Appropriate for Income

Recommendation

We consider bonds of Ford (and its subsidiaries) to be an appropriate holding for Edward Jones clients who seek Income as an objective within a well-diversified portfolio.

Edward Jones Credit Strength Assessment

Investment Summary

Ford has recently encountered decreased profits, and new management plans to revamp the company’s operations and pieces of its business model. This will include cost cutting, exiting certain business lines where Ford sees little hope for reaching strong profitability, and improving overall efficiency. The company has announced its intent to exit the vast majority of its U.S. car business to focus on its profitable truck and SUV lines, which we view favorably. With the recent downgrade by Moody’s to Baa3 and the rating agency maintaining a negative outlook on Ford, the probability has increased somewhat that Ford could have a noninvestment-grade rating, at least at one rating agency. However, we still see a number of significant strengths in the company, including its highly profitable line of trucks in the U.S. and its significant cash holdings. We expect the company's performance to improve once the effects of its more efficient business model take effect in coming years.

Bond Strengths

• Ford’s truck line, including the F-150, is a highly profitable franchise that we believe has substantial ongoing value.
• Ford recently had cash and marketable securities of $24 billion in the company's automotive segment versus automotive debt of $14 billion.
• We believe the company has the incentive to maintain a strong financial position with the intention of maintaining investment-grade ratings due to the large amounts of funding needed for Ford Motor Credit.

Bond Weaknesses

• The cyclical nature of the auto industry presents a challenge for Ford and other automakers.
• Ford must balance the execution of fixing or exiting underperforming businesses with its continuing investment in new technology, like self-driving vehicles.
• There may be a number of new entrants to the auto industry in coming years with a number of technology companies rumored to be developing electric cars.
Recent News and Analysis

4/25/19: Ford posted first-quarter operating EPS of $0.44, which was above the $0.27 analyst consensus estimate. Sales were also well above consensus estimates. The company is now guiding for better results in 2019 than it posted in 2018. This was a solid quarter for Ford overall, in our view. The company’s shift away from car sales in the U.S. in favor of trucks and SUVs along with its cost-cutting efforts are starting to show benefits for the company’s profitability. Overall revenue was down due to the discontinuation of various car product lines, but profit margins benefited handsomely from the increased sales of higher profit trucks and SUVs, which grew 4% and 5% respectively in North America from a year ago. While sales were not as strong in Ford’s other markets globally, cost cutting kept profit about the same as it was in the first quarter of 2018 in the markets outside of North America. This was a better result than analysts expected. At the end of the first quarter, Ford had $24 billion of cash at its automotive business, $10 billion in excess of its automotive debt. We believe this excess cash is an important characteristic in Ford’s overall credit profile and better positions the company for a future downturn in the auto cycle. Ford Credit, the company’s lending business, continues to perform well, and the excess cash it generates is another important piece of its overall profile, in our view. There has been some concern among investors that Moody’s may cut Ford’s credit rating to noninvestment grade given it currently sits at the lowest level of investment grade with a negative outlook. We expect that this quarter’s strong earnings coupled with the benefits that were seen from Ford’s cost-cutting efforts should provide Ford some additional time to show further improvement in its operations. We think the cost-cutting benefits seen in this quarter should generally repeat in future quarters, and on the earnings conference call management indicated there are more operational improvements to come that should increase Ford’s efficiency. While we saw this quarter as a significant improvement operationally from prior quarters, we plan to continue to monitor Ford’s credit profile closely. We consider bonds of Ford (and its subsidiaries) to be an appropriate holding for Edward Jones clients who seek Income as an objective within a well-diversified portfolio.

Company Outlook

Ford Has Improved Its Operations Significantly - Ford has spent the last decade focusing on improving its operational structure. We believe Ford has made many significant improvements operationally, including bringing its fixed costs under control and improving its efficiency by building vehicles off fewer underlying platforms. Ford has aggressively reduced costs and the size of the overall company to employ a strict focus on profitability. The company has reduced the size of its workforce and has signed contracts that allow for these reduced labor costs to remain under control. Ford has also reduced the number of vehicle platforms off of which it builds its cars and trucks. In 2007, the company designed its vehicles off of 27 different platforms. The company consolidated its production to 15 platforms in 2013, and now operates on just nine platforms, with the goal of further reducing this number. Sharing platforms allows different makes of car or truck to have common design, engineering and production attributes, which ultimately leads to cost savings. This renewed focus on profitability has allowed Ford to operate with a significantly lower breakeven production level (the number of vehicles it would need to produce in a given year to not lose money for the year). We believe current breakeven levels may be more than 40% lower than those in 2009. This reduction in the breakeven level is very positive for bondholders because it reduces the probability of large losses in what has historically been a very volatile industry. We also note that Ford has sold brands that it either owned or had stakes in (including Volvo, Jaguar and Land Rover, among others) to focus solely on its Ford brand and, to a lesser extent, its Lincoln brand.

Despite Simplifying Its Operations, Ford Has Generally Kept Its Vehicle Lineup Fresh – We have been impressed by Ford’s ability to “right-size” its operations while at the same time innovating and producing vehicles that are relevant to consumers. Ford’s North American market share stood at 13.9% in 2017, down slightly from 14.2% in 2014. In its 2015 model year, Ford introduced a new F-150 pickup truck with an aluminum body. This was a big risk given the popularity and profitability of the F-150 line, but it has been a successful innovation. We believe this may give it a bit of an advantage over its closest competitors. This new F-150 is lighter than a steel-bodied version and offers better fuel economy.
Geographic Diversification a Mixed Bag – Ford has a presence in nearly all regions worldwide but the vast majority of the company’s sales still originate from North America and Europe. However, in recent years the vast majority of its profit has been derived from North America. We expect underperforming regions to be thoroughly addressed when new management announces its strategic plan.

While Europe has been a difficult market, Ford had shown promising results in China. While Ford has been behind many of its competitors in penetrating the Chinese market, it made important strides in recent years. However, more recently, the company’s Chinese operations have struggled, which appears to be due in part to product that needs to be refreshed. The company plans to release fresh product to the Chinese market in 2019. Ford’s Chinese market share was 4.2% at year-end 2017. While the Chinese market is still a relatively minor part of Ford’s business, we do believe this is an important market for the company given its growth characteristics. While the auto industry has a strong cyclical component in both North America and Europe, Chinese market growth has tailwinds beyond the whims of replacement cycles as there are still plenty of Chinese consumers who have yet to purchase their first vehicle. In fact, since 2009, industry volumes in China have grown from 14 million vehicles in 2009 to over 28 million vehicles in 2017, a roughly 10% compounded annual growth rate. This gives a good indication of why China is an important market for auto manufacturers.

New Management to Provide New Vision for the Company - Jim Hackett, the company’s new CEO, was appointed to navigate the company into the coming automotive world that is expected to focus on electric vehicles, autonomous vehicles and ride sharing. Jim Hackett has provided investors with some of his views on the course he sees Ford taking in coming years. Key points have included cutting costs substantially to operate more efficiently and improve profit margins, increasing the company’s focus on trucks and SUVs relative to cars, and increasing its focus on development of electric vehicles. We believe Ford is taking positive steps to evolve in a changing automotive industry. From a bondholder’s perspective, we were pleased with what we heard. We believe the company is trying to strike a balance between the current world, in which trucks and SUVs have become increasingly popular due in large part to low gas prices, and preparation for the future world of autos.

Financial Strength

Ford’s financial condition has improved dramatically over the past 10 years. The company’s debt has been upgraded several notches by major credit-rating agencies because Ford has cut expenses, lowered debt, and enhanced its outlook. At the end of 2017, Ford’s automotive sector had approximately $26 billion of cash and cash and marketable securities on its balance sheet versus $16 billion in debt. Taking into account the positive cash flows we project going forward, as well as unused lines of credit, Ford retains sufficient liquidity at this time.

We also note that Ford has diligently improved the funding of its pension plans. Ford’s pension plans were about $6 billion underfunded at the end of 2017, a strong improvement from nearly $19 billion underfunded at year-end 2012. The majority of this improvement was due to its significant contributions to the plan. While Ford has made great strides in improving its financial condition over the past several years, it still operates in a highly competitive, cyclical industry. However, we believe the company’s improved financial position, more moderate cost structure, and overall improved operating efficiency should allow the company to weather the next economic downturn while enduring less financial stress than in previous downturns. Ford has been quite bondholder-friendly recently as it has heavily reduced debt and improved its pension funding.

Edward Jones Credit Strength Assessment

We believe Ford’s credit strength assessment is below average. The company has improved its operations markedly and has paid down debt in recent years to improve its financial position. Additionally, Ford has made meaningful progress in reducing its underfunded pension liability. However, while these are all positive steps for bondholders, Ford operates in a cyclical and highly competitive industry. Recently the company has lost some of its advantages on the cost side and has seen weakening results in China and Europe. The company plans to address these issues with a plan that it will discuss in coming months. While investors know that this discussion will come, important factors, such as total expected cost savings, which businesses may be eliminated, and the time frame for these changes, are not yet known. This uncertainty and lack of transparency make us somewhat more cautious on Ford’s bonds than previously.
Required Research Disclosures

The table lists the percent of corporate credits we follow globally in each of the equivalent rating categories. We do not assign a “Buy” rating to any corporate credits. Investment banking services indicate the percentage of those subject companies that have been investment banking clients within the last 12 months.

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<th>May 21, 2019</th>
<th>BUY</th>
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<th>SELL</th>
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Initiated Coverage (SELL) 11/15/10...(S) 11/15/10-4/11/14...Appropriate for Income 4/11/14-

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- Edward Jones Credit Strength Assessment: Low –Our opinion is these credits are of low financial quality. We believe these credits are the most likely to default and experience the most financial hardship. Below Average – Our opinion is these credits are of below-average financial quality. We believe these credits are more likely to default or experience financial hardship than the average. Average – Our opinion is these credits are of average financial quality. We believe these credits have a low probability of default or low chance of experiencing financial hardship. Above Average – Our opinion is these credits are of above-average financial quality. We believe these credits are less likely to default or experience financial hardship than the average. High – Our opinion is these credits are of the highest financial quality. We believe these credits have the lowest probability of default and will experience the least financial hardship.
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