MANHEIM CONSULTING

Auto Industry Brief

August 2006

*Accelerate **Your Business***

SUMMARY

- **A slowing economy is impacting our industry—and it will be felt strongest in the used vehicle market.**
- **High new vehicle inventories and incentives are slowing purchases of used vehicles at auction, because domestic franchises simply have too much new vehicle inventory on the ground.**
- **Meanwhile, incentives and a resurgence of leasing have pushed new vehicle monthly payments to a level where some used vehicle buyers are opting for new.**
- **As we know from historical data, lower retail sales mean lower used vehicle prices at auction.**
- **The Manheim Used Vehicle Value Index has declined 4.2% since January.**

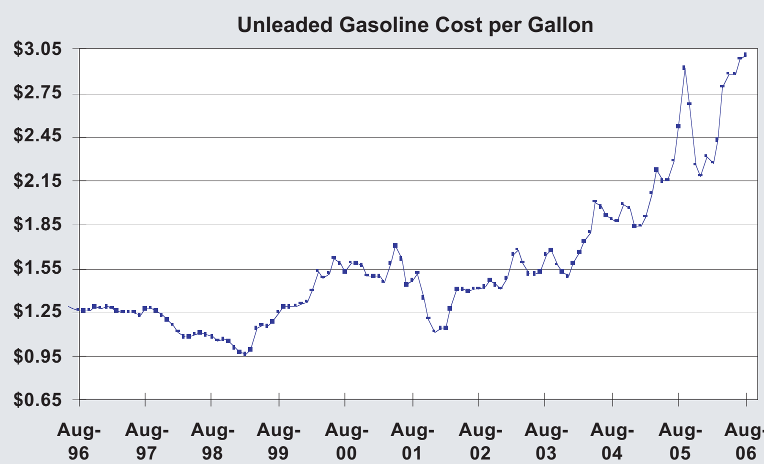
THE SLOWING ECONOMY STRIKES HARDEST AT USED VEHICLE BUYERS

The overall economy is slowing. The end of the housing boom, rising interest rates, and increased inflationary pressure are all factors.

The state of the economy impacts the new car and used car markets differently. Used vehicle buyers feel a greater budgetary squeeze than new car buyers. While overall consumer confidence remains stable, the University of Michigan's consumer confidence measure now shows the widest divergence between high and low income households in more than 20 years. The primary reason is that higher gas costs have a disproportionate impact on low to middle income households—in other words, used vehicle buyers.

Employment growth is slowing. New job creation, the primary driver of used vehicle retail demand, has been anemic averaging only 112,000 per month over the past four months.

Gasoline Prices Continue Upward March



Source: Oil Price Information Service

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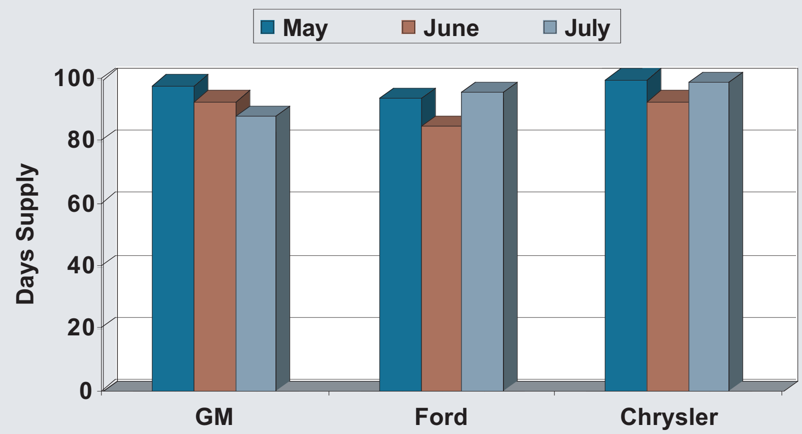
HIGH NEW VEHICLE INVENTORIES AND INCENTIVES DEPRESS USED VEHICLE BUYING AND PRICES

High new vehicle inventories are slowing dealer purchases of used vehicles at auction. Domestic franchises simply have too much new vehicle inventory on the ground. Truck inventories are especially high: Chrysler (99 days), Ford (96), GM (88). For many models, the days supply is well into triple digits, as compared to an industry norm of 60-65 days.

Domestic Manufacturers Unable to Reduce Truck Inventories Going Into Model Year Closeout

Days Supply* of SUVs, Pickups, and Vans at Beginning of the Month



**Industry norm/ideal is 60–65 days supply*

With that much new vehicle inventory, dealers have little interest in stocking used vehicles. The dealers' No. 1 focus is to sell those new units since they will shortly become "like used" if not sold before model year closeout.

Domestic dealers now have more inventory than last year going into the model year closeout. Last year, that situation prompted employee pricing that cleared the inventory quickly, but put pressure on used vehicle values. Today, the manufacturers are showing restraint, but dealers are uncertain this restraint will last and, thus, they are cautious in their auction bidding.

Incentives, plus a resurgence in leasing, have pushed new vehicle monthly payments to a level where some used vehicle buyers are opting for new. There are natural historical relationships that exist between prices for new vehicles and the same model in the used vehicle market. Increased leasing and reduced rate financing (options not generally available in the used vehicle market—except for CPO units) have kept new vehicle monthly payments affordable, while monthly payments for used vehicles have risen due to higher retail loan rates.

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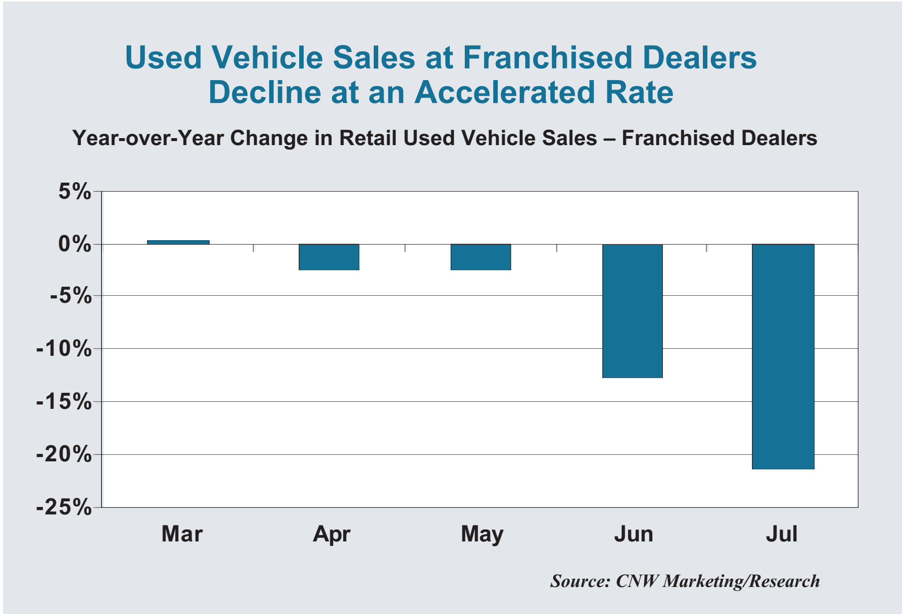
A SLOWER, AND LESS STABLE, RETAIL MARKET REDUCES WHOLESALE DEMAND

Lower retail sales mean lower used vehicle prices at auction. Franchised dealer sales are down 9% for the first seven months of 2006. The rate of decline has accelerated. Franchised dealer used vehicle sales were down 13% in June and down 21% in July.



Diverging dealer performance causes reduction in dealer bidding. The publicly-traded dealership groups had a 4% increase in used retail unit sales during the second quarter of 2006 versus an overall market decline of 6%. This suggests more concentrated buying by successful dealers and a dropping out the market by the less successful ones. **The end result is less active bidding in the lanes.**

Diverging values for market segments lowers overall market. The overall market is down, but retail CPO unit sales increased 3% in the first half and the premium paid for these units (at both wholesale and retail continued to rise). Units incapable of being brought up to CPO standards have suffered a more-than-corresponding reduction in price.

Dealers lower their auction bids to cover the increased costs of transport. Some dealers stop bidding at distant auctions altogether. In addition, dealers have higher holding costs due to rising interest rates and more expensive or delayed reconditioning since many have capacity-constrained service bays. Because of the competitive nature of the used vehicle market, none of these costs can be passed onto the retail customer. **So, in order to maintain retail margins, dealers needed to lower their auction bid prices accordingly.**

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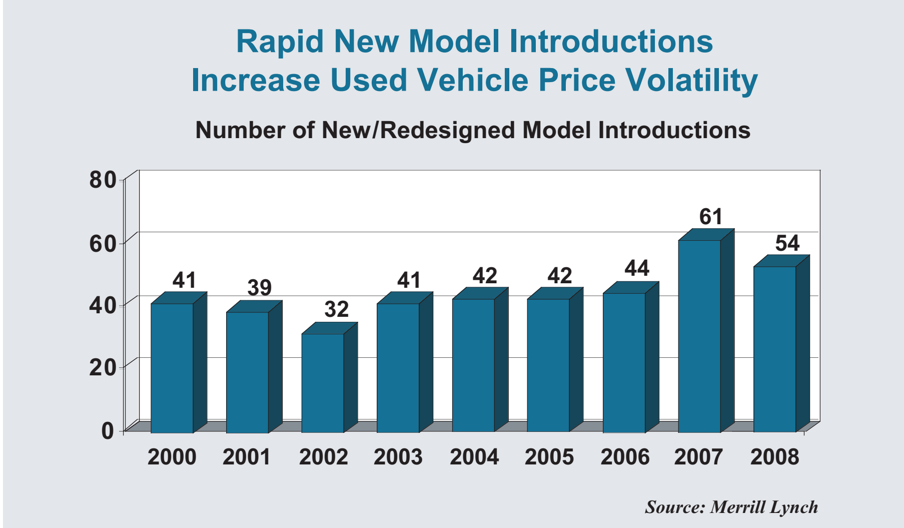
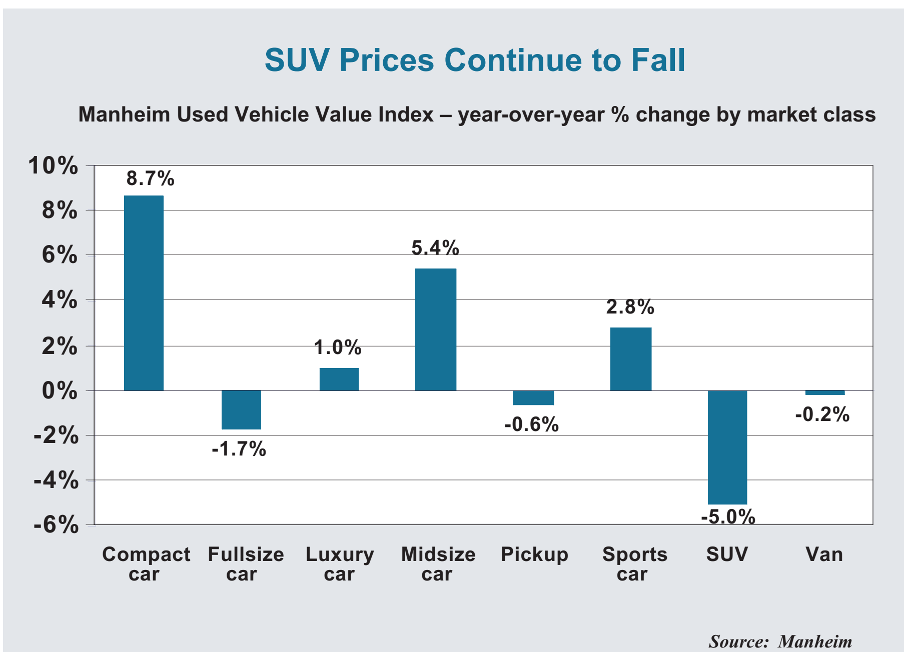


Increased model proliferation and quicker new model introductions increase the risk premium when buying vehicles at wholesale. The wholesale market must increasingly deal with a wider array of niche products, which increases volatility in pricing and thus make dealers more cautious when bidding.

JULY MANHEIM INDEX SUMMARY

Wholesale used vehicle prices on a mix, mileage, and seasonally adjusted basis have declined 4.2% since January. Over the past year, overall prices are up 2.4% with compact and mid-size cars leading the way—up 8.7% and 5.4%, respectively. The weakest segment has been SUVs with the overall category down 5.0% and full-size models down 10.3%.



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DEALERS POINT TO HIGH INVENTORIES AS REASON FOR DECLINE IN WHOLESALE BUYING

Manheim conducted a survey of 46 domestic dealer customers in late July to gather comments on the state of the market from their perspective. In general, the response from dealers was that "Manheim is doing just fine for us, it's just a lousy marketplace and cars are not needed."

In the surveys, dealers told us that with new car sales incentives lowering the sale-price of new cars to very close to that of late model used cars, they are seeing consumers opt for the new cars. They see this competitive pressure growing in the second half of 2006 as manufacturers offer model-year closeout incentives.

Dealers also say new car sales are causing an increase in trade-ins, adding to their dealerships' used car inventories. A similar pattern has played out over the last several years as consumers have opted to buy rather than lease, thus producing trade-ins rather than turn-ins. **This increased trade-in inventory, coupled with a slower used car market, has reduced the need for dealers to purchase wholesale inventory from auctions.**

Q & A WITH TOM WEBB

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Q. What is happening at our domestic factory sales?

A. Since the beginning of July, Manheim's domestic factory sales have slowed in terms of dealer attendance, sales percentages, and retention.

Q. What are the primary factors contributing to this performance?

A. A number of macro-economic factors are at work.

- The overall economy is slowing, which has an especially big impact on retail used car buyers.
- New car inventories are higher than usual, putting pressure on franchised dealers to move new car inventory at the expense of used car inventory.
- Incentives and more new vehicle leasing are dropping new vehicle monthly payments to a level where some used car buyers are opting for new.

Q. Is the auction system responsible?

A. Professional remarketers understand the dynamics of the marketplace and the true cause for the current weakness. They also know that Manheim locations, by and large, outperform the national averages. But, that said, the field people are measured against their ability to achieve vehicle retention and reasonable sales throughs. As such, it is only logical that they are expressing some dissatisfaction. It is important that we listen to them and work on ways to improve their near-term results.

Q. Will this trend continue?

A. Although new vehicle inventories are being reduced there is still an over-supply and a severe imbalance with respect to certain market segments and individual models. Thus, it is likely that the already weak segments of the wholesale market will feel additional pressure as those imbalances are corrected.

And, as is often the case, strengths and weaknesses in the wholesale market can be exacerbated by supplies moving in the opposite direction of demand. Take SUVs, for example—it's not that sellers are dumping them on the market. It's simply that the high level of new SUV sales in past years has created a supply of used SUVs that are now entering a market that is much less favorable for them.

It is important to remember that the wholesale market is where supply and demand are equated. The adjustment process is in real-time and it can be painful or unsettling to both buyers and sellers, but it is a necessary process and one that also creates opportunities.

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