



Accelerate *Your Business*

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## SUMMARY

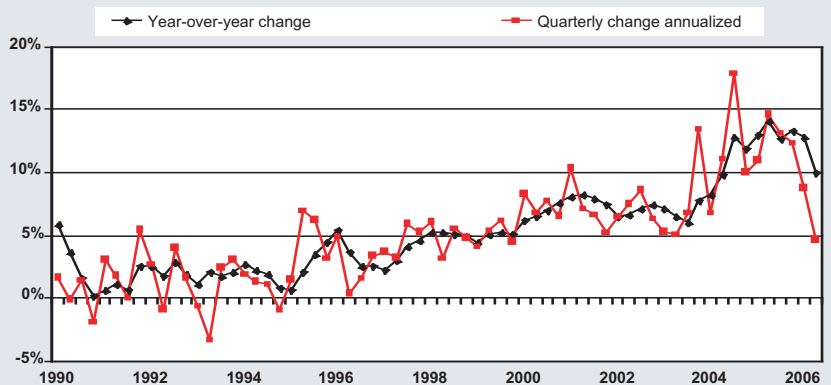
National economic conditions, as well as performance in the retail and wholesale used vehicle marketplaces, improved marginally in August. Of significance to our longer-term outlook, there was further clarification on two major trends - one negative (the slowdown in housing) and one positive (the decline in gasoline prices).

## HOUSING — A NOT-SO-SOFT LANDING

**Rapid real estate price inflation and low interest rates have boosted consumer spending.** Using their homes as a personal ATM machine (extracting money though equity lines and refinancings) consumers have been able, in recent years, to spend beyond their income on new and used vehicles, household improvements, and a myriad of luxury goods.

**That prop has now been removed.** In the second quarter of 2006, home prices were still up 10% versus a year-ago, but the annualized rate of increase during the second quarter alone was only 4.8%, the slowest pace since the fourth quarter of 1999. Real estate analysts are now anticipating the fastest deceleration in home price inflation ever.

### Home Price Appreciation Slows Sharply



Source: Office of Federal Housing Enterprise Oversight



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**High flying real estate markets fall the fastest.** States that have enjoyed the fastest price appreciation in recent years (Florida, California, Arizona, and Nevada) are now experiencing the fastest deceleration. As a result, in these markets, the pre-owned luxury vehicle market has begun to suffer as many of those purchases were previously supported by home equity loans or the general sense of wealth created by rising home values.

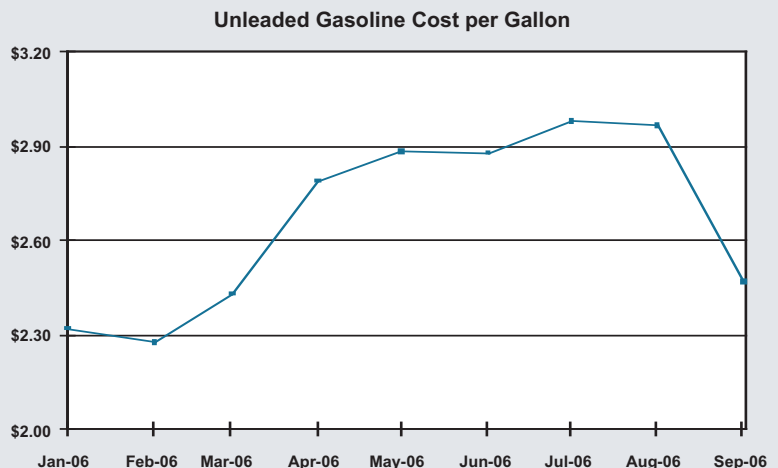
**Previously slow markets are now in decline.** States that never enjoyed significant home price appreciation (Michigan, Ohio, and Indiana) and are now experiencing declines due to the slowdown in the auto industry. Here, one should be on the lookout for weakness in the lower price points of the used vehicle market and possibly a rise in auto loan delinquencies.

## LOWER PUMP PRICES WILL BOOST CONSUMER SPENDING IN LATE 2006 AND EARLY 2007

**Used vehicle buyers will benefit the most.** Lower-middle income working households (in other words, used vehicle buyers) were the most impacted by rising fuel prices. Likewise they will benefit the most from the decline in pump prices. Over the past month, pump prices have fallen from approximately \$3.00 a gallon to less than \$2.50 a gallon. **Note that every penny decline means a savings to consumers of more \$1 billion on an annualized basis.** For an individual household, the pump price reprieve could make the difference between making, or not making, their monthly used car payment.

**Lower pump prices are unlikely to improve already weak vehicle segments or alter manufacturing marketing strategies.** Why? Because consumer behavior and buying preferences were altered for the long-term by the surge in gas prices that occurred post Katrina. Those preferences and patterns won't change in the near-term, if ever.

### Consumers Get Reprieve From Rising Gas Prices



Source: Oil Price Information Service

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## METRICS THAT MATTER

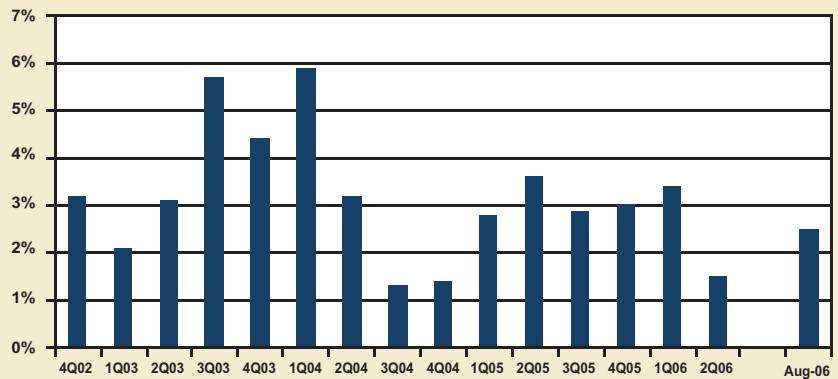
### Wal-Mart Same Store Sales

**Customer base matches used vehicle buyer profile.** There is no such thing as a typical used vehicle buyer. They run the gamut from the purchaser of a certified pre-owned luxury car to the buyer at a Buy-Here Pay-Here lot. However, a broad proportion of the used vehicle market is encapsulated by lower-middle income America – the same demographic of Wal-Mart's customer base as opposed, to say, Target that has a higher demographic customer profile.

**Tracking millions of buyers daily.** To be sure, divining changes in consumer buying behavior from the results of one company can sometimes be misleading – the company may be experiencing temporary operational issues (e.g., store renovations) or strategic changes in direction (e.g., opening new stores that knowingly cannibalize existing stores). But, Wal-Mart is huge (over 110 million customers every week) and listening to company conference calls and executive presentations provides useful insights. For example, if the company sees a higher level of its sales coinciding with the paycheck cycle (first and fifteenth of the month or Fridays), then it is a sure bet that households are under financial pressure.

**Wal-Mart results confirm the importance of gasoline prices.** For several years, Wal-Mart same store sales numbers have suffered in tune with surges in gasoline prices, which naturally impacts their customer base more than the overall population. However, Wal-Mart sales for August were respectable during the important back-to-school selling season and company executives gave upbeat assessments for the months ahead.

#### Wal-Mart Same Store Sales Growth



Source: Wal-Mart

\* Quarters end Apr, Jul, Oct, and Jan

## MANHEIM USED VEHICLE VALUE INDEX

**Prices strengthen in August.** Wholesale used vehicle prices (on a mix, mileage, and seasonally adjusted basis) rose 0.4% in August. Much of the normal used vehicle pricing turbulence created by model-year changeover appears to have occurred in July. Although dealers entered and exited August with new vehicle inventories that were out-of-balance with respect to certain models and market segments, the aggregate unit count and days supply were reasonable. And, importantly, the commitment of manufacturers to take production cuts instead of artificially stimulating demand through incentives appears to be instilling more confidence in dealers when they bid at auction.

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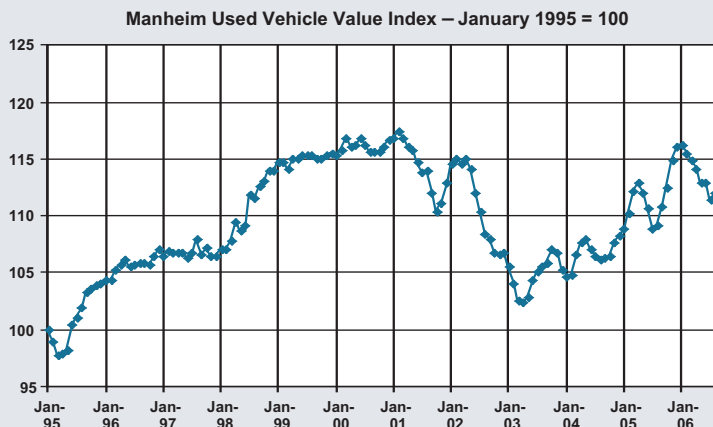
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## August Increase in Wholesale Prices is the First of 2006



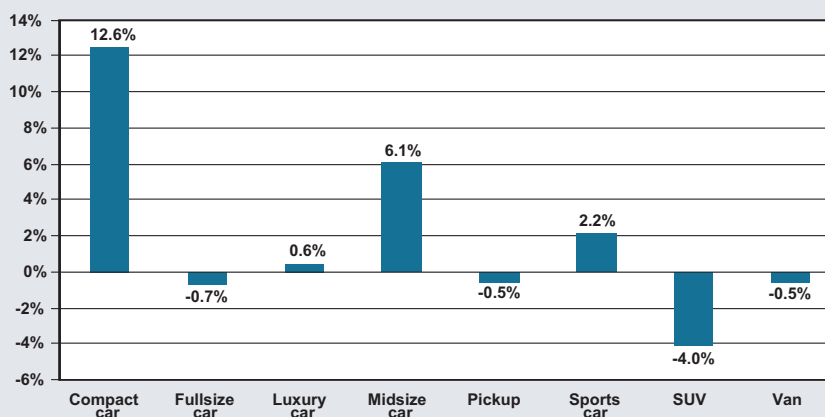
Source: Manheim

**Luxury market weakens in August.** The luxury segment had weaker prices in August, possibly due to the not-so-soft landing in housing. Many of the ultimate retail buyers of these used luxury units are undoubtedly the same over-aspiring, over-spending, households that financed their aspirations on ever-rising home prices.

Values for late-model small cars remained exceptionally strong in August with the overall segment up 12.6% over the past year. The rise partly reflects a richening of mix within the category, but there is also no denying that there is increased demand for these units that the used vehicle market cannot yet fully satisfy.

## Small Cars Command High Prices

Percent change in average wholesale prices – August 2005 to August 2006



Source: Manheim

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**Q. How is the new vehicle market performing currently?**

- A.** Sales came in line with expectations in August and many dealers reported very good sales during the Labor Day weekend. Still, for some manufacturers, new vehicle inventory levels remain way too high. Thus, additional incentives have come in the form of 0% financing for long-term loans or the extension of warranties.

**Q. Why are small car prices so strong in the wholesale market?**

- A.** It's a simple case of demand. As evidence, note that new unit sales of subcompact models are up 43% for the year, with some models selling at full sticker or above. The used vehicle market, of course, can only satisfy this higher demand with vehicles that were previously produced, thus, the upward pressure on prices.

**Q. Is the recently reported decline in consumer spending a concern?**

- A.** Not really. Overall confidence measures still remain higher than following the recession and last month's survey was taken before much of the decline in gas prices. Additionally, as measured by their willingness to spend, most households seem unconcerned about their financial future.

**Q. The subprime financing market remains very supportive to wholesale pricing despite an adverse credit cycle (rising cost-of-funds/inverted yield curve). Why?**

- A.** Credit it to the bigger role played by large independent and bank-affiliated subprime lenders. With their delinquencies and defaults remaining low, the lenders' willingness to lend is unlikely to diminish. And, notably, their borrowers are more likely to be positively affected by the reduction in gas prices than negatively affected by the slowdown in housing. (The majority of subprime borrowers are renters.)

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