MANHEIM CONSULTING

Auto Industry Brief

December 2006

Accelerate ***Your Business***

METRICS THAT MATTER

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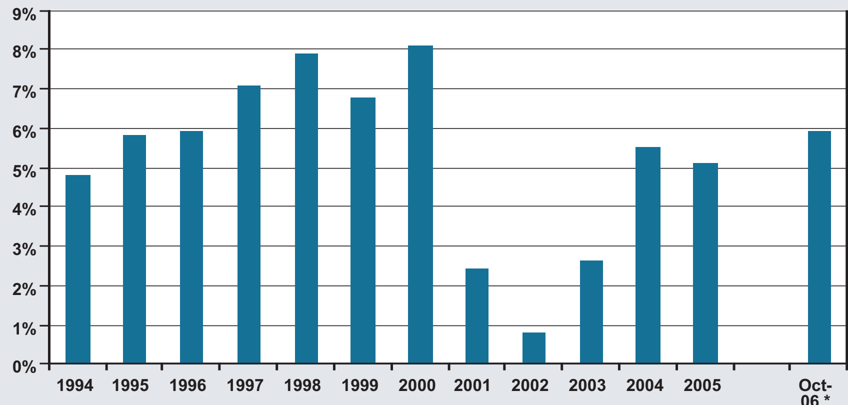
SUMMARY

The stronger-than-expected November retail sales report and the preliminary indicators for December paint a picture of upbeat consumers spending freely. And, since the gift of choice seems to be a gift card (or an item on back order), the current sales strength is expected to continue into 2007. Nevertheless, fundamentals indicate that the overall pace of economic growth will be sub-par for most of next year. That does not mean, however, that used vehicle valuations, volumes, or dealer profitability will suffer. Indeed, all three are likely to show modest improvement in the year ahead.

A SOLID, BUT SLOWING, ECONOMY

Without the option of extracting ever-larger amounts of equity from their homes, how are consumers continuing to shop without dropping? Answer: the old-fashioned way—plastic. Revolving debt statistics are only available on a much delayed basis, but even the September and October numbers showed credit card debt accelerating, while growth in other forms of debt slowed.

This shifting of household balance sheets away from long-term debt at below market rates to short-term debt with an average APR in the mid-teens, is not a prescription for building future strength in consumer spending. Credit card debt has, however, been an important component in keeping the economy moving, indirectly producing the wage and salary gains that will enable households to meet their growing debt obligation.



** 3 month moving average – annual growth rate*
Source: Bureau of Economic Analysis

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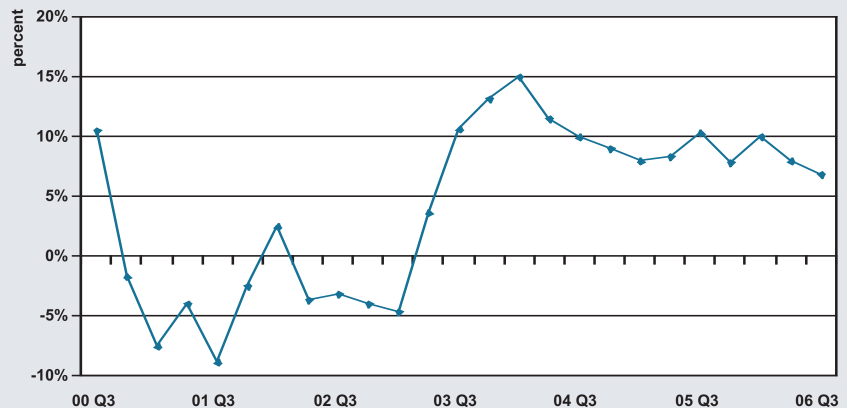
"Outside of the housing and motor vehicle sectors, economic activity has, on balance, been expanding at a solid pace," — Federal Reserve Chairman Ben Bernanke, November 28, 2006. Given the overwhelming importance of the housing and auto industries, this statement out of context appears to be almost a joke along the lines of "other than that, Mrs. Lincoln, how did you like the play?" A more nuanced analysis indicates a legitimate point—you cannot have recessions without job loss, and spillover effects from the problems in housing and autos have not weakened the labor market: Payroll growth averaged 149,000 per month over the last eleven months, the unemployment rate is currently 4.5 percent and initial jobless claims are near their cyclical low point. One reason is that the blow from the housing correction has been dampened by declining gas prices, low interest rates and more recently, a rise in equity prices.

Energy prices—even the recent rise—contains good news. The price of a gallon of gasoline fell from more than $3 in late July to less than $2.25 in November, providing a needed boost to discretionary income. The cost of a barrel of crude went from $77 in August to $56 in mid-November. But with OPEC's announced production cutback, the price jumped to more than $62 per barrel in mid-December. Even here, the bad story is good news. The announced production cutback (it was the second in recent months; the first was not adhered to) was a recognition by these countries that, if nothing was done, prices would continue to retreat. Additionally, the lower production schedule (to the extent that is followed) will add spare capacity, which should mitigate some of the volatility in future pricing.

Rising stock prices more than offset slower growth in home equity. Despite slower home appreciation (and, in some regions of the country, declines), household net worth grew at a 6 percent annual rate in the third quarter, and that growth is likely to continue in the fourth quarter. Attribute it to the double-digit rise in the Dow, S&P 500, and the NASDAQ over the past year. Much of this newly created wealth is not liquid, instead tied up in retirement accounts, but it still enhances consumer confidence and loosens purse strings.

Household Net Worth Continues to Grow

Year-over-Year Percent Change by Quarter



Source: Federal Reserve Board

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METRICS THAT MATTER

Our ongoing series is designed to discuss economic variables, surveys and company statistics that help in understanding, and anticipating shifts in, the used vehicle marketplace. Past issues of* Auto Industry Brief *have reviewed initial jobless claims, Wal-Mart same-store sales, consumer confidence, wage and salary income, the interest rate yield curve and overtime hours. This month, we look at only one metric—debt service burden—as it allows us to present an additional graph.

Debt Service Burden

What it is. On a quarterly basis, the Federal Reserve Board computes both a household debt service ratio (DSR) and a financial obligation ratio (FOR). DSR measures required payments on outstanding mortgages and consumer debt as a percent of disposable personal income. The FOR is similar, but on the debt side it also adds in auto lease payments, rent on tenant-occupied housing, homeowner's insurance and property tax payments.

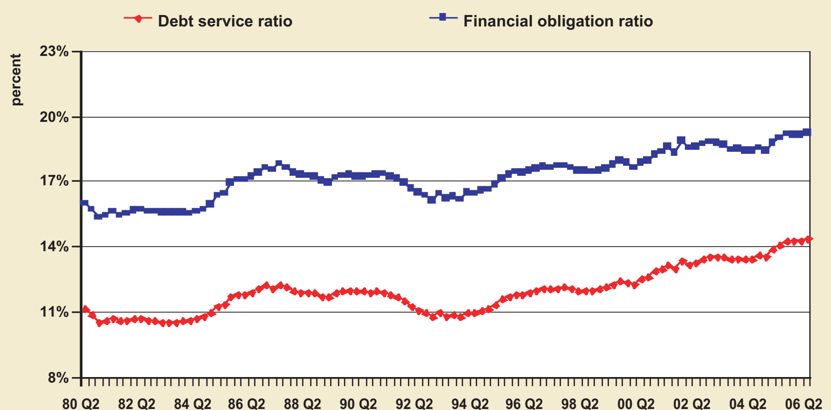
Why it is important. There are only three things that people can do with money—pay for present consumption, save for future consumption, or pay down debt used for past consumption. As such, these debt service measures give an indication of the financial health of consumers and insight into future spending patterns. Higher debt service ratios can also be a precursor of rising loan delinquencies and defaults.

What are the measures telling us now? That's a difficult one. It's always a mistake to simply look at a ratio without separately studying the movement of its two components. In this instance, the analysis is further complicated in that one variable (debt) is a "stock" (point-in-time measurement) while the other (income) is a flow.

Additionally, it is important to avoid the tendency to assume that a rising debt level is a bad thing. Credit extension, and its proper use, enables economies to grow and should smooth out the business cycle, not amplify it. As such, advanced economies like the U.S. have higher debt service ratios than less-advanced economies. Even within the U.S., debt service ratios rise over time.

From the individual's standpoint, taking on additional debt can also be a good thing. For example, a 3 percent, no-down, teaser-rate ARM is a no-brainer good deal when real estate values are rising at a double-digit rate.

Debt Service Burden Reaches New High



Source: Federal Reserve Board

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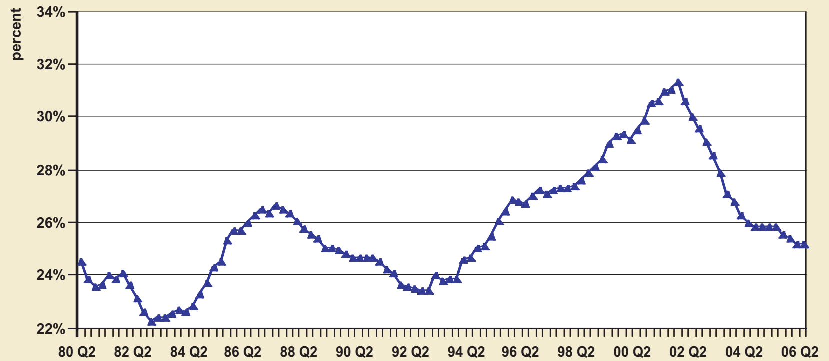
METRICS THAT MATTER

In the second quarter of 2006, both the DSR and the FOR reached record highs (both series only go back to the first quarter of 1980). Even with the qualifications noted above, this must be reviewed at with some concern, as it suggests the possibility that consumers will slow future spending.



A positive for the economy—and the used vehicle market—is that most of this increase in debt is a result of larger mortgages, which are supported by higher home values. This is reflected when we look at the FOR for renters versus homeowners. Renters are a very important component of the middle and lower end segments of the retail used vehicle market; their debt ratios have improved steadily since peaking in late 2001. It is not a coincidence that default rates on used car loans have also fallen.

MANHEIM USED VEHICLE VALUE INDEX

Prices move up for second consecutive month. Wholesale used vehicle prices (on a mix, mileage and seasonally-adjusted basis) moved higher from October to November, but showed a larger year-over-year decline due to the comparison against strong pricing in the wholesale market last November. The Manheim Used Vehicle Value Index stood at 112.9 in November, representing a seasonally adjusted gain of 0.8 percent for the month. Over the past year, average wholesale prices, after accounting for mix and mileage changes, are down 1.7 percent. Wholesale used vehicle pricing in November benefited from an improved new vehicle inventory situation and fewer end-of-service program rental vehicles entering the market.

Despite disappointing new vehicle sales, production cuts allowed for a significant reduction in the total inventory unit count in November. Targeted incentives during the month created a better model mix balance within the inventory and reduced the share accounted for by carryover 2006 model year vehicles.

Total inventory at the beginning of December for GM, Ford, and Chrysler Group was almost 265,000 units lower than a year ago. Lease deals, cash incentives, and reduced rate financing pushed out the 2006 models and reduced their share of inventory to 14 percent at GM dealerships and 15 percent at Ford stores. Chrysler's carryover stock was also reduced in November, but remained abnormally high at about 35 percent

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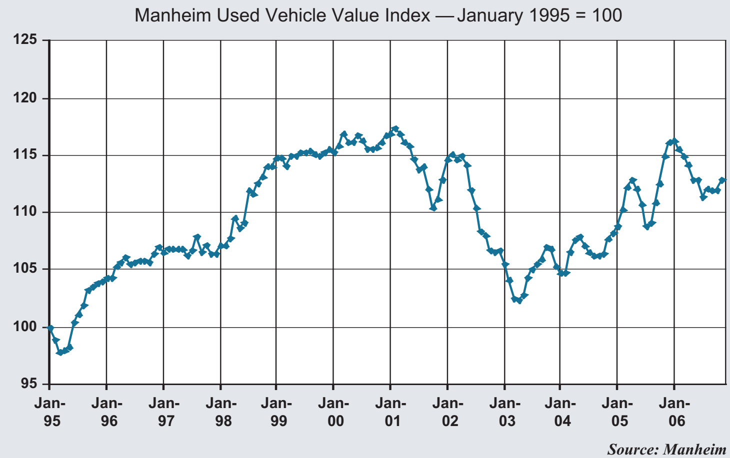
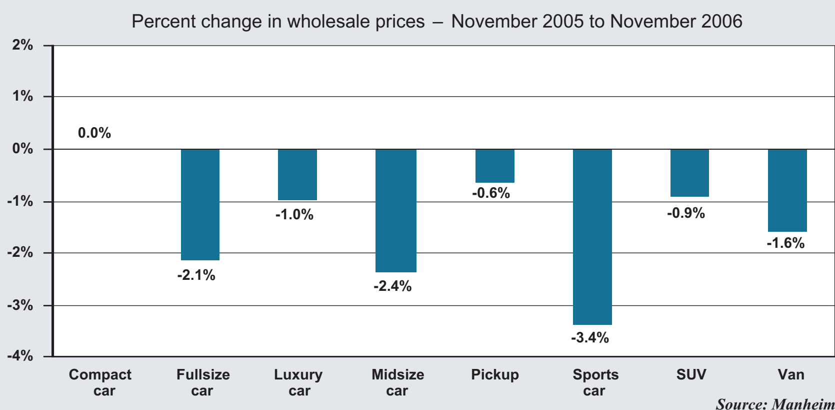
(not counting an untold number of units remaining in the sales bank). Scheduled production cuts in the first quarter of 2007 (9 percent for GM, 14 percent for Ford, and a yet-unannounced-but-expected 5 percent reduction for Chrysler) suggest domestic manufacturers hope to be able to simultaneously reduce incentives and inventory days supply in the first part of 2007. Achieving that objective will be dependent upon the economy avoiding any significant reversal.



SUV and pickup prices improve in November. With many market segments having run an extended up cycle in pricing, matching year ago levels proved impossible for all classes except compact cars, which were even with last November. During the month, wholesale prices for SUVs showed more than their normal seasonal improvement. Used pickup prices also improved in November despite the large incentives being used to clear out new carryover 2006 model year pickups.

Among consignor types, commercial fleets enjoyed strong pricing on their rapidly growing number of end-of-service vehicles entering the wholesale market. Pricing was also strong for off-rental program cars, especially for those makes and models where there was not an excessive supply of carryover new units in dealer inventory.



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Q & A WITH TOM WEBB

Q. Recent press reports describe a surge in subprime mortgage defaults and a general turmoil within that industry. Why have we not seen more of a spillover into the subprime auto lending market, since it is generally the case that consumers will fall behind on their auto loans before letting mortgage payments slip?

A. Lax lending standards, such as no-doc, no-down loans, based on the assumption that rapid home price appreciation would continue forever, are the basis for the problems in the subprime mortgage market. Subprime auto lenders, meanwhile, have not materially changed their lending practices. They were burned in earlier credit cycles and appear to have learned from the past.

Also, remember that the majority of subprime auto borrowers are renters, not homeowners. As seen in the earlier discussion of debt burdens, the balance sheet of the average renter has not deteriorated; indeed, it has improved.

That said, it should be noted that recently, there has been a slight increase in subprime auto delinquencies and an uptick in early loan defaults (defined as those that occur within six months of origination). Neither is a problem yet, but each bears watching.

Q. Auto manufacturers say they are going to reduce incentive activity, bring sticker prices closer to actual transaction prices, pull back from unprofitable sales to rental companies and more closely align production to retail demand. But they have said this in the past. Is it different this time?

A. Absolutely. They mean it, and when it occurs, it will be a good thing. Large and fluctuating new vehicle incentives damage the pricing credibility of both manufacturers and dealers, create customers that shop the deal rather than the brand, instill a distressed selling environment and reduce "reported" residuals (since residuals are usually calculated from sticker prices rather than transaction prices).

Beyond those specifics, the large variance and sometimes hidden nature of incentive activity reduces price transparency and discovery in the new vehicle marketplace. As the manufacturers initiate actions to bring sticker prices closer to transactions prices, the new vehicle market will gain some of the price transparency that has always existed in the wholesale used vehicle market. Therefore, by definition, market efficiency will improve.

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