

# Fixed Income Research

Aerospace/Defense  
Autos/Automotive Suppliers  
Industrials/Manufacturing  
Services  
Technology

## 2006 Outlook

**High Grade  
Aerospace & Defense/  
Autos/Technology/  
Diverse Manufacturing  
2006 Outlook**

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We are maintaining our marketweight recommendation for aerospace and defense as companies continue to see robust cash generation.

- Boeing and its major suppliers in our coverage universe (GR, HON, and UTX) can easily fund the R&D for new aircraft without stressing balance sheets.
- If equity prices of defense players stall on slower spending growth, this may increase pace of share-holder friendly actions. However, we do not expect any of the major primes to be so aggressive with shareholder-friendly actions (in an effort to compensate for the slower top-line growth) that they would materially damage their credit profiles.



## Aerospace

- U.S. carriers remain financially challenged, but we expect continued strength in commercial orders outside North America should sustain strong backlog.
- High oil prices can help rather than hurt demand in strong macroeconomic backdrop.
- High order activity in '05 should start driving higher deliveries in '06, risks of supply chain bottlenecks.
- Single digit traffic growth should support aftermarket demand.
- Exogenous risks remain (e.g. terrorism, avian flu) but 9/11 and SARS showed that the fears were worse than the financial impact on aerospace companies we cover.



## Defense:

- FY2006 appropriations bill included \$148.6 billion for the investment accounts, up from the President's request (\$146 billion).
- FY2007 budget to be presented Feb '06, we continue to believe that "cuts" are likely to result in slower—but still positive—rates of growth.
- We do not expect any program revisions (QDR, budget) to significantly challenge the credit fundamentals of the major primes.



We reiterate our marketweight recommendation for the technology sector.

- Despite high energy prices and rising interest rates, we expect the economy to remain supportive for tech spending (BSC econ forecast 2006 real GDP 3.8%, PCE 3.6% business equipment 8.3%).
- Some names in this sector have increasingly become subject to speculation about LBO possibilities, with much of the current focus on CSC and FDC.
- When names like CA are tossed about this runs counter to our view that a LBO of a company with an enterprise value significantly above \$10 billion likely requires the company to have substantial securitizable assets to supplement the debt raised in the bank loan and high yield bond markets.



We maintain our marketperform recommendation for FDC -- though we see this is a binary situation in which spreads an either rally or sell-off substantially based on scenarios that we currently have a hard time handicapping:

- On its own, we would not be overly concerned about a separated Card as we would not expect ratings to fall below single-A. Given that spreads are currently cheap for a single-A issuer, we would view the credit as attractive if we were convinced that this was the extent of capital structure change. Unfortunately, we are not convinced that this is necessarily the case
- Certain of FDC's businesses are ratings sensitive, which has led management to assert a desire to maintain single-A ratings in the past but, it is possible to envision scenarios in which these are separated with existing debt remaining at a much more leveraged Western Union as the successor entity
- Ultimately we believe it more likely that the final outcome will be beneficial to bondholders but that near-term headline-driven volatility could persist. Furthermore, given still relatively tight spread levels compared to some possible outcomes, we would think it prudent for particularly risk averse investors to reduce exposure into recent strength
- CDS more risky than cash as some scenarios could entail tender for existing debt before levering up successor entity.



We have a marketperform on CSC even though we are not generally fans of the IT outsourcing field, and like FDC, this remains a binary situation:

- Press reports cite a possible deal with HPQ and private equity joint bid
- While the structure cited in the media is somewhat more credible in our mind than the previously speculated LMT/private equity, we still believe it difficult to achieve sufficient IRR at \$65/share
- Even if deal is done, relatively limited room for secured debt, and relatively small size of outstanding debt in relation to deal size, suggest possibility of tender
- Press reports suggest a possible call option for HPQ on private equity stake, if so could limit downside



We are maintaining our marketweight recommendation on capital goods and diverse manufacturing:

- We still expect most of the names in this group to continue seeing strong fundamentals as the economic up-cycle moves forward. Indeed, many key end-markets suggest room for sustained demand at strong levels through this year
- Despite the positive fundamental environment, at current levels, we do not believe that names like Caterpillar, Deere, Emerson Electric, Honeywell, and United Technologies have much room to benefit



We recently moved to an outperform on Tyco bonds and maintain a marketperform on Tyco CDS, and post the announcement are upgrading CDS to outperform.

- On January 13, Tyco announced that it will split into three public companies: Electronics (\$12.0 billion of revenue and \$1.9 billion of 2005 operating income), Healthcare (\$9.5 billion and \$2.3 billion), and Fire Security/Engineered Products and Services businesses (\$18 billion and \$1.9 billion)
- All three businesses to be capitalized in such a way to provide solid investment grade ratings. The company's existing debt is expected to be allocated among the three companies or refinanced
- Concurrent with announcing the deal, Tyco lowered its first quarter and full year earnings guidance owing to weaker than expected revenue and margins in its fire and security and healthcare businesses. While the earnings revisions were negative and the breakup can pose more risk to operating performance given the potential distractions, we ultimately believe that resolution of this issue should finally lift the cloud of uncertainty that has hung over this name
- Prior to the formal announcement we believed that bondholders would likely be taken care of, but that some of the scenarios could have held somewhat greater risk for CDS. With the break up now formally announced and Tyco making it clear that it will seek to capitalize the surviving entity with a solid investment grade balance sheet, it appears that upside remains for both cash and CDS



We are maintaining our outperform rating on GM and Ford and marketperform on Chrysler:

- As we look into 2006 we see spread performance driven by questions about supply disruptions, consumer resilience, volume and mix, cost control, restructuring, product acceptance, capital structure, and size of float
- Our continued long-term outperform ratings on GM and Ford remain grounded, not in the expectation that they are likely to become great companies any time soon, but rather in the belief that the pervasive negativity regarding the sector in general, and these two companies in particular, is exaggerated

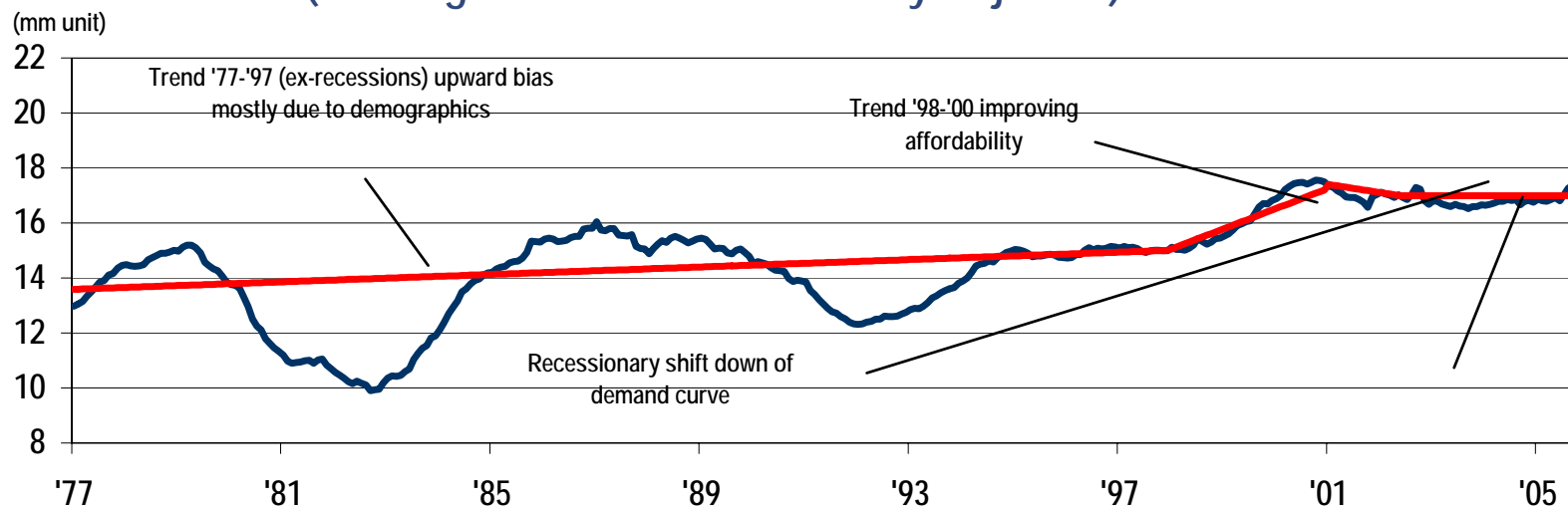


- We continue to believe that product cycles matter and that restructurings can stabilize both companies enough to live to fight another day. This is critical in our view because we believe—both from the point of view of competitive position and the drag of legacy costs—that time is their friend
- With the index transition of Ford winding down, we believe that the major drivers for the auto basis will revolve around the Delphi situation and GM asset sales. We still anticipate outcomes that take the auto basis tighter on both fronts
- While the timing of news is tough to handicap, we would advocate living with the interim mark-to-market volatility rather than waiting for the headlines to occur before taking positions. We continue to favor front-end GMAC securities and long maturity GM securities



- As the economy exits recession it often takes a fair bit of time for demand to return to non-recessionary levels.
- U.S. auto sales did not rise back to the non-recessionary trend line until the end of 1984 following the 1980-1982 double dip and into 1994 following the 1990-1991 recession. What some often refer to as pent up demand, to us appears to be more of a normal cyclical shift in propensity to consume.
- If we view a typical economic cycle as a 7–10 year period usually consisting of a fairly short period of actual recession, a somewhat longer period of uncertain recovery, and often an even longer period of sustained expansion, we would argue that the economy is likely in the process of shifting from the second phase to the third.

## Sales Trend (TTM Light Total—Not Seasonally Adjusted)

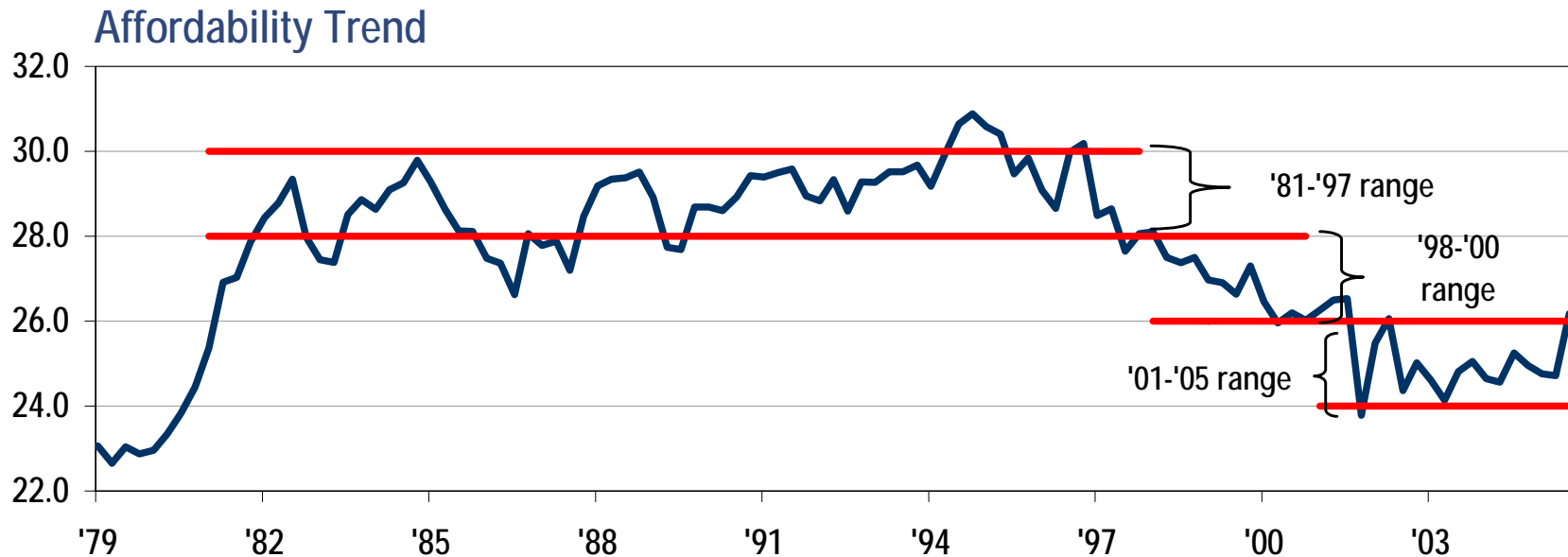


Source: Bear Stearns; Dept. of Commerce

# Autos—Demand Dynamics



- We believe that as in previous recessions, propensity to consume did indeed decline, shifting the demand curve down. However, we also note that over this period we continued to see significant improvements in affordability, shifting us out on the lower demand curve - resulting in only fairly moderate declines in quantity demanded.
- Affordability improvements in recent years were driven by low interest rates, sustained high levels of employment supporting consistently positive disposable income growth, and rapidly escalating incentive levels.



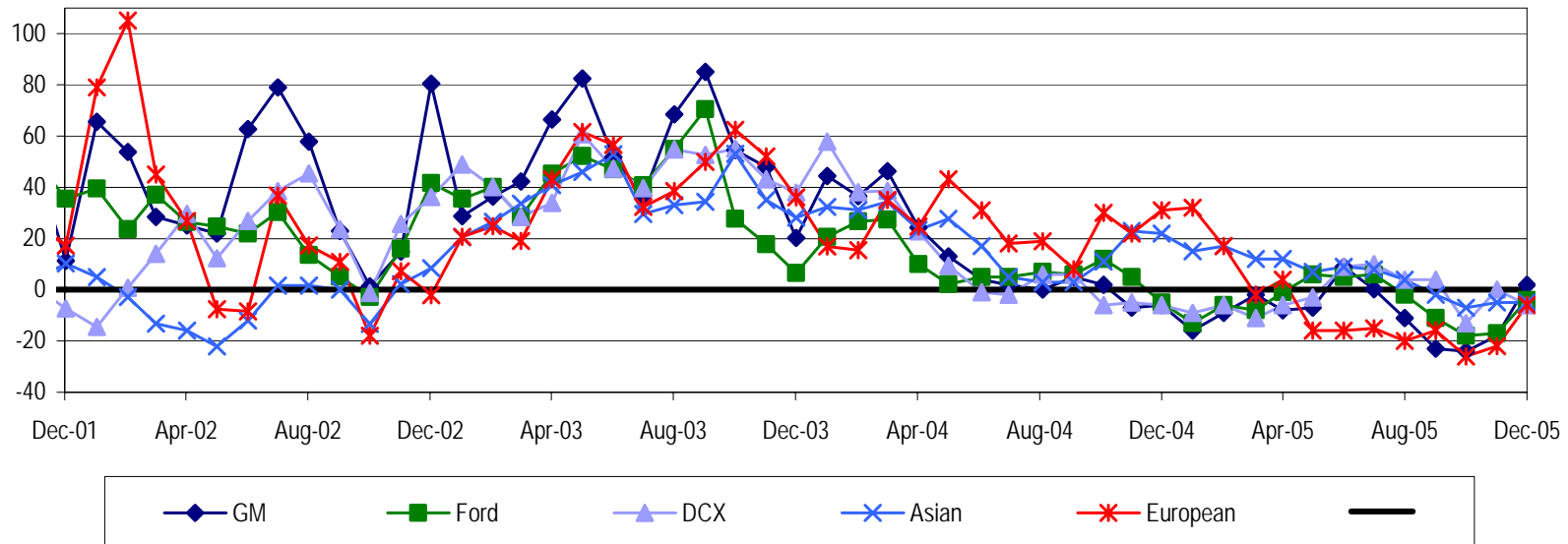


- Given our economists forecast for continued robust growth we expect to see continued strength in auto demand in 2006, with variation in quantity demanded largely reflecting affordability.
- We expect interest rates to be a significant drag on affordability, with this perhaps even exacerbated by continue trading up by consumers. However given our economists outlook for healthy growth in personal income, we believe that the net impact of the macro-economy on auto affordability is likely to be fairly neutral and that pricing decisions by auto makers will play the larger role.



- We have made the argument that the economic recovery should have somewhat supported pricing, and the BSC economic forecast suggests that pricing should remain positive.
- Indeed, we believe that the last twelve months have seen flat to positive net price retention as reflected by declining year-over-year incentive levels.
- While this does not always correspond perfectly to net pricing, anecdotal comments from the Big Three also support the contention that the severe negative net pricing pressure had begun to ease by late 2004.

Year-Over-Year Percentage Change in Incentives

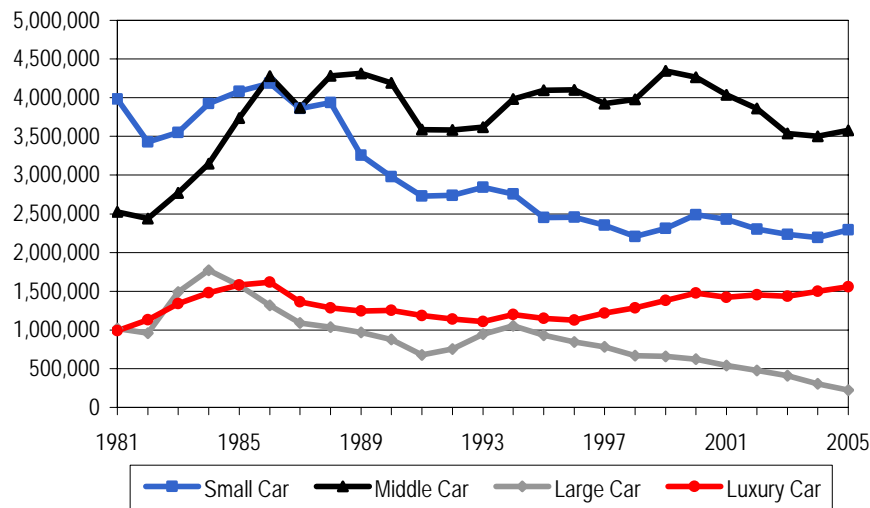


# Autos—It's In the Mix

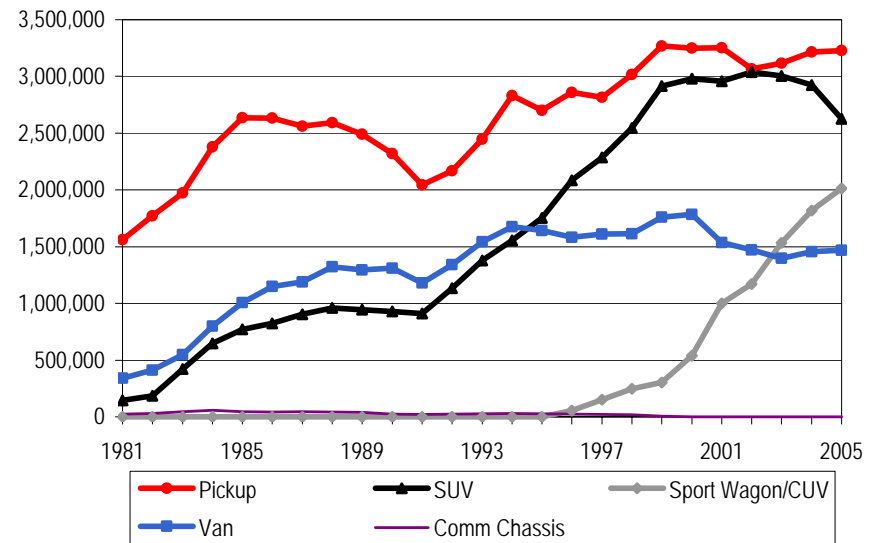


- While the overall market stayed robust, and pricing pressure was less than in some recent years...Ford and GM lost market share at a precipitous rate, and lost that share in the very vehicles that carried the richest margins for them.

U.S. Market New Vehicle Sales by Car Segment (1981–2005)



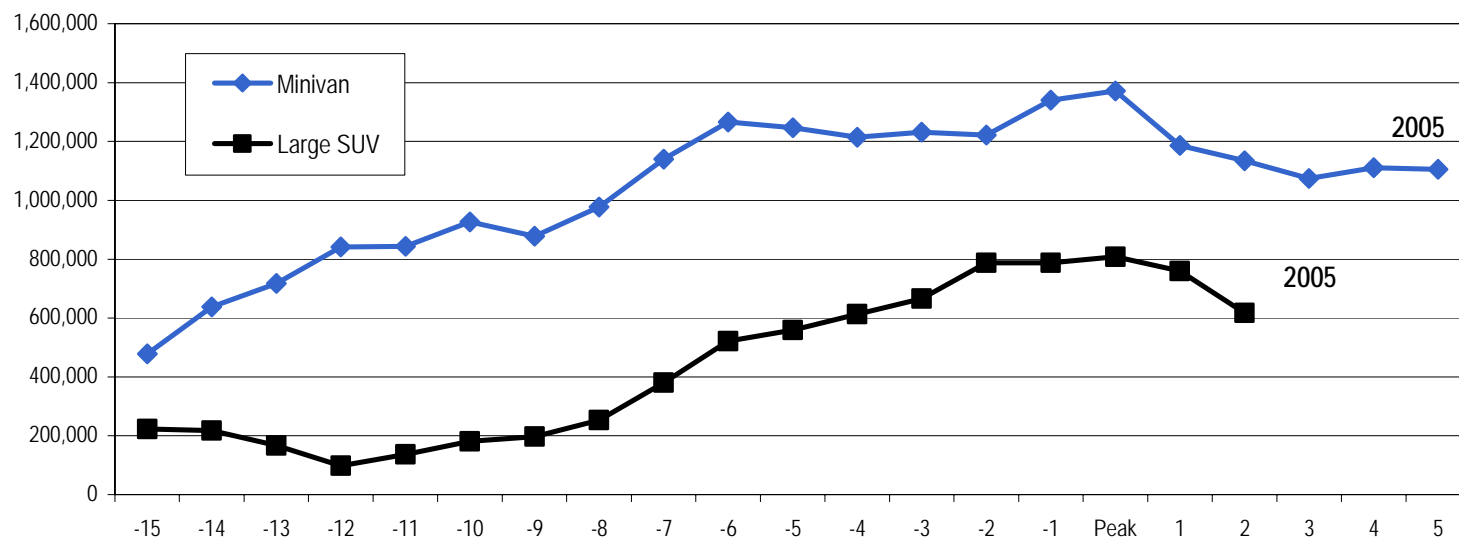
U.S. Market New Vehicle Sales by Truck Segment (1981–2005)





- The weakness has largely been focused on SUVs—and even among these we believe that there have been different dynamics at play.
- In midsize SUVs we believe that the proliferation of the CUV by most manufacturers has been the largest driver of pressure by Ford and GM.
- On the larger SUV side we believe that changing preferences and product cycles played larger roles.
- If the pattern seen with minivans is any indication then the decline is largely behind us. Unlike midsize SUVs, we believe that crossovers are a much weaker substitute for the natural buyer in this segment, though there may be some substitution into pickups as more offerings appear with larger and better quality interiors.

## Minivans vs. SUVs



Source: Autodata

# Autos—Quality and Dependability



- The Big Three have been closing the gap for several years in initial quality versus the transplants.
- We see the same trend beginning to emerge in the longer-term dependability data.
- Perception currently lags reality, but we do not expect this trend to continue indefinitely.

**J.D. Power Vehicle Dependability Study Problems Per 100 Vehicles**

NAMEPLATE	2005	2004	2003	2002	2001
Lexus	139	162	163	159	173
Porsche	149	240	193	278	292
Lincoln	151	194	212	282	253
Buick	163	187	179	279	298
Cadillac	175	196	209	280	285
Infiniti	178	189	174	194	219
Toyota	194	216	201	276	278
Mercury	195	224	240	287	311
Honda	201	209	218	251	278
Acura	203	212	196	228	255
BMW	225	264	262	281	320
Ford	231	276	295	<	361
Chevrolet	232	262	272	<	<
Chrysler	235	285	295	<	<
<b>Industry Average</b>	<b>237</b>	<b>269</b>	<b>273</b>	<b>355</b>	<b>382</b>
Saturn	240	267	273	<	355
Oldsmobile	242	314	283	<	354
GMC	245	262	269	<	<
Pontiac	245	297	293	<	<
Mazda	252	285	288	337	<
Hyundai	260	375	342	<	<
Subaru	260	288	266	314	353
Volvo	266	346	330	<	<
Jaguar	268	310	247	N/A	250
Dodge	273	298	312	<	<
Nissan	275	280	267	321	371
Mitsubishi	278	327	339	<	<
Mercedes Benz	283	327	318	<	296
Saab	286	265	255	<	362
Jeep	289	314	321	<	<
Suzuki	292	365	403	<	<
Audi	312	295	318	<	328
Daewoo	318	411	421	N/A	N/A
Isuzu	331	393	368	<	<
Volkswagon	335	386	391	<	<
MINI	383	N/A	N/A	N/A	N/A
Land Rover	395	472	441	<	<
Kia	397	432	509	<	<

Note: < denotes below industry average

# Autos—Product Updates



General Motors Corp. [GM]	Jan-Nov/05 Volume	Model Year (unless noted)	
		Last Major Change	Expected Major Change
Buick LaCrosse	85,879	2005	N/A
Chevrolet Cobalt	195,839	Q400	N/A
Chevrolet Impala	224,295	2006	N/A
Chevrolet Malibu	148,719	2004	N/A
Chevrolet Colorado	119,531	2004	2009
Chevrolet Equinox	120,675	1999	2010
Chevrolet C/K Suburban	107,075	2000	2Q06
Chevrolet Silverado / C/K Pickup	637,211	1999	2H06
Chevrolet Tahoe	137,399	2000	1Q06
Chevrolet TrailBlazer	220,414	2002	2008
GMC Envoy	99,177	2002	2Q07
GMC Sierra 1000-3000 Pickup	208,157	1999	2H06
Buick Lucerne	3,009	Add 2006	N/A
Pontiac G6	112,202	2005	N/A
Pontiac Grand Prix	114,686	2003	2009
Pontiac Torrent	5,982	Add 2006	N/A
Saturn ION Coupe / Sedan	94,146	2003	N/A
Saturn Vue	84,271	2006	2010
Yukon/Yukon XL	114,072	2000	1Q06/2Q06

Ford Motor Company [F]	Jan-Nov/05 Volume	Model Year (unless noted)	
		Last Major Change	Expected Major Change
Ford Focus	173,805	2001, replaced Escort	2008
Ford Fusion	9,415	Add 2006	N/A
Ford Freestyle	70,889	Add 2005	2008
Ford Mustang	150,749	2005	facelift 2009
*Ford Taurus	181,929	2000	Drop Wagon 2005, Drop sedan 2010
Ford Econoline Van	134,837	1997	No Major Change Expected
Ford Escape / Hybrid	152,752	2004	1Q07
Ford Expedition	104,552	2002	2007
Ford Explorer, Sport, SportTrac	220,792	2000 Sport trac / 2002 Explorer	2008
Ford F-Series	811,972	2004	1Q08
Ford Ranger Pickup	112,524	1998	2010
Ford Five Hundred	99,611	Add 2005	N/A

\* Replaced with Five Hundred, Freestyle, Fusion

DaimlerChrysler Corp. [DCX]	Jan-Nov/05 Volume	Model Year	
		Last Major Change	Expected Major Change
Chrysler 300	131,846	2004	2010
Chrysler Pacifica	78,329	2004	2009
Chrysler PT Cruiser	123,573	2005	2008
Chrysler Town & Country	164,836	2005	2008
Chrysler Sebring	84,687	2001	2007 replace
Dodge Neon	108,954	1999	2Q06, replaced with Dodge Caliber
Dodge Caravan	207,732	2005	2008
Dodge Durango	109,024	2004	2010
Dodge Ram 1500-3500 Pickup	369,565	2002/2003	2009
Dodge Nitro (mid sized SUV)	---	---	Add 2H06
Jeep Grand Cherokee	191,852	2005	2011
Jeep Patriot (small SUV)	---	---	Add 2H06
Jeep Compass (small SUV)	---	---	Add 2H06
Jeep Liberty	149,218	2005 refresh	2010

# Q&A



# **2006 High Yield Sector Outlook**

**Aerospace/Defense  
Automotive Suppliers  
Industrials/Manufacturing  
Services  
Technology**

**Alexi Coscoros**





- Recovery in commercial aviation could continue to be driven by better-capitalized international carriers (particularly in Asia and the Middle East)
- Deferral of domestic aircraft purchases has increased the need for aircraft refurbishment already significantly delayed
- Commercial launch of the A-380 could drive wide-body equipment demand
- Emergence from Ch. 11 of select carriers to prove a short-term sector positive; consolidation is a more pressing need
- Recovery in the business jet market benefiting select issuers
- Sector remains susceptible to geopolitical risks and other exogenous factors
- Marketperform: Sequa
- Underperform: BE Aerospace

# Defense - Marketweight



- Department of Defense Budget could experience low-single-digit growth through 2010
- Iraq-related Defense Budget Supplemental request could provide additional revenue upside
- 2005 Quadrennial Defense Review and fiscal 2007 Budget request, expected in February, could provide further clarity on anticipated program cuts
- Department of Homeland Security spending increase could materialize in 2006
- Strong cash flow generation likely to support tight trading levels that remain attractive relative to investment-grade peers
- Marketperform: L-3 Communications, DRS



- Industry fundamentals likely to remain weak for Ford- and GM-exposed suppliers
- Ford and GM expect flat sales in 2006, while production visibility remains poor
- Suppliers to Ford less likely to benefit from new product launches; instead, focus is on Jan. 23 turnaround plan
- Suppliers to GM have greater new-product launch upside; e.g. GMT-900; nevertheless, higher gas prices are influencing consumer affinity to higher-margin SUVs
- Persistently high raw-material prices and OEM-driven parts pricing pressure could continue to depress supplier margins
- A potential UAW strike at Delphi remains the principle short-term risk
- High yield supplier credits feature highly leveraged capital structures, very thin margins and poor liquidity



- Credit metrics are likely to deteriorate, with asset coverage eroding further as companies raise additional liquidity
- Further bankruptcies across the supply chain are likely, absent an improbable reversal in market-share gains by Japanese OEMs from Ford and GM
- Suppliers could benefit from consolidation, although OEM tolerance of decreased pricing power remains uncertain
- Commercial-truck sector to remain robust ahead of stricter emission standards coming into effect in 2007
- Trading levels could remain volatile, and fundamentals are less relevant against backdrop of potential Delphi strike and GM bankruptcy talk, and the impact of Ford and GM's North America restructuring programs on the supplier base
- Not an attractive entry point for value investors yet; Ch. 11 not a supplier cure-all, absent radical turnaround at Big Two



- This remains a trading sector, and we only recommend buying the dips and selling the rallies on a paired-trade basis (including a combination of cash, CDS, senior secured, unsecured, subordinated, convertible debt, equity, options, higher vs. poorer quality, OEMs vs. Suppliers)
- The following credits are listed within each tier in order of descending credit quality:
- Tier 1 (Fallen Angels): ArvinMeritor; American Axle and Manufacturing; Lear; Cooper Tire & Rubber; Goodyear Tire & Rubber; Dana; Visteon
- Tier 2 (Moderate Near-Term Risk): Tenneco; Cooper-Standard Automotive; Mark IV Industries
- Tier 3 (High Risk): Hayes Lemmerz International; Metaldyne; Advanced Accessory Systems; Dura Automotive Systems; Autocam; Remy International



- U.S. capacity utilization has increased to 80.2% in November 2005 from an April 2003 low of 74.6%
- Broader U.S. capital expenditures are expected to increase
- Chemical, Commodity (including NA agriculture), Construction, Energy and Transportation sectors are strong
- Risks to the sector include impact of higher interest rates on economic activity; energy, plastic resin and steel costs; a potential residential construction slowdown; exposure to the auto sector; and the potential use of strong free cash flow for acquisitions after a two-year slowdown in M&A activity
- Principal secular risk remains correctly gauging the opportunity and threat posed by growth in China and India
- Outperform: Itron
- Marketperform: Gardner Denver, Greenbrier Companies

# Services - Overweight



- Services companies could continue to benefit from the overall improvement in the economy and strong capacity utilization
- Demand for temporary employment services remains strong
- Risks to the sector include the impact of higher interest rates on economic activity, a potential residential construction slowdown and a continued inability to pass on labor-cost inflation in addition to a tightening labor pool
- Outperform: Clarke American, Insurance Auto Auctions
- Marketperform: Allied Security Holdings, Iron Mountain
- Underperform: Danka Business Systems



- Technology end-markets could post single-digit growth
- Telecommunications capital expenditures could increase, following completion of merger activity
- Select high yield issuers feature investment-grade-like credit statistics, including strong free cash flow
- EMS, IT services and telecom equipment consolidation could occur
- Risks include shareholder friendly activity, e.g. share repurchase programs, leveraged buyouts
- Outperform: Telcordia Technologies
- Marketperform: Lucent Technologies, Nortel Networks
- Underperform: Unisys

# Q&A



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