

Special Comment

Moody's Global Corporate Finance

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U.S. Automakers: Credit Implications of Three Scenarios Have Broad Reach

Summary

This Special Comment describes three bailout and bankruptcy scenarios for Detroit automakers Chrysler, Ford, and GM. We assess the probabilities of these dire scenarios and discuss their differing implications on industries ranging from U.S. banks to chemical manufacturers. The three scenarios we explore in this report are:

- government bailout;
- prepackaged bankruptcy with government assistance;
- freefall bankruptcy.

In "Three Automaker Scenarios" (page 2), we describe the scenarios, their probabilities, and the implications each scenario has for the three automakers.

In the articles that follow, we address how these scenarios affect different industries, beginning with an overview of how the entire economy would be affected.

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To further discuss this topic Moody's has scheduled a teleconference for Tuesday, December 16th beginning at 10:00AM EST/15:00 GMT/16:00 CET. For more information visit <http://www.moody's.com/events>.



Moody's Investors Service

US Automakers: Credit Implications of Three Scenarios Have Broad Reach

Implications of Three Automaker Scenarios

The big three domestic auto manufacturing companies have asked the US government to provide urgent financial assistance. GM and Chrysler have stated that a sudden bankruptcy filing could occur within the month. Although Ford's liquidity position may allow the company more time, its management has indicated that a filing by the other companies would cause stress that might prompt a near term filing by Ford as well. In this special comment, we describe three bailout and bankruptcy scenarios for Detroit automakers Chrysler, Ford, and GM. We assess the probabilities of these dire scenarios and discuss their differing implications, including losses for auto manufacturer debt holders.

The three scenarios and their estimated probabilities are:

- 1. A 25% probability of a government bailout without a near-term automaker bankruptcy.** Under this scenario, a comprehensive bailout package is agreed to that enables the automakers to restructure without any bankruptcy filings during 2009. The degree of economic disruption and direct financial loss for investors is contained, at least in the short term. However, the risk exists that the reorganization will be inadequate and that at least one of the automakers files for bankruptcy beyond 2009 anyway. Bondholder losses would be the least in this scenario.
- 2. A 5% chance of a "freefall bankruptcy" without a prepackage plan and without government involvement.** This scenario involves the most significant disruption to the economy, including potential bankruptcies in associated industries such as auto parts suppliers and auto dealers. The erosion of franchise value caused by negative consumer sentiment toward the Detroit-3 automakers would make the reorganization process more complex and a chapter 7 liquidation of at least one of the automakers would be possible. Bondholder losses could be in the 75-100% range in this scenario.
- 3. A 70% chance that a prepackaged bankruptcy filing coupled with government financial assistance will be needed to restructure.** While a prepackaged bankruptcy might be the best approach to current problems, achieving timely agreement from a broad range of creditors for a prepackaged bankruptcy would be highly difficult, especially given the critical funding status of GM and Chrysler. To facilitate the process, the government would provide immediate stopgap financing to bridge the companies until a prepackaged agreement can be reached sometime in early 2009. In addition, the government would offer support by providing or guaranteeing debtor-in-possession (DIP) financing. Bondholder losses would probably be less than 75% in this scenario.

Government Bailout

We ascribe a 25% probability to the scenario that U.S. government bailout funding is provided without any bankruptcy filings by the car companies. This assessment considers the urgency of the situation—GM and Chrysler have indicated that they lack adequate cash to continue operating beyond year end without government support—balanced against the greater complexity and near-term risk that might be associated with other scenarios in the current macroeconomic environment.

Under this scenario, car companies would implement out-of-court restructurings under heavy government supervision. Through various regulations attendant to receiving government funds, and the naming of a "Car Czar" to administer the program, the government would oversee the reorganization of the car companies in much the same way as a court would oversee a company going through bankruptcy reorganization. The goal would be to achieve a restructuring of the businesses without the stigma and complexities of a bankruptcy filing.

Avoiding such stigmas and complexities is important to the ultimate success of the process. We expect a reorganization of the car makers under this scenario would involve some market share loss as consumers defect to non-U.S. brands, but the magnitude of loss could be limited to a single-digit percentage of market share. In other scenarios involving bankruptcy filings, market share loss would likely be more significant.

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If the magnitude of market share loss can be contained, the scope of the restructuring that will need to occur is less. Under this scenario, with single digit market share loss, we believe that capacity of the Detroit-3 would still need to be reduced by at least 15% and that headcount reductions would be around 20,000. These are still significant endeavors, but represent more manageable initiatives than needed under other scenarios.

A key problem under this scenario is the risk that any restructuring done outside of the bankruptcy process will have a "negotiated" result that is less significant and less complete than one implemented by the bankruptcy courts. The bankruptcy process brings with it important restructuring options, such as the ability to reject contracts. Absent such capabilities, the restructuring achieved under this scenario might be inadequate and leave the Detroit-3 with cost structures and financial conditions that do not position them for long-term success.

Given the significant reduction in auto demand and the potential for elimination or radical scaling back of some brands or models, the ability to address contracts with suppliers could be critical to any restructuring program. Labor agreements, particularly with the UAW, will also need to be assessed, particularly if headcount reductions and benefit changes are required to achieve the stated goal of near-term cost parity with transplant automakers. If the magnitude of restructuring achieved under this scenario is inadequate, bankruptcy filings could still occur at later dates, and the bailout funding would have merely delayed the process. The proposed use of a Car Czar to oversee the bailout process could provide an offset to this risk, but the specific responsibilities and powers of the position have not been detailed.

Another problem associated with this scenario is establishing the priority of claim that any government bailout funding would have in relation to existing creditors. Because the auto companies have already pledged significant portions of their assets to secure existing debt, the ability to offer a meaningful security package for any new government funding is limited. However, the government would want to ensure that its bailout funding achieves a priority status. Resolution of this issue will be complex and could leave any funding structure subject to court challenges.

Another consideration associated with this scenario would be the reduced likelihood that any pension obligations would be put to the Pension Benefit Guaranty Corporation (PBGC). In the current market environment, it is likely that poor returns on pension assets will drive the underfunded status of automaker pension plans higher, working against the improvements being sought through restructuring.

Under this scenario, we believe losses for investors, while less than under other scenarios, could still be significant if the companies use distressed exchange transactions to restructure their balance sheets. GM has already indicated that it is considering such initiatives and they could involve losses of 50% of par value for investors. Ford has repurchased small amounts of its debt in the open market at values below par, but has not indicated any plans to pursue a distressed exchange. Chrysler only has bank debt outstanding; all of its bond obligations were retained as obligations of Daimler at the time of sale. Depending on the terms and conditions of any government bailout program, automakers could be pushed to seek concessions from existing debtholders that could result in losses.

Freefall Bankruptcy

Freefall bankruptcy filings by the automakers, without a prepackaged plan and without government support, would be the most problematic scenario for the industry, but we only put its probability at 5%. This scenario would significantly increase the difficulty of successfully reorganizing and cause collateral damage to other sectors that rely on or support the automakers. We believe a freefall bankruptcy filing by Ford in the near term is less likely than it is for the other two car makers. A freefall bankruptcy filing by Chrysler alone might not drag down the other two car companies, but a freefall filing by GM alone or by Chrysler and GM simultaneously would have a high likelihood of sufficiently disrupting the supplier base and consumer sentiment to result in a filing by Ford as well.

With a freefall bankruptcy, we expect greater defection of car buyers to non-U.S. brands. In such a case, the collective market share loss for the Detroit-3 could exceed 15 percentage points in the near term—particularly if Chrysler were unable to successfully reorganize. Such incremental market share loss, on top of already

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depressed shares, would mean that the Detroit-3 would need more significant restructuring actions and capacity reductions than those associated with the other scenarios. Capacity reduction would possibly approach 50% and headcount reductions would likely exceed 100,000. Similarly, dealer bases would need to be more aggressively reduced and auto parts suppliers would suffer more significant losses—many would follow their car maker customers into bankruptcy. Because residual values of autos made by the Detroit-3 would likely erode more significantly under a freefall bankruptcy scenario, finance companies that support auto sales would likely experience much higher loan losses and find their business models unsustainable. In short, under a freefall scenario, the scope of restructuring required before any of the auto companies could emerge from bankruptcy would need to be very deep and very broad, including not just the car companies, but the large industrial complex that surrounds them as well. The complexity of such an endeavor would suggest that the process would take years to complete.

Despite the significant challenges of reorganizing after a freefall bankruptcy, we believe that Ford and even GM would successfully emerge from the process. The ability of Chrysler to emerge after reorganization under this scenario is less certain, and a Chapter 7 liquidation proceeding is a possibility.

Because of the extreme stress that would result from a freefall bankruptcy, losses for investors would be more severe than under the other two scenarios, and could be in the range of 75-100%.

Prepackaged Bankruptcy with Government Assistance

If restructuring outside of bankruptcy with a government bailout carries a risk of an incomplete or insufficient restructuring, and a freefall bankruptcy carries the risk of systemic disruption and higher losses, a compromise scenario is a prepackaged bankruptcy filing of the automakers with financial assistance provided by the government. This assistance would likely take the form of a stopgap advance of funds sufficient to bridge the auto companies until a prepackaged agreement could be negotiated as well as participation in the DIP financing either as a direct lender or as the guarantor of the DIP financing. We believe that this is the most likely way that a complete restructuring can be achieved and, therefore, estimate a 70% probability for such a scenario.

Achieving agreements with all of the parties necessary for a prepackaged bankruptcy would be highly challenging for a large complex credit such as an auto company. Consequently, we do not see a prepackaged filing of any of the auto companies happening before the second quarter of 2009. Given the liquidity pressures facing GM and Chrysler in particular, some government funds would need to be provided before year end to bridge the companies until a prepackaged arrangement could be negotiated.

Given the current status of the financial markets, the availability of government-sponsored DIP financing would also be critical to any such plan. Reorganization of the auto companies in bankruptcy would require multi-billion-dollar DIP facilities for each company, but such funding might not be readily available in the current tight credit markets. The government-sponsored DIP would provide the certainty of adequate operating funds to keep trade credit available to the companies.

The magnitude of restructuring that would occur under this scenario would likely be greater than under a bailout with no bankruptcy, but not as significant as under a freefall bankruptcy. Some consumer defection to non-U.S. brands would likely occur, but it would probably be contained to less than 10 percentage points of market share. Capacity reduction would likely be in the 20% range and headcount reductions in the 50,000 range.

We believe the potential loss for creditors under this scenario would exceed the loss that would occur in a scenario where the restructuring did not involve a bankruptcy filing, but will probably be less than the 75-100% range associated with a freefall bankruptcy scenario.

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Different Paths for Different Car Companies

While we have offered three broad scenarios which involve identical treatment of all three car companies, events could transpire that result in different outcomes for individual companies. For instance, even under a plan in which government support is provided to the industry outside of bankruptcy, the restructuring initiatives that each company pursues might not be equally successful, and a bankruptcy filing by one of them could still occur.

Chrysler, generally considered to have the most significant long-term business risks, might still find a bankruptcy filing necessary even if GM and Ford do not. Ford has indicated that it has sufficient financial resources to continue as a going concern as long as bankruptcy filings by GM and Chrysler do not cause significant disruptions in the supplier base. It is possible that under a scenario where the government provides DIP financing for GM and Chrysler, the degree of industry disruption could be contained and Ford might not need to use the bankruptcy process to reorganize. Also, in the case of a bailout program that does not involve bankruptcies, Ford might not elect to participate in the program if it deems the terms to be economically unattractive.

— Bruce Clark

The Economic Impact of a Big Three Bankruptcy

Mark Zandi is Chief Economist of our affiliate, Moody's Economy.com. The opinions are his own, and may not reflect the views of rating analysts in Moody's Investors Service.

The Big Three automakers are on the precipice of bankruptcy. Without immediate financial aid from the federal government, GM and Chrysler will soon run out of cash, and Ford will be hobbled as the automakers' shared supplier and dealer network crumbles. Freefall bankruptcy in the next few weeks would throw the broader economy into chaos, costing the economy 2.5 million jobs at its peak impact in summer 2010 and pushing the unemployment rate to a depression-like near 11%. The cost to the U.S. Treasury as tax revenues plunge and demands for government services soar in the eroding economy is an estimated \$240 billion in fiscal years 2009-10. This makes the \$14 billion request from GM and Chrysler appear insignificant by comparison.

Freefall Bankruptcy Now Means Liquidation

Without help from the government, the Big Three will enter bankruptcy and be effectively liquidated. GM and Chrysler are in the worst shape, burning through cash so quickly that they won't have enough to operate in a matter of weeks. Ford has a bit more financial latitude, but it too will be at significant risk of bankruptcy if GM or Chrysler fails, given the disruption to Ford's supply base, dealers and creditors. The financial pressure on the entire industry is rapidly intensifying as vehicle sales have crashed.

The automakers would file for Chapter 11, a restructuring, but that would likely turn into an effective Chapter 7, a liquidation. Their factories and other operations would be shut and their assets sold to pay creditors. Bankruptcy would probably cause a large drop in sales, unless vehicles are discounted to fire-sale levels. Few will want to buy cars from companies that may not be around to fulfill warranties or provide service. Falling resale values would also scare away buyers.

Making liquidation even more certain is the turmoil in the financial system and resulting credit crunch. So-called debtor-in-possession financing would be all but impossible to get. Bankrupt firms need such financing to pay suppliers, finance inventories and meet payroll while they restructure. Lenders who offer debtor-in-possession financing take significant risks even in good times, but they become senior creditors in bankruptcy court, standing first in line whenever a bankrupt firm's assets are distributed. Such lenders also earn high rates and fees. Yet in the current credit crunch, few if any lenders will want to risk financing the automakers in bankruptcy.

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Economic Fallout

Bankruptcy for the Big Three in the next few weeks or months would be very damaging to the sliding economy. The Big Three employ some 225,000 people in the U.S., but given their broad links into the rest of the economy, closer to 2.25 million jobs would be immediately at risk. The auto industry has among the largest economic multipliers of any industry. For every lost auto assembly job, another nine jobs are lost in other supplying industries (see Table 1). Those facing considerable negative repercussions include auto suppliers and dealers, steel and metal suppliers, plastic and rubber companies, healthcare providers and trucking and freight operators. As hard-hit workers and other stakeholders in these industries pull back their spending and investment, industries throughout the economy would be hurt.

Bankruptcy for the Big Three was simulated on Moody's Economy.com's macroeconomic model to quantify the resulting fallout. Under our baseline, or most likely, scenario, the Bush Administration provides just enough financial aid to the automakers to avoid immediate bankruptcy. A comparison scenario assumes that help is not forthcoming and the automakers file shortly after Jan. 1. In the case of just enough help to avoid immediate bankruptcy, our model sees vehicle sales plunge to an annual pace of 7.5 million units through the first half of 2009, far below the already distressed pace of around 10 million units annualized in the fourth quarter of 2008, and around 13 million units for all of 2008. In this scenario, domestic vehicle production collapses, with output of only 3.5 million units in the first half of 2009, as vehicle imports quickly increase and the Big Three's inventories are sold off at deep price discounts.

The hit to the economy under this scenario is devastating. Real GDP falls by more than 9% annualized in the first quarter of 2009 (see Table 2). This reflects the lost output of the Big Three on top of an already very weak economy. Even in the baseline scenario with no bankruptcy, real GDP is expected to fall, but by less than 3%. The bankruptcy costs the economy 2.5 million jobs at its peak impact in the third quarter of 2010. Of these job losses, approximately 1.4 million are at the Big Three and directly supplying industries. Unemployment peaks in summer 2010 at almost 11%, compared with a 9% peak under the baseline.

The impact is catastrophic on the industrial Midwest, where the Big Three's operations are centered. Michigan and Ohio have been in recession more or less since the beginning of this decade, and the collapse of the Big Three would undermine their economies well into the next decade. Other states significantly hurt include Indiana, Illinois and Wisconsin. Exacerbating the fallout, unemployed workers in the industrial Midwest would find it difficult to relocate nearer to the surviving foreign-owned auto plants in Kentucky, Tennessee or Alabama. That is because Midwestern house prices have fallen so sharply that many homeowners owe more on their mortgages than their homes are worth. To move would require them to either put up more cash or default on their existing loans.

Damaged Confidence

The fallout could be even more serious than anticipated in the bankruptcy scenario. It is difficult to gauge how a collapse of the Big Three would affect consumer and business confidence, which already is near record low levels. The image of GM as the backbone of American industry still resonates with many households, and a GM bankruptcy could cast a pall over the collective psyche. The current crisis of confidence is creating a self-reinforcing negative cycle that would be exacerbated by a Big Three bankruptcy.

It is also difficult to determine the degree of damage that such a bankruptcy would do to the fragile global financial system. It is assumed in our bankruptcy scenario that the financial fallout would be manageable. U.S. automakers have approximately \$100 billion in outstanding debt, and their captive finance companies have close to \$300 billion; most of this debt is secured, and little is held within the banking system. The automakers' debt has been rated below-investment-grade for some time and thus is not extensively held by pension funds and insurance companies; most is owned by investors who specialize in distressed debt. Moreover, the credit-default-swap market has already priced in a high likelihood of default. Nonetheless, the Big Three's financial relationships are not fully understood, and the systemic risks posed by their bankruptcy are unclear. A similar uncertainty caused policymakers to let Lehman Brothers fail—a mistake that helped precipitate the current financial panic.

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What's Next?

The Bush Administration is expected to provide the \$14 billion requested by GM and Chrysler to avoid immediate bankruptcy. Federal officials understand that bankruptcy would result in economic chaos; besides, the cost to taxpayers of not responding would be measurably greater than \$14 billion as tax revenues plunge and government spending rises to deal with a more severe recession. According to our simulation, bankruptcy would add \$240 billion to the budget deficit in fiscal years 2009-10.

Funds remaining in the Troubled Asset Relief Program—the TARP—to which Congress gave \$350 billion earlier this year seem the most logical source for the cash. The TARP was set up to address the economic crisis, and a collapse of the Big Three would certainly exacerbate the crisis.

However, the Big Three's problems will not be resolved for \$14 billion. We estimate it will cost the federal government between \$75 billion and \$125 billion to keep the Big Three out of bankruptcy over the next two years. This is based in part on the expectation that light vehicle sales will rise over the next three years, averaging close to 11 million units in 2009, 13.2 million units in 2010, and 15 million units in 2011. For historical context, vehicle sales averaged almost 17 million units annually from 1999 to 2006. Three factors drive the weak outlook: the current decline in employment and rise in unemployment; the severe credit crunch, which limits buyers' access to vehicle loans and leases, and the significant amount of spent-up demand created earlier this decade, when automakers used aggressive financial incentives to pump up sales.

The cost of keeping the Big Three out of bankruptcy also significantly depends on their ability to slow the decline in their share of total vehicle sales. Detroit's share has been falling since the mid-1990s from nearly three-quarters of the market to less than half in recent months. This reflects many factors, but most critically the higher price of gasoline in recent years. Gasoline went from as low as \$1 a gallon for regular unleaded at the start of this decade to more than \$4 a gallon this past summer. Prices have since receded to below \$2 a gallon, but the damage to the Big Three's market share has been done. Vehicle buyers still expect pump prices to rise again, and will not quickly return to buying the Big Three's less fuel-efficient vehicles.

The Big Three's market share will come under even more intense pressure given their current financial problems. Potential buyers will worry that a new car will not be serviced properly and that warranties might become void. Foreign automakers will also seek to gain market share through more aggressive marketing and discounting. Although some of these pressures may be mitigated by government help, they are unlikely to be dispelled.

Given the long-running decline in the Big Three's market share, prospects for higher gasoline prices in the future, and more intense competition, it will be very difficult for the Big Three to hold their market share. If they remain close to 50%, the cost of avoiding near-term bankruptcy will be only \$75 billion. If Detroit's share falls to 40% over the next two years, then the cost will be closer to \$125 billion.

Conclusions

Whether policymakers are willing to provide the Big Three this future aid will depend on numerous factors, including their own internal restructuring efforts, economic conditions, and other bankruptcy-related concerns. Odds are the Big Three's stakeholders, from creditors to vendors to the United Auto Workers (UAW), will concede just enough to satisfy policymakers and get the funds they need to avoid bankruptcy. The Big Three will become much smaller companies, and Chrysler could very well be dismantled and sold off, but this will be done outside of bankruptcy court. However, there is a significant chance that they will be unable to restructure sufficiently on their own, and that the costs of bankruptcy are eventually deemed by policymakers to be less than the cost of continued federal assistance.

A concerted, comprehensive and consistent government response to the current financial and economic crises is vital. The economy needs a large and prolonged dose of fiscal stimulus and a large foreclosure mitigation plan, but the government's resources are not unlimited and must be used wisely. The federal budget deficit, which topped \$450 billion in the 2008 fiscal year, will easily exceed \$1 trillion in the current fiscal year and again in fiscal 2010. Borrowing by the Treasury will be even greater, topping \$2 trillion this year. The

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automakers' current pleas for government help must be answered, but the \$14 billion that the Bush Administration is expected to provide will provide the automakers only a brief respite. The Big Three must make fundamental and ultimately very painful changes to justify more help from taxpayers and thus avoid bankruptcy. This will prove very challenging, and we must prepare for the real possibility that they will not succeed.

-- Mark Zandi

Auto Parts Suppliers

Government Bailout

If government bailouts are provided to automakers, the plight of the auto parts suppliers would be considerably easier than under other scenarios. It would be less likely that large numbers of parts suppliers would need to pursue bankruptcy filings during the near term. However, over the intermediate term, the restructuring of automakers that will take place with or without a bailout will cause considerable dislocation for parts suppliers. The potential for discontinuation of certain auto brands or elimination of models within brands suggests termination of some supply agreements and lower volumes of parts needed under ongoing agreements. Automakers will also seek to reassess contract terms on supply agreements with the objective of lowering costs. In sum, these actions will drive lower revenue for parts suppliers and require these companies to implement their own significant restructuring programs. In some cases, the magnitude of change needed will be significant, and bankruptcies of a number of auto parts suppliers would still be likely.

Under this scenario, the liquidity position of automotive parts suppliers would be pressured because of lower earnings and cash flow generation and because of the potential for weaker operating performance to adversely impact covenant compliance under debt agreements. The pressures on liquidity would not be as sharp or immediate as they would be under the other scenarios that involve bankruptcy filings by the automakers. Nevertheless, over the coming months the stresses would become increasingly apparent.

Prepackaged Bankruptcy with Government Assistance

The impact of a prepackaged bankruptcy with government assistance would be similar to the effect of a bailout package without bankruptcy filings. Near-term liquidity pressures for parts suppliers would be more contained than under a freefall bankruptcy scenario. The purpose of the government support under this scenario would be to facilitate normal operations by the automakers, including timely payment of trade creditors—both pre-bankruptcy through a stopgap bridge funding and post-petition through debtor-in-possession financing. Consequently, if trade payments are maintained current, there would be less risk of any immediate liquidity shortfall as could occur under the freefall scenario.

Nevertheless, over time this scenario would still have significant negative implications for parts suppliers as automaker downsizing will ultimately cause reduced demand for auto parts. With the expected consumer aversion to buying an automobile from an OEM in Chapter 11, the downsizing would be somewhat more significant under this scenario than under a scenario involving a bailout with no bankruptcy. Given the operating leverage in most auto parts manufacturing operations, this shift would cause massive cost inefficiencies in the near term at most auto suppliers and further drain liquidity. When viewed in combination with likely production declines from OEM transplant automakers and production declines in Europe, this scenario would raise the default risk of most automotive suppliers compared to a scenario involving a bailout with no bankruptcies.

Finding adequate DIP financing would be difficult given the current state of the financial markets. As such, this scenario could result in the automotive suppliers seeking government financial support as well.

Freefall Bankruptcy

Freefall bankruptcies of the Detroit-3 would be devastating to the automotive supplier sector. The most immediate impact would be on liquidity. The receivables held by U.S. auto suppliers for the products they sell

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to the Detroit-3 generally carry terms of more than 60 days. At any given time, most rated parts suppliers have exposures valued in the tens of millions of dollars to each of the Detroit-3 automakers. If collection of those receivables was delayed or impaired by bankruptcies of the automakers, it would materially weaken the cash flow of the auto parts suppliers. Reduced cash flow would potentially leave these companies with insufficient funds to meet operating costs or service principal and interest payments on debt. As a result, default risk would meaningfully increase.

Under this scenario, a critical variable would be the degree to which the courts protect trade claims of parts suppliers due from automakers. Those companies that are deemed to be essential suppliers to the automakers could receive current payment on pre-petition claims which would help to moderate any near term liquidity pressures. But without protection of the trade credit, this scenario would involve very severe near-term liquidity risks.

Automobile production levels have been declining for some time, and auto parts makers have had difficulty adapting their operations to the volatile changes in OEM parts orders. A freefall bankruptcy of the OEM's would likely involve further sudden and sharp production cuts, and the inefficiencies created by these would weigh heavily on the performance of the parts suppliers into 2009. Parts suppliers would not be able to adapt their cost structures to such a radical reduction in demand. Many parts suppliers are already reporting operating losses, but the magnitude of red ink in the industry would radically increase following freefall OEM bankruptcies.

The prospect of increasing losses would make it likely that many auto parts suppliers would be unable to maintain compliance with financial covenants in their loan agreements. Indeed, many parts suppliers already have very narrow cushion in their financial covenants, and some have sought waivers and amendments to avoid technical defaults. Most parts suppliers have already pledged the majority of their assets under existing secured borrowing arrangements, and there is limited ability to offer further inducements to the banks for additional waivers or amendments. Because the freefall bankruptcy of the automakers would create a long-term disruption to their businesses, many parts suppliers would need to pursue debt restructurings with their lenders.

We believe that under the freefall bankruptcy scenario many of the rated auto parts suppliers doing business directly or indirectly (as tier two suppliers) with the Detroit-3 would themselves end up filing for bankruptcy protection. In many cases, particularly those where a company is not a low cost provider or where it lacks technology leadership, a chapter 7 liquidation could be possible.

Under the freefall scenario, the availability of DIP financing for bankrupt parts suppliers would be a critical concern. With the ongoing disruption of the credit markets, banks have scaled back all lending activity, including DIP lending. If multi-billion-dollar DIP facilities are required by each of the automakers, the remaining capacity available for parts supplier DIP financing could be severely constrained, further complicating their efforts to restructure.

—Tim Harrod and Zhenyu Zhao

Captive Auto Finance

The performance of the auto finance affiliates of the Detroit-based auto companies is highly sensitive to the shifting fortunes of the U.S. auto sector. This is a reflection of the concentrated business relationships each finance company has with its auto manufacturer counterpart that affects its volumes, asset quality, profitability, and liquidity. Below, we examine the implications of three bailout and bankruptcy scenarios for the U.S. auto companies on the performance of their finance affiliates. We note that the performance of the auto captives has also been negatively affected by weak economic and capital market conditions. These, we expect, will continue to be a source of operating and financial stress in the intermediate term, regardless of what transpires with the auto manufacturers.

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Government Bailout

Under this scenario, we believe that the U.S. auto captives would, in the near-term, continue to operate as they have recently, with government intervention focused only on the manufacturers. This includes Ford Credit, which is the only of the three domestic auto captives that is wholly-owned by a manufacturer and which could therefore potentially come under the purview of a government-appointed "Car Czar" (GMAC is owned 49% by GM, 51% by FIM Holdings; Chrysler Financial is owned by Chrysler Holdings, which also owns Chrysler Auto).

However, business-as-usual means that the auto captives will likely continue to face dislocated capital markets and deteriorating economic conditions that could threaten their liquidity, asset quality, profitability and earnings, and capital levels. As noted earlier, auto manufacturers could suffer sales declines under this scenario, which would lead to lower finance volumes at the finance affiliates. However, the captives have already significantly curtailed lending and leasing activity, a consequence of contractions in the credit markets that have forced them to match origination levels with committed and available funding sources. The asset runoff that ensues from reduced activity levels should generate needed cash to help meet the captives' upcoming debt maturities. As well, tighter credit standards should, over time, partially mitigate negative asset quality trends.

However, the lack of investment in new assets weakens franchise positioning and requires a rationalization of operations to reduce costs. In addition, we expect overall higher trending loss rates in both retail and wholesale portfolios will add further pressure to operating results in coming quarters. This is a function of risk expansion in recent years from underwriting a higher proportion of loans with higher LTV ratios and expanded term (see "Auto Finance Sector Update: Implications for U.S. Banks and Finance Companies" published in October 2008), as well as the effect of the economic recession on consumer credit quality generally.

Among the captives, we believe that Ford Credit is best positioned from a liquidity standpoint to traverse the current operating environment due to its large cash balances. Were GMAC to successfully convert to a bank holding company, its liquidity prospects, which we believe are constrained presently, could improve materially if it is able to access TARP funds and issue government guaranteed debt under the TLGP. Chrysler Financial's funding is all secured, but it has significant annual renewals. The auto captives ratings and ratings outlooks (GMAC at C, developing outlook; Chrysler Financial at Caa2, negative outlook; and Ford Credit at B3, negative outlook) reflect these varied challenges and opportunities.

We believe a "Car Czar" would not mandate any restructuring that materially affects the nature of the relationships between the auto captives and their respective auto affiliates in this scenario. Captive auto finance companies support the manufacturing and sales objectives of their auto affiliates by offering a continuous (in stable markets) source of retail (loan and lease) and wholesale (dealer floorplan) financing across multiple markets. Auto companies' cooperative relationship with their finance affiliates allows them to introduce programs to stimulate auto sales in an advantageous and expeditious manner; examples include below-market (subvented) interest rates, supported lease rates and residuals, and payment holidays. The captives also leverage their servicing and collections operations to make offers to customers that help them strengthen brand loyalty, resulting in repeat purchases for the auto companies. In brief, for the auto companies, the captives are an important and controllable means for stimulating and governing auto sales levels. We expect that the auto companies and a "Car Czar" would seek to preserve these relationships.

Freefall Bankruptcy

We would expect this scenario to have the most significant consequences for the auto captives. We don't believe that a bankruptcy by any of the Detroit-3 would, of its own, result in its associated finance affiliate also filing for bankruptcy right away. Rather, we believe that a bankrupt auto company, while it reorganizes, would be motivated to maintain the operating viability of its finance affiliate for the reasons noted above. However, an auto company bankruptcy could cause ripple effects that, in tandem with a weak economy and constrained capital market access, could undermine efforts by the finance affiliate to preserve its franchise, potentially resulting in a bankruptcy filing and reorganization or liquidation at a future date, absent a timely re-emergence of the auto company from bankruptcy and a restoration of capital market access. The risk of a bankruptcy

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filing by an auto captive is most acute if the filing by its associated auto manufacturer is a Chapter 7 liquidation.

Ripple effects relating to an auto bankruptcy that could potentially affect the auto captives include:

1. a sharp decrease in demand for the bankrupt auto company's vehicles, resulting in an immediate and potentially significant decline in used car values;
2. accelerated bankruptcy filings by auto dealers, particularly in the case of an auto company liquidation, which could exacerbate the decline in used car values if excess new car inventories are subjected to forced sale;
3. a strong potential that retail customer defaults also rise, reflecting both higher unemployment statistics as workers in the broader auto and supplier industries lose jobs, as well as opportunistic default behavior stemming from concerns regarding warranty coverage, availability and cost of dealer servicing and parts, and car value declines;
4. a consequent increase in loss frequency and loss severity and a rise in residual losses, resulting in higher credit costs and lease impairment charges, negatively impacting earnings and capital levels; and
5. a further loss of confidence on the part of potential investors, essentially eliminating the possibility of raising new capital at economically feasible levels, particularly in currently constrained markets. GMAC is probably the most vulnerable to this series of stresses among the captives, given its exposure to troubled subsidiary Residential Capital, LLC, its high leverage and weakening liquidity, and its tight leverage covenant compliance.

Contracts between a bankrupt auto company and its finance affiliate could also be subject to rejection or modification, such as contracts relating to manufacturer repurchase agreements (for certain dealer inventories) and lease residual risk sharing arrangements. GM and Ford pay interest rate subvention up front, but any amount payable at the time of bankruptcy filing would be at risk. As noted, we believe that the auto companies would seek to preserve their relationships with their finance affiliates as long as they are perceived to be able to operate viably.

We believe that the auto finance captives are somewhat less likely to default than the automakers because the liquidity embedded in their assets provides alternatives available only in much smaller measure to the manufacturers. For example, the auto captives can more readily sell portfolios of auto loans (because they generate relatively predictable cash flows) than the auto manufacturers can sell plant and equipment (idle P&E generates no cash). Furthermore, in weak asset markets, such as exist currently, auto finance captives can cease new originations and generate cash by liquidating their portfolio through servicing in place. More importantly, these attributes can also result in higher recovery for creditors of the auto captives, should there be a default, than for creditors of the automakers. This has been the basis for Moody's assigning ratings to the captives that are one-to-two-notches higher than the ratings of their auto affiliates. However, GMAC and, to a lesser extent, Ford Credit have demonstrated deteriorating asset coverage metrics (discounted unencumbered assets/unsecured debt) due to increased use of secured sources of financing and, in the case of GMAC, higher stand-alone (ex-ResCap) leverage. This, combined with the effects of the weak economy and the credit crunch on asset quality and asset prices, has somewhat narrowed the gap between expected losses at the auto manufacturer and at the finance affiliates, in our view.

Prepackaged Bankruptcy with Government Assistance

For the auto captives, this scenario has elevated risks relative to a government bailout, but features fewer downside risks than freetail bankruptcy. A prominent government role in a prepackaged bankruptcy could reduce some of the concerns attendant to a freetail bankruptcy that could propel a sharp decline in used car values and an increase in defaults. However, the performance of the auto captives would continue to be subject to the operating stresses relating to capital market constraints and weak economic trends.

— Mark Wasden

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Automobile Rental Companies

We rate four U.S.-based automobile rental companies: Enterprise Rent-a-Car, Baa2/Stable; Avis Budget Car Rental LLC, Ba2/Negative; Hertz Corporation, Ba3/Stable; and Dollar Thrifty Automotive Group, Inc., B3/Negative.

There are three areas in which automobile rental companies are vulnerable to the operational and financial stress, or bankruptcy, of an OEM. The first relates to OEM commitments to repurchase "program" vehicle that are purchased by rental companies. Under these agreements, OEMs are obligated to repurchase vehicles at a predetermined price from the rental company, generally after the vehicle has been used for six to twelve months. For the rental company the purchase cost of "program" vehicles is generally higher than that of non-program cars. However, they are protected from the risk of erosion in the vehicle's residual value when it is sold. Should an OEM be unable or unwilling to honor a repurchase agreement, as might be the case in the event of bankruptcy, the rental company would bear any loss between the book value and market value of the vehicle.

As an alternative to acquiring "program" cars, rental companies may purchase non-program "risk" vehicles. The purchase price of these cars is considerably lower than that of program cars. However, the rental company takes on the vehicle's residual value risk and bears any loss due to erosion in the vehicle's market price relative to book value. A bankruptcy by an OEM could severely erode the residual value of rental vehicles and expose rental companies to potentially high losses.

Finally, to the extent that a rental company has a large supply arrangement with an OEM that files bankruptcy, the manufacturer's potential inability to supply the adequate type and number of vehicles could pose a source of risk to the rental company.

Government Bailout

We do not anticipate that the bailout scenario, in which government funding provides adequate liquidity to the OEMs for the coming twelve months, will result in additional pressure on the operational performance and credit quality of the four auto rental companies we rate. However, even under this relatively favorable scenario, the ratings of some daily rental companies could be subject to downgrade. For instance, the performance of Dollar and Avis will remain pressured due to their over-fleeting positions relative to other rental companies, and the severe declines in used car values. Moreover, Dollar's market share and long-term competitiveness are much less robust than that of the other three, much larger rental companies. Consequently, the severity of the current economic downturn poses considerable challenges to Avis and Dollar notwithstanding any government assistance for the OEMs.

Prepackaged Bankruptcy with Government Assistance

Under the scenario in which OEMs file for chapter 11 with the government filling the roll of DIP lender, auto rental companies face the risk of a manufacturer choosing to reject vehicle repurchase agreements. Ultimately, an OEM's decision to reject uneconomic repurchase agreements will be determined by a balance between the need to preserve a relationship with a large customer during a time of stress, and the savings that could be achieved through contract rejection. On balance, we expect that preservation of the business relationship will be the more important consideration and that repurchase agreements will generally be affirmed.

The greatest risk under a controlled bankruptcy scenario would be the potential erosion in the residual value of vehicles due to consumer concerns over the long-term viability of an OEM and the integrity of vehicle warranties. The erosion of residual values can have a significantly negative impact on the operating performance of rental companies. The degree of vulnerability to this risk would largely be determined by the diversification of supply within each rental company's fleet. Enterprise has the most diversified fleet. Hertz's vehicle purchases are relatively balanced between Ford and GM, and a full range of Asian and European suppliers; it has modest exposure to Chrysler. Avis's largest supplier of vehicles remains GM. Finally, Dollar purchases the vast majority of its vehicles from Chrysler under long-term supply agreements.

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Dollar faces the greatest risk of erosion in residual value because of its significant concentration with Chrysler, and because of this OEM's very challenged business model. We view Avis as the next most vulnerable due to its relatively high reliance on GM. Hertz benefits from having a greater degree of supplier diversification than Avis does, and would consequently be somewhat less vulnerable to residual value erosion. Finally, Enterprise enjoys the greatest degree of supplier diversification, and also has the most well-developed network and systems for disposing of vehicles.

Freefall Bankruptcy

Under an uncontrolled bankruptcy scenario, we would expect the residual values of vehicles to decline sharply. The resulting financial and rating impact on a rental company exposed to an OEM facing this scenario would be very severe. Were Chrysler to face such a scenario, the viability of Dollar would be highly questionable. A filing of this nature by GM would severely test the financial and operating position of Avis and possibly Hertz. However, the impact on Hertz could be mitigated to some degree by the diversification afforded by its equipment rental operations and its international car rental business. Enterprise would benefit from its relatively lower exposure to both Chrysler and GM, and from its more robust level of financial flexibility. Should this scenario also include Ford, the viability of Hertz and also Enterprise might become questionable as the residual value of all vehicles, irrespective of the supplying OEM, would likely be eroded.

— Bruce Clark

U.S. Banks, Canadian Banks, and the CDS Market

U.S. Banks

For the rated U.S. banks, direct exposure to domestic auto manufacturers and suppliers is not a major risk. This contrasts, for example, with commercial real estate exposures, which are a far more substantial risk for the average U.S. bank. The long decline of domestic auto manufacturers allowed banks to exit or trim their exposures over several years.

The most affected banks, in our view, will be those institutions with a large presence in the Midwest in the U.S. and in Ontario, Canada, where most North American manufacturing plants are located. As an example, Comerica, rated B- for bank financial strength and A1/Prime-1 for deposits, and which until recently had its headquarters in Detroit, publicly disclosed a 37% drop in auto manufacturer/supplier loan outstandings since year-end 2005. Auto-related loans are currently less than one-quarter of Comerica's pro-forma Tier-1 capital (including TARP preferred). If there were an automaker bankruptcy such an exposure could depress successive quarterly results because of the need for higher provisions. However, the comparative modest size of the exposure means it will be less damaging to Comerica's capital structure than the problems that banks with large commercial and residential real estate exposures face.

Notwithstanding the limited nature of most U.S. banks' exposure to domestic auto manufacturers and suppliers, failure of any or all of them will impact banks in several ways. Most obviously, the exposures they do have will become impaired. Even for secured exposures, we expect high loss severity because collateral value could be low due to overcapacity in the industry. Secondly, we expect there will be ripple effects on small businesses and consumers in local communities (i.e., if one or more people in a household that is a customer of a bank was employed by a manufacturer/supplier). Finally, future business volumes in those communities, potentially both deposits and loans, will suffer. However, because of the characteristics outlined above, direct rating impact from these manufacturer/supplier bankruptcies would appear to be limited.

Exposure to auto dealers, either through floor plan lending, or through lending against a dealership's real estate assets, is another potential concern. In our opinion, dealers of a bankrupt auto manufacturer are at risk of going out of business. However, the impact on most rated U.S. banks in this scenario is also limited. This is so because rated banks have, for the most part, focused on large dealer groups, which have multiple locations and multiple franchises, both foreign and domestic. In contrast, smaller dealers with exposure to only one domestic manufacturer are often financed by that manufacturer's captive finance company or a local

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community bank. Nonetheless, the bankruptcy of a domestic manufacturer could result in some losses from this business for the rated U.S. banks.

Lastly, exposure to U.S. consumers through car loans and leases is an additional area of focus. For example, to the extent consumers stop paying for a car where they think the warranty might not be honored, that would impact the banks. For a detailed discussion of the consumer finance impact please refer to Moody's Special Comment [Auto Finance Sector Update: Implications for U.S. Banks and Finance Companies](#) published in October 2008.

Canadian Banks

The Canadian province of Ontario has been a major North American automobile manufacturing center since the Automotive Products Trade Agreement of 1965 liberalized automobile trade between Canada and United States. Thus, the bankruptcy of one or more of the North American auto manufacturers would be felt profoundly in the Southwestern part of the province where Ford, GM, and Chrysler all have major plants. This dislocation would, in turn, impact the Canadian banks.

The five largest Canadian banks all have sizable exposures to the automobile sector, totaling at least 58% of Tier 1 capital on average, as illustrated in Table 1. The largest segment of this exposure is consumer loans, but the banks do have funded wholesale automobile exposures that approach 20% of Tier 1 capital. We point out several important caveats in interpreting this table: (1) disclosures are somewhat incomplete so actual exposures could rise; (2) much of the undisclosed exposures are likely Canadian consumer auto loans, at least some of which will be secured by the consumer's primary real estate via home equity loans / lines of credit; (3) some of this exposure is to non-North American manufacturers, dealers, and parts suppliers – Toyota and Honda each have significant plants in Ontario and sizable Canadian market shares; and (4) much of the off-balance sheet auto exposures are in asset-backed commercial paper (ABCP) conduits that have transaction-specific credit enhancement which will partially shield the banks from losses.

Table 1

Funded Automobile Disclosures						
Preliminary Estimate based on Current Exposure						
CAD Millions						
	BMO ⁽²⁾	CIBC ⁽³⁾	Royal Bank	Scotiabank	TD ⁽⁴⁾	Total
Automobile Exposures ⁽¹⁾						
On Balance Sheet						
Consumer	5,738	ND	ND	7,800	1,200	14,738
Wholesale	3,942	ND	3,999	5,200	3,033	16,174
Off Balance Sheet						
Consumer	3,284	2,713	9,800	5,098	4,498	25,393
Wholesale	1,571	44	581	-		2,196
Total Exposures	14,535	2,757	14,380	18,098	8,731	58,500
Tier 1 Capital	18,729	12,365	25,173	23,263	20,679	100,209
Consumer Exposures as % of Tier 1 Capital	48%	22%	39%	55%	28%	40%
Wholesale Exposures as % of Tier 1 Capital	29%	0%	18%	22%	15%	18%
Total Exposure as % Tier 1 Capital	78%	22%	57%	78%	42%	58%

Notes: (1) ND = Not Disclosed

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Thus, the major direct impact on Canadian banks of the bankruptcy of GM, Ford, and/or Chrysler would be rising loan losses in the wholesale and consumer portfolios. On the wholesale side, most losses would come from exposures to dealers and parts suppliers, as the banks have reduced direct exposure to the big three North American automobile manufacturers over the past several years. On the consumer side, as and if residual values on North American automobiles decline, those automobile owners may have greater incentives to default on their loans than in prior cycles, which could push up delinquencies and losses.

The indirect impact on the Canadian banks would be a product of the economic shock of a bankruptcy or bankruptcies as felt in the country's largest province, Ontario, which accounts for 40% of real Gross Domestic Product. We note that Ontario is Canada's largest manufacturing province and the automobile sector is the province's largest manufacturer. Indeed, dislocations in the automobile sector have already weakened Ontario's economy which is, for the first time in many years, the slowest growing economy in Canada. Put another way, the Canadian recession is already felt most acutely in Ontario and automobile bankruptcies would only intensify this trend. Since 40% of Canada's GDP and population stem from and reside in Ontario, we think it reasonable to conclude that stresses in this province would impact 40% of any given Canadian banks' retail portfolio.

Thus, we foresee negative rating pressure on the Canadian banks were the North American automobile manufacturers to declare bankruptcy. That said, this event would be part of a broader weakening of credit profiles already incorporated into our ratings and outlooks. We note that three Canadian banks already have negative outlooks – Canadian Imperial Bank of Commerce, the Toronto-Dominion Bank, and Royal Bank of Canada. The negative outlooks are mainly a product of institution-specific factors, but also incorporate an expectation that the Canadian economy will be in recession in 2009.

CDS Market

GM and Ford, along with their finance subsidiaries, are major reference entities for credit default swaps (CDS). According to The Depository Trust & Clearing Corporation, these entities combined are referenced in over \$16 billion of net notional CDS.¹

We do not think that the possible bankruptcy of the Big Three will prove to be a major systemic event for the CDS market, which has already priced in very significant potential losses. As can be seen from **Figure 1**, the cost of acquiring CDS protection on a dollar of Ford and GM bonds is more than 70 and 80 cents, respectively, which incorporates both a very high probability of default and a low recovery. The worst actual bankruptcy scenario is unlikely to exceed what is priced in by the market by a significant enough margin to expose the CDS market, or its major participants, to unexpected outsized losses.

It should also be noted that CDS contracts are marked to market, with daily collateralization, such that much of the gradual increase in the price of CDS protection on the Big Three has already been reflected in the earnings of market participants.

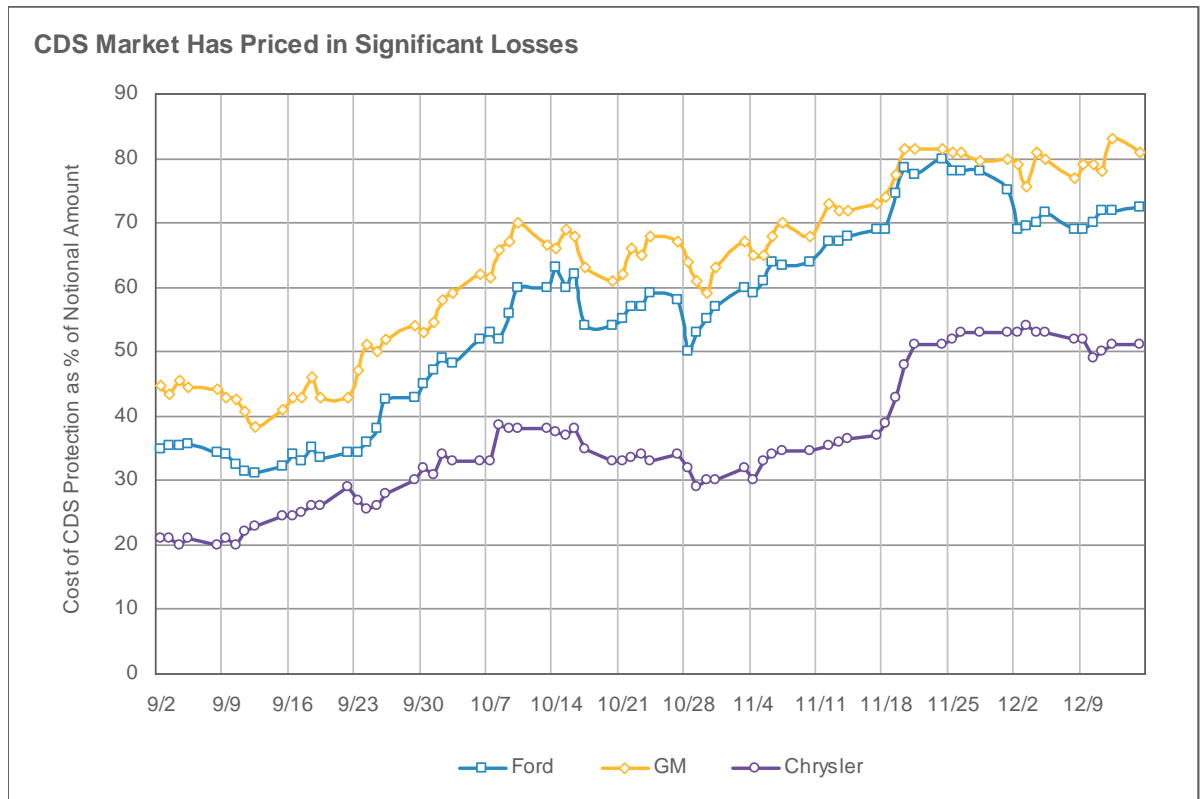
Furthermore, as we have noted previously in our research on the CDS market, the major rated CDS dealers² run predominantly net flat CDS books, as a result of their market-making business models. We do not expect them to have major (or any) long exposure to the Big Three through credit default swaps, and think it is likely that they may be net buyers of CDS protection for purposes of hedging on-balance sheet credit exposures to the Big Three.

¹ We do not have exact information for CDS referencing Chrysler as it was not among the top 1000 CDS reference entities disclosed by DTCC as of the time of this report.

² This includes major rated wholesale US investment and commercial banks, such as Bank of America, Goldman Sachs, JPMorgan Chase, and Morgan Stanley. Also included in these definitions are European universal banks such as Barclays, Credit Suisse, Deutsche Bank, UBS, and others active in the CDS market.

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Figure 1



Note: Chrysler CDS is loan-based (LCDS), which implies a higher recovery, whereas Ford's and GM's deliverable obligations are senior unsecured bonds.

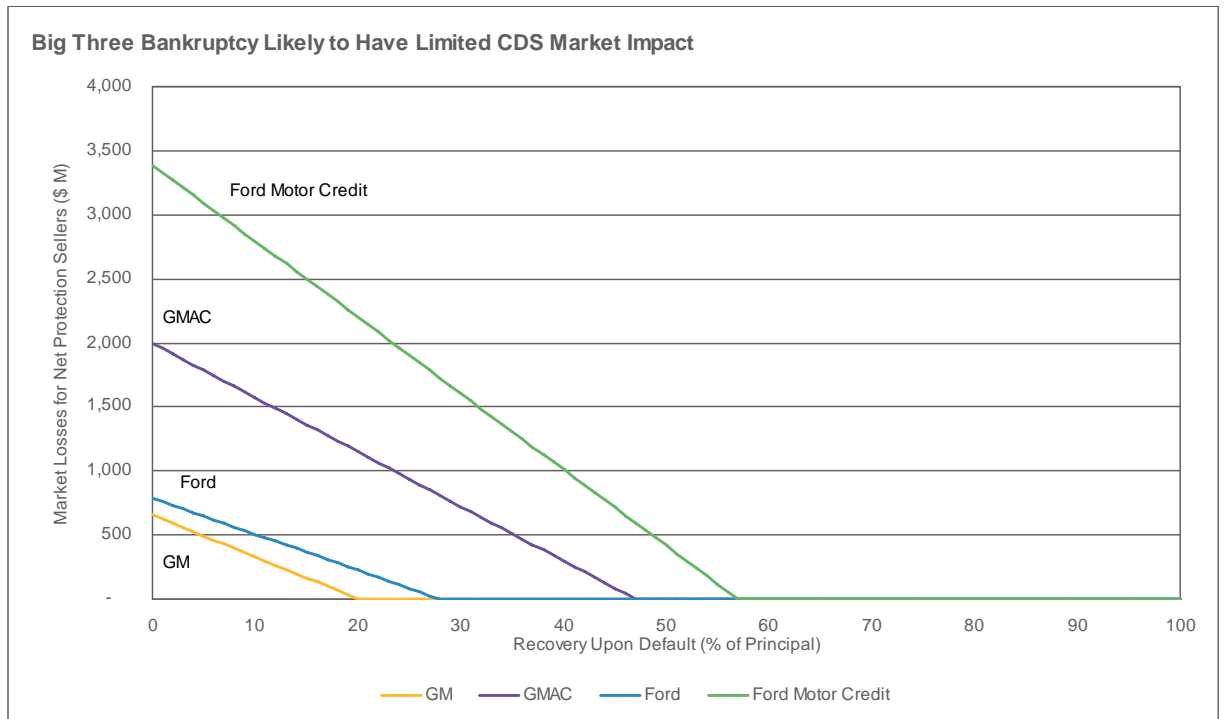
Source: Moody's CreditQuotes

As **Figure 2** shows, the aggregate amount of losses for net sellers of protection on the Big Three is highly sensitive to final recovery expectations.³ However, given the negative scenarios already priced in by the market, the aggregate amount of potential further losses for protection sellers, especially with a reasonable recovery assumption, is fairly limited.

³ In the event of default, ISDA will conduct an auction which will determine the final payout level under the CDS contracts. This payout level will be broadly correlated with the market's consensus on final recovery.

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Figure 2



Note: Amounts are based on single-name CDS only and do not include CDS indices (n.b.: GM represents 1% of the notional amount of the CDS HY index).

Source: Moody's CreditQuotes, DTCC's Trade Information Warehouse

Notwithstanding the above, the bankruptcy of the Big Three will represent yet another test for the CDS market's infrastructure, which has so far held up through the recent credit events, but remains vulnerable to counterparty credit risk and potential operational issues.

— Allen Tischler, Peter Routledge, Alexander Yavorsky

Auto Retailers

Government Bailouts

A government bailout would be the least disruptive scenario for the rated auto retailers, which include AutoNation (Ba1-negative outlook), Sonic Automotive (Ba3-stable outlook), Group 1 Automotive (Ba3-on review for possible downgrade), Penske Automotive (B1-stable outlook), and Asbury Automotive (B1-stable outlook). While there would likely be a rationalization of the dealer bases on the part of the Detroit-3, this could actually benefit the rated retailer universe, potentially providing acquisition opportunities as further consolidation of dealers would certainly occur. The impact on liquidity would be largely benign as existing floor plan arrangements would likely remain in place.

All five rated auto retailers have been consciously reducing their domestic exposures, with AutoNation maintaining the highest share on a unit basis of 31%, Sonic, Asbury, and Group 1 are all in the low 20% range, and Penske's share is 6% on a revenue basis. This rather low reliance segment-wide on the domestics somewhat mitigates the estimated at least 15% capacity reduction for the Detroit-3 contemplated earlier in this report. In addition, as all five rated retailers are better represented in imports than they are in domestics, this product shift would potentially have relatively minor negative short-term impact as the consumer sorts through the possible alternatives. There is some potential for negative rating momentum depending on level of domestic market share and ability to exploit the potential increased velocity of a shift to the imports.

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Freefall Bankruptcy

A freefall bankruptcy would logically result in the most disruption, with likely multi-notch ratings impact; however, the potential level of distress is not expected to be grave. Liquidity, especially future floor plan financing, would be disrupted in the short-term, making it difficult for the domestics to entice dealers to continue to sell their vehicles. While dealer rationalizations would be more acute, since the rated retailers are typically the highest-volume and best-performing, any more than modest reductions would be surprising. The potential benefits to the rated auto retailers, while likely to occur, would take longer to materialize.

Capacity reductions approaching 50% for the Detroit-3 would ultimately be absorbed by the imports, but there would likely be a disruptive lag in overall volume as the consumer sorted out the situation. Ratings would be addressed on a detailed, case-by-case basis, with variability of impact depending on a variety of factors. These factors would likely include 1) loss of volume, 2) loss of related business, 3) diminution of domestic franchise value, with charges expected, and 4) potential strain on debt covenants from charges.

Prepackaged Bankruptcy with Government Assistance

A prepackaged bankruptcy would cause increased disruption, but would not be catastrophic. The impact on liquidity would be minimal as any DIP program would certainly include a component of replacement floor plan financing for new vehicles. Dealership rationalizations would be greater than in a government bailout, with the same potential benefits to the rated retailers on the acquisition front. It would be highly unlikely that the rated retailers would be affected by material closings due to their typically operating the top performing stores in each segment.

The potential capacity reduction of around 20% could have moderate ratings impact, with the impact tied to the level of domestic product mix. Negative rating movement would consider the potential levels and speed of absorption by the import brands. Ratings impact across the segment would be fairly variable, and probably not of the multi-notch variety.

— Charles O'Shea

Steel & Other Metals

Our negative outlook for the U.S. and global steel industry reflects the virtual collapse of end markets, resultant lower prices, and capacity utilization rates that have fallen to around 50%. Throughout 2008, significant declines in auto production have already resulted in reduced steel shipments to manufacturers. A meaningful decline in car production, even temporarily, would have a severe impact on the steel industry as further capacity is idled and production is redirected to other steel consuming industries, which are themselves suffering from weaker demand.

To dimension the potential exposure of the steel industry, we estimate that about 10% of the 110 million tons of steel produced in the U.S. is consumed in U.S.-built vehicles, but there could be another 10% that is linked to the auto industry. The exposure primarily relates to flat rolled sheet, which tends to be the province of the integrated steel producers. However, autos also require high strength alloys, special bar quality (SBQ) steel, merchant bars, mechanical tubulars, wire and fasteners. Additionally, steel of all types is used in the tools and industrial equipment that the OEMs, parts suppliers, machine shops and forging shops operate throughout the far-flung auto manufacturing network. Then there is the steel that goes into the trucks and rail cars that transport raw and semi-finished materials and finished automobiles around the country. Therefore, all steel companies will have some exposure to the ubiquitous U.S. auto industry and the Detroit-3.

The companies most exposed to the Detroit-3 include the integrated steel companies, AK Steel, ArcelorMittal, U.S. Steel, and Severstal, although Nucor and Steel Dynamics also have exposure. All companies report end-market exposures differently, but AK Steel indicates that 2007 sales to GM, its largest customer, were less than 10% while U.S. Steel's 2007 shipments to the transportation sector were roughly 18% of its flat rolled production and approximately 12% of its total production. Companies producing specialty and other steel products that would be impacted include Allegheny Technologies, Carpenter Technology, Timken and Snap-

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on Inc. From a liquidity perspective, receivable exposure to the Detroit-3 has declined in line with reduced shipments during 2008 and can be managed within the overall liquidity profile of the major steel producers.

Detroit-3 exposure for other metals producers and metal distributors is less pronounced than for steel producers. The aluminum content in U.S. cars and trucks, although it has been growing year-on-year, remains relatively small. Among rated aluminum issuers, Alcoa and Rio Tinto Alcan have some exposure, albeit small relative to their overall business footprint. While lead (for batteries) and zinc (for galvanizing) depend heavily on auto production, there are no rated companies that are heavily dependent on these metals. However, one rated producer of platinum and palladium (used in catalytic converters) would be at risk, Stillwater Mining Company, which has long-term sales contracts with Ford and General Motors. The North American metal distributors have minimal to no direct exposure to the Detroit-3, although they are likely to sell to auto suppliers and industries that support the auto industry.

There are several reasons that a bankruptcy filing by the Detroit-3 would be less catastrophic than it would have been a decade ago:

1. Over the last several years the U.S. steel producers have diversified their sales away from the Detroit-3 to the new domestics.
2. It is unlikely that production would completely cease in a bankruptcy filing (we note that contractual sales to the Detroit-3 are typically for a specific platform, so the discontinuation of certain models or entire brands will impact some steel companies more than others).
3. The intensity of use of steel in passenger vehicles has been decreasing in recent years as mix has changed, truck and SUV sales have declined, and weight has been taken out of vehicles due to the push to reduce fuel consumption and emissions. Currently, we estimate that the average vehicle requires about $\frac{3}{4}$ tons of steel, down from over 1 ton not that long ago.
4. Industry consolidation has increased the size and diversity of the steel companies, many of which now operate on several continents and produce a wide range of products. The smaller companies that ten years ago might have predominantly sold one product – flat rolled sheet, SBQ or bead wire for tires – to the automotive industry have gone out of business or been acquired.
5. Steel producers directly supplying the Detroit-3 are in stronger financial shape than they were ten years ago.

In summary, we believe the dependence of the U.S. steel industry on the auto sector has diminished over the past 10 years while the steel companies themselves have benefited from a number of developments that have diversified their operations and strengthened their financial position. Nonetheless, a significant decline in auto production would have a deleterious effect on the steel companies, especially for the integrated steel producers and especially in the current adverse economic environment. The degree of financial impact on individual companies will ultimately depend on the scale of production cutbacks, types of vehicles affected, and the ability of the companies to mitigate such negative effects.

— Carol Cowan, Steven Oman, and Brian Oak

Chemicals

The potential bankruptcy of one or more of the three U.S. automobile manufacturers would not, in and of itself, likely result in the downgrade of one or more chemical companies. While there are several companies have meaningful exposure to the auto industry (DuPont, Dow, PPG, PolyOne, Unifrax, etc.), no company has more than 10-15% of its revenue tied to this industry on a global basis, with the exception of Unifrax. Moody's could change the outlook or ratings of Unifrax, which has a sizable exposure to US, European and Japanese automakers, depending on which entity or entities file for bankruptcy. For all other companies in the chemicals industry, the profitability of sales to this industry is typically lower than most other industrial applications. Hence, when looking at their global earnings exposure to only the "Big Three" and their Tier I, II and III suppliers, we believe that maximum exposure of these companies is less than 5%. We also believe that such an event would prompt these companies to announce, or accelerate previously announced, cost reduction programs.

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However, if two or three of the Big Three automakers does file for bankruptcy, the resulting impact on the U.S. and global economies would likely have a significant ratings impact on chemical companies at the lower end of the ratings scale, companies with the vast majority of their sales in the U.S. or companies that have, or will undertake, large debt financed acquisitions. These companies include: Georgia Gulf (B3, Negative), Arclin (B2, Negative), KRATON (B2, Negative), Reichhold (B2, Under Review - Down), OMNOVA (B2, Stable), Momentive (B3, Stable), Ashland (Ba2, Negative) and Avery Dennison (Baa1, Negative).

In this scenario, Dow's (A3, Under Review Down) ratings could come under increased pressure due to the increased difficulty in generating free cash flow to reduce debt from the pending Rohm & Haas acquisition. We would expect Dow to undertake additional cost reduction efforts (in addition to those announced last week) or accelerate identified divestitures to attempt to compensate for its weaker performance. DuPont's ratings could come under pressure as the combination of weaker earnings and the loss of royalty revenue from its pharma business in 2010 could cause credit metrics to weaken meaningfully below levels currently incorporated in the A2 ratings. PolyOne, on the other hand, may be able to avoid a downgrade due to the company's ample liquidity and on-going restructuring efforts. Additionally, Chemtura (B1, Stable) would be impacted but the rating already incorporates the combination of weaker metrics and potential event risk. In this scenario, the vast majority of companies in this industry would be negatively impacted so there could be changes to a number of outlooks in addition to the potential ratings actions identified above.

— John Rogers

State and Local Governments

All three scenarios will have similar impacts on state and local governments—industry downsizing and plant closings will result in decreased tax revenues in the near term and, to the extent that the lost jobs are not replaced, over the long term as well. The difference between the three scenarios is primarily a matter of the magnitude of the revenue loss.

Government Bailout without Bankruptcy

This scenario will have the least impact of the three on state and local governments, but it will create new fiscal pressures for many governments already strained by earlier cutbacks in the auto industry and the nationwide recession. For states, plant closings and job losses will further reduce personal income and sales tax collections already running below budgeted levels. The impact would likely be most intense in Michigan (general obligation rating Aa3/stable outlook), the location of the greatest concentration of GM, Ford and Chrysler facilities and the source of 23% of the nation's auto manufacturing-related GDP. In recent years, Michigan has reined in spending, imposed new or increased taxes, and used one-time funding measures to offset the impact of the industry's downsizing.

The other states likely to be most affected are Ohio (general obligation rating Aa1/negative outlook) and Indiana (issuer rating Aa1/stable outlook), the source of 13% and 11%, respectively, of the nation's auto manufacturing-related GDP. Michigan and Ohio are expected to revise their economic and revenue projections in coming weeks, and these projections are expected to incorporate more severe job losses based in part on the auto industry downsizing. The job losses anticipated in this scenario are in line with or only slightly greater than what these states have been or are likely to be forecasting. As a result, this scenario, while requiring difficult spending discipline, could prove manageable for states.

For local governments, including cities, counties and school districts, plant closings will result in declines in property, sales, and (in states such as Ohio where local governments rely on income taxes) income tax receipts. In the near term, these declines, in many cases likely compounded by reductions in state aid, will pressure budgets, forcing government to cut expenditures and/or raise taxes. In the long term, where the local economy is unable to replace the lost jobs or redevelop the site of the former plant, an extended period of credit decline is possible as we have observed in other communities that have lost a key element of their manufacturing base. The impact on individual local governments will extend beyond Michigan, Ohio and Indiana and will depend upon which facilities are closed. The impact will be most severe where the auto facilities represent a large share of local employment or the local property tax base and where the regional

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economy cannot absorb the job losses in other sectors. Nationwide, in 21 cities rated by Moody's, domestic manufacturing and suppliers represent greater than 3% of property valuation, ranging high as 50.6% in Wayne, Michigan (general obligation, limited tax rating A3). Please see **Figure 3**. Outside of Michigan, the highest concentration is 13.6% in Wentzville, Missouri (general obligation, unlimited tax rating A2).

Figure 3

Cities with the Highest Levels of Domestic Auto Concentration in Tax Base				
City	Rating	Full Value (Millions)	% Taxable Valuation of Auto Concentration	Top Ten Taxpayer
MICHIGAN				
Auburn Hills	A2*	5,198	18.9	Chrysler 18.9%
Bay City	Baa1	1,623	12.2	GM 12.2%
Dearborn	A1	10,020	23.0	Ford 21.9%; ACH 1.1%
Detroit	Baa2	26,145	9.5	Chrysler 7.5%; GM 2.0%
Lansing	Aa3	6,014	6.7	GM 6.7%
Livonia	Aa3	12,271	6.8	Ford 5.1%; GM 1.7%
Milford Township	A2	2,347	14.1	GM 14.1%
Pontiac	Ba2/neg*	3,795	29.8	GM 29.8%
Saginaw	WR	1,584	12.6	GM 7.5%, Delphi 5.1%
Sterling Heights	Aa2	12,446	9.1	Chrysler 4.6%; Visteon 2.6%; Ford 1.9%
Van Buren Township	A3*	3,064	9.4	Visteon 8.5%; GM 0.9%
Wayne	A3*	1,939	50.6	Ford 50.6%
Wixom	A1	2,026	11.3	Ford 11.3%
Ypsilanti	A3	1,009	9.7	ACH 9.7%
Ypsilanti Township	A1*	4,038	15.5	GM 15.5%
MISSOURI				
Fenton	A1	1,046	7.8	Chrysler 7.8%
Wentzville	A2	1,966	13.6	GM 13.6%
NORTH CAROLINA				
Mount Holly	A2	761	10.3	Freightliner 10.3%
OHIO				
Avon Lake	Aa3	2,470	3.2	Ford 3.2%
Twinsburg	A1	2,076	9.0	Chrysler 9.0%
TENNESSEE				
La Vergne	A1	1,917	3.3	Bridgestone 3.3%

The above chart include only cities that were both rated by Moody's and listed in company website as maintaining a current facility.

Ratings included above are ratings on issues secured by the entity's general obligation unlimited tax (GOULT) pledge except where noted.

* Denotes a rating on the entity's general obligation limited tax pledge only, which is often one notch below the entity's GOULT rating.

ACH - Automotive Component Holdings, LLC

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Bankruptcy Filing with Government as DIP Lender

The impact of this scenario on state and local governments will be similar to that of the first, but incrementally more severe. Michigan, Ohio and Indiana would likely see larger and more difficult to manage revenue shortfalls, possibly resulting in downward rating pressure. In addition, other states with a domestic manufacturing presence, such as Illinois (general obligation rating Aa3/stable outlook) and Missouri (general obligation rating, Aaa/stable outlook), may see significant revenue shortfalls. For local governments, the impact would be similar to that described in the first scenario, but more widespread, as more communities face plant closings. Further, under the bankruptcy scenario, local governments may have to deal with delays in property tax payments from manufacturers, even for plants that ultimately remain in operation.

Free-Fall Bankruptcy

This scenario would have far-reaching economic effects for states and local governments throughout the country. Michigan, Ohio and Indiana would face more intense revenue shortfalls, likely well beyond what is anticipated in their most negative forecasts and, at least for Michigan and Ohio, in excess of the pressure captured in their current ratings. In addition, all states nationwide would see new budget shortfalls as the effects of this scenario ripple through the broader economy. It is important to note that states generally have broad powers to raise revenues and to decrease expenditures, and these powers would be tested in a free-fall bankruptcy scenario. For local governments, the direct impact of plant closings would be much more widespread than anticipated in the first two scenarios. In addition, communities nationwide with no auto presence would likely see tax shortfalls due to the secondary economic effects of the free-fall bankruptcy.

— Kenneth Kurtz

Dealer Floorplan Securitizations

These asset-backed securitizations are based on pools of loans to vehicle dealers, which enable them to purchase autos from a related manufacturer. The loans are secured by a first lien in the autos. In each scenario, we will examine what happens to payment rates, dealer defaults and recovery values for the inventory, as these variables are determinants in credit performance.

Government Bailout

A bailout of the auto loan industry that avoids manufacturer bankruptcy will lend near-term stability to performance. Payment rates, a measurement of vehicle sales and dealer loan repayment, will largely be unaffected and will remain above transaction trigger levels. Even in an environment of historically low vehicle sales, payment rates have been sustained because of the manufacturers' earlier efforts to tailor production of vehicles consistently with decreased demand. A negative aspect of the bailout is the status quo ante of the bloated dealer base. Because dealers are favored generally by state franchise laws, a rationalization of the dealer base is more difficult and prolonged for the auto manufacturers in the event of a bailout. Slowly, dealers too dependent on vehicle sale margins, finance and insurance products will voluntarily exit their businesses. Those dealers able to weather down cycles with revenue from parts and service will remain, but this process will extend well beyond the near term. Recovery values of the underlying inventory would remain relatively stable in the absence of an onrush of dealers exiting the business.

Freefall Bankruptcy

Freefall bankruptcy will result in levels of disruption that depend on whether the manufacturer files for reorganization or liquidation. The federal government's refusal to bail out the industry may hasten a conversion from reorganization to liquidation if the debtor in possession fails to attract financing from the private sector or if creditors view the refusal as a vote of no confidence. Consumer concerns about the manufacturer's ability and willingness to honor warranties would flow from a freefall bankruptcy. Payment rates will drop precipitously because even if a customer did want to buy a vehicle from a bankrupt manufacturer, funding for the customer's retail purchase may be non-existent. The manufacturer bankruptcy

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will cause a large-scale winnowing of the dealer base as the manufacturer rejects its executory agreements with weaker dealers. New vehicle recovery values would be negatively impacted and the magnitude of the stress would depend on whether the manufacturer were reorganizing or liquidating.

Prepackaged Bankruptcy with Government Assistance

A manufacturer bankruptcy with government debtor-in-possession financing would enable the manufacturer to transition to a smaller company more smoothly than otherwise. The financing would enable the manufacturer to make considered choices about its current vehicle distribution channels. The bankruptcy will deliver a recoverable shock to payment rates. As a going concern, the manufacturer can layer incentives on vehicles to spur sales, but it will be crucial that the customer see and understand the long-term goals of post-bankruptcy for the payment rates to be sustainable. Bankruptcy would enable the manufacturer to reject unprofitable dealer relationships and debtor-in-possession financing would give the manufacturer means to support a stronger dealer base. Recovery values could be sustained as the manufacturer undertakes an organized redistribution of vehicles among a smaller dealer base.

Our recent rating actions in this space have involved all outstanding floorplanning transactions sponsored by the U.S. domestic manufacturers. The rating actions reflect the result of our simulation of losses occasioned by dealer default, manufacturer default and inventory recovery values in stressed scenarios. Differences among the rating actions for the U.S. domestic manufacturers reflect the size of credit enhancement available to cover losses in scenarios unique to each manufacturer.

For GMAC's s linked floorplan structures, the senior bonds were downgraded by two to three notches; the subordinate tranches were downgraded by multi-notches from investment to non-investment grade categories. For GMAC's de-linked floorplan structures, the downgrades were to lower investment grade categories. All ratings remain under review for further possible downgrade. Chrysler's senior floorplan bonds were downgraded to A3 or placed under review for possible downgrade. All tranches of Ford's floorplan deals were placed under review for possible downgrade.

— Mack Caldwell and Mark A. DiRienz

Auto Loan and Lease Securitization

Used car price declines and servicer disruption are key risks that will magnify losses in retail auto loan and lease ABS to varying degrees in the various stressed scenarios facing the Big Three. A decline in prices of used cars has a direct and inverse relationship with the recovery on vehicles repossessed for defaulted auto loans. Similarly, but to a much greater extent, lease transactions are exposed to market value risk for those vehicles that are turned in.⁴ In auto loans, generally a small percentage of the collateral pool is subject to repossession and resale, while 80% to 90% of leased vehicles for the Big Three manufacturers are turned in at lease termination. Turn-in rates increase when car prices decline, as the lessee's "purchase option" becomes more expensive than prevailing market prices.

In the near term, a government bailout would result in the least decline in used car prices, and a freefall bankruptcy would result in the highest decline in used vehicle prices. A bailout could instill confidence in the financial stability of the automakers. In a bailout, servicing disruption is likely to be immaterial for both loan and lease ABS transactions. Avoiding servicer disruption is central to lease ABS performance as a higher percentage of vehicles needs to be auctioned.

We believe that new and used vehicle prices are likely to decline precipitously in a freefall bankruptcy. For example, a manufacturer reorganizing in a Chapter 11 bankruptcy proceeding may be motivated to heavily discount new vehicles to encourage sales; the discounted new vehicles would negatively impact used car resale values. In this scenario, the odds of disruption to servicing are also likely to increase. In a freefall bankruptcy, the lack of financing for vehicles will also be a significant driver of used car prices. A freefall

⁴ Historically, a small percentage of total expected losses in lease deals are attributable to credit loss. An obligor may default on his monthly lease payments, at which point the lease would be terminated prior to maturity. An increase in defaults is possible in a bankruptcy scenario given that a high percentage of lessees are located in Michigan. On the other hand, vehicles that are turned-in early have typically suffered less depreciation and therefore should have retained a relatively higher resale value.

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bankruptcy will also raise concerns over continuation of existing brands and models, disruption to servicing through the dealer channel, spare part availability and warranties. These expectations will lead to depressed prices of new and used cars. Loan and lease servicing quality may also deteriorate in the short run due to staff cuts and voluntary turnover, while confusion on the part of the borrowers may disrupt the regular payment stream to the securitizations. Spikes in unemployment rates owing to a manufacturer bankruptcy will impact default frequency and further strain reorganizing servicing platforms.

In a government-sponsored Debtor-in-Possession financing we expect that vehicle prices would be adversely impacted to a greater extent than in a situation where there is a government bailout. In this case, consumers will still have some confidence in manufacturers' ability to honor warranties, service the vehicles, and continue to produce most of the existing brands and models. In this scenario, it is also likely that the securitization sponsors would continue to perform their servicing and collection duties as usual.

The consequence of a bankruptcy scenario for the ratings of auto loan ABS depends on several factors, including the extent of repossessions and the credit enhancement build-up to that point in time. The non-declining credit enhancement in many transactions (particularly before the 2006/2007 vintage) would likely be sufficient to compensate for the lower recovery rate. The risk, of course, is that in an increasingly challenging economic environment defaults may rise at the same time as vehicle prices come under pressure.

We have recently placed under review for possible downgrade the subordinate notes in three auto loan securitizations sponsored by Chrysler due to worse than expected performance. As the transactions closed in 2007 and 2008, credit enhancement has not yet built up significantly. In addition, the rating actions are mostly driven by the higher than expected borrower default rate, although lower recoveries compared to historical rates have contributed to boosting overall losses. The deterioration in these transactions has outpaced that of other recent vintage prime auto loan pools and is also not reflective of the general performance of auto loan transactions from other U.S. or foreign automakers. We have also recently downgraded the ratings of 16 classes of notes in 11 lease securitizations sponsored by GMAC LLC and Chrysler Financial Company LLC. The ratings remain under review for possible further downgrade; a bankruptcy scenario, particularly in the freefall case, would put downward pressure on the ratings.

— Maria Luisa De Gaetano Polverosi, Navneet Agarwal and Mark A. DiRienz

Rental Car Securitizations

The key considerations in analyzing rental car securitizations are the creditworthiness of the rental car company and the residual values of the vehicles in the rental car fleet. In a rental car securitization, to the extent a rental car company is unable to fulfill its obligations to the trust, the trust has recourse to the collateral (that is, the rental car fleet).

Most rental car fleets contain a mix of program and non-program, or risk, cars. Program cars are subject to a repurchase agreement under which the cars' manufacturer agrees to repurchase the vehicles at a specific price, thus reducing the rental car company's exposure to used car market price fluctuations, but increasing its exposure to the creditworthiness of the manufacturer. Risk cars, on the other hand, are not subject to a manufacturer buyback arrangement, but their value will be affected by, among other things, the market's perception of the manufacturer's viability.

The recent general trend in the rental car industry has been to shift from heavy reliance on program cars to a fleet that is more weighted to risk cars. In addition, with the exception of Dollar Thrifty whose fleet has approximately an 80% concentration in Chrysler cars, most rental car companies have attempted to diversify their fleets in recent years to somewhat reduce their exposure to the Detroit-3.

A rental car company requires a dependable and on-going supply of cars to remain in business. A liquidation of a key car manufacturer will disrupt the supply of cars to the rental car companies relying on that manufacturer, forcing them to secure cars from other sources (not perceived to be difficult at present due to manufacturing overcapacity). Also, if a manufacturer fails to honor its program agreements, the rental car company is obligated to treat those cars as risk cars, thus triggering an increase in credit enhancement. In addition, when cars are sold at a market price below book value, and loss is recognized, the rental car

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company is obligated to "top up" the credit enhancement. This topping-up of credit enhancement could have an adverse affect on the rental car company's balance sheet and on its ability to meet future mark-to-market obligations. Finally, rental car companies normally adjust depreciation rates to reflect expected market value at time of disposition, which to some degree moderates the risk of shortfalls in enhancement due to market value declines.

Government Bailout

A bailout, depending on its terms, could avert the bankruptcy of the auto manufacturers, and therefore would have a positive effect on rental car securitizations. A bailout that ultimately facilitated the restructuring of the Detroit-3 would in all likelihood result in current program agreements being honored, on-going car supplies assured and consumers less likely to discount used car prices because of fears of a manufacturer bankruptcy. A bailout that does not effectively address the persistent problems facing the Detroit Three could, in the long-run, have a negative effect on rental car companies if the unresolved issues force a manufacturer into liquidation.

Prepackaged Bankruptcy with Government Assistance

A manufacturer bankruptcy coupled with government-provided debtor-in-possession financing would not be as favorable as a bailout, but would be less stressful than a free-fall bankruptcy. In chapter 11, manufacturers would have an incentive to affirm their program car agreements to maintain positive relationships with the rental car companies, who are among their largest customers. A chapter 11 filing, could, however, put pressure on residual values of risk cars if the manufacturers pursue a strategy of aggressively promoting new car sales.

Freefall Bankruptcy

A free-fall bankruptcy could increase the probability that a manufacturer will be unable to effectively restructure, thus increasing the likelihood of a chapter 7 liquidation. In a liquidation scenario, both program and risk car residual values will be significantly negatively affected and, in the short-run, the car supply chain will be disrupted. Even in a free-fall scenario, if the manufacturer pursues a reorganization, there is a strong likelihood that it will honor program car arrangements to maintain an on-going relationship with such high-volume customers as the rental car companies.

— Xiaochao Wang and Linda Stesney

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