The long drawn out marriage of Porsche and VW

…I thee wed

The dynastic battle between VW and Porsche over who controls whom reads more like a summer block-buster than the sobriety we associate with Germany's industrial elite. Cornering the market in VW share options, the suicide of an investor, the summary removal of Porsche's long-serving CEO, newspaper spats among rival branches of the same family. But, as the dust settles, it's still not clear who has come out on top: the Porsche's or the Piëch's?

Tracing the origins of the situation goes back at least to 2005. In that year Porsche's chairman, Wolfgang Porsche, started on a collision path with his cousin, VW CEO Ferdinand Piëch, by starting to amass a decisive share stake in VW…or did he? The man who may have sold him the idea could have been Wendelin Wiedeking himself, put in place by Piëch when he was head of Porsche in the early '90's.

Others say that it really began in 2000 when Holger Härter arrived at Porsche and began reorganizing its Treasury back office into a profit-oriented options trading house. In effect an in-house hedge fund. It was this department that managed the opaque VW share buying and generated the billions needed to buy them.

Family insiders say Piëch fell out of favour with Porsche AG in 1972 when, anticipating a change in Can-Am series rules, he built 16-cylinder engines for the 917. They were costly and never used, and Piëch left for Audi the same year. However, this coincided with another chapter in the constant feuding between the Porsche and Piëch sides of the family

Whenever the public feud began recent events are clear: Porsche built up a controlling stake in VW but saddled itself with at least €10BN of debt on the way. Given the current state of the global economy, to clear those debts it needs to refinance itself, by selling 17% of its stock to Qatar, worth €10BN and getting VW to buy €3.3BN of the Porsche sports car business. Then, it can restructure by merging into VW and become its 10th brand.

Confused? That's unsurprising so here's how it happened and what could emerge.

For years it was reported that Porsche Chairman Wolfgang Porsche, 66, and his cousin, VW CEO Ferdinand Piëch, 72, favoured a combination of their car making businesses. They only disagreed over how the two firms should come together and who should be in ultimate control. Behind this deadlock is a very murky history and the oft-reported ambition of Ferdinand Piëch to reform the companies into one.

The production logic is overwhelming for a tie-up. Porsche relies on VW, its number one supplier, for much of its financial success – the Cayenne. Estimates are that Cayenne contributes 50% of the Porsche bottom line, 911 around 40% and the Boxster/Cayman 10%. Max Warburton, formerly of Bernstein Research estimates that Porsche might only be paying VW an average of €22,000 for each Cayenne it delivers and selling them for up to €90,000 each!

US CAFE regulations also pose a challenge. Porsche needs a relatively high-volume fuel-efficient model or two to meet stringent new Corporate Average Fuel Economy and more importantly, European Union CO2 emissions standards. So far, it has just two models on the way to handle the problem, the hybrid Panamera and hybrid Cayenne. Absorbing Porsche into VW Group's CAFE and CO2 numbers is a good solution for the integrity of the Porsche brand. Car enthusiasts should cheer: It will allow Porsche to keep producing high consumption and high emission cars.

The Porsche Battle Plan

Back in early 2007 the financial plan cooked up in 2005 by neighbours Wendelin Wiedeking, then chief executive of Porsche, and Holger Härter, then his finance director, first came to light. These two crystallized Wolfgang Porsche's plan to take control of the VW Group, a target about 6 times the market capital of Porsche (VWG €44.5BN vs. Porsche SE €7.7BN). That doesn't mean that Ferry Piëch didn't know all along. He may have been more concerned with staying in control than the emblem on the banner flying outside. In any case, the original Ferry Porsche was his hero, so why not keep the name?

Having already bought 27% of VW, Porsche raised its stake to 31% in March 2007, triggering a formal take-over bid under German corporate laws. Protesting that they did not want to take control, just to protect VW from takeover by hedge funds, who might later break it up because the European Union (EU) began moving against the so-called 'VW Law' that protected VW from takeovers.

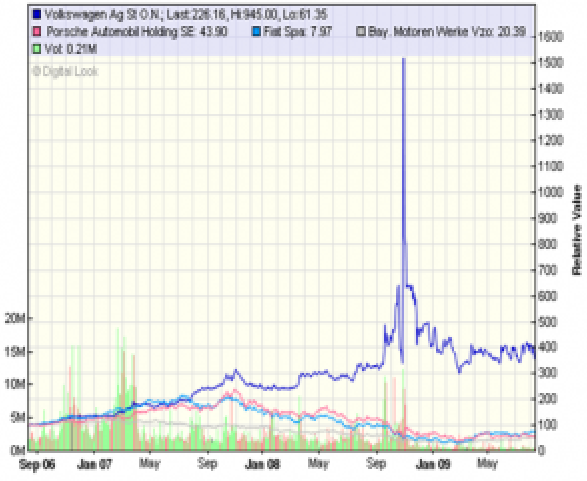
Under the original "Volkswagen Law", any shareholder in VW cannot exercise more than 20% of the firm's voting rights, regardless of their level of stock holding.

Following fast on the EU Court ruling against the existing VW Law, in March 2008 the Porsche Board announced they intended to raise their VW stake to 50% and create a Porsche controlled super group.

Although the families are über-rich, Porsche still needed €25BN to buy the VW shares. This is where Holger Härter's restructuring and centralisation of treasury operations, ultimately turning its treasury function into a profit centre, paid off. He used stock option trades to rack up profits of €3.6BN in 2007 and almost €6BN in 2008. Between Fiscal Year 03/04 and 07/08, shareholders equity rose 500% from €2.9BN to €16.8BN. Almost €10BN was generated by Härter's team.

While Porsche were bullish about their plans, global stock market investors, particularly hedge funds, were less sure. Seeing a growing gap between the share price of VW and comparable firms they began to place bets in the second half of 2008 on the VW share price tumbling. What they did not know is that Porsche had built up a controlling interest in 75% of VW shares using a mixture of outright purchase and cash settled options. With the state of Lower Saxony owning 20.1% of the shares, that meant only 5% of the shares were readily available, although hedge funds had placed bets on 13% of them. The VW share price refused to fall. Then, when the traders tried to close their bets, they had to replace 13% of the shares but only 5% could be bought. The price of VW shares began to rise. Within two days the shares had quadrupled in price and hedge funds had lost a reputed €30BN.

While hedge funds struggle for sympathy, the Porsche manoeuvre s produced one true casualty: Adolph Merckle, a German billionaire whose losses on VW shares pushed him to suicide in January 2009.



Undoubtedly, Porsche had made a financial killing. There are circa 294MN VW shares, so 5% would be almost 15MN. At the peak the shares topped €1,000, but Porsche bought them for €225 or thereabouts.

Their annual accounts for FY 07/08 show they gained a net €4.6BN after fees by helping out the hedge funds. Sounds like a lot but, when you add in the €14BN gain in equity over the last 4 years, it still leaves a €6.3BN gap to fund the purchase of 50% of VW. More when you add in the ongoing Capex and working capital needs.

Porsche had two choices – abandon a solo bid or borrow money to buy the shares. By opting for the latter they began to slip into a financial problem of their own making.

By November 2008 it was clear that Porsche, like everyone else, was suffering from the global economic slowdown and they decided to delay their VW takeover plans. Although, in January 2009 they announced ownership of 51% of VW, they failed to mention is that they had saddled themselves with €10BN to achieve it.

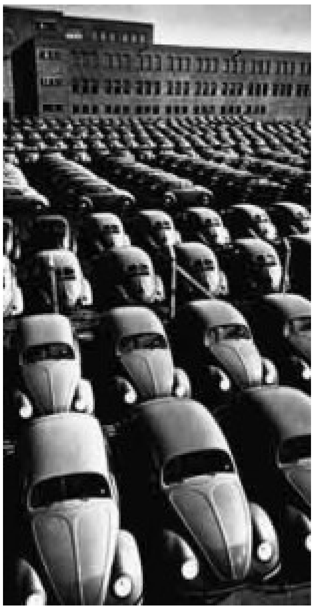
Matters went from bad to worse. In March, Merrill Lynch and ABN Amro refused to reschedule Porsche's €10BN credit line.

To stay afloat, Porsche has to borrow €700MN from VW for nine months. By May the families agreed that the two firms would come together, with Porsche as VW's 10th brand. The rest, as they say, is history.

In June Germany's KfW Group state-owned development bank rejected a 1.75 billion-euro loan request, saying Porsche failed to show that a cash shortage didn't result from mismanagement.

In July, apparently to appease VW's boss, Ferry Piëch, both Wiedeking, and Härter stepped down. After all, they had hinted since October 2008 that things would change at VW. Mr. Piëch may have thought they had served their purpose and could be sent to clear their desks with gold-lined bin liners.

Accounting hurts!



Game over you might think? But, you might be wrong. By taking control of VW, Porsche found itself on the wrong side of two important accounting technicalities.

With the increase of the stake in VW to 50.76 percent on January 5 2009 Porsche was obliged to fully consolidate Volkswagen. This triggered a so called Purchase Price Allocation (PPA) under which all assets and liabilities of the group Volkswagen that Porsche part owned had to be valued and compared with the price paid for the shares. As the book value of the assets is far less than the value of the shares, Porsche had to account for a substantial book loss.
Secondly, to reduce debt Porsche has agreed to sell to Qatar the options it bought on 17% of the VW shares. This should provide around €1.0BN in cash for the options, but make a book loss of double that. Taken together these two accounting issues should lead to earnings before taxes for fiscal year 2008/09 of up to minus €5.0BN .
But, VW may also not have thought through the implications of reversing the takeover game plan and taking over Porsche instead of vice versa.
Warburton wonders if the VW management and its state shareholder Lower Saxony will be able to explain the price they eventually pay for Porsche. Worse, he raises the point that VW actually could end up paying a takeover premium to acquire its own earnings. That might not upset Ferry Piëch who owns 13% of Porsche, but VW shareholders may be unhappy.
The key issue is the Porsche Cayenne manufactured by VW in Bratislava, with Porsche then fitting the Cayenne S and Cayenne Turbo engines at its own facility at Leipzig, while the Cayenne V6 and Cayenne diesels arrive from VW all but complete.
If the Cayenne does account for 50% of Porsche EBIT, it’s a ’gift’ from VW. What VW will buy if it acquires Porsche’s operating business is a small assembly plant at Zuffenhausen, Stuttgart, capable of building 911s and engines, a screwdriver plant at Leipzig, a distribution network, an engineering consultancy and a fantastic automotive brand. How much is that worth?
Watch out for a future blog post on the valuation.
The Lex column reckons that VW’s first step is to recapitalise Porsche SE, their indebted holding company. To do this, the family will “contribute” Porsche Austria, its unlisted car parts distributor, worth some €3bn, into the holding. They get it back when VW pays for their 42% share of the sports car business.
Shareholders will be asked to inject cash in a rights issue in 2010. The Qataris will take on most of Porsche SE’s options over VW; this is their passport into Germany’s industrial

heartland. Finally, the VW stake in Porsche AG, the carmaker owned by the holding, will release cash to Porsche SE.

How well did the family do out of this?

Number one they remain in control of Porsche the sports car maker, which owns a majority of VW. Number two, the business is run by one of their own, VW chairman, Ferdinand Piëch, who wants to leave his family an extraordinary legacy: a recombined Porsche/VW. Number three, the family feud is over.

The end result is a debt-free Porsche SE, owning 54% per cent of VW alongside its minority partners the state of Lower Saxony, with 20 per cent, and the Qataris with 17%. The final step is to merge Porsche SE with VW. Even if the Porsche family does not end up with a majority, it will still be VW’s largest investor, a remarkable feat. VW, meanwhile, gets the stable investor base it has long craved. It will be impregnable.