table. But now we're focused.

How did that happen?
It was when I gave a presentation at my friend Jim Grant's spring conference. I went into the equity implications of our credit ratings product–talked about being able to anticipate strategic changes in equity pricing. Then, at the end of the presentation, I was overwhelmed with guys wanting to talk about our equity performance "product." Well, it didn't really exist–at least not in a saleable, presentable, public format. So it was then, at the Grant's conference, that I turned to Pete Arnold, who does marketing for us, and we both laughed and said, "Gee, I think we better do this." That was March 29th. It then took about a month to get the not-so-new product into presentable form. But, of course, we are still improving it. We already have a number of very happy hedge guys, the sort who take a strategic view, as launch clients for our "Long /Short Performance Product" and it seems to be very well-received by both equity and fixed-income guys. We're promising clients 40 strategic long/short calls a year.

Is it too soon to say what sort of investors find it most helpful?
Well, this may sound very odd. And it is definitely a simplification. But even some of the people who identify themselves as value investors these days see a decline in the price of a stock and assume, just because it previously traded at a higher price, that there's some value there.

Then they're not very good value investors.
Exactly. They should at least be checking the soundness of its balance sheet and making adjustments to the financials to get some kind of normalized operating income and get a sense of where the company is going. And that's what we have always tried to do with every company that we look at. Then too, as we observe many growth investors, we often see them acting more like momentum investors than anything else. That it's, they're not sitting back and assessing whether or not this company is able to sustain its growth and whether there's going to be new competition that comes into its market, what might happen to the margins going forward, the investment rates. But we're trying to assess those questions with every company that we look at.

You're making a big assumption these days—that someone wants to hold a stock for more than a nanosecond or two. And isn't just buying or selling it as part of some package trade.
Exactly. That's a bad assumption in many cases, we recognize that.

And you're doing it in a pretty tough market for independent research—
It *is* very tough, but we have been able to identify opportunities that other people haven't been able to see. Perhaps it's because of the way we look at companies differently than the typical analyst, because of our background on the credit side, but we've been fortunate in our calls. They've panned out pretty well, on both the long and short sides of the market. What we're doing for the equities service is culling out those cases where it appears that there are aberrations in the market–where the valuation assigned by equities investors appears to be off. The cases where we especially shine are those where we see some difficulties with the company sustaining itself.

When the stock market sees only wine and roses?
Exactly. As in Enron and WorldCom, which were early examples. More recently, I'm sure you saw the articles and reports asserting there was no way Delphi was going to file for bankruptcy protection, because GM would always support them. But not from us. We questioned whether that was possible because GM was–and is–having enough difficulty of their own. We made other timely calls on **Northwest Airlines** (NWACQ) and **RiteAid** (RAD). Now, airlines in general are looking a little bit better, just because the demand for travel has been fairly strong. That's what has kept a number of them out of bankruptcy over the past 12 months, despite fuel prices that have obviously increased.

That and the fact that they've generally been too strapped to leverage up and go out and blow a bunch of capital on new planes. But you did recently express doubts about JetBlue. (JBLU)
Exactly. The story on JetBlue has changed. It used to be the low-cost, low-leveraged airline that was flying in major metropolitan airports and was really the new darling in the discount airline sector. The problem is that **Southwest Air** (LUV), which is the Wal-Mart of this industry, is now entering those major markets. They did not do that before. They felt they could not compete head-to-head against the legacy carriers. But now Southwest has crossed the Rubicon. They're in Philadelphia and they're entering other major markets too. So JetBlue is hemmed in in that way. Not to mention that JetBlue is not that low-leverage airline that it used to be. It has taken on a lot of debt to grow. It has sold off some aircraft, I think, within the past month, but that still doesn't significantly alter their high leverage. Now, JetBlue's stock has done decently over the past month or so because of the rise in the whole airline industry. But it remains a highly leveraged company whose base market is under attack from Southwest Air.

Your report actually says the "B" word isn't out of the question.
It remains a potential, yes, as JetBlue's operating income gets squeezed and the debt keeps growing, especially in a rising interest rate environment. And it's very likely we saw the top of the credit cycle six months ago.

So let's talk about the elephants in the living room. GM and Ford. You're not nearly as sanguine as the folks who keep appearing on the boob tube talking happy talk about all the workers who're accepting buyouts and new high-tech cars.
The buyouts are a red herring. Why are they a red herring? Well let me share with you a few numbers if I can. Let's say the blended cost is about $80,000 for the workers that are accepting the buyout offer. Certainly some are near $140,000 some are down around $35,000 or so, but let's say the average cost is about $80,000 per buyout. That's just the salary cost for the people who are leaving–forgetting about thee healthcare benefits when they're retired and forget about their pension benefits because those are going to continue whether they accept the buyouts or not, it's just a matter of timing. Let's say, though, that the workers who accept buyouts are paid around $50,000 annually and let's say the workers who are replacing them are paid around $30,000. So it's roughly a salary savings of $20,000. But they have some training costs for the new employees, that might be $5,000. So maybe their net savings is, $15,000. But let's be generous and say it's $20,000, just to make it easy to work the numbers.
That means they're paying $80,000 today to save $20,000 annually over the next 5-10 years. That's an okay return but it's not not spectacular for the simple reason that GM is going to have to continue supporting these retirees in retirement. They're going to have to continue, in most cases, to pay their pension and healthcare costs. Some of its employees obviously are giving up healthcare coverage, some are giving up pensions, but for the most part GM is going to have to continue to pay them. In fact, it's only when the buyouts involve people in its "job bank" that GM will generate terrific savings from the buyout. Furthermore, there is something else to consider, any new employee requires a break-in period. Some new employees are not going to work out, you have to spend time training them, the quality of their output is not always terrific.

In other words, productivity will likely suffer?
Exactly. As opposed to the guy who took the buyout who had been doing it for the past 20 years and could probably do it blindfolded. He was older but he was probably still more productive than the kid; 18-20 year olds have other things on their minds. So we don't get very excited about the buyouts. Then too, while some people celebrating because Delphi might not go on strike, that doesn't get us very excited about either company's future prospects. On the other side of the ledger, we're now seeing GM announce zero interest rates, six-year financing on their vehicles and other sales incentives. So despite GM's claim that they're not going to follow the other manufacturers, it appears as though they're heading right in that direction. It's a price war, basically.

It's only way they can "sell" cars.
That's it. And they need to move inventory. They can't put up with too many months where they're down 16% and Toyota is up 17%. So it's a price war. They said at the beginning of 2005 that they weren't going to provide any significant discounts, but they ended up doing it. They said that again this year. They said they were going to go to a new low price every day sort of scheme. Yet here they are, six months later, doing the exact same thing as last year. Clearly, the margins in the auto industry are not what they used to be.

I'm getting the idea you're not bullish on Detroit.
We're not. Another way to look at the industry is to measure those key success factors that determine which companies are going to succeed in the auto industry. We've put together a little matrix to use in comparing GM or Ford versus **Toyota** (TM). The first factor is market share. Why is market share important? Because last time we checked, the auto industry was still an economies of scale business, globally, and nothing is going to change that. If you can spread the costs of developing a hybrid engine system over 2,000 vehicles rather than 50 vehicles, you're much better off making (and selling) 2,000 vehicles.

Of course.
Well, on market share, Toyota is gaining and Ford and GM are losing. If you look at the models they are offering to the market, Toyota, for the most part, is selling the high-profit, high-growth models, while Ford and GM are not. The growth now is in the non-truck, non-SUV area–

And Detroit got caught with all the wrong gas-guzzlers again.
Exactly. And we think that market share trend is going to accelerate for the simple reason that Toyota will reduce the cost of the hybrids. You can count on that. They've done it on everything else, so they'll do it with the hybrids–which they will extend throughout the product line. That's going to change things. When it comes to technology, Toyota has it. They've been out in the market for, what, four years now with the hybrid system. GM, meanwhile, has just been talking about developing hybrids. They're so focused on alternative fuels, hydrogen or ethanol, that make for great copy in *Popular Mechanics*, but I think really are 10 to 15 years off.

If people think that it's hard to move ethanol around and store it, wait until they try hydrogen. They ain't seen nothing yet. Wait till the NIMBY folks get a hold of that one.
I know. One explosion, and that'll be it. It will all be over. Another crucial factor on our matrix is manufacturing costs. GM is at an $1,800 per vehicle disadvantage vis-à-vis Toyota and that is probably going to accelerate.

Are you talking in all-in manufacturing costs? With the cost of benefits, etc.?
Yes. And coupled with that are capital expenditures: Toyota is spending about $14 billion per year and GM is spending about $8 billion per year.

You get what you pay for.
True. Unless we can somehow assume that Toyota is far less efficient in their capital expenditures than GM, which is hard to believe. In fact, you could probably make the counter argument fairly easily. The next factor we look at is financial position and probably the best measure for that is the credit rating. Toyota has a AAA credit rating and GM and Ford are down in the single A or BBB minus category.

You're talking about your credit ratings?
No, those are actually the competition's. They haven't quite caught up with us. Standard & Poors has a single B-minus rating on General Motors with a negative watch. Moody's has a CAA1 rating on it with a negative outlook. That's for General Motors. We're below them. We're at the CCC level for General Motors and at the B

level for Ford. But the point, in terms of our industry matrix, is that there's a huge spread in funding costs between a AAA credit like Toyota and a Ford or GM that's now carrying a speculative rating.

What else counts on that matrix of yours?
Image is another big factor, and the way we capture that is by looking at that the quality surveys and perhaps also at the luxury sedan market, which often drives an automaker's whole brand image. In the latest J.D.Powers survey, again, Toyota and Lexus were way up on top, and GM and Ford were closer to the bottom.

And they can only sell so many monstrous *Escalades*.
Yes. Among luxury sedans, GM used to be in good shape with its Cadillacs, but it's rare to see a Cadillac anymore, at least in this area in the country. You see gobs of Lexus vehicles and, of course, Mercedes and BMWs and Acuras, but you see relatively few traditional Cadillac sedans. And when it comes to Ford, you don't see anything, really.

Around Manhattan, you do see lots of Cadillacs being driven by the various black car services—
But outside Manhattan, those disappear. And that's significant because luxury sedans really set an auto brand's image. That's also where the carmakers probably make the most money, in sedans. But Ford and GM have been all-but locked out of that market. And they probably stay locked out for the foreseeable future. Then, the last factor in our matrix is recent earnings.

Isn't that an oxymoron for Ford and GM?
It's terrible and we don't think it's going to get better anytime soon. GM, on a pre-tax basis, had $15 billion of losses last year. And if the accounting board has its way, they're going to have to recognize $60 billion in unfunded healthcare liabilities–that you really can't shrug off as just a "one-time" event. Because if you take that $60 billion and spread it out over the last 10 years, it means that GM was, has been and continues to be –

Overstating whatever slim profits it managed to report?
Yes, exactly. They are a walking zombie. They're dead and they don't know it.

Did you see the recent *Wall Street Journal* piece that neatly dissected how much of the pension costs it is always moaning about aren't obligations to the rank and file like everybody assumes, but are actually the result of supercharged executive pensions?
No, I did not.

I'd recommend it. [*As Workers' Pensions Wither, Those for Executives Flourish*, by Ellen E. SCHULTZ and Theo Francis, June 23] GM wasn't the biggest offender cited. But it was up there.
I'm sure that's going to make it easier when GM negotiates with the unions.

Anyway, what you're saying with your matrix is that Ford and GM really aren't competitive on any meaningful level with Toyota?
When we line all these things up on our matrix, even though we know some people believe that Ford and GM could be shrunk back to profitability, we have a real problem with that notion. For the simple reason that there really isn't any place to hide. You know, both companies *might* be able to–if their senior managements would really focus on it–maybe shrink down to, let's say, sell some profitable SUVs and trucks. Maybe they could just go after that segment of the market, like Harley Davidson goes after the motorcycle market, and sell just to people who want an American truck and are willing to pay a 10% or 15% or 20% premium for that. But there's no way that the current management is going to do that. They're not even going to entertain a strategy like that until they've been forced to file for bankruptcy. It's easier for Mr. Wagoner to just make people feel better about things with these buyouts and hope to stay in the saddle for another year or two, than to take drastic action like that. And he wouldn't get support from the UAW, anyway, so they really couldn't do it. The UAW basically owns the company. They can't do anything without the UAW's approval.

Weren't you encouraged that they at least sold GMAC, even if they didn't get as much as some hoped for it?
Not really. It went for below book value. When was the last time a financial services company was sold for below book value?

It's been quite a while.
It certainly has been. I can't remember one. The last couple big sales have been of retailer credit card operations and those have all been for premiums. So the price they accepted for GMAC is an indication of how difficult things are. If you're putting zero interest rates, six-year loans into that operation, you have to know that the company is pushing the envelope as much as possible. In fact the zero interest and other incentive programs both companies are putting into motion assure us that Ford and GM will report operating losses. What's going on here, quite simply, is mutually assured destruction [See report summary, opposite.]. So that's why we're not bullish on GM and Ford. We may be missing something, but we haven't found it yet.

Until just this week, it sounded like you were slightly less bearish on Ford.
Only because it hasn't sold off its crown jewel yet. They still have Ford Credit. That's a positive. The negative is that Ford probably has a weaker product line-up than GM. Alternatively, GM has higher relative pension and healthcare costs than Ford. So, they're neck in neck, roughly, in a race no one wants to be in. I think the only real difference lately has been that GM has had a better PR effort than Ford recently. Bill Ford is exercising with the Detroit Lions while Rick Wagoner is flying around the country.

If GM's and Ford's boards believed you were right, they should have filed yesterday.
There's no question. But it all depends on your perspective. If you are Wagoner and you know you're going to be tossed on your ear upon the filing or shortly thereafter, you're better off holding on. He has every incentive to hold on, as does Bill Ford and the Ford family, while a more rational professional manager who came in with a clean slate would probably throw in the towel.

In that case, why would any presumably rational professional investor be trifling with either equity?
I think a lot are for the simple reason that they believe Uncle Sam will come to the rescue the way we did with Chrysler.

Chrysler was a long, long time ago, in a very different world.
It certainly was. There are also some who believe that GM has been a part of the foundation of the country and always will be, so

they're holding on. But the competition is not letting up. Toyota has a new truck factory that's coming on later this year. They already have plans to expand it. And they're looking for another factory. So any oasis that Ford and GM might have is going to vanish shortly.

What sort of competitors would the Japanese be if they didn't try to take advantage of Detroit's woes?

Similar to the ratings industry, actually. As you know, S&P and Moody's had terrible (positive) ratings on WorldCom, Enron, Global Crossing, Genuity, Delphi. Sent completely the wrong messages to investors. The SEC says they have been looking at it, but have done nothing. Meanwhile, S&P's and Moody's revenues continue to grow. Essentially, the rating agencies are providing all the service that you could expect from a partner monopoly.

Don't you mean "duopoly?"

No, in our opinion duopoly is the wrong word because a duopoly is two firms competing against each other. But since every issue needs two ratings, okay, S&P and Moody's don't compete against each other. They're partners in every sense of the word. When an offering comes down, S&P gets their fee and Moody's gets their fee. They're not negotiating against each other in any way.

And Fitch has traditionally been in there as a fig leaf?

Exactly. If Fitch grows too much, S&P and Moody's use their monopoly power to lean on the investment banks not to give too much business to them.

No surprise, but having a lot of independent credit research out there might not always be seen as in the interest of the investment banks—

There's no question. What they want are lap dog ratings agencies. Ones that say something is investment grade when it's four days from bankruptcy. And by the way, ones that will give advance information to the investment banks before they cut a rating.

It's clear you think highly of your own rivals. What about GM's and Ford's? Have you issued positive reports on Toyota, for instance?

No, because they're not very interesting. They are just the Wal-Mart of the auto industry.

Yet that is the way, if I'm not mistaken, that you've found some of the companies you've written up from the long side—

Absolutely. But our view is that Toyota and Honda are just going to continue to make life very difficult for Ford and GM –and unless there's a dramatic change in the political environment, it's going to be extremely difficult to fight that.

Still, you haven't washed your hands of everything connected to Detroit. I saw Goodyear (GT) on your positives list—

Yes. Goodyear is interesting because even though it's in the general automotive business, it gets over 60% of its revenues from the aftermarket. That's point No. 1. Point No. 2 is that it is not solely dependent on the U.S. for manufacturing. Goodyear can source products from outside the United States and so it has some leverage over its domestic operations. Or let me say that another way: If the UAW shuts down their operations, it will be very difficult– but the company could deal with it. That's a completely different case than with GM and Ford, which desperately need the approval of the UAW and their other unions to operate.

Goodyear also has a CEO in who has been swinging an ax—

Absolutely, and that's what they need. They're making the right cuts so that they can improve operations.

What about Goodyear's balance sheet?

It's been improving. One of the first things that we look at, though it's not directly a balance sheet item, as a measure of financial health, is pre-tax interest coverage. And that's been at 2.4-to-1. It's not terrific, but at least it's not negative, or below 1-to-1, which is the case for a lot of other companies in the general automotive industry sector. And Goodyear is focusing on reducing debt.

That helps, particularly in a rising rate environment.

Exactly, and Goodyear has reduced its debt by $400 million over the past year. Which is, I mean the net debt is still at $3.7

Egan-Jones' Latest On Detroit:

EJR AFFIRMS FORD MOTOR CO AT CCC (NEG.) (S&P: B+)

FORD MOTOR CO — EJR Sen Rating(Curr/Prj) CCC/ CC
Rating Analysis - 6/29/06 — Debt: $151.1B, Cash: $39.1B
F_060629.htm — Buyout Prob.: Low; Value/Price: $1.47/$6.19

FORD Motor Co's (the Company or F) revenues were $41.1 billion for the quarter ending March 2006 compared to $45.1 billion for the prior year. The Net Loss realized for the March '06 quarter was $1.2 billion, a decline over the prior year's $1.2 billion income.

Mutually Assured Destruction - the zero interest and other offers assure that F and GM will report operating losses. F's share price drop also reduces financial flexibility and credit quality. F recorded $2.5B in special items for the March quarter and will record $3B additional charges in 2006 for healthcare costs. F faces pressure from: supplier support costs, plant closings costs, increased labor costs, increased funding costs, declining market share, unfunded pension and healthcare liabilities, increased production costs, and tired product lines. Like GM, F might sell a majority interest in Ford Credit to reduce funding costs, but without Credit earnings, F's losses will accelerate. We rate Ford Credit at BB-/B+.

*Annual Ratios Ratios for 4 Rolling Quarters

CREDIT POSITION	12/05	P12/07*	3/05	6/05	9/05	12/05	3/06
Pretax Int Coverage (x)	2.4	-1.3	3.9	3.5	2.6	2.6	-0.3
Funds fr Oper/Debt (%)	10.5	4.0	9.9	10.0	10.6	10.7	9.3
Fixed Chg Cov (x)	6.8	1.5	14.3	15.1	14.4	14.1	11.6
Return on Equity (%)	14.5	-73,389.7	16.6	18.9	14.7	14.5	-2.9
T Debt/Cap(w Debt)(%)	91.1	100.4	90.7	92.2	91.3	91.7	92.2
(Debt+10xRent)/(Cap+10xRent) %	91.8	100.4	91.3	92.8	92.0	92.3	92.7
Implied Sen. Rating	B+	CCC+	BB-	BB-	B+	B+	B-

INDUSTRY RATIOS	AA	A	BBB	BB	B	CCC
Pretax Int Coverage (x)	8.0	6.5	5.0	3.7	2.6	1.7
Funds fr Oper/Debt (%)	25.0	20.0	15.5	12.2	9.6	6.4
Fixed Chg Cov(x)	30.0	25.0	20.0	15.4	9.7	5.6
Return on Equity (%)	27.5	22.5	17.5	12.5	7.5	2.5
T Debt/Cap(w Debt)(%)	50.0	55.0	64.3	70.0	93.2	124.1
(Debt+10xRent)/(Cap+10xRent)%	46.9	52.8	58.4	64.4	73.0	84.6

PEER RATIOS	S&P Sen.	Pretax Int Cov(x)	Funds from Oper/ Debt(%)	Fixed Charge Cov(x)	ROE(%)	T Debt/ Cap(%)	Ratio-Implied Rating*
Toyota Motor Corp.	AAA	104.5	212.9	132.0	11.5	7.0	AAA
DaimlerChrysler AG-REG	BBB	4.5	18.4	14.8	7.7	68.2	BB+
Ford Motor Co.	B+	2.4	10.5	13.9	14.5	91.1	B
General Motors Corp.	B	-4.7	1.9	0.8	-67.6	94.5	CCC

* Using only last reported annual data and not smoothed.
Rating Chg Antic. (1 is best, 100 worst): 78.0 Old EJR Sen.: CCC S&P Sen.: B+

million, but that's down from $4.1 million a year ago. So they're going in the right direction. The major negative for Goodyear is that their raw material costs have been rising. That reduced March quarter operating income before interest to $238 million from $262 million a year earlier. The company is focusing on reducing costs, but more needs to be done. Still, this is a company with $1.6 billion in cash and, we'd say, a decent chance of being bought out. The value range we put on it is somewhere between $15 and $35, roughly.

What else has caught your eye, long or short?
On the short side, there's a Canadian company, called **Nova Chemicals** (NCX). The basic problem with the company is that its operating income has been deteriorating just terribly. Just for the December quarter, it's fell from $59 million in 2004 to a $4 million loss for December '05.

Is that because its feedstock is petroleum based?
Yes. They used to have access to cheap Alberta natural gas and petroleum. But what used to be cheap is no longer cheap. Its March operating numbers were more or less as dismal as December's. They had operating income last March of $170 million–which fell to $49 million this March. Their interest expense, in the meantime, has gone the exact opposite way–from $26 million up to $42 million, so they don't have much cushion in their operations.

How did you come across this idea?
By virtue of our work on the credit side, where we saw that unless there's some dramatic change in the pricing structure, which is tough because the market in chemicals is worldwide, this company was going to continue to have some severe difficulties. Their relatively small size means they can't become dramatically more efficient than the next firm. Meanwhile, there's a wholesale shift going on in the chemicals industry, with production moving from the U.S. and Canada to the Middle East, where more production capacity is being created every year. So its ever more difficult for Nova to realize the earnings it once did, but to sustain its structure requires the sorts of margins that it doesn't have anymore. Barring a buyout, which seems unlikely with Nova reporting losses, we expect its shares to remain under pressure.

Okay, let's end on an up note. Tell me about one more thing you like here.
Veritas (VTS). It is a drilling services company–provides survey and seismic information and analysis.

The name would be better for a winery. But it's in a good business to be in these days.
No question. I think we first recommended the stock around 45.75; now it's up to 49. But the demand for their services will continue. It appears to be cheap on a relative value basis. If you look at it on a multiple of EBITDA or EBIT basis, its multiple is much lower than the multiples on some similar companies. Plus, there's a good chance that this one will be bought out by one of its major competitors.

Relative value can be a slippery slope.
Well, the median multiple of EBITDA on comparable companies is at 17. We back that down to a 12 multiple in our valuation, and we still get an enterprise value of $140 a share on fiscal '07 numbers. And when we do the same thing with EBIT, backing Veritas' multiple down to 12 from a peer average of 22, it still looks fairly attractively priced. Besides, this company is the right size for somebody who wants to bulk up to come in and buy. It's market cap is only around $1.5 billion, it has annualized EBITDA of $265 million and interest expenses of only $4 million. And it has more cash than debt. Then too, it seems to have developed some proprietary technology, which they're using to build up their mapping service. It would be an attractive bolt-on acquisition for a number of firms. After all, the demand for and price of energy is likely to remain robust for the next several years–which will stoke demand and margins in the energy field. So about the only negative we see with Veritas is the possibility that it pays up to do too many share buybacks or gets taken out too soon.
Thanks, Sean.