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GMAC: Is Half A Loaf Better Than The Whole?

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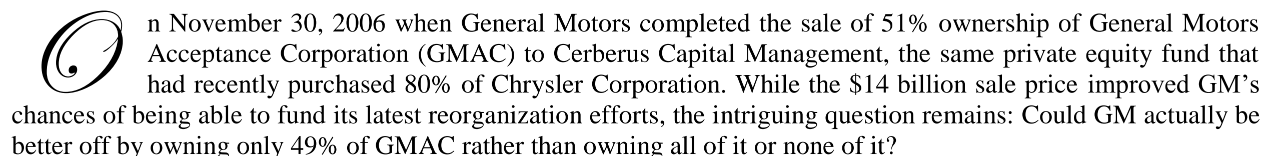
ABSTRACT

In November 2006 General Motors sold 51% ownership of its subsidiary, the General Motors Acceptance Corporation to Cerebus Capital Management in a complicated transaction. This paper demonstrates that GMAC produced over 90% of consolidated General Motors profit over the past two decades and tries to determine why the GM team sought to sell its best player and answer the natural follow-up question: why sell 51% of GMAC, instead of all of it? A number of possible explanations are considered, including cleaning up GM's balance sheet, unlocking the submerged market value of GMAC, and improving GMAC's credit rating/ access to capital. The paper concludes that the partial divestiture was a sound move that could easily have resulted in better financial performance for GM than the status quo, but that the entire strategy was upset by the subprime loan crisis of 2007-08.

Keywords: Cost of capital, partial divestitures, credit ratings, parent-subsidiary relationships

INTRODUCTION



On November 30, 2006 when General Motors completed the sale of 51% ownership of General Motors Acceptance Corporation (GMAC) to Cerberus Capital Management, the same private equity fund that had recently purchased 80% of Chrysler Corporation. While the $14 billion sale price improved GM's chances of being able to fund its latest reorganization efforts, the intriguing question remains: Could GM actually be better off by owning only 49% of GMAC rather than owning all of it or none of it?

GMAC

General Motors Acceptance Corporation was established in 1919 as a wholly-owned subsidiary of General Motors to provide GM dealers with financing for their auto inventories and retail buyers with a convenient form of credit for new auto purchases. Twenty years later GMAC began to diversify its operations by selling insurance to its retail customers, and by 1985 had entered the mortgage business, eventually forming the GMAC Commercial Mortgage Corporation (GMACCM) and the Residential Capital Corporation (ResCap). (In early 2006 GMAC sold 78% of GMACCM to Capmark Financial.) While many people think of GMAC as primarily an auto financing business, the ResCap operation generated over $189 billion of new mortgage loans in 2006, making it the 7th largest originator of residential mortgage loans in the United States. Although approximately 80% of these loans were later packaged and resold in the mortgage-backed securities market, by 2006 ResCap was servicing $412 billion of mortgages and retained ownership of $69 billion in mortgage loans, or almost 40% of GMAC's receivables.

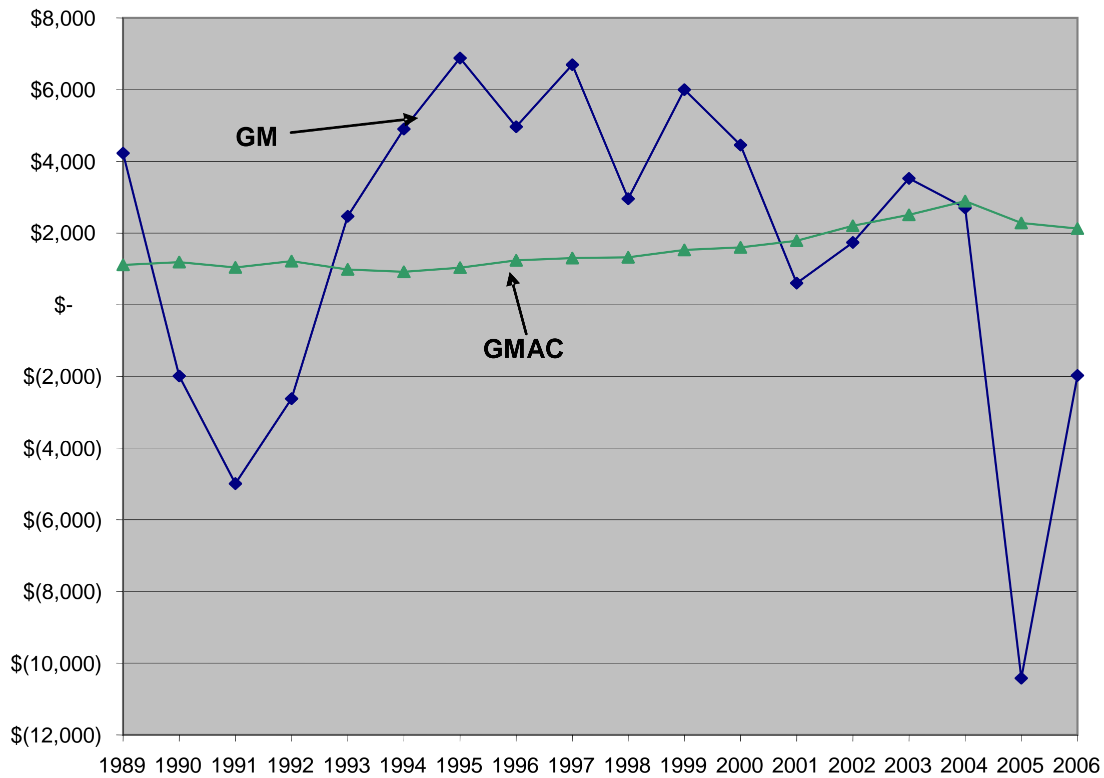
While General Motors was generating most of the headlines, GMAC was producing most of the profits. In the 1989-2006 period GM earned a total of $30.1 billion, but as Table 1 shows, 93% of the consolidated net income was produced by GMAC's lending operations.

As Figure 1 demonstrates, GMAC's profit was also very consistent and predictable, which served to dampen the normal cyclical swings in GM's automaking results:

Table 1: GM and GMAC Profit (1989-2006)

Year	GMAC Segment Profit (In Billions)	GM Consolidated Profit (In Billions)
1989	$ 1.111	$ 4.224
1990	1.190	(1.986)
1991	1.038	(4.992)
1992	1.218	(2.621)
1993	.981	2.466
1994	.920	4.901
1995	1.031	6.881
1996	1.240	4.963
1997	1.301	6.698
1998	1.325	2.956
1999	1.527	6.002
2000	1.602	4.452
2001	1.786	.601
2002	2.203	1.735
2003	2.506	3.525
2004	2.894	2.701
2005	2.282	(10.417)
2006	2.125	(1.978)
TOTAL	$ 28.280	$ 30.111

Figure 1: GMAC Profit vs. GM Profit



THE PARTIAL SALE OF GMAC

Despite the consistently strong financial performance of its financing subsidiary, in early 2003 General Motors began to seriously explore the sale of all or part of GMAC. With the financial press questioning the underlying reasons for such a transaction and speculating about the potential proceeds involved, the deal was on-again, off-again for three years. Finally, in early 2006 Cerberus Capital Management emerged as the leading bidder, and in April of that year GM announced that it would sell 51% of GMAC to Cerberus in a complicated transaction valued at just over $14 billion. At the November 30, 2006 deal closing, Cerberus paid $7.4 billion in cash for its stake, as well as allowing GMAC to give GM a dividend of $2.7 billion in cash and $4.1 billion in auto assets under lease just before the change in control took place, thus raising the total value of the deal to the announced $14 billion. Four months later GM agreed to refund $1 billion of the purchase price as a retroactive adjustment to reflect the rapidly deteriorating loan portfolio at GMAC's ResCap unit.

REASONS FOR THE SALE

Normally corporations sell assets because they need to raise cash or they are unable to turn around an underperforming business. However, in this case it appears that neither of these reasons was the underlying motivation for the sale. Although its subprime loan problems were later to be problematic, at the time of the sale GMAC was a stellar performer with strong growth prospects and no serious weaknesses. From 2002 to 2006 its interest revenue grew an average of 10% per year, and the company was just beginning to tap significant new loan markets in China. Additionally, in the five years prior to the sale, GMAC paid GM over $8 billion in much-needed cash dividends

While the $7.4 billion in proceeds from the sale to Cerberus was clearly helpful in improving GM's cash balance to a relatively healthy $30 billion as it approached a major cash-draining restructuring in 2007-09, liquidity needs do not appear to have been the overriding motivation for the sale. We argue below that a number of beneath-the-surface factors were much more critical in the decision to sell a majority stake in GMAC.

Cleaning Up GM's Balance Sheet

While the sale of half of a subsidiary operation normally would not have a significant impact on the parent's balance sheet, as Table 2 demonstrates, in this case the effect was quite dramatic:

Table 2: General Motors Condensed Balance Sheet (Before and After GMAC Sale)

(dollars in billions)	9/30/2006	12/31/2006		9/30/2006	12/31/2006
Cash	$ 17.8	$ 23.7	Current Liabilities	$ 68.6	$ 67.8
Other Current Assets	41.2	$ 40.4	Long Term Liabilities	389.9	123.8
Long-Term Assets	410.6	114.6			
Investment in GMAC	______	7.5	Stockholder's Equity	11.1	(5.4)
Total Assets	$ 469.6	$ 186.2		$ 469.6	$ 186.2

The November 30, 2006 sale of 51% of GMAC was just enough to trigger a switch from consolidation to the equity method of accounting, which effectively removed all the GMAC receivables and borrowings from GM's books. While still highly-leveraged, GM now appeared as a "leaner, meaner" operation with improved liquidity and primed to undertake a major restructuring in 2007-08. In the six months following the sale, Standard & Poors removed GM from its "CreditWatch" list and upgraded their overall credit rating from B+ to BB-, which may have in part been due to its slimmed-down balance sheet.

Improving GMAC's Credit Rating / Reducing Borrowing Costs

As a lender, it was imperative that GMAC maintain a low cost of borrowing and maximize the interest spread (the difference between the interest charged on loans and cost of debt) in order to remain competitive and generate profitability. As shown in Table 3, from 2002 to 2006 GMAC's interest expense increased steadily, which caused its interest spread to deteriorate:

Table 3: GMAC Interest Revenue vs Interest Expense (2002-2006)

(Dollars in Billions)	2002	2003	2004	2005	2006
Gross Financing Revenue (including leases)	$ 16.4	$ 18.7	$ 20.3	$ 21.3	$ 23.1
less: Depreciation on Leased Vehicles	(4.8)	(5.5)	(4.8)	(5.2)	(5.3)
= Interest Revenues	$ 11.6	$ 13.2	$ 15.5	$ 16.1	$ 17.8
Interest Expense	6.8	7.6	9.7	13.1	15.5
Interest Spread in Dollars	$ 4.8	$ 5.6	$ 5.8	$ 3.0	$ 2.3
Interest Expense / Interest Revenue	58.6%	57.6%	62.6%	81.3%	87.1%
Average Interest Rate Spread	3.0%	2.8%	2.5%	1.2%	1.0%

Not coincidentally, during this period the company experienced a series of negative credit rating changes from several agencies, which increased its cost of borrowing and caused the rapidly shrinking interest rate spread. Credit rating changes for 2003 to 2006 for GMAC as provided by Moody's Credit Rating Service are shown Table 4.

Table 4: GMAC Credit Rating Changes

Date of Rating	Rating Change
June 2003	A2 to A3
November 2004	A3 to Baa1
April 2005	Baa1 to Baa2
August 2005	Baa2 to Ba1

The declining credit quality and increased borrowing costs at GMAC were largely attributable to its position as a wholly-owned subsidiary of GM, which was simultaneously being downgraded even more aggressively by the same agencies. As GMAC followed its parent into junk bond status, its interest costs began to rise sharply and its ability to compete effectively in the lending markets was threatened. Analysts were concerned that as GMAC's credit quality deteriorated, it would only be able to write loans for buyers with the worst credit ratings, leaving it with a weak loan portfolio. As Table 5 shows, compared to risk-free 5-year Treasury notes, GMAC's weighted average cost of debt rose significantly from 2003 to 2006.

Table 5: GMAC Weighted Average Cost of Debt (2000-2006)

Year	5 Yr T Note	Weighted Average Cost of Debt	Risk Premium
2000	6.16%	6.42%	0.26%
2001	4.56%	5.50%	0.94%
2002	3.82%	4.32%	0.50%
2003	2.97%	3.64%	0.67%
2004	3.43%	4.31%	0.88%
2005	4.05%	5.10%	1.05%
2006	4.75%	5.88%	1.13%

The increase of 63 basis points in the risk premium over the 2002-06 period cost GMAC an estimated $1.8 billion of additional annual interest costs, which in turn led them to develop a number of strategies to counteract their inability to issue debt at favorable interest rates:

- In an effort to lower the firm's cost of capital, GMAC bundled auto loans and used them as collateral for bond issues, as opposed to raising money by unsecured debt offerings. In 2001, these asset-backed securities comprised 21% of GMAC's new debt financing, but by 2004 it was almost 38%. Because of the predictability of auto-loan cash flows, asset securitizations carry lower risk premiums than more traditional forms of financing, but they don't represent a permanent solution. Per Sanjiv Khattri, CFO, of GMAC "Eventually, you need some unsecured debt to finance your business."[1]
- From 2003 to 2006 the total loan portfolio on GMAC's balance sheet only grew 2.3%, while the large volume of loans that they originated, sold, but continued to service rose 46.0%. This suggests a plan to sell off a larger portion of their newly-originated loans to investors with presumably lower costs of capital.
- Through ResCap, GMAC dramatically increased their high-risk lending operations, where the higher interest rates charged on loans would better offset their higher cost of debt capital. From 2003 to 2006 subprime, second mortgage, and non-conforming loans increased from 50.3% to 73.3% of their lending portfolio.
- GMAC attempted to build up their insurance and loan-servicing business in order to produce revenues that were independent of credit ratings and interest rates. Aided by a strong stock market, from 2003 to 2006 the insurance operation went from producing 6.4% of the company's operating profit to 37.4%, while the loan-servicing portfolio grew by 46% over the same period. While still known as a lender, by 2006 GMAC had made significant strides toward diversification as a financial services provider.
- The ultimate strategy was to split off GMAC from GM to try to restore its investment grade debt rating and better position the company for future growth. A sale of a majority stake in the operation would provide board governance independent of GM, and it was anticipated that such independence would hopefully provide improved funding at lower rates, increased capital for expansion, and access to any special expertise possessed by an acquiring firm. In late 2005, Standard & Poor's volunteered that "…the potential for [debt] downgrades of the finance unit and its related operations… stem solely from the deteriorating rating outlook at GM. The potential for upgrades depends on these entities achieving substantial separation from their parent, [which] now seems to be more likely to occur."[2] When the idea of a partial sale was proposed, GMAC's Khattri reasoned "It is better to be the partial owner of a growing organization that has competitive access to funding, than to be full owner of an organization whose funding might be constrained."[3] The firm's inability to borrow at competitive rates was making it almost impossible for GMAC to win a fair share of new loan business from borrowers with a low to normal risk profile. Something had to be done before a sound business became a basket case.

Unlocking GMAC's Market Value

Another major motivator for change was the May 2005 attempt to take over General Motors by Kirk Kerkorian's Tracinda Corporation. John Casesa of Merrill Lynch saw it clearly: "There is no doubt in our mind that Tracinda's interest is not in the auto business, but rather in unlocking value embedded in the noncore businesses."[4] Since the most valuable and most easily separable noncore business was GMAC, sale of the financing unit began to be seen as a necessary strategy to unlock its market value and simultaneously make GM a less enticing target for corporate raiders, especially considering GM's bargain price tag as the lowest valued stock among the Dow industrials.

Just how much value was there to unlock? Based on the final sale price of $14 billion for a 51% stake, an independent GMAC appeared to be worth about $28 billion at November 30, 2006, or approximately 1.32 times the book value of its equity. Retroactive application of this same market-to-book ratio to prior years produced the estimated market capitalization shown in Table 6.

Table 6: GMAC Estimated Market Capitalization (in billions) 2000-2006

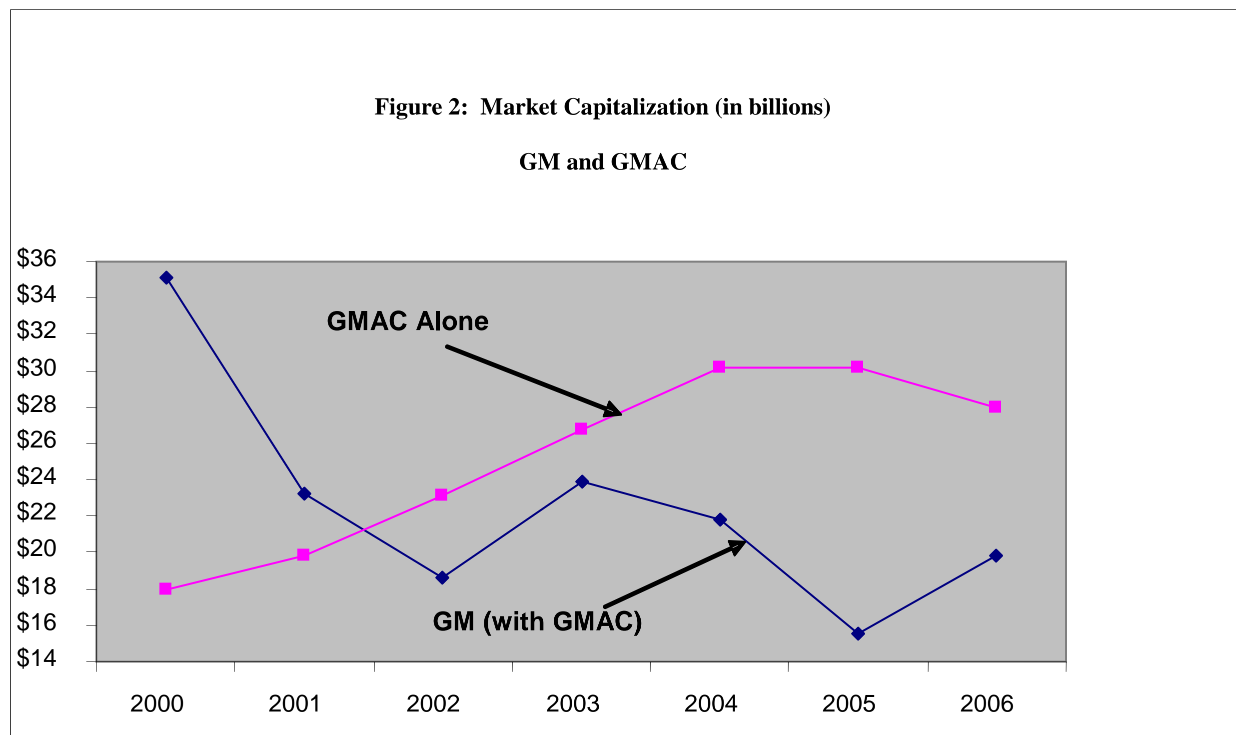
	9/30/00	9/30/01	9/30/02	9/30/03	9/30/04	9/30/05	9/30/06
Assets	$ 160.2	$ 180.4	$ 211.0	$ 275.8	$ 311.8	$ 314.2	$ 309.8
Liabilities	146.7	165.4	193.5	255.6	289.0	291.4	288.7
Equity	13.5	15.0	17.5	20.2	22.8	22.8	21.1
Market to Book Multiplier	1.32	1.32	1.32	1.32	1.32	1.32	1.32
Estimated Market Capitalization	$ 18.0	$ 19.9	$ 23.1	$ 26.7	$ 30.1	$ 30.2	$ 28.0

For comparison, the market capitalization of GM as a whole (including GMAC) is shown in Table 7:

Table 7: GM Market Capitalization (in billions) 2000-2006

	9/30/00	9/30/01	9/30/02	9/30/03	9/30/04	9/30/05	9/30/06
GM Shares Outstanding	564.9 m	555.5 m	560.4 m	560.7 m	564.8 m	565.5 m	565.6 m
Market Price Per Share	$ 62.13	$ 41.72	$ 33.25	$ 42.67	$ 38.55	$ 27.40	$ 34.92
Market Capitalization	$ 35.1	$ 23.2	$ 18.6	$ 23.9	$ 21.8	$ 15.5	$ 19.7

The graphical comparison of the market capitalization of GMAC independent of the GM consolidated entity shown in Figure 2 provides a very compelling reason for management to consider the sale of their most profitable business unit:



By 2002 the estimated market value of GMAC began to exceed the market capitalization of the consolidated GM entity, thereby creating an enticing opportunity for an outside investor to mount a takeover bid and then sell GMAC alone for more than the purchase price. By 2005 the pressure for a transaction of some type was mounting, as GMAC's market capitalization of $30 billion was almost exactly twice that of the consolidated GM entity. If GM didn't act to monetize the unrecognized market value of GMAC, then an unfriendly suitor might. On

the other hand, if GM sold off a portion of the financing unit, it would simplify GM's balance sheet, increase its liquidity, improve GMAC's access to low-cost debt financing, and unlock GMAC's market value for the benefit of its own shareholders rather than for a corporate raider. Seen in this light, the partial sale of GMAC was not really a surprise, but more an inevitability.

CONCLUSION AND EPILOGUE

GM's initial divestiture strategy was build on strong foundations: the sale of 51% of GMAC to Cerberus afforded it a level of independence that would provide better access to funding, an improved credit rating and a correspondingly lower cost of borrowing; simultaneously, the deal would streamline GM's balance sheet as well as allowing the monetization of a major asset that had long been undervalued in the financial markets. GMAC CEO Eric Feldstein suggested that GMAC's profits could double with a better credit rating and that GM would be better off with $14 billion cash and 49% of an improved GMAC than with 100% of the old operation. The sale of the majority interest presented opportunities for growth and expansion into new markets, as Cerebrus offered capital, resources, experienced management and industry expertise. However, in the commercial world even the best-laid plans sometimes go astray, and the results of the divestiture have thus far been disappointing.

Any hope that the sale to Cerberus would help market values was dashed by high oil prices and Toyota's recent dethroning of General Motors as the world's largest auto manufacturer. By early 2008 GM's market capitalization had fallen to $9 billion, less than half of what it was before the GMAC transaction closed.

However, the main culprit in GM's foiled divestiture strategy has clearly been the recent sub-prime loan crisis, which had a devastating impact on the ResCap division of GMAC. In 2007 GMAC announced a provision for loan losses of $3.1 billion, which was three times the level reported in 2005. As a result, GMAC reported a huge loss and GM had to book a loss of $1.25 billion on its remaining equity-method investment. Not surprisingly, the hoped-for credit rating improvement did not happen; in May 2008 GMAC debt was rated B+ by Fitch and the ResCap division carried a separate S&P rating of CC, or just above default status. By the end of 2007, GMAC's average risk premium was 1.97%, resulting in an increased average borrowing cost of 84 basis points from the November 2006 sale. Freeing GMAC from GM was a theoretically a sound idea and would probably have been successful if GMAC had not had a millstone around its neck in the form of a huge subprime loan exposure at ResCap.

What are the lessons to be learned from the GMAC sale? First, while you may love an operation and hate to part with it, you may have to sell it in order to save it. GMAC under GM control and with GM's credit rating was no longer a viable business. Second, partial divestiture is messy and full of pitfalls, but it can be a sound strategy in a given set of circumstances; half of a fresh loaf is better all of a stale loaf. Finally, even a well thought out divestiture strategy can be ambushed by an event as tumultuous as the subprime loan crisis.

AUTHOR INFORMATION

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