Bayerische Motoren Werke AG

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Recommendation: Buy

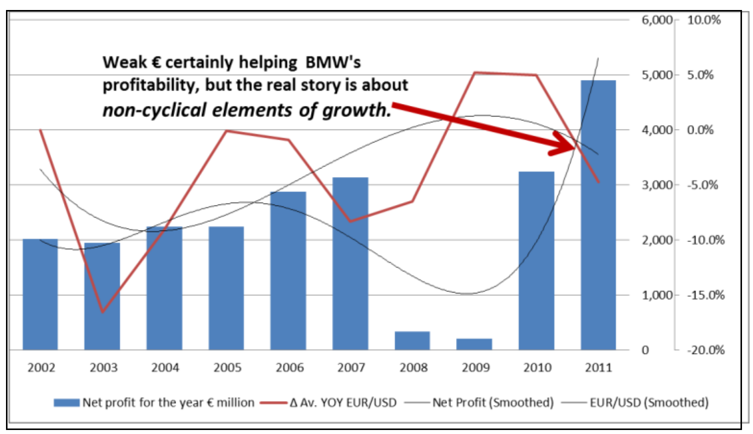
The key message of this report is that while cyclical forces certainly affect BMW, the current cycle has increased BMW's competitive advantage. This broadening of the moat has positioned BMW to increase ROIC over the next decade and disproportionally benefit from secular growth trends in emerging Asia. The European financial turmoil has created an entry point into BMW at a particularly attractive valuation.

Background: The past few years have not been kind to the global automobile industry. The shake up has broadly penalized the shareholders of large (i.e. heavily geared), un-focused OEM's. It has also created a real opportunity for strong, focused companies like BMW to lay the groundwork for excellent financial performance over the next decade. BMW is in the proverbial driver's seat when it comes to capitalizing on increased emerging markets consumption, but most importantly is in a position to deliver substantial shareholder returns from the growth based upon growing ROIC.

<u>BMW's Strategy "#1" = *"To be profitable and to enhance long-term value in times of change."*</u>

These times of change are very much upon the global auto industry. Detroit's debt levels accrued over decades of ill-conceived acquisitions caused it to take a giant leap towards the dustbin of history. Electric and hybrid vehicles are nearly ubiquitous. Energy price-shocks continue. High-performance materials continue to develop. Nevertheless, humans still pay money to ride rollercoasters. High-performance mobility seems to have an enduring share of the wallets of the world's industrialized citizens.

BMW's managers have been true to their Saxon disciplines and continued to produce automobiles faster, better, and cheaper than ever before. This discipline has rewarded them with the opportunity to place the proverbial spinnaker to the wind.



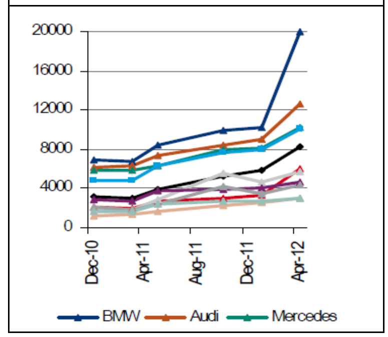
Tailwinds

- Emerging Markets consumption growth provides an expanding market for products.
- Focused market position/strong business momentum suggest less vulnerability to cyclical forces.
- As the leader in lightweight-construction and "Efficient Dynamics" technologies, BMW is well positioned for regulation-driven growth in Europe. (Upgrade-driven demand dampens cyclical effect).

Branding – Enduring Value and Defensible Moat

By strategically focusing on exclusively premium, high-performance brands, BMW has created a pure premium global brand. BMW is easily recognizable throughout the world, and maintains a very strong market position in key growth markets in Asia.

Average Hits/Day for Premium Cars on Baidu.com



This kind of brand strength is difficult to place a numeric value on, but it certainly comes through in the margins. Current guidance is for a 10% EBIT margin in 2012 for the group. This comes on the back of a 12% result for 2011. There are several factors influencing this metric discussed below, and notably BMW's management has been traditionally very conservative in their estimation of it.

Key Debate

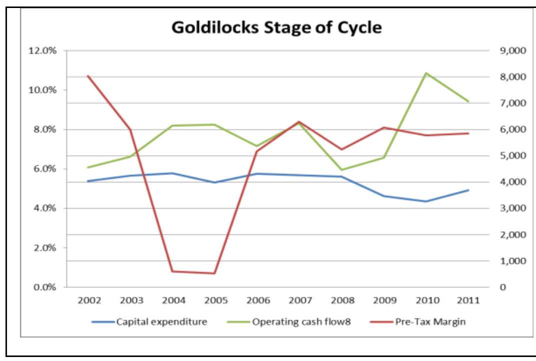
Since 2008 BMW has enjoyed a bit of a "Goldilocks" period where competition sagged, leading to stable margins and moderate CAPEX. The critical debate at this point is weather cyclical forces will lead to a period of higher CAPEX and shrinking margins in the coming years.

My Take:

- *I do not believe that BMW's business is as cyclical as most fear.*

  The effort and resource which BMW has put into product and market development, especially during the recent uncertain years are now paying off for two key reasons.

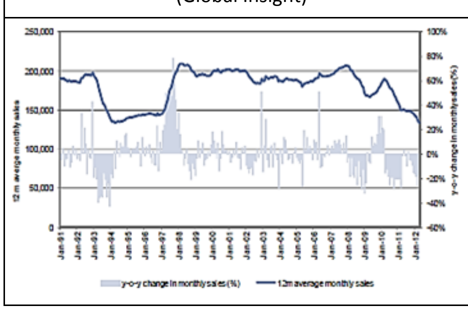
  1. Investments in China are enabling BMW to enjoy excellent penetration leading to <30% unit sales growth so far this year.
  2. BMW has the best new product lineup in the premium segment, leading to increased market share.



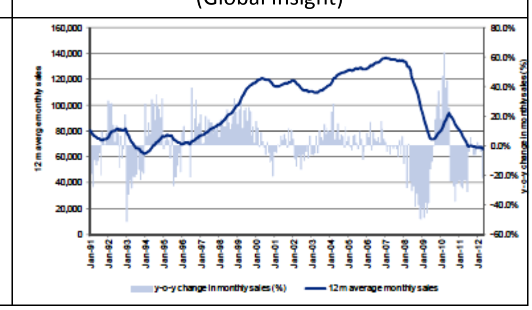
- *European pricing environment and demand weakness are already baked-in.*

  Undeniably European demand is soft and not improving as Southern European demand weakness moves North. The question becomes whom does it affect most? More importantly what does it mean for the next 5 years? Historically auto demand tends to be deferred in times of financial turmoil, since the functional need for mobility still grows and existing car stock wears out. This pent-up demand will prove to be counter-cyclical for BMW.

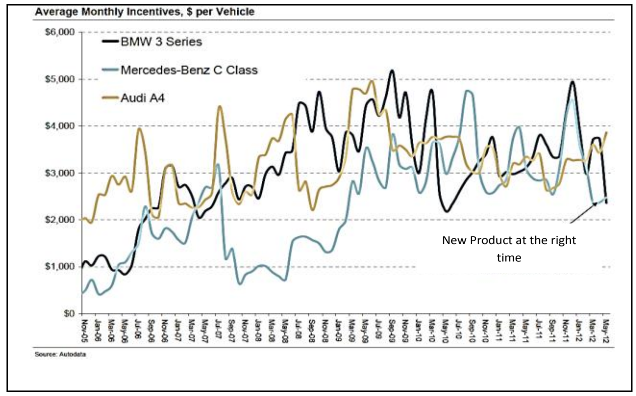
Italian Car Sales
(Global Insight)



Spanish Car Sales
(Global Insight)



Recent industry research notes that Daimler (the weakest of the big 3 German makers) has initiated a round of price-cutting which will affect BMW, however to a substantially less degree than Daimler and VW. This is primarily due to a robust lineup of new products which allows BWM to defend their margins more than the heavily discounted competition. New products (like the 3-Series) are helping to reduce the effect of slack overall European demand.



- *Mandated upgrades*

EU legislation is underway which will enact a binding limit on carbon dioxide emissions to 95 grams per kilometer for cars registered within the EU. This compares to the currently set standard of 130 g/km. This is a substantial upgrade cycle which will support demand within the EU market.

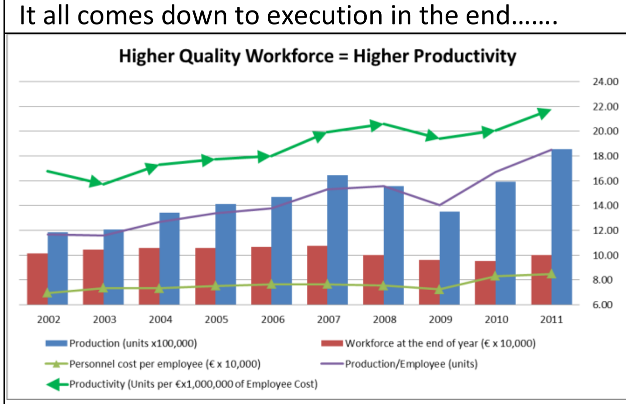
The Kyoto Protocol introduced fixed reductions of C02 emissions globally. The European Union has been the most proactive in creating requirements for passenger cars due to the large number of cars in Europe which account for 12% of EU emissions. Taking Europe as a barometer for future global regulatory patterns, this causes an enormous upgrade cycle which BMW is well positioned for.

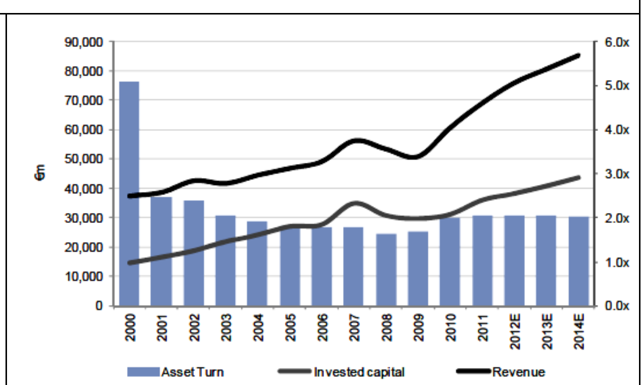
- *BMW will benefit from this disproportionately: Brand, Management Skill, Market Positioning, and High ROIC.*

The enduring nature of BMW's brand affinity is a testament the skill of management to remain focused upon the goal of profitably delivering high-performance mobility to the market. BMW's culture is one of efficiency and this manifests itself not only in their automobiles, but also very much within their workforce development and asset efficiency.

BMW's invested capital in the Industrial segment has doubled over the past decade and the company has consistently managed two turns of utilization, easily double what any of the Detroit OEM's could do.

It all comes down to execution in the end…….





Understanding BMW's Balance Sheet

Debt Breakdown (Reported)		31.3.2012
Reported Group Debt(+)		71,994
Reported Group Cash (-)		14,862
(=) Net Group Debt	€	57,132
By Segment: (Derived)		
Industrial Segment Debt		-4,914
Industrial Segment Cash		9,160
Net Industrial Segment Cash	€	14,074
Finacial Segment Debt		76,908
Financial Segment Cash		5,702
Net Financial Segment Debt	€	71,206
Reported Financial Segment Equity		7,375

BMW has two operational segments, Industrial and Financial. The Industrial segment is the traditional automobile OEM business. The Financial segment handles captive and 3rd party leasing as well as credit financing of sales. There are substantial IFRS eliminations between the segments which cloud the picture a bit, however the approach I have taken is to value the group as two discreet components. The Industrial segment deserves a valuation driven by ROIC and Growth rates, for the Financial Segment, I take the view that it exists primarily to facilitate growth on the industrial side and therefore I value it at 1x Book Value. The short-duration and high-collateralization of auto loans provides a good validation of this approach. BMW provides a high level of transparency into the segmentation of its balance sheet. To understand the financial leverage picture better I have broken it out in the table.

BMW Valuation Breakdown and Ratios		
Analytic Firepower Estimates as of 6.20.12		
Price (6.20.12)	€	58.07
(x)Shares Outstanding (mln)		654
(=)Mkt Cap	€	37,978
(-)Financial Segment at Book Value	€	7,375
(=)Mkt Value of Industrial Segment	€	30,603
(-)Industrial Cash	€	14,074
(=)EV of Industrial Segment (derived)	€	16,529
Industrial Segment (EV per Share)	€	25.27
P/E of Industrial Segment (NTM, derived)		3.9
Dividend (NTM)	€	2.75
Yield		4.74%

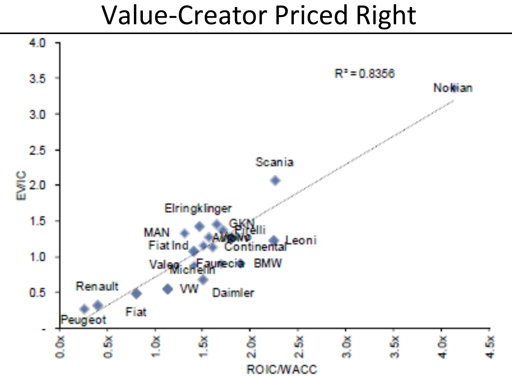
The key to understanding the business is to break it down by its Industrial and Financial components. Perhaps it may be simplistic to take the Financial Segment at Book Value, but I do believe that this method provides the best insight into the underlying performance and pricing of the industrial segment.

This analysis points to an attractive low single-digit multiple currently on this business, combined with a mid-single digit yield. A potential flaw in this analysis would be if the Financial Segment were to endure deterioration of credit quality of its loan book. Historically Auto loans, owing to their short duration and high collateralization have had quite predictable default rates. Furthermore, BMW's collateralization (in terms of the vehicle's resale value) has tended to endure better than the overall auto sector.

Auto Loans Tend to Be High-Quality

S&P/Experian Consumer Credit Default Indices			
National Indices			
Index	**May 2012** **Index Level**	**April 2012** **Index Level**	**May 2011** **Index Level**
Composite	1.62	1.86	2.23
First Mortgage	1.50	1.76	2.09
Second Mortgage	0.88	0.93	1.42
Bank Card	4.35	4.49	5.93
Auto Loans	1.03	1.07	1.34

Value-Creator Priced Right



Value – European Turmoil Provides Opportunity

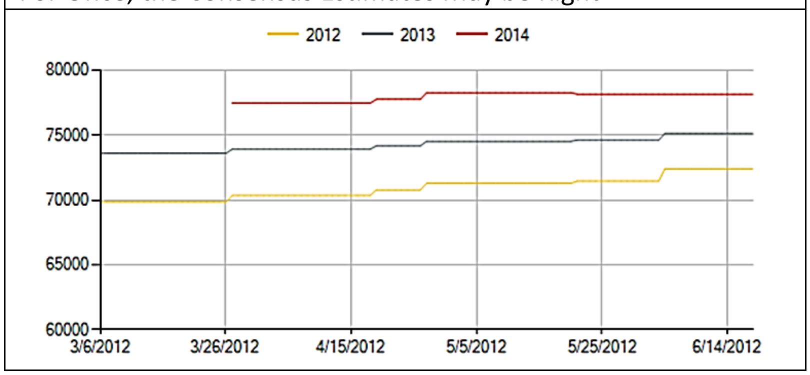
Traditionally high ROIC companies have not come cheaply. The current turmoil in Europe has presented an opportunity with BMW. The high quality management of BMW has historically managed the cyclical aspects of the business well which enables them to capitalize on more secular growth drivers exactly when weaker competitors undergo financial stress as is currently the case with many competitors.

Margin Dynamics for 2012	Steel Index
Structural: **Efficiency Gains** = +25 bps from ongoing modularization of components and scale. *Cyclical* **Commodity Prices** = +25bps for 2012 from lower commodity price levels **Pricing** = -200 bps from discounting in developed markets (primarily Europe) .	

Bluntly stated, I am of the opinion that the current market price for BMW reflects an enormous fear of a step-function drop-off of global demand. The rather straightforward forecasts presented in the table portray a dampend-cyclical company with mid-teens ROIC and a

Consensus estimates for BMW have been moving in the right direction for some time now, yet the valuation has sagged in concert with overall European indices. While I am no fan of sell-side analyst estimates, I would note that generally the automobile analyst tend to incorporate cyclical factors into their estimates, the aggregate presented here does not show evidence of this.

For Once, the Consensus Estimates May be Right



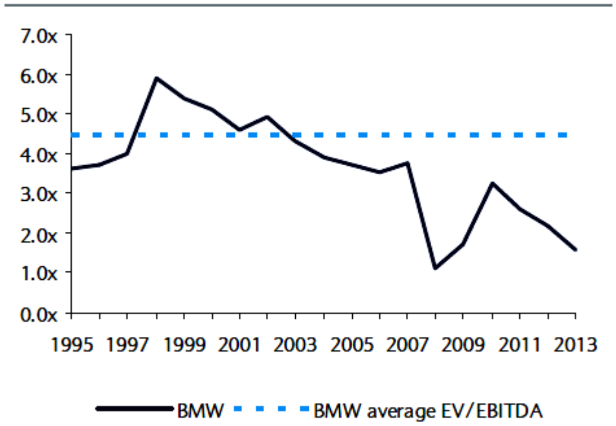
Reuters Consensus Estimates (Median)

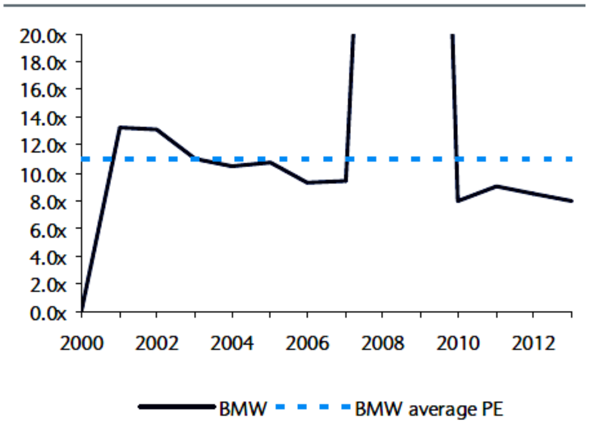
Recommendation	Target Price	LT Growth Rate
OUTPERFORM(2.14)	EUR 81.05	10.90%

EPS (Pre Except) (EUR, Major)

FY (Dec.)	Q1	Q2	Q3	Q4	FY
2011:	1.84a	2.75a	1.64a	1.22a	7.45a
2012:	2.05a	**2.18e**	**2.09e**	**2.16e**	8.04e
2013:	**2.03e**	**2.38e**	**2.17e**	**2.42e**	8.28e

Using the dynamics discussed above as well as managements guidance of a 10% EBIT margin for the balance of the year, I derived the following forecasts for the next twelve month period for BMW.



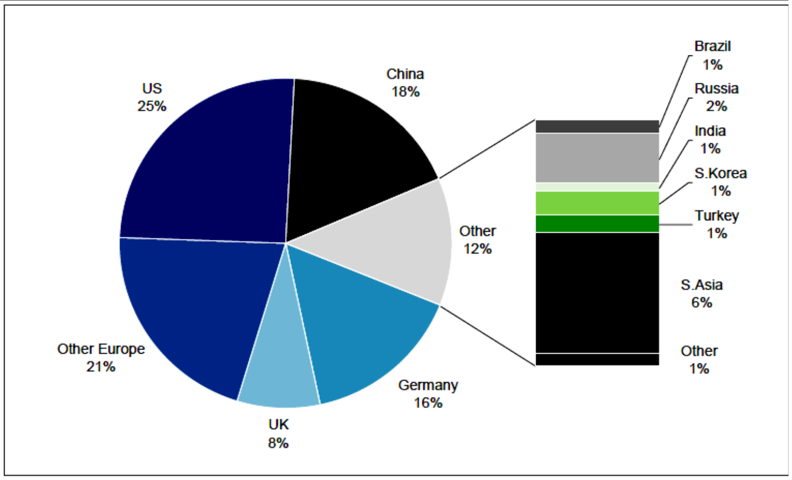


BMW's rating upgraded

In April 2012 the rating agency Standard & Poor's raised BMW AG long-term rating from A– (positive outlook) to A (stable outlook). At the same time, the short-term rating was also raised by one level from A-2 to A-1. The main reasons for the upgrade are strong demand for premium vehicles, the sharp rise in Group profitability and the successful implementation of Strategy Number ONE. The BMW Group therefore has the best ratings of all European car manufacturers.

Bayerische Motoren Werke AG			
Industrial Segment Income Estimates as of 6.20.12			
(€ Millions)			
	Industrial (*Next Twelve*		**Industrial** (*Q1 2012*)
Revenues	66,432.00		16,608.00
Cost of sales	(53,024.00)		(13,256.00)
Drivers			
Commodity Prices	166.08	0.25%	
Effeciency Gains	166.08	0.25%	
Pricing	(1,328.64)	-2.00%	
Change in GM		-1.50%	
Gross profit	12,411.52		3,352.00
Gross Margin	18.68%		20.58%
SG&A	(5,704.00)		(1,426.00)
Other Operating (net)	8.00		2.00
Profit before financial result	6,715.52		1,928.00
EBIT Margin	10.1%		11.7%
Tax	(2,261.31)		(649.00)
Tax Rate	-34%		-34%
NOPAT	4,454.21		1,246.88
IC	31,210		30,210
Changes in Capital	1000		
ROIC (NTM, Q1 Annualized)	14.3%		16.5%
Financial result (Net)	-368		-92
Profit before tax	6,347.52		1,836.00
Pretax Margin	9.6%		11.3%
Income taxes	(2,137.39)		(649.00)
Net profit/loss	4,210.13		1,187.00
Net Margin	6%		7%
EPS (Industrial Only, Diluted)	6.44		

Global Premium Car Demand by Market, 2011A



Conclusion: The only time one has the opportunity to buy a large-cap global luxury brand with a superlative managerial talent and good growth trajectory is when somebody fears that it is all going to go away. My analysis concludes that there is no evidence that BMW's business is likely to moderate to any great degree in the foreseeable future.

I find a disconnect between the business momentum and outlook and the current market valuation. Where crisis breeds opportunity is exactly the same place that BMW is positioned. The good news is that the crisis has sidelined several competitors at a critical time which has allowed BMW to establish itself in a leading position in the world's largest car market (China).

Finally, a wise old man told me once that when the yield exceeds the P/E, the market might have something backwards.

BMW AG	
	Next Twelve Months
P/E of Industrial Segment (NTM, derived)x	3.93
Yield	4.74%

2012 EV/IC vs. ROIC/WACC
(Based on Goldman Sachs Estimates)

Post-Script

How Car Companies Die – One trait of unsuccessful auto manufacturers is that they have unfocused product lines and attempt to compete in the mass market. Large OEM's with multiple brands and replicated distribution/overhead tend to have weaker balance sheets from past brand acquisition sprees. The resulting lack of focus leads to intense competition within brand and cannibalization among brands. These issues are exacerbated by a rapidly shifting consumer demand profile driven by fuel price shocks.

How Car Companies Thrive – Focus, execution, and financial strength

BMW has true operating leverage in its asset base, in contrast to the likes of the old GM, which had lots of brands of no value, and replicated distribution. GM was *supposed* to have operating leverage, but in reality it was only financial leverage)