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GM profit may mask struggles to come

Its North American division loses $39 million despite cuts

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General Motors Corp., like Ford Motor Co. last week, surprised investors Tuesday with better-than-expected second-quarter profits.

GM reported an $891-million margin, more than double what Wall Street had expected, but analysts caution that the turnaround at the nation's largest automaker is far from complete.

In fact, the road could get rough again soon, because GM's North American division practically broke even -- it lost $39 million in the quarter -- despite cutting $9 billion in annual costs and hitting peak production of the full-size pickups and SUVs that have provided the company with its greatest profits.

Despite apparent progress in cutting costs, both automakers are losing customers and not making enough money in the crucial North American market, analysts say.

"GM's merely breakeven performance in North America at the peak of its product cadence likely sends the message additional further restructuring remains imperative," Goldman Sachs analyst Robert Barry said in a note to clients.

GM Vice Chairman and Chief Financial Officer Fritz Henderson said the company is reaping benefits of hard work on fundamentals to turn around its North American operations, but he said the second half of 2007 looks to be a tough one for the U.S. auto industry and in particular for GM.

"The U.S. market is certainly selling below trend," Henderson said.

GM's $891-million profit, while a major improvement over its $3.4-billion loss in the same quarter last year, reflects a slim 1.9% profit margin.

Economists and analysts say demand for new vehicles will slow in the second half of the year due to higher fuel prices, reduced consumer confidence and a slowing housing market.

"They have taken pretty aggressive action to reduce their cost structure," industry analyst Erich Merkle of IRN Inc. said. "And GM is starting to turn a bit of a corner with its new product offerings. But the second half of this year is going to be incredibly tough for the automaker. ... At some point this year -- it depends on when they decide to cut back on production -- they will probably be back in the red."

While GM reported positive cash flow in the second quarter, Henderson said, the automaker expects to return to spending money faster than it makes it before the year is up.

Ford, too, is burning through cash and looks at selling its European luxury brands to raise money it might need to pay for up-front costs in the UAW contract. Negotiations between the automakers and the UAW began last week and are expected to continue through mid-September.

Analysts expect reducing the union portion of GM's $64-billion health-care liability to be a top priority for the automaker in those talks. While Henderson wouldn't comment on UAW talks, he reiterated Tuesday that GM remains focused on stanching its rising health care costs.

Retiree benefits already cost GM $1 billion this year.

David Cole, chairman of the Center for Automotive Research in Ann Arbor, acknowledged that "a great deal depends on the labor negotiations this summer."

Nevertheless, he said, the surprise profits at GM and Ford are evidence that analysts "are not taking a very accurate look inside the companies" and that the Detroit automakers' financial turnarounds are taking hold.

"In GM's case, they are pretty well along in their turnaround," Cole said.

GM's $39-million North American loss includes $520 million in one-time charges associated with the bankruptcy reorganization of former parts arm Delphi Corp. and other items.

Excluding Allison Transmission, which it is in the process of selling, North American operations reported a slight profit of $78 million for the quarter, compared with an adjusted loss of $94 million from continuing operations a year earlier.

At the same time, the company benefited from 80 cents of earnings improvement from tax-related gains.

"GM still has a long road ahead, in terms of the turnaround," analyst David Kudla of Mainstay Capital Management wrote Tuesday. "But this earnings report is further evidence that the plan is working."

And, there's another story that's very important, Cole said: While the second half of the year promises to be a tough one in the United States, "the rest of the world is beginning to kick in pretty strongly."

GM Chief Executive Rick Wagoner said in a statement: "Our heavy commitment to key growth markets around the world really paid off in strong growth and earnings."

GM's European unit had its largest profit since 1996 with a $217-million profit after posting a $39-million loss a year earlier. First-half sales in the region were a record 1.13 million cars and trucks. Profits in the GM division that covers Latin America, Africa and the Middle East grew 53% to $213 million.

While revenue from GM Asia-Pacific vehicle sales rose 44% over the year-ago quarter, net profit fell compared with the same quarter last year when GM recognized the $212-million gain from the sale of its stake in Isuzu Motors Ltd.

GM also recognized a $139-million gain from its 49% stake in lender and insurer GMAC, which reported a $293-million profit in the second quarter, despite losses in the division that lends to borrowers with sub-prime credit.

Still, the automaker and analysts say, GM must be profitable in North America, the world's largest region for auto sales and historically the most profitable.

The company Saturday began offering 0% financing for up to 60 months on certain versions of its full-size pickups to boost sales of the redesigned trucks.

"North America is still their most important single market," Cole said. "They've got work to do here ... But there is hope."

Bloomberg News contributed to this report.