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European Auto Stocks' Race to the Finish Line in 1997

Overview

The European passenger car market continues to grow in line with our expectation of a 2-3% pace, with demand approaching 13.2 million vehicles for 1997. Explosive incentive-driven demand in Italy has offset the pullback from the incentive hangover in France, while strength in Spain and a healthy U.K. market offset problems in Germany. Growth in markets beyond Europe offers additional performance advantages to those manufacturers with superior global footprints.

With mid-year reports due out soon, we see VW on target for superior earnings and stock price performance and maintain our outperform rating. Fiat will improve sales and earnings for 1997's first six months and will finish the year strongly, as the impact of incentive-driven volume sales hit the bottom line and cause rising earnings estimates. Next year, however, the payback will reverse some of this good fortune when the program expires. Renault and Peugeot, still in their own incentive hangover period, are expected to turn in negative earnings at mid-year. A strong currency wind may help them break even by year-end. A stronger exposure to the British pound and some product success allow us to slightly raise our earnings expectations for Renault. Fiat and the two French automakers appear to have more attractive valuations than VW, but are also subject to much greater risks, and are rated market-perform.

proving sales by 11% year-over-year on the back of product-led market share gains in Europe and growth in international markets. Earnings are also continuing to expand on the leverage of the growing volumes over an improving cost base (see Exhibit 1). We expect pretax earnings for first-half 1997 to be over DM1.4 billion and reported net income to exceed DM400 million — up 50% year-over-year.

Fiat's domestic sales boom should improve sales by 6% to over ItL42 trillion and earnings should begin to respond to the high capacity utilization and to increase operating income to ItL1.6 trillion for the first six months of 1997 — up 5% compared to the same period last year. PSA and Renault are trading water with a weak French franc; improving international sales are playing a key role in earnings preservation. Sales for PSA and Renault are expected to be up 6% and 4%, respectively, while earnings shrink under the pricing pressures at home.

For the year, we see Volkswagen on track to deliver 35-40% in earnings growth, coming in above the consensus of DM70 at DM75 per share. The company's Audi and Seat divisions continue to grow sales aggressively, and VW will begin rolling out the new key Golf IV model by year-end. Fiat will also enjoy a healthy finish as the second half better captures the incentive impact. The blistering first-half sales pace will slow by year-end, with the soft renewal of government incentives — but not before showing Fiat shareholders' an adjusted earnings growth of about 40%. The French companies will both continue to struggle for break-even results in a slowly improving

Mid-year performance and expectations

With the mid-year reports for the European automakers approaching, we see the Volkswagen Group im-

Exhibit 1 Earnings Outlook

	Volkswagen (DM billion)								Fiat S.p.A. (lira trillion)							
	1H:96	1H:97E	Growth	1996	1997E	Growth	1998E	Growth	1H:96	1H:97E	Growth	1996	1997E	Growth	1998E	Growth
Sales	50.5	56.0	11%	100.1	111.9	12%	121.0	8%	40.7	43.1	6%	77.9	90.2	16%	92.9	3%
Oper. Inc.				0.4	1.7	348	3.2	84	1.5	1.6	5	1.8	3.4	86	3.2	(4)
Reported Net Inc.	0.3	0.4	53%	0.7	1.7	147	3.4	105				2.4	2.3	(4)	2.0	(14)
EPS				20	49	147	77	58				474	426	(10)	368	(14)
Adj. EPS ¹				55	75	37	100	33				265	378	43	368	(3)
	PSA (franc billion)								Renault (franc billion)							
	1H:96	1H:97E	Growth	1996	1997E	Growth	1998E	Growth	1H:96	1H:97E	Growth	1996	1997E	Growth	1998E	Growth
Sales	89.0	94.6	6%	172.7	178.7	3%	184.4	3%	90.0	93.5	4%	184.1	187.0	2%	190.3	2
Oper. Inc.	1.3	0.8	(37)	1.7	0.8	(50)	2.5	197	(0.2)	(0.9)	293%	(1.8)	(0.7)	(62)	2.0	nm
Reported Net Inc.	0.6	0.4	(39)	0.7	0.3	(65)	1.5	469	0.2	0.0	nm	(5.2)	0.0	nm	1.9	nm
EPS				15	5	(67)	29	480				(22)	0	nm	8	nm
Adj. EPS ¹				-	-	-	-	-				(4)	-	-	-	-

¹ Adjusted earnings exclude restructuring charges/earnings for Renault and Fiat, and include DVFA adjustments for VW.

Note: Items left blank are due to detail omissions by companies in mid-year reporting.

Source: Corporate reports and Bernstein estimates.

French market, with the strengthening British pound offering key earnings support.

Demand distortions impact manufacturers' fortunes

The dramatic demand distortions caused by government incentive programs have had a decisive impact on demand in France and Italy (see Exhibits 2 and 3). Renault and PSA have suffered and will continue to be at risk due to their heavy reliance (almost 40% of their sales) on the domestic market. French demand fell a staggering 34% in January after incentives were eliminated (see Exhibit 4). With fixed costs a problem during such a volatile sales shift, Renault and PSA have been forced to more aggressively market cars at home and abroad to maintain unit volumes. We expect a corresponding deterioration of margins. Our year-end estimate of a 17% decline in demand for the French market could be conservative. With tough comparables coming in the second half (second-half 1996's sales were driven by consumers snapping up ending incentives), there is a risk that the recovery will be even slower than the current trend. If the

current year ends down 20%, for example, PSA's earnings could drop to zero; a 25% decline could pull earnings down to Fr(15) per share. The same scenarios would drive Renault 1997 earnings to Fr(2) and Fr(5), respectively. Continuing weakness in market fundamentals (record unemployment levels and declining consumer confidence and spending on manufactured goods) adds risks to these stocks that go beyond the current year.

Although Fiat is enjoying the upside of incentive-induced volumes in a market that has grown over 30% year-to-date, "manufactured" sales at home should be valued cautiously. As Fiat scales up fixed costs to catch up with the runaway demand (and to beat off starving competition from the French), it is increasing its exposure to the downside risk of a demand contraction expected in the post-incentive period starting at the end of next year.

Market share trends

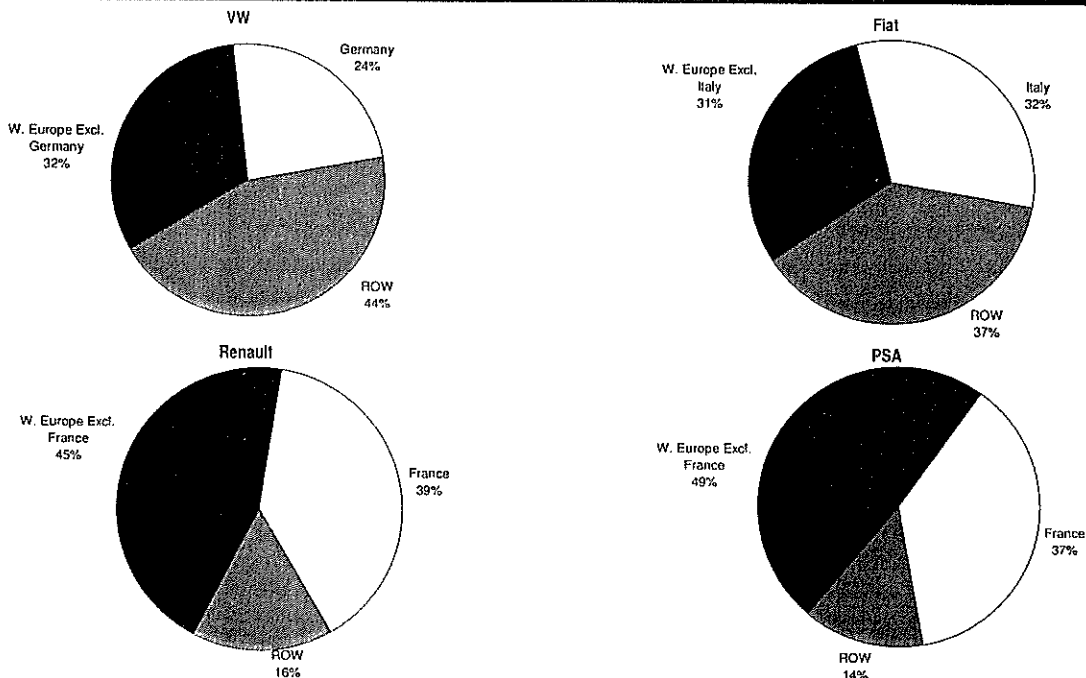
Fiat's slide in market share outside of Italy is also an early warning indicator that other risks are at hand. Although volumes are up, Fiat has lost share of market in each of the key European countries—including at home, in Italy (see Exhibit 5). A market share gain in all of Europe is possible due to Fiat's weight in the Italian market. With all its European production at home, the company will continue to be disadvantaged abroad under the strengthening Italian lira (see

Exhibit 2 Government Incentive Impact on Passenger Car Demand: Before and After

	1996	1997 YTD	1997E	1998E
Italy	1.5%	32.0%	27.5%	(5.0)%
France	10.4	(24.0)	(17.5)	3.0

Source: Bernstein estimates.

Exhibit 3 Geographic Sales Mix



Source: Ward's.

Exhibit 6). The Japanese have attacked market share in Western Europe this year despite a negative currency trend in Italy, Germany and France that forces margins down (see Exhibit 7). The regressive nature of incentive programs favors small cars and the price-sensitive consumer — leveraging many of the current competitive strengths for the Japanese. The French are also using the weak franc to their advantage to compete for sales in Italy and to import more profits from the U.K.

In addition to a push of the Twingo, Espace and Megane in Italy, Renault has had broader market share advances on the back of the very successful Scenic minivan. The company is currently enjoying the profitable advantage of being early to market — a market that is soon subject to change, with product introductions by all key players on the way. We see competitive product introductions as a strength for Fiat and VW in the long run, with their aggressive five-year product plans.

Volkswagen has taken market share across Europe by leading the assault with recent successful introductions by Audi, SEAT, Skoda and VW. This share advance is a notable achievement given the German market is down 3% to date from last year and the company's key volume model, the Golf, is winding down in anticipation of year-end replacement (see the July 3, 1997 Note, "VW: Momentum Building"). In the long term, we see VW, Fiat and the Japanese as winners of market share.

Margin defense

Volkswagen is the best positioned among the European volume manufacturers to defend and grow margins, as the company continues to leverage grow-

ing global volumes over a restructured and improving cost basis. The goal has been to move a growing number of models down to only four platforms. By year-end, the company will have moved 16 platforms to 10, including the high-volume Golf IV (representing about one-quarter of almost 4 million vehicles the company will sell worldwide). VW expects 90% of the remaining 51 planned models and versions to be on the four cost-sharing platforms within the next 30 months.

More importantly, VW's models have been a success and factories are backlogged with orders for the Golf, Polo and Arosa. Beginning this month, the company will add 30 extra shifts in the Wolfsburg plant to keep up with demand, driving utilization and margins up over the heavy fixed-cost base in Germany. Margins are also accelerating due to the

Exhibit 5 Western Europe Passenger Car Market: Change in Market Share from 1H:96 to 1H:97

	Western Europe	Italy	France	Germany	U.K.	Spain
Volkswagen	0.2%	(1.2)%	1.5%	(0.2)%	0.8%	2.1%
Fiat	0.8	(0.2)	(1.2)	(0.4)	0.0	(2.4)
Renault	(0.4)	0.4	(0.1)	0.7	0.9	0.0
Peugeot	(0.8)	0.6	(1.4)	(0.4)	0.2	0.2
Japanese	0.9	1.2	0.4	1.0	0.9	1.0

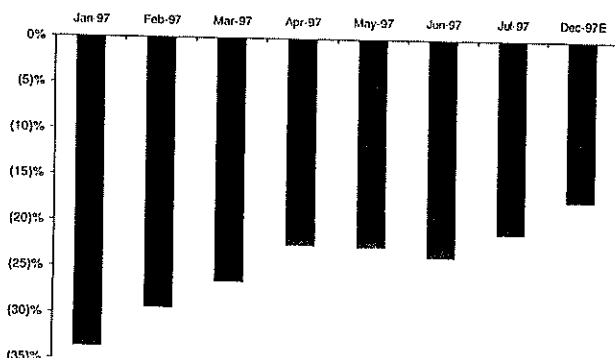
Source: Ward's International, ANE and AID.

Exhibit 6 Manufacturers' Net Export (Import) as a Percentage of European-Produced Vehicles

	PSA	Renault	VW	Fiat
France	30.5%	25.6%	(5.4)%	(7.1)%
Germany	(6.7)	(10.8)	19.6	(7.8)
Italy	(3.0)	(6.3)	(5.9)	32.8
Spain	9.3	12.4	10.9	(1.8)
U.K.	(7.6)	(8.0)	(3.9)	(4.2)

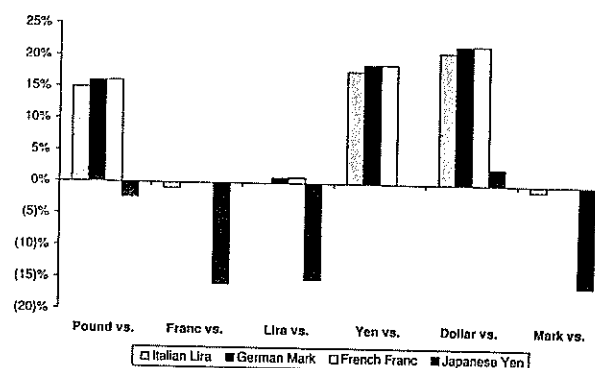
Source: Bernstein estimates.

Exhibit 4 French Year-to-Date Cumulative Passenger Car Sales by Month



Source: ACEA and Bernstein estimates.

Exhibit 7 Key Currency Performances vs. Other Currencies



Source: FactSet.

highly profitable growth from Audi, as it advances on competitors in the luxury segment. Year-to-date Audi revenues are up 16% globally, 30% in the U.S. and 18% in Japan, as the company runs factories at almost full capacity utilization. With Seat and Skoda now both operating profitably, the company has few reasons to deny shareholders strong earnings growth in the next few years.

Risks

The primary risk to VW would come from a product failure for a key model launch, such as the Golf IV. Current other product successes may cause the company to encounter problems scaling up production for a full-scale launch of the Golf IV, currently planned for October. Although a delay is possible, industry surveys suggest that consumers are eagerly awaiting its arrival. The current negative trend, due to the model-end cycle decline, suggests sales of only 525,000 Golfs in Europe this year and 420,000 in 1998 (assuming no renewal). Our estimates show the new Golf impacting this trend and raising unit sales to 575,000 in 1997 (adding DM2 per share). In 1998, we are anticipating a 300,000 unit rebound that represents over DM10 per share in our DM100 estimate.

The French companies are most at risk from a continued weakness in their home market. Moreover, a reversal of exchange rates could prove deadly with their limited production footprint.

Fiat earnings could be at risk in 1998 if the new, more limited incentive program were to fail to keep the market charged. We believe that the program is sufficient enough to tap the additional pent-up demand, and are more concerned with the Fiat's production strategies for the post-incentive period. For Fiat to maintain momentum from year-end 1998, we will look for a sustainable turnaround in Italian mar-

ket fundamentals or a downsizing of Fiat Auto's fixed-cost base.

Investment Conclusion

At the mid-year, we see VW (DM1,356) on target for superior earnings and stock price performance and maintain our outperform rating. The company has outpaced its competitors with a constant flow of new products, substantial cost cutting and improving capacity utilization. We believe that earnings revisions for VW will continue to rise as the company completes its platform-consolidation initiative with key product introductions and strong global growth (see Exhibit 8). We estimate 1997 earnings to be DM75, above the consensus at DM69. In 1998, we are expecting DM100, while consensus looks for about DM90.

Fiat and the French automakers may appear to have more attractive valuations—but are also subject to much greater risks than VW, and are rated market-perform. We are raising our estimates for Fiat (ItL6,005) from ItL300 to ItL378 per share for 1997 and from ItL350 to ItL368 for 1998, due to the robust incentive-driven demand in Italy and the improved expectations for the Iveco commercial vehicle division. The dramatic increase in auto sales volumes from the incentive program greatly improves Fiat's fixed-cost coverage over its usually disadvantaged domestic production base for Europe. Given that the government has announced a "soft" renewal, including some environmental criteria, we see earnings momentum continuing into 1998. Iveco seems to be performing better than the overall depressed market for heavy commercial vehicles because of a business mix weighting towards more popular lighter commercial vehicles.

Higher sales costs at PSA (Fr717) and Renault (Fr172) are holding down the healthy benefits from currency moves for the two companies. Renault qualifies for a slight upward revision of estimates for two reasons. The first is a greater exposure to the British pound, which has strengthened by about 17% relative to the French franc. The second is the success of the currently freshened product line, led by the profitable new Scenic minivan. Our 1997 estimates are now up from Fr(3) per share to break-even, and our 1998 expectations have moved from Fr1 per share to Fr8 per share.

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Exhibit 8 VW: Earnings Revisions Move Upward¹ (DM/share)

	Mean		High		Low		Upward Revisions ²
	1997E	1998E	1997E	1998E	1997E	1998E	
8/97	68.6	88.8	79.9	107.1	58.0	75.0	3
7/97	68.4	88.8	79.9	107.1	58.0	75.0	3
6/97	68.3	88.3	79.9	107.1	60.0	75.0	9
5/97	67.5	87.9	79.9	107.1	60.0	75.0	11
4/97	66.3	87.9	79.9	107.1	57.0	80.0	22
3/97	49.0	67.4	70.0	96.8	35.0	41.9	7

SCB 75 100

¹ I/B/E/S estimates based on an average of 35-40 analysts.

² No downward revisions since 5/97.

Source: I/B/E/S.