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OBSERVATIONS

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Overview of the Used Vehicle Market in Canada

Whenever people ask about the pre-owned side of the automotive industry, I like to preface my comments with a rhetorical question: "What's the best alternative to a new vehicle?"

Unless I'm speaking to a group of public transportation lobbyists, I invariably receive the answer for which I was fishing: a used vehicle. I often follow this question with another: "How do you manufacture a used vehicle?" Puzzled faces stare back until they hear the answer: "You sell a new vehicle!" The flip side of this axiom is that you can determine the type of used vehicle being "manufactured" by noting the type of customer buying the new vehicle. More on that point later.

There are few auto sector analysts who take the time to expand their knowledge of the used vehicle sector beyond the above truism. This is unfortunate because the used vehicle sector is one of the most important aspects of our industry.

There is no shortage of excellent information available on the new vehicle market. Virtually every market, finance, and product analyst in the automotive industry studies it with the highest-powered microscope at his or her disposal. Entire magazine racks are devoted to new-vehicle rumours, views, and reviews, while the comparatively un-sexy used vehicle sector is restricted to newsprint classifieds and the occasional "Lemon-Aid" guide. This latter term is unfortunate because it conjures up a very negative image of the used vehicle market - an image that is undergoing rapid change thanks to the efforts of a number of used vehicle associations in Canada. These organizations have done a commendable job cleaning up an industry that for years operated in a "culture of deceit."

The reason for all the attention paid to new vehicles is that the entire North American supply base and its client OEMs are dependent on consumers purchasing brand new cars. To put this point into perspective, Canada manufactures about $100 billion in new vehicles and OE parts each year.

Used vehicles manufacture themselves, so to speak. Although the volumes of vehicles involved are much higher (a fact many people forget), the used segment involves smaller dollar values, and it is because of this 'dollar' size difference that less attention is paid. There are only a few American analysts who understand the used vehicle market with any degree of depth, and I believe we are the only Canadian company dissecting the field with professional rigor. There are at least two dozen trade associations active in the new vehicle sector, but only a few devoted to used cars.

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

	New Sales 000's	Percent New	Used Sales 000's	Percent Used	Total Sales 000's	Total Units in Operation (Millions)	Sales as a Percent Of UIO
1995	1,130	30.4%	2,583	69.6%	3,713	15,725	23.6%
1996	1,173	31.6%	2,536	68.4%	3,709	15,823	23.4%
1997	1,388	36.8%	2,381	63.2%	3,769	16,077	23.4%
1998	1,389	39.3%	2,148	60.7%	3,537	16,536	21.4%
1999	1,501	41.5%	2,116	58.5%	3,618	17,071	21.2%
2000	1,549	43.4%	2,019	56.6%	3,569	17,101	20.9%
2001	1,571	43.7%	2,022	56.3%	3,592	17,668	20.3%
2002	1,703	44.4%	2,133	55.6%	3,837	17,911	21.4%
2003	1,594	41.8%	2,215	58.2%	3,809	18,207	20.9%
2004	1,534	40.3%	2,276	59.7%	3,810	18,709	20.4%
2005	1,583	40.7%	2,311	59.3%	3,894	18,883	20.6%
2006	1,615	41.2%	2,301	58.8%	3,915	19,183	20.4%
2006/2005	2.0%		-0.4%		0.5%	1.6%	
2007 F	1,532	38.4%	2,460	61.6%	3,992	19,475	20.5%
2008 F	1,500	37.1%	2,541	62.9%	4,040	19,709	20.5%
2009 F	1,526	37.3%	2,566	62.7%	4,092	19,961	20.5%
2010 F	1,604	38.6%	2,552	61.4%	4,155	20,270	20.5%

Note: 2006 units in operation is forecast
Source: DesRosiers Automotive Consultants Inc., AIAMC, CVMA, and Registration Data © R.L Polk & Company, 2005 Data Released 2006

I would argue that a healthly portion of an OEM's success or failure in the new vehicle market is directly related to the machinations of the used market. Newspapers are quick to cover the falling fortunes of vehicle OEMs, noting that the new vehicle market (especially in the U.S.) is shrinking. What they fail to report is that the wider automotive market, which encompasses the used sector, picks up the slack in times of economic downturn. The total volume of vehicles sold - both new and used - is remarkably stable and rarely fluctuates with the kind of grand swings seen in the new vehicle market.

There is an abundance of proof that the two vehicle markets are counter-cyclical. When growth occurs on one side - be it new vehicles or used vehicles - decline occurs on the other. It is important to remember that people who need vehicles will buy vehicles. External factors determine the age, price, and size of vehicles under consideration, but the overall rate of turnover remains remarkably steady. Remember, most consumers are shopping for a newer vehicle, so the prime competition for a new vehicle is one that is nearly new. Similarly, nearly new vehicles compete with middle aged used vehicles for the same customer dollars.

Prices in the used market therefore have a significant impact on whether consumers purchase new or not. Higher used vehicle prices give consumers more equity towards purchasing a new vehicle, as their trade-in covers a larger-than-expected portion of the down-payment. High used vehicle prices also narrow the cost gap between new and used vehicles and often succeed in steering customers towards new vehicles. Therefore, high used vehicle prices are good for the new vehicle market. The opposite is true with low used vehicle prices; they take equity out of the market and push many consumers to the used vehicle market.

In Canada, roughly 20 to 23 percent (20.4 percent in 2006) of consumers replace their vehicle each year. This statistic hasn't changed very much in more than two decades. Change has occurred, however, in the United States, where the vehicle turnover rate has fallen from the 30 percent range in the mid-1990s to the present rate of 25.2 percent in 2006. Given the fact that the total size of the combined new and used vehicle market (around 60 million units) has not changed appreciably in the past decade, this statistic is more indicative of growing multiple-vehicle-ownership than anything else. More Americans are buying new or used vehicles without selling their old ones, increasing ownership and driving down the turnover rate.

In Canada, we see a very positive future for the used vehicle market. Years of near-record sales in the new vehicle sector are poised to "catch up" as leases and loans reach the ends of their average four to six year terms. As a flood

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of vehicles from the highly-successful 2003-onwards period hits the market, buyers will face tough decisions between compelling used vehicles and higher-priced new counterparts.

Our studies show that modern consumers no longer attach a stigma to the concept of buying secondhand. One can attribute this to increased vehicle quality or the "younger" nature of used vehicles on the market (off-lease and off-fleet vehicles are often younger than off-loan counterparts). Returning to the rhetorical questions I asked before, "How do you manufacture a high-quality used vehicle?" The answer is quite simple: "You make a high-quality new vehicle." The exceptional durability baked into most new vehicles over the past decade has created a much higher quality average used vehicle.

In addition, one of the primary ways in which the used industry has effected a wholesale image change has been through the growth of manufacturer-level certified pre-owned programs (CPOs). CPOs provide great value to the customer - a customer who feels comfortable crossing between the new and used vehicle markets and no longer worries about buying "someone else's problems."

Vehicles enter the used market through four channels: off-lease, off-fleet, consumer trade-ins, and private sales. The latter is the only channel that does not involve a vehicle dealer (used or new) and presently comprises 36.3 percent of the market. Conversely, the other three are dealer-supported and represented 63.7 percent of the used vehicle market in 2006. Most notably, the independent used car dealer has increased its share of used vehicle sales from 18.1 percent in 1996 to 24.3 percent in 2006. This is a success story that speaks to the image rehabilitation currently underway in the used vehicle sector. Independent used car dealers have adopted the sophisticated marketing tactics and sales professionalism more commonly associated with new vehicle dealers, and the results speak for themselves.

One of the most direct ways in which the used market has influenced the nature of vehicle consumption in Canada has been through leasing. The leasing of new vehicles (in the retail market; fleet sales have long been lease-based) has quickly morphed from an unpopular option (4.4 percent of the retail market in 1990) to viable finance product (46.8 percent in 1997) to majority choice (50.1 percent in 2006). In concrete terms, this translates into a leasing pool over 650,000 vehicles strong (compared to 45,000 vehicles in 1990), all of which return directly to the dealer if the consumer does not exercise their buy-out option.

Leased vehicles are often "young" (i.e. three to five years old), but the "youngest" used vehicles on the market are obtained through the fleet channel. Fleet deals (largely daily rentals, but also company cars, executive fleets, and government vehicles) account for around 18 percent of new

Used Vehicle Sales by Channel

	New Car Dealer	Independent Used Car Dealer	Private Sale	Total	Total Units in Operation	Sales as a Percent Of UIO
1995	1,042	468	1,073	2,583	15,725	16.4%
1996	970	458	1,109	2,536	15,823	16.0%
1997	934	448	999	2,381	16,077	14.8%
1998	922	394	831	2,148	16,536	13.0%
1999	893	436	788	2,116	17,071	12.4%
2000	919	408	693	2,019	17,101	11.8%
2001	868	403	751	2,022	17,668	11.4%
2002	909	418	806	2,133	17,911	11.9%
2003	899	473	843	2,215	18,207	12.2%
2004	908	514	854	2,276	18,709	12.2%
2005	905	556	850	2,311	18,883	12.2%
2006	906	560	835	2,301	19,183	12.0%
2006/2005	0.1%	0.7%	-1.8%	-0.4%	1.6%	

Note: 2006 units in operation is forecast
Source: DesRosiers Automotive Consultants Inc., AIAMC & CVMA

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vehicle sales in Canada (287,596 units in 2006). These vehicles are usually between six and twenty-four months old and often enter the used vehicle market having accrued less than 40,000 kilometres. The preponderance of fleet vehicles are GM, Ford, and DaimlerChrysler products, as most import nameplate manufacturers choose not to compete in the daily rental market.

As leasing continues to grow in popularity, the volume of off-fleet and off-lease vehicles (together comprising the "young" sub-segment of the used vehicle market) is expected to increase. This trend bodes well for the new vehicle dealer, as the majority of one-to-five year old vehicles (69.6 percent in 2006) are sold through that channel. When the age factor is eliminated and the used vehicle industry is evaluated as a whole, new car dealers are still the largest players, commanding 39.4 percent of all used vehicle sales. Private sellers are close behind, with 36.3 percent of the market, but it's important to keep in mind that the majority of sales in the private seller channel are of vehicles six years or older. Independent used car dealers derive the majority of their volume from vehicles six-to-ten years old, but the majority of their revenue stems from higher-profit nearly-new vehicles.

The new vehicle dealer is the most important retail channel for used

Used Vehicle Sales by Channel

	New Car Dealer	Independent Used Car Dealer	Private Sale	Total
1995	40.3%	18.1%	41.5%	100.0%
1996	38.2%	18.1%	43.7%	100.0%
1997	39.2%	18.8%	42.0%	100.0%
1998	42.9%	18.3%	38.7%	100.0%
1999	42.2%	20.6%	37.2%	100.0%
2000	45.5%	20.2%	34.3%	100.0%
2001	42.9%	19.9%	37.2%	100.0%
2002	42.6%	19.6%	37.8%	100.0%
2003	40.6%	21.4%	38.1%	100.0%
2004	39.9%	22.6%	37.5%	100.0%
2005	39.2%	24.1%	36.8%	100.0%
2006	39.4%	24.3%	36.3%	100.0%

Source: DesRosiers Automotive Consultants Inc.

vehicles. This is slightly paradoxical, since new vehicle dealers' primary business relates to the sales and service of new vehicles. The car dealer is known to be fickle; it will ignore its used lot when new vehicle sales are strong and shower it with attention when the market heads for a downturn. Despite huge popularity and continually rising sales, import-nameplate vehicle dealers have more difficulty securing used products than their American-branded counterparts. Our research indicates that import-nameplate consumers keep their vehicles longer than GM, Ford, or DaimlerChrysler customers by an average of three to four years. With fewer customers returning to trade in their vehicles and exponentially fewer fleet sales, import nameplate dealers are at a profound used car inventory disadvantage compared to the GM/Ford/DCX competition.

Although leasing is the most popular finance option among new vehicle buyers, it is still relatively unpopular in the used vehicle market. This is because it is very difficult to predict residual values for used vehicles that may be six to ten years old at lease-end. In addition, every used vehicle is unique at the time of sale, adding even more complexity to the task of establishing a resale value.

Despite the fact that nearly-new (i.e. still retaining a substantial portion of their original MSRP) used vehicles comprise the majority of used purchases (39.4 percent in 2006), leasing has yet to capture even five percent of the used vehicle finance market. The majority (58.2 percent) of customers prefer to take out a loan, while a large minority (37 percent) pays for their vehicles with cash. This cash portion is concentrated in the lower-priced segment of the used vehicle market.

While leasing has grown from nothing (1 percent in 1990) to almost-something (4.8 percent in 2006), the gulf between used and new vehicle finance methods still represents a major break point between the two sides of this industry's retail sector. Dealers, consumers, and media commentators are still adjusting to the increased quality and longevity that has been on offer for the past decade. As the vehicle buying public (and the vehicle-selling industry) internalizes the knowledge that nearly-new used vehicles are just as good as new vehicles, it remains to be seen whether leasing will gain popularity as a used vehicle finance option. DAR