

## The Games OEMs Play

Each month, we dutifully publish new vehicle sales data and each month the OEMs dutifully send out glowing press releases about how well they are doing in the market. These press releases make for entertaining reading: "Record sales were achieved by XYZ model;" "Best month ever," etc.

But wait a minute: quick math tells us your total sales were down 20 plus percent! Where is that statistic in your press release? My media friends call me and we all have a good chuckle. It seems that the more positive the "language" of the monthly sales release, the more negative their actual sales performance. Although we laugh at these missives, they are indeed more insulting than informative. They are one of the reasons most media are cynical about announcements from vehicle companies. "If you lie to us in your monthly sales releases, why should we believe anything else you tell us?"

Putting aside these obvious missteps, sales data also hide a number of the other things some OEMs do to misrepresent their market performance. We call them "safety valves," and we have identified five specific things that can warp actual market performance. The five "safety valves" are:

- Consumer incentives
- Fleet sales
- Extended model runs
- Sub-vented lease residuals
- Loading dealers up with inventory

I'll discuss each of these separately, but it is fundamental to note that an OEM's usage of one (or more) of these "safety valves" is not necessarily bad. It is the over-use of any or all that is problematic.

### Consumer Incentives

Is there a better analogy for our industry's reliance on consumer incentives than a junkie's addiction to hard drugs? Without drugs, most people feel normal. Without drugs, addicts writhe in pain. Last October - "Black October" - couldn't have given better proof of this unfortunate situation. After an intense summer long binge, General Motors, Ford, and DaimlerChrysler pulled back on their consumer incentives and promptly went into heavy withdrawal. GM saw sales fall 11.2 percent while Ford experienced an 12.7 percent drop in the same period. DaimlerChrysler dropped 11.0 percent from October of 2004.

Two distinct phenomena are at work. First, the Detroit-based automakers have conditioned their regular customers to expect deep discounts. In the absence of those discounts, vehicle purchases are put off. Second, vehicle purchases that were planned for the fall were simply moved ahead to the summer. Thus, GM, Ford, and DaimlerChrysler cannibalized their own fall sales in order to boost the summer numbers. Both of these actions are hallmarks of the prototypical addictive personality: aware of long-term consequences, but so deeply wedded to the short term that no forward progress is ever achieved. Consequences be damned, we need that fix!

Just for comparison, Honda achieved a natural high this past October: an incredible 34.1 percent over October 2004. All this with average incentives tracking at one of the lowest levels in the entire industry. The bottom rungs of the incentive ladder are staked out by Honda, and Toyota and most other import nameplate OEM's. Indeed, there is a \$2,000 to

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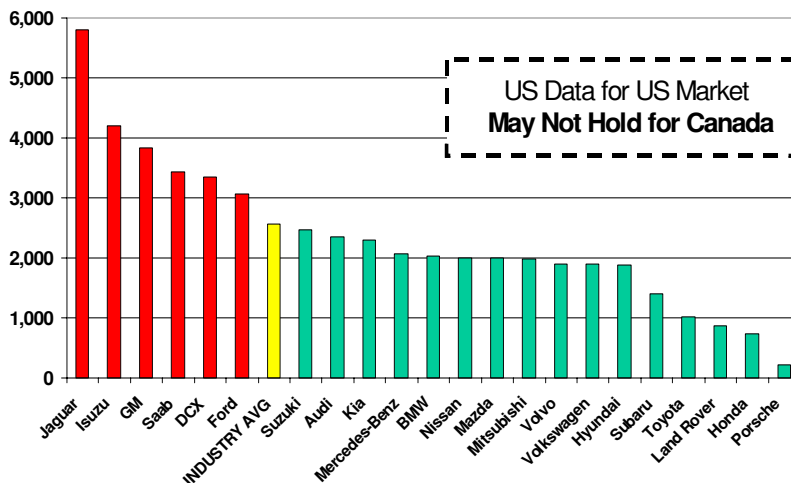
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\$3,000 per vehicle difference in average incentive levels among these brands versus GM, Ford, and DCX brands. Yet the import brands see increasing market shares while the others as a group see market shares falling. They talk about lessening their reliance on incentives but how much confidence would you have in a recovering addict who was perennially "tapering off?" Very little and consumers know this. Thus, the consumer sits on his hands and waits and waits knowing full well that eventually the vehicle companies will cry "uncle" and put serious money on the hood of each vehicle to move the product. A vicious circle.

Implicit in these incentives is higher profits for import nameplates. What are these companies doing with these profits? Two things: building new plants and updating/expanding their product offerings. GM, Ford, and DCX are closing plants (or have in the past) and although there has been a lot of focus on product renewal, the import nameplates will offer more new products than Detroit-based OEMs over the next few years. Thus market shares of import nameplates continue to grow with no end in sight.

## Average Incentive per Unit - 2005



Source: AutoData

### Fleet Sales

Gregg Valentino (<http://www.greggvalentino.net>) used to be a professional bodybuilder. Disappointed with the level of success his middling physique was generating, he quit the pro circuit and concentrated on a single objective: making his biceps the largest in the world. His grotesque, 26" diameter upper arms currently own that title. He freely admits injecting steroids directly into his biceps. So it is with the Detroit-based automakers' love affair with fleet sales. They can boast impressive volumes, but a good number of those sales are regularly achieved through cut-rate fleet packages. These are empty victories. There is no meaningful profit made from these

vehicles. As with strong-man Gregg Valentino, all that bulk doesn't translate into actual strength.

The fleet market normally comprises around 18 percent of the total Canadian light vehicle market. In 2005, 280,405 fleet vehicles were sold in Canada. Of those, 90.1 percent were GM, Ford, or DaimlerChrysler products.

When fleet sales are factored into the equation, the Detroit-based OEMs control around 56 percent of the Canadian light vehicle market. When the fleet volumes are removed, however, Detroit's share falls to just 48 percent. The 50 percent threshold is a symbolic one to cross. Like an x-ray of Gregg

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### Sales to Fleets - Total All Vehicles

	GM Units	GM Share	Ford Units	Ford Share	Chrysler Units	Chrysler Share	Import Nameplates Units	Import Nameplates Share	Total Fleet Market	Total Fleet Market Share
2000	115,434	39.6%	82,846	28.4%	72,134	24.8%	21,026	7.2%	291,440	18.8%
2001	120,442	40.5%	80,536	27.1%	74,905	25.2%	21,313	7.2%	297,196	18.9%
2002	133,421	42.4%	88,231	28.1%	64,937	20.7%	27,730	8.8%	314,319	18.5%
2003	118,254	42.6%	81,482	29.4%	50,944	18.4%	26,895	9.7%	277,575	17.4%
2004	123,660	44.4%	71,907	25.8%	55,018	19.8%	27,627	9.9%	278,212	18.1%
2005	122,703	43.8%	65,557	23.4%	64,307	22.9%	27,838	9.9%	280,405	17.7%
2005/2004	-0.8%		-8.8%		16.9%		0.8%		0.8%	

Source: DesRosiers Automotive Consultants Inc. and CVMA

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Valentino's arms, a fleet sales analysis lays the facts regrettably bare.

There are valid reasons for any OEM to play the fleet market and not all fleet is "bad". An OEM can actually make money selling to fleets. But too often fleet sales are used as a "safety valve" to soak up idle capacity, or into which OEMs can dump under performing vehicles that consumers will not buy. "Fleet" is also used to hide problems rather than to deal with them outright, such as closing factories or canceling model runs. The unfortunate truth is that American vehicle lineups still contain more problems than their Japanese competition and the reluctance to address these problems is one of the critical reasons these companies are languishing.

Even more unfortunate is that, like incentives, fleet sales are a distinctly short-term solution. Fleet purchasers (daily rental companies, governments, utility companies, police and taxi services, etc.) keep their vehicles for very short periods of time, often replacing them within six to twenty four months. A glut of low mileage, late model vehicles end

up in the top tier of the used vehicle market, competing with the new vehicle market for the same buyers. In the final calculation, the OEM that plays heavily in the fleet market loses twice: first, when the fleet vehicle delivers very little profit; and again, when the off-fleet vehicle steals a potential consumer market new vehicle sale.

2005 witnessed two of the three Detroit-based OEMs making efforts to reduce the percentage of fleet sales within their respective companies (GM's fleet sales dropped by 0.8 percent Ford's by 8.8 percent). DaimlerChrysler increased fleet sales by 16.9 percent in 2005 but had a drop in sales to consumers of 2.1 percent which dropped DCX's share of the consumer market to its lowest level since we started tracking it, only 11.7 percent. Toyota/Lexus at 12.2 percent achieved a higher share of the consumer market last year than DCX.

### Extended Model Runs

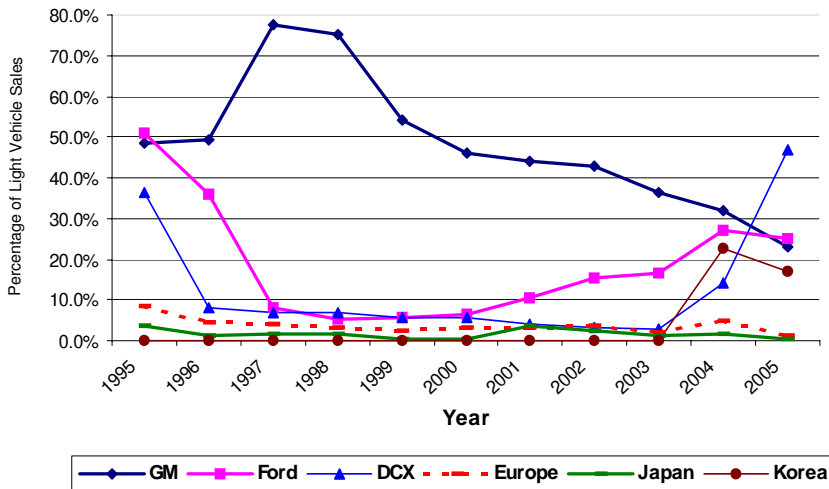
Extending a platform's production life is another one of our industry's safety valves. An all-new platform costs between \$1 and \$2 billion dollars to bring to market so

extending an existing platform is a great way to avoid spending money. Judging from the statistics, the Detroit-based automakers have avoided spending a lot of money.

In 2005, GM and Ford were responsible for selling about 80 percent of all light vehicles based on platforms that had not been completely redesigned in nine or more years. These are vehicles like the Ford Crown Victoria or Chevrolet Blazer, both of which can trace their lineage to the early-1980s. GM bitterly complains that they do not receive credit for the quality in their new model introductions. Well, there's a reason that some GM (and Ford and DCX) products don't stack up against their import nameplate competition: there are two or more design cycles separating them. GM Canada sold 7,579 Chevy Blazers and 6,730 GMC Jimmys last year. These vehicles were first introduced 22 years ago. I would venture to say that the consumers who bought these Blazers and Jimmys are not going to be as satisfied as the 12,984 consumers who bought the new Chevrolet Equinox - and rightfully so! This dissatisfaction surfaces in many ways and hurts GM's image as a producer of quality vehicles. By way of comparison, Toyota did not sell a single vehicle last year with engineering over 8 years old. Their products are of the highest quality and are built on relatively new platforms.

The GM J-platform was introduced in 1982 to combat the Honda Accord, then entering its second generation. In 2004, the last year of the J-Car (survived by the Chevrolet Cavalier and Pontiac Sunfire), the Accord was in its seventh generation while the J-Cars had only received one major exterior restyling. There wasn't much in the way of shared parts between 1982 and 2004

## Percent of Each OEMs Sales Over 8+ Years Old



Source: DesRosiers Automotive Consultants Inc., CVMA and AIAMC

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Cavaliers, but certain platform bits - floor plan stampings, proportional relationships, interior packaging - remained the same. Even if you count the 1995 Cavalier/Sunfire restyle as a true redesign, the Honda Accord had still cycled through three distinct generations between 1995 and 2004 while the Js remained unchanged.

OEMs engaging in such practices will cry foul. They will argue that there has been a program of continuous improvement in place, and that some of the vehicles I call "War Horses" are in-fact modern cars. The 2006 Chevrolet Impala is based on the same platform as its predecessor, but it is improved in most every way. One could say the same, however, about the previous-generation Impala and the Lumina that preceded it - or the Lumina that preceded that Lumina. Indeed, the GM W-Car platform has gone through three discreet iterations since its 1988 launch, but it's unclear exactly how much changed under the skin between restyles. One has the sneaking suspicion that certain GM "redesigns" are little more than glorified skin jobs. I would argue that until GM cleans out these very old products from their line-up they will never receive full credit for their new products.

## Sub-venting Lease Residuals

To understand this "safety valve," you need to understand the structure of a lease. In a traditional

lease, a residual value is established (i.e., the vehicle's price in the used vehicle market at lease end). The consumer only pays the difference between the MSRP and the residual (and interest on the declining balance), and since they don't pay off the entire capital cost of their vehicle their monthly payment is lower. Some OEMs deliberately increase residuals above expected market conditions at lease-end, resulting in lower monthly payments. These OEMs know full-well that at the end of the lease they will lose money on the re-sale but these losses are four years down the road at lease-end, so they conveniently get forgotten. However, these losses are very real and potentially very negative for the leasing company.

In Canada, banks are not allowed to lease vehicles, so the captive finance arms of the OEMs control about 90 percent of the leasing market. Some consumers buy their vehicle at the end of the lease, so they absorb some of these losses (Barnum and Bailey were right: there *is* a sucker born every minute). Some lease residuals are insured, so the risk is off-loaded to an insurance company, while some leases (particularly dealer leases) are "open" so the consumer bears the loss. However, in most cases, the loss falls at the feet of the OEM. These off-lease vehicles steal from new vehicle sales and undermine the market and image of each OEM. Sub-vented lease residuals have once again become

popular in Canada (the billion dollar losses of the late 1990s have vanished into the chasm of short memory), and the only possible outcomes are negative.

High-residual leases do indeed move a lot of product, but everyone loses in the long term.

## Dealer-Level Downloading of Inventory

There is an old saying in the automotive sector [paraphrased, naturally]: "Dealers can never get enough of the hot product, but they're rich in slow-selling inventory". It's a classic "cat and mouse" game between most OEMs and their dealers.

Increased local inventory is good for the market in that it increases product availability. And, since dealers have to warehouse the cars, they become more aggressive trying to move their excess inventory. But there is a limit. Forcing dealers to take significantly more "slow movers" to get access to more "best sellers" can be (and often is) taken too far. And the line in the sand is difficult to define.

Too much inventory can significantly weaken a dealer's financials. It can also result in them putting a lot of consumers into mediocre vehicles, while potentially bypassing the purchaser's needs in lieu of a quick deal. Both of these consumer issues can be seriously negative for an OEM - nothing can be worse for an OEM's reputation than a body of vocal, dissatisfied consumers.

I would also argue that maintaining a strong dealer body is to the financial advantage of any OEM.

In this way, we have five "safety valves", common across many OEMs, all with serious negative consequences in both short and long terms. Be careful with those monthly market share statistics - there is often more behind them than meets the eye.

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## New Light Vehicle Financing

	Retail Sales (units)	Cash % share	Lease % share	Loan % share
2000	1,258,001	19.1%	29.6%	51.3%
2001	1,273,433	14.1%	27.0%	58.9%
2002	1,388,927	15.4%	28.7%	55.9%
2003	1,315,931	9.6%	35.9%	54.5%
2004	1,256,203	11.9%	39.5%	48.6%
2005	1,302,886	11.0%	45.0%	44.0%

Source: DesRosiers Automotive Consultants Inc.