

The Misunderstood Used Vehicle Market

One of the most difficult-to-understand, complex and often controversial aspects about the automotive sector is the used vehicle market. There is no shortage of excellent information available on the new vehicle market. Indeed, the new vehicle market is studied by virtually every automotive market analyst and automotive financial analyst in North America. Consumer publications are full of information about the new vehicle market. The reason for all the attention paid to this segment is that the entire supply base in North America is dependant on consumers purchasing new vehicles. To put this into perspective, Canada manufactures about \$100 billion in new vehicles and OE parts each year.

The used vehicle segment involves much smaller numbers. Because of this size difference, much less attention is paid to this sector. There are only one or two U.S.-based analysts who understand the used vehicle market and I believe we are the only company in Canada that studies the used side of the market in depth. We can identify at least two dozen trade associations involved with the new vehicle sector, but only two or three tied to the used vehicle sector.

I would argue, however, that success or failure in the new vehicle market is directly related to the used vehicle market. Newspapers are quick to cover the falling fortunes of vehicle OEMs, noting that the new vehicle

market is shrinking. What is not reported is that the wider automotive market, which encompasses the used sector, picks up the slack in times of downturn. It is important to remember that *people who need vehicles will buy vehicles*. External factors determine the age, price, and class of vehicles under consideration, but the overall rate of turnover remains steady.

In Canada, about 21 to 23 percent of consumers change their vehicle each year. This relationship hasn't changed very much in all the time we have been studying the vehicle markets in Canada.

The rate of turnover in Canada yields a used vehicle market in the 2.0 to 2.5 million range. In the U.S., turnover is slightly higher, in the area of 26 to 29 percent. With the much higher vehicle ownership levels in the U.S., this yields a U.S. used vehicle market in the range of about 42 to 44 million units. This is yet another example where the 'one in ten' formula for Canada in relation to the U.S. does not hold.

These turnover ratios mean that about one in five consumers in Canada changes their vehicle each year and about one in four consumers in the U.S. changes their vehicle each year.

In both markets the new and used vehicle sectors are countercyclical. When new

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vehicle sales are soft, used vehicle sales tend to grow (and vice versa). This interplay between the two markets is very important. I ask a simple question: How do you manufacture a used vehicle? Well, you don't. First you produce a new vehicle, sell it, and then wait for a consumer or fleet owner to re-market it. Remember, most consumers are shopping for a *newer vehicle*, not necessarily a new vehicle. The prime competition for a new vehicle is a *nearly new* used vehicle. Prices in the used market therefore have a significant impact on whether consumers purchase a new vehicle. Higher used vehicle prices give consumers move equity towards purchasing a new vehicle and make it easier for consumers to actually afford that new vehicle. High used vehicle prices also narrow the cost gap between new and used vehicles and result in more consumers choosing the new option. High used vehicle prices are therefore good for the new vehicle market. The opposite is true with low used vehicle prices; they take equity out of the market, leading to a greater number of consumers purchasing used vehicles.

Furthermore, our studies show that today's consumers no longer attach a stigma to the concept of buying second hand. Factors such as steadily increasing new vehicle product quality, as well as manufacturer-level certified used vehicle programs, have given the consumer a great measure of transaction confidence when

buying used. The old adage that when you buy a used vehicle you are "buying someone else's problem" is generally not the case. It can be true but the reality is that consumers in the used vehicle market are generally buying reliable long lasting vehicles. Indeed, of individuals whose previous purchase was a brand new car, 20 to 25 percent are likely to shop the *nearly new* market for a present-generation, low-km, warranty-covered vehicle.

Vehicles stream into the used market from four main sources, listed here in order of industry importance:

- Off-fleet
- Off-lease
- Consumer trade-ins
- Private sales

The problems inherent in this supply system are best exemplified by looking at the first channel -- fleet. Whereas midsize cars represent just 30 percent of the new vehicle mix purchased by consumers in 2004, fleet buyers selected models such as the Chevrolet Malibu and Dodge Stratus to the tune of 50 percent. This outsized statistic leaves little room for other products, resulting in a major mismatch between consumer wants (entry

level) and available product (midsize). The majority of these mid-sized fleet vehicles leave the daily rental lots as early as six-to-eighteen months into their service lives, destined for the driveways of ordinary consumers who will have cross-shopped them with similarly-priced brand new cars of an equivalent or smaller size class.

This mismatch between supply and demand merits further consideration. The new Canadian light vehicle market is biased towards entry-level vehicles (almost 50 percent of the mix in 2004). Both new and used sectors follow this trend, since the physical vehicle stock remains the same as it transitions through different phases of ownership. Buyers shopping used are typically making a compromise; for example, with a \$25,000 ceiling, someone can either purchase a new small car or a mid-sized "nearly new" vehicle. An off-lease 2002 Honda Accord, for instance, represents quite an attractive bargain when stacked next to a brand new 2005 Civic. Many buyers are keen to take advantage of the increased longevity and decreased maintenance requirements that the past few generations of new

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Vehicle Market - 2004 Market Share

	"Big Three"	Import Nameplates
Passenger Cars Sold to Consumers	32.7%	67.3%
Passenger Cars Sold to Fleets	80.8%	19.2%
Light Trucks Sold to Consumers	69.8%	30.2%
Light Trucks Sold to Fleets	96.2%	3.8%

Source: DesRosiers Automotive Consultants Inc., AIAMC and CVMA

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cars have provided. If a used vehicle offers the consumer the right blend of price, quality, content, and image, he will purchase a larger used vehicle rather than a smaller new vehicle.

I have written before about issues related to fleet sales – how they too-often represent a patchwork short-term solution to a long-term problem, but the effect that late-model ex-fleet cars have had on the used market proves my point. If you

shop the used market for a newer model, chances are that you will find yourself behind the wheel of a GM, Ford or DCX vehicle. These vehicles make up an astounding 80 to 90 percent of all Canadian fleet purchases, so there is a constant, predictable glut of GM, Ford, and DCX product hitting the used market barely two years after original delivery. This has the unfortunate consequence of depressing prices of their

models across the board. With so much supply in the segment, resale values weaken and this increases the stereotypical residual losses associated with these vehicle brands.

One might also cite the overabundance of 'nearly new' GM, Ford and DCX vehicles as a serious *new vehicle* sales disincentive for both dealers and consumers. Fraught with heavy cash incentives and ultra-lean pricing, a new Impala might generate a weak \$500 to \$1,000

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New and Used Vehicle Sales in Canada (000's of units)

	New Vehicle Sales	Percent New Vehicles	Used Vehicle Sales	Percent Used Vehicles	Total Vehicle Sales	Total Units in Operation	Sales as a Percent Of UIO
1995	1,131	31.3%	2,484	68.7%	3,616	15,725	23.0%
1996	1,173	32.5%	2,436	67.5%	3,609	15,823	22.8%
1997	1,386	37.8%	2,281	62.2%	3,667	16,077	22.8%
1998	1,390	40.3%	2,059	59.7%	3,449	16,536	20.9%
1999	1,501	42.5%	2,030	57.5%	3,531	17,071	20.7%
2000	1,549	44.3%	1,945	55.7%	3,494	17,101	20.4%
2001	1,570	44.7%	1,943	55.3%	3,513	17,668	19.9%
2002	1,703	45.4%	2,047	54.6%	3,750	17,911	20.9%
2003	1,594	41.7%	2,226	58.3%	3,819	18,207	21.0%
2004	1,534	40.2%	2,278	59.8%	3,812	18,397	20.7%
2004/2003	-3.7%		2.3%		-0.2%	1.0%	
2005 F	1,510	38.5%	2,409	61.5%	3,919	18,662	21.0%
2006 F	1,475	37.2%	2,495	62.8%	3,969	18,902	21.0%
2007 F	1,412	35.2%	2,598	64.8%	4,010	19,095	21.0%
2008 F	1,492	36.8%	2,558	63.2%	4,050	19,284	21.0%
2009 F	1,543	37.6%	2,557	62.4%	4,100	19,526	21.0%
2010 F	1,628	39.1%	2,536	60.9%	4,164	19,828	21.0%

Source: DesRosiers Automotive Consultants Inc., AIAMC, CVMA and Registration Data © R.L. Polk Canada, Inc. 2004

New and Used Vehicle Sales in the United States (000's of units)

	New Vehicle Sales	Percent New Vehicles	Used Vehicle Sales	Percent Used Vehicles	Total Vehicle Sales	Total Units in Operation	Sales as a Percent Of UIO
1995	14,726	26.1%	41,758	73.9%	56,484	193,386	29.2%
1996	15,094	27.0%	40,801	73.0%	55,895	191,134	29.2%
1997	15,113	26.8%	41,237	73.2%	56,350	193,091	29.2%
1998	15,531	27.6%	40,841	72.4%	56,372	196,898	28.6%
1999	16,882	29.3%	40,739	70.7%	57,621	201,245	28.6%
2000	17,340	29.4%	41,620	70.6%	58,960	205,170	28.7%
2001	17,119	28.7%	42,624	71.3%	59,743	209,206	28.6%
2002	16,811	28.1%	43,025	71.9%	59,836	213,540	28.0%
2003	16,633	27.6%	43,572	72.4%	60,205	218,375	27.6%
2004	16,861	28.4%	42,545	71.6%	59,406	224,982	26.4%
2004/2003	1.4%		-2.4%		-1.3%	3.0%	
2005 F	16,400	27.7%	42,803	72.3%	59,203	227,705	26.0%
2006 F	16,000	26.8%	43,800	73.2%	59,800	229,999	26.0%
2007 F	15,800	26.7%	43,361	73.3%	59,161	232,004	25.5%
2008 F	16,100	26.5%	44,764	73.5%	60,864	234,093	26.0%
2009 F	16,700	26.6%	45,990	73.4%	62,690	236,565	26.5%
2010 F	17,300	27.3%	46,139	72.7%	63,439	239,391	26.5%

Source: DesRosiers Automotive Consultants Inc., Ward's Automotive Reports

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profit. Conversely, a two to five year-old counterpart, identical in specification, can realize dealer profits in the \$1,500 to \$2,500 range. Used cars are available in greater supply, generate more profit, and have the potential to create more maintenance business. Thus many GM, Ford and DCX dealers are more focused on their used rather than their new vehicle departments. Quick, effective, and results-proven, used fleet models have become the anabolic steroids of the auto sales business.

As with steroids, however, momentary muscle begets long-term impotence. In the realm of auto sales, this translates to impotence in a variety of areas: lost new vehicle sales, plummeting used vehicle residuals, and a persistent inability to stem the continuous market share erosion inflicted upon GM, Ford and DCX by Japanese automakers. Residual values of GM, Ford and DCX products are typically 10 to 20 points lower than their Japanese competitors, and one of the main factors feeding this trend is the surplus of discounted product on the late-model used market.

Bolstering the theory that excess product is causing a

problem is the simple fact that a greater surplus exists today than in the recent past. As recently as 2002, over 200,000 used cars a year crossed the border into the waiting parking lots of U.S. importers. Increasing parity between U.S. and Canadian currency has had the effect of nullifying much of the advantage enjoyed by U.S. buyers, and only 96,621 used cars were exported in 2003. 2004 numbers, while not fully available as I write this, are equally dismal. With the larger U.S. market unwilling to absorb as great a proportion of excess Canadian stock, prices must drop in order to move the cars.

In the combined new-used vehicle market, used transactions dropped almost 14 points between 1995 and 2001, with the overall mix going from 68.7 percent used in 1995 to 55.3 percent in 2001. In the years following, however, the used sector has recovered, with 2004's market share of 59.8 percent representing the highest used composition since 1997. Accordingly, the number of new vehicles being sold has declined, dropping from 45.4 percent in 2002 to 40.2 percent in 2004. We estimate that 2,278,000 second-hand vehicles were sold

in 2004. 39 percent of those units were handled by new car dealers, with just 20 percent filtering through independent dealers and a full 41 percent trading hands privately. This number (roughly 2.3 million) has generated disagreement in the used vehicle sales industry, as it is smaller than the three-to-four million estimates previously accepted as average volumes. The used vehicle industry naturally wants itself seen in the best possible light (i.e., the highest possible sales volume), so it draws ire when I negatively downgrade its size. I too respect the importance of this sector, but I am also a believer in the value of accuracy. Although my market size for Canada is slightly low, I believe it is close to mark.

What does all of this mean? As I noted at the outset, the used vehicle market in Canada is complex and its behaviour has far-reaching consequences for the entire Canadian automotive sector. Without a proper understanding of the used market, a full grasp of the workings of the new market is not possible. In terms of improving everyone's knowledge of the used vehicle segment and how it affects overall automotive sector performance, it would be useful if more attention were paid to this segment by both analysts and the media. **DAR**

For more information on the used vehicle market contact Amy Coy (905)-881-0400 x20 to obtain a copy of the DesRosiers/Black Book "Used Vehicle Report".

Light Vehicle Sales - Fleet vs Consumer - 2004

	Total Market	Consumer Share	Fleet Share
Entry Level	603,020	39.3%	17.7%
Mid Size/Family	519,927	33.9%	49.5%
Large/Luxury/Sport	170,157	11.1%	8.1%
Primarily Commercial	241,311	15.7%	24.7%
Total	1,534,415	100.0%	100.0%

Source: DesRosiers Automotive Consultants Inc., AIAMC and CVMA