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OBSERVATIONS

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Market Shifts

There is an age old problem in the automotive industry. The vehicle distributors around the world including Canada can usually never get enough of the vehicles that are selling well and have too many of the one's that are not. Making matters worse, it is at this time of the year in the Fall that distributors have to order their vehicles from their factories for next year and even though the best forecasters can get their prediction close, few can get it dead on the money. Even if they forecast the total volume of vehicles pretty closely it is much more difficult to get the various segments correct and even more difficult to be precise by brand and by model. We've taken the approach of being conservative in our forecasting. Most OEMs use our forecast as one of the inputs into how many vehicles to order. Understand that once vehicles are on a boat or train or landed in Canada it is near impossible to send any back although it is sometimes possible to get additional product. We would rather have our clients pleading for more product than pleading for incentive money to move product that isn't selling.

Why do some vehicles not sell or at least not meet expectations? There are many reasons and I would argue that most Canadian auto executives understand the issues very well but are often caught up in factory issues and are unable to do anything about it. There is also a lot of gaming inside some OEMs which makes it difficult to get the mix of vehicles correct. For instance, most know which vehicles fall on each side of the equation but to get more of the popular vehicles, any country specific OEM may have to accept more than they would like of the unpopular vehicles. It is also common for near identical vehicles to realize different profit levels in various countries. A vehicle can be very popular in Canada but if an OEM can make a lot more money selling to an American consumer then it becomes more difficult for the Canadian OEM to meet their volume requirements, especially if there is a capacity restraint. There are many situations where the 'head office' says "I'm sorry but we need you to take xyz number of a certain model" and the Canadian distributors have no choice but to accept this, even though they know they will have trouble moving them at the end of the day.

A lot of the problems are also at no one's fault. Who could have predicted that the compact SUV/CUV segment would take off like it has? And remember it takes a number of years to build a new plant and/or to change over an existing plant. First, they have to let the current product run to its natural 'best before' date and then they have to change over to the new vehicles. So over the last number of years,

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Light Vehicle Sales by Segment - Market Share

Canada	1990	2000	2010	2017
Passenger Car				
SubCompact	11.8%	3.8%	5.7%	3.2%
Compact	25.7%	24.1%	23.1%	17.1%
Sport	5.8%	2.4%	1.9%	1.6%
Luxury Compact	-	0.7%	0.6%	0.7%
Luxury	1.4%	2.3%	3.2%	2.6%
Intermediate	22.4%	19.6%	9.6%	5.0%
Luxury High	1.3%	1.6%	0.8%	0.8%
Luxury Sport	0.3%	0.3%	0.3%	0.4%
Light Truck				
SubCompact Sport Utility	1.2%	0.4%	0.1%	3.4%
Compact Sport Utility	1.4%	4.0%	16.0%	20.8%
Intermediate Sport Utility	2.5%	5.2%	7.9%	8.8%
Large Sport Utility	0.5%	2.0%	0.6%	1.1%
Luxury Compact Sport Utility	0.0%	0.1%	1.2%	3.5%
Luxury Intermediate Sport Utility	0.0%	0.8%	2.5%	2.8%
Luxury Large Sport Utility	0.0%	0.1%	0.4%	0.9%
Small Pick up	4.5%	1.7%	2.8%	1.7%
Large Pick up	9.9%	13.1%	16.3%	19.1%
Small Van	8.8%	15.8%	5.5%	4.3%
Large Van	2.6%	2.1%	1.5%	2.1%
Total Light Vehicles	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: DesRosiers Automotive Consultants Inc. (DAC), CVMA, GAC

many OEMs have not been able to fill the demand for vehicles in this segment. Meanwhile the segment most affected by the surge in compact SUV/CUV has been compact passenger cars and many of them are not selling well at all.

Over the years there have been many shifts in the segments that consumers prefer with some happening very fast and this inevitably leads to both; over supply such as mini vans in the first part of this century and under supply such as most luxury light trucks during the last ten years.

No fault can be placed on any OEM executive for not anticipating the collapse in oil prices which sent sales spiralling down. Sudden changes in oil prices have happened often and had a direct impact on sales in various segments both positive and negative. No one anticipated the financial crisis so every OEM ended up with too much product to sell. Sales in Canada went from a SAAR of 1.7 million to 1.5 million virtually overnight. It was even worse in the US where sales went from a SAAR of 17 million to 13 million and ended up at 10 million in less than 18 months.

Assembly plants also require very large levels of capital expenditures and they need to be amortized over the life of the vehicle in order to make any profit. Thus there is a natural tendency to keep a vehicle

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around longer than perhaps it should in order to cover the cost of developing the vehicle and the capital to build the plant. A vehicle with relatively young engineering will usually sell better than a vehicle with older engineering. They have the latest and greatest technology and usually have been tweaked to better meet the attributes consumers are looking for in Canada whereas older engineering often leads to softer sales. Unfortunately there are many exceptions to this rule which make it even harder to forecast the correct number of vehicles to bring into the market. For instance, the longer a vehicle has been in the market the more likely the fixed costs related to developing the vehicle and building the factory are paid for. At this point the OEM has some pricing latitude and you often see substantial price reductions as a vehicle ages which can lead to better sales of an older vehicle rather than fewer sales.

NORTH AMERICAN SALES OF VEHICLES - # OF UNITS

-INCLUDES HEAVY DUTY TRUCK

CALENDAR YEAR	US TOTAL	CANADA TOTAL	MEXICO TOTAL	RTH AMERICA TOTAL
1990	14,146,404	1,314,118	544,930	16,005,452
1991	12,541,321	1,287,056	642,981	14,471,358
1992	13,117,846	1,227,841	706,914	15,052,601
1993	14,162,443	1,188,203	603,067	15,953,713
1994	15,363,582	1,254,872	597,252	17,215,706
1995	15,116,325	1,162,512	188,591	16,467,428
1996	15,455,113	1,199,509	340,053	16,994,675
1997	15,497,860	1,422,994	502,671	17,423,525
1998	15,967,287	1,426,592	665,384	18,059,263
1999	17,414,728	1,540,379	706,380	19,661,487
2000	17,811,673	1,586,083	902,372	20,300,128
2001	17,472,378	1,597,875	942,431	20,012,684
2002	17,138,652	1,731,823	1,003,717	19,874,192
2003	16,967,442	1,625,050	999,106	19,591,598
2004	17,298,573	1,574,803	1,119,585	19,992,961
2005	17,444,329	1,630,142	1,162,158	20,236,629
2006	17,048,981	1,666,008	1,177,100	19,892,089
2007	16,460,315	1,690,345	1,144,305	19,294,965
2008	13,493,165	1,673,522	1,068,736	16,235,423
2009	10,601,368	1,482,232	773,385	12,856,985
2010	11,772,220	1,583,388	846,881	14,202,489
2011	13,040,613	1,620,221	935,093	15,595,927
2012	14,787,690	1,716,178	1,022,693	17,526,561
2013	15,883,443	1,780,523	1,098,907	18,762,873
2014	16,841,973	1,889,386	1,169,117	19,900,476
2015	17,845,624	1,936,990	1,387,361	21,169,975
2016	17,865,773	1,981,609	1,647,703	21,495,085
2017	17,550,521	2,076,078	1,572,043	21,198,642
2017/2016	-1.8%	4.8%	-4.6%	-1.4%

Source: DesRosiers Automotive Consultants Inc. (DAC), CVMA, GAC, Ward's Automotive, AMIA

The vehicle companies are also highly competitive with each other and react quickly to each other's incentive programs which can change market dynamics. The best example I can think of was the response of the industry to the 9/11 attacks in the U.S. in 2001. GM/Ford/FCA were in the midst of a fairly serious restructuring that would have been more manageable if the market held. There was a legitimate fear that the market would collapse so GM launched what was called the "get America rolling" campaign with substantial discounts on their vehicles. Every OEM responded with similar discounts so instead of going through a natural cyclical correction the market was sustained in the 17 million range for another 5 to 6 years and this was one of the reasons the collapse following the financial crisis was so severe. Between 1999 and 2008 North Americans bought almost 200

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million vehicles so most had no need to buy a vehicle.
If one gets down into the weeds and examines specific models there are dozens of examples where they do not meet expectations and require significant aid to clear showrooms. Some of these are just plain ‘mistakes’ but more often the vehicle is so far along in its development process that an OEM has virtually no choice but to introduce it even though changes in the market signal that it will be difficult to sell as many as they otherwise would have. For instance, subcompact cars consistently sold about 100K per year during the high gas price era and last year sold only 65K now that gas prices dropped dramatically. Small pick-up trucks consistently sold 40K to 50K units but dropped to only 15K when Ford suddenly dropped out of this segment of the market.

All of the examples so far have identified reasons why any particular vehicle can exceed expectations and create a situation where any OEM is not able to meet the available demand alongside an equal number of situations where demand does not meet expectations and OEMs need to use a variety of methods to move the product. There is a long list of tools at their disposal which I call ‘safety valves’. These could command an Observation on their own to properly review and there are many: dumping vehicles into the fleet market since elements of the fleet market are less sensitive to the attributes of the vehicle and instead are pure price buyers, offering consumer incentives of various types, offering dealers incentives to take more inventory or offering them their own incentives to encourage them to sell specific vehicles. At one point sub-venting residual values in a lease was popular; the higher the residual the lower the monthly payment so if an OEM sets an artificially high residual they can usually sell more. This can back fire as well in that if a segment collapses at the same time, like minivans, the resale value can also collapse and these high residuals could be become extremely costly at lease end. Another safety valve is turning a blind eye to exporting the excess product. The OEMs usually don’t like exports of new vehicles but in a pinch they may ignore dealers who do this.

There are also many cases where demand is managed very well. The growth in the luxury segment as whole has been anticipated and managed with aplomb. To be sure, there are always some miss-matches no matter how well overall volumes are anticipated but the demographic and economic metrics pushing the luxury segment forward have been pretty well understood and most of the luxury OEMs have been able to avoid having to extensively use some of the more costly ‘safety valves’ to sell excess inventory. DAR

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