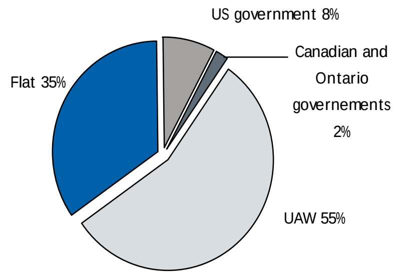
ECONOMICS | RESEARCH

CURRENT ANALYSIS

August 2009

CHART 1

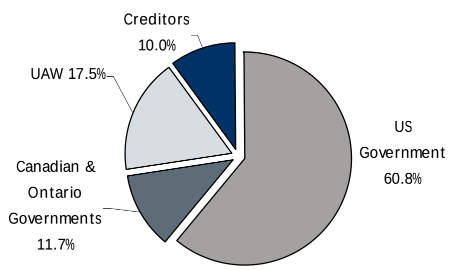
Chrysler ownership structure



Source: Chrysler, RBC Economics Research

CHART 2

New GM ownership structure



Source: GM, RBC Economics Research

Robert Hogue
Senior Economist
416-974-6192
robert.hogue@rbc.com

Josh Heller
Economist
416-974-8593
josh.heller@rbc.com

Auto sector: The dawn of a new era?

Battered by the financial and economic crisis, the global auto industry has just gone through its darkest days since the Great Depression. Plunging sales have pushed industry giants over the edge, causing widespread plant closures, employee layoffs and ripple effects throughout the supply chain. Now that Chrysler and parts of GM have emerged from bankruptcy protection in the United States, what does it mean for the auto sector from a Canadian perspective?

Q: Are we out of the woods yet?

A: Chrysler and GM have won some significant breathing space, but uncertainty will persist until motor vehicle sales recover meaningfully from recent deeply depressed levels. They dipped below the 10-million unit mark (annualized) in the United States for the first time since 1982 during the first half of this year. Sales did move up well above that line in July and August thanks to the "cash for clunkers" rebate program, although it remains an open question whether the increase can be sustained in the near term. While restructured companies will break even at lower sales levels than in the past — the new GM says it will turn a profit when the U.S. sales are sustained above 10 million units — it will take an improvement to perhaps 12 million units or more in U.S. sales before the motor vehicle assembly business can be considered back on track. Equally important is the situation of parts manufacturers, who are still very much on shaky ground (they have been under intense pressure for a number of years). Several large players have filed for bankruptcy protection in recent months in the United States (including Visteon, Metaldyne, Hayes Lemmerz, Noble International and, in early July, Lear) and a host of others are said to be in trouble. Given the symbiotic relationship between the large motor vehicle manufacturers and their parts suppliers, risks in the overall sector will remain elevated until both have returned to health.

Q: How has Canada's auto sector changed during this crisis?

A: Changes have been at all levels — corporate, assembly, parts manufacturing, retail distribution, financing.

➤ **Corporate**: Chrysler Canada's parent, Chrysler Group LLC, is now owned by Fiat, the United Auto Workers (UAW) and the U.S., Canadian and Ontario governments (Chart 1). General Motors of Canada is part of the portion of General Motors Corporation that has become a private company, majority-owned by the U.S. government, with stakes also held by the UAW, Canadian and Ontario governments and creditors (Chart 2). The new GM has shed four of its eight North American brands (Saturn, Hummer, SAAB and Pontiac). At Chrysler, Fiat has committed to bringing its technology, platforms and powertrains for small- and medium-sized cars that have been a success in the European market. Chrysler and GM's new ownership structures, lower debt levels and narrower production focus point to a new era in the way these companies operate: less encumbered by bloated legacy structures; streamlined in production/distribution/marketing; operating with lower costs; and, focusing more sharply on energy-efficient vehicles.

TABLE 1

Canadian auto assembly plants

Company name	Location	Capacity
CAMI	Ingersoll	200,000
Chrysler	Brampton	285,000
Chrysler	Windsor	350,000
Ford	St. Thomas	230,000
Ford	Oakville	230,000
GM	Oshawa - car	510,000
GM (Closed)	Oshawa - truck	275,000
Honda	Alliston	390,000
Toyota	Cambridge	300,000
Toyota	Woodstock	75,000

Source: Industry Canada, RBC Economics Research

- **Motor vehicle manufacturing (assembly)**: The Canadian light vehicle assembly base will emerge modestly (less than 10%) smaller, but even more competitive than it has been in the past. Canada has seen one production facility — GM's truck plant in Oshawa — terminated permanently (effective this past May), removing 275,000 units (or roughly 9.7%) of Canadian capacity (Table 1) — although recent production levels had been much lower than rated capacity. The closure returns the light vehicle assembly base to nine complexes (all in Southern Ontario), including twin plants in Oshawa (GM) and Alliston (Honda), and more than offsets the earlier gain from the start-up in December 2008 of Toyota's newest plant in Woodstock (with initial capacity of 75,000 units per shift).

Consolidation in the Canadian industry is roughly proportionate with that taking place south of the border, where six assembly plants (two at Chrysler and four at GM) are permanently closing — in addition to the closure of three plants last year. As a condition for the financial aid received from the Canadian and Ontario governments, both Chrysler and GM will have to maintain the historical share of North American vehicle assembly in Canada (estimated between 15% and 20%). Consequently, Canada's relative position in the North American industry will be preserved. In fact, Ontario — which surpassed Michigan in terms of vehicle produced in 2004 — will cement its status as North America's pre-eminent auto manufacturing hub since three of the closing U.S. plants are located in Michigan. As part of the restructuring efforts, competitiveness at the "Detroit Three" operations has improved. Several rounds of negotiations with the Canadian Auto Workers union have significantly reduced labour costs, including so-called "legacy" costs related to pensioners. This will complement the strong reputation earned by Canadian plants for quality and productivity, enhancing the viability of the industry in the longer-term.

- **Parts manufacturing**: The process of consolidation that began a few years ago across North America has yet to run its course, with several more firms recently filing for bankruptcy protection and shutting down facilities in both the United States and Canada. The sharp drop in demand from auto manufacturers since the fall of 2008 and the bankruptcy filings of Chrysler and GM in the United States have exacerbated the intense pressure under which parts manufacturers have been operating for some time. Excess capacity, higher costs of raw materials, tough demands to reduce output prices and the strong Canadian dollar have all weighed heavily on this sector. Many more firms — both large and small — remain in serious financial trouble, likely leading to further near-term capacity closures. The problem in the Canadian industry is being compounded by the close alignment of domestic parts manufacturing operations with the "Detroit Three" where most of the downsizing is occurring. GM will be closing its transmission plant in Windsor in 2010. Nevertheless, Canada still benefits from world-class players, which should continue to form a solid industry core. Reflecting the reduction in the North American vehicle assembly base, the parts industry in Canada will emerge smaller in size and concentrated among fewer players.

- **Retail distribution**: As part of its restructuring, GM will terminate its relationship with 2600 U.S. dealers, or roughly 40% of total, and 245 in Canada (35% of total), although a portion of those dealers (470 in the United States) are affiliated with Hummer, Saturn and Saab, which are in the process of being sold. In June, Chrysler sent termination notices to 789 dealers in the United States (25% of total), but the company has yet to indicate similar plans in Canada. The number of new vehicle dealerships in Canada has been in decline since 2000, with the drop entirely attributed to the Detroit Three (and, among them, mostly GM and Chrysler). The upcoming closures will, therefore, speed up an existing trend. However, it is important to note that not all terminated dealerships will go out of business. A certain proportion of them will either switch their affiliation to another manufacturer or become independent used-car dealerships.

While there will be a modest shrinking of the population of new-vehicle dealerships in Canada in the near-term, a partial offset will come from some increase in used-vehicle dealerships. The GM terminations would represent a 7% drop in new-vehicle dealerships (Chart 3), although this is on the high side given that Hummer, Saturn and Saab dealerships are likely to continue operating outside the new GM. The closures will be concentrated among small stores (typically selling fewer than 100 vehicles per year), leaving the remaining retailing base with higher sales volumes per store. The culling of dealerships at GM and Chrysler in the United States will reduce intra-brand price competition, which should lessen pressure on margins. Longer-term, as motor vehicle sales recover, the Canadian dealership base might gradually retrace some of its losses.

➤ **Financing**: The global financial crisis greatly disrupted automotive financing, in particular sideswiping captive auto financing companies, which are key players in the industry. However, the financing business is being repaired and expected to eventually return to a pre-crisis position, although market shares between the players might be different. The problems in auto financing have arisen primarily as collateral damage from the residential mortgage lending collapse in the United States that resulted in the virtual shutdown in the trade of securitized assets. Car loans and leases, up until last year, were widely securitized. The difficulties of the captive financing arms of GM and Chrysler were exacerbated by the deep troubles of the parent companies. While deteriorating since mid-2008, the quality of auto loans themselves has not degraded to the same degree as that of residential mortgages, based on the U.S. experience. As part of their unprecedented efforts to shake off the financial crisis and jump-start the economy, U.S. and Canadian authorities have put large-scale programs in place to support the issuance of asset-backed securities (the Term Asset-Backed Security Loan Facility in the United States and the Canadian Secured Credit Facility in Canada), specifically designed to unclog the flow of credit through the securitization channel.

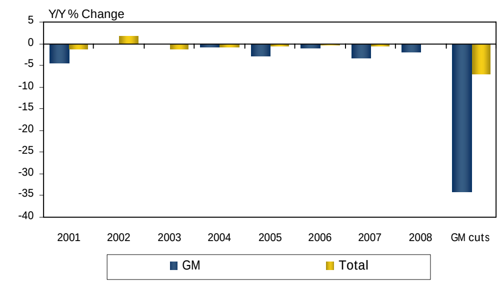
Evidence to date suggests that these programs, which have only kicked in recently, are succeeding in making financing more widely available to dealerships. Captive auto financing firms — with some exceptions (e.g., Chrysler Financial with respect to car loans) — have become more active again at providing financing for leasing, car loans and floorplan loans after retrenching substantially at the height of the financial crisis when the asset-backed securities market dried up. In Canada, the void left earlier by captive financing companies has been partially filled by chartered banks, which have either established or broadened relationships with dealers at every level of the business.

Q: Is this a permanent change in the Canadian auto industry or a cyclical episode?

A: Both. The North American industry had excess production and distribution capacity, primarily among the Detroit Three owing to their protracted mar-

CHART 3

Dealer franchises in Canada



Source: DesRosiers Automotive Consultants Inc., CADA, RBC Economics Research ket share loss since the mid-1980s. Some culling of capacity had to occur — this is the process now under way. At the same time, the financial and economic crisis, particularly in the United States, destroyed motor vehicle demand. U.S. lightweight vehicle sales plummeted to a 27-year low of 9.1 million units in February of this year (Chart 4), clearly well below what could be considered sustainable levels. Just to maintain the overall fleet size (that is, to compensate for the number of vehicles being scrapped), the U.S. market has needed between 11 million to 14 million new units in the past few years. Thus, a large portion of the decline in Canadian motor vehicle and parts production is attributable to the recession/financial crisis. Once the U.S. economy begins to recover, which we expect during the second half of this year, and consumer confidence bounces back more firmly, and with financing availability and terms improving, U.S. motor vehicle sales should pick up and production in Canada should initiate a cyclical rebound.

CHART 4

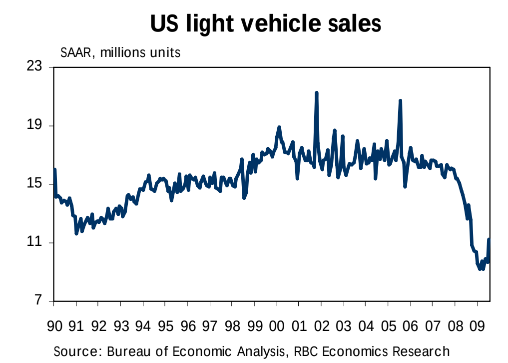
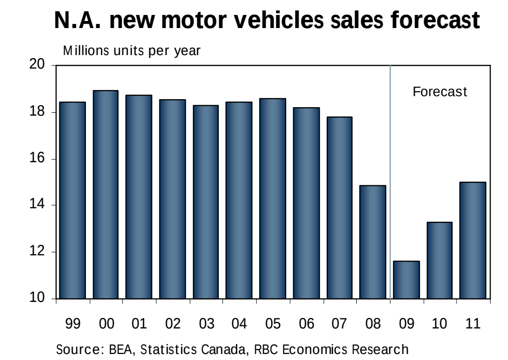


CHART 5



Q: What is the outlook for auto sales and production?

A: We expect auto sales in the United States to rise very modestly during the second half of this year, totalling 10.2 million units overall in 2009, and continue to move higher to 11.5 million units in 2010. This would compare to 13.2 million units in 2008 and an average of 16.6 million in the previous five years. The deeply depressed sales levels through the first half of this year reflected the unusually weak economic and financial conditions and did not represent a permanent shift to such levels. U.S. families and businesses still need and will continue to need to travel on a daily basis, and motor vehicles are and will remain the principal mode of transportation. As economic and financial conditions turn a corner in coming months and households feel more confident — bolstered partly by fiscal stimulus measures such as tax cuts — U.S. consumers will return to showrooms, as they did in July on the lure of the "cash for clunkers" program.

Officially called the Car Allowance Rebate System (CARS), this program was introduced by the U.S. government late in July and quickly exceeded expectations, exhausting the initially allotted US$1 billion funding within a week and causing a sudden jump in sales in July to an annualized 11.2 million units. An additional US$2 billion was injected into the U.S. program in early August, which also was used up rapidly. The Obama administration ended CARS on August 24. However, beyond the temporary rush to benefit from the government rebates, buyers of new vehicles are not expected to be as plentiful in the next year or two as in recent years due to the dampening effects of high unemployment and the continuation of the deleveraging taking place among U.S. households. Similarly, in Canada, sales of new motor vehicles are expected to move modestly higher starting in the second half of this year, totalling 1.5 million units in 2009 and 1.6 million units in 2010 compared to 1.7 million in 2008 and an average of 1.6 million in the previous five years. In the medium- to longer-term, the "new normal" for sales in North America is likely to be a little lower than the average of 18.5 million units (perhaps in the 17.5 to 18 million range) recorded in the 1999-2007 period due to a slower projected growth in the driving-age population.

The implications for auto production in Canada is that 2009 will probably be the low point of this cycle — indeed, this will be the worst output performance since 1982. In the first half of this year, the number of motor vehicles produced in the country fell to 1.2 million units (annualized rate), or about one-half the average since 2000. Going forward, the pace of production should pick up alongside the improvement in North American sales. During August, Ford, GM and Chrysler have boosted their Canadian output schedules for the coming months. Given extremely low production rates during the spring and early summer that boost will translate into a large increase on a quarterly basis in the third quarter, although this burst of activity will quickly moderate thereafter. Over the medium-term, annual production rates in Canada could well return to the range of 2.2 million units that has often been achieved this decade. However, moving much above such levels — to, say, earlier peaks of 2.7 million units — would be quite unlikely in light of the reduction in capacity that has just taken place.

Q: What is the impact of the turmoil in the auto sector on Ontario's economy?

A: The immediate impact is significant, although difficult to quantify with precision. Ontario has long been the nexus of the auto industry in Canada, home to the country's entire light vehicle assembly capacity and to 93% of parts manufacturing production. Motor vehicle and parts is the largest manufacturing industry in the province, directly representing 3.7% of total real GDP and 2.2% of employment (in 2008), so the precipitous decline in auto production since the end of last summer has necessarily been a tough blow to the overall economic performance of the province. That drop and its corollary in parts manufacturing have been directly responsible for between two-fifths and one-half of the significant contraction in provincial real GDP in the fourth quarter of 2008 and the first quarter of this year (down 5.9% and 7.7% at annualized rates, respectively, according to Ontario Ministry of Finance figures). Moreover, indirect effects such as lower consumer and business spending resulting from the associated loss of personal and business income can be as large as the direct hit (albeit this cannot be as precisely measured), making the auto sector downturn undoubtedly the biggest factor contributing to the recession in Ontario.

As mentioned above, the crisis in the industry has both structural and cyclical components. This means that, as the cycle turns upwards, activity will, indeed, pick up again in the province. Ontario will remain a leading auto manufacturing hub in North America, benefitting from the presence of world-class players, a well-established supplier base, strong skills and expertise, excellent infrastructure and advantageous geographic location. However, growth will be constrained by some loss in productive capacity, mostly on the parts manufacturing side. This is a key reason behind our forecast of Ontario lagging the rest of the country in the recovery — real GDP growth in the province is projected at -3.4% and 2.2% in 2009 and 2010, respectively compared to -2.4% and 2.5% for Canada. That being said, the resumption of production at the Chrysler plants (idled during May and June while the parent company worked through the bankruptcy procedures in the United States) and other facilities during the summer is likely to produce a certain pop in real GDP mid-year, helping the province move towards positive growth overall during the second half of the year.

Q: What are the key challenges/risks facing the industry going forward?

A: They are many.

➤ **Another leg down in the economy**: The expected recovery in the North American economy in coming quarters might not materialize or be sustained. This would cause consumers to rein in any plans to purchase big ticket items, keeping motor vehicle sales at depressed levels for a prolonged period.

➤ **Energy prices**: A sharp rise in energy prices would cut down on both the usage of and demand for motor vehicles.

➤ **Other shoes to drop?** The crisis in the auto sector was focused on the troubles at Chrysler and GM. As these two companies are reborn and compete from a stronger position, other players might no longer be able to stay alive. The precarious state of parts manufacturers raises the possibility of more plant shutdowns and industry-wide disruptions.

➤ **Government/union ownership:** While this arose as part of the solution for Chrysler and GM — and, with respect to government's stakes, not intended to be permanent — it represents a precedent in North America and it is not clear at this stage how well it will work on both strategic and operational levels given the disparity interests of the new ownership groups.

➤ **Emissions regulation:** More stringent environmental regulation is being adopted all around North America and stricter, ambitious emissions standards are being set. The auto industry is under the gun to quickly improve fuel efficiency. In fact, the U.S. government's financial assistance is contingent on GM and Chrysler meeting bold targets for fuel efficiency by 2016, thus requireing substantial investment in research and innovation, as well as tremendous efforts to bring new products rapidly to market.

➤ **China/India**: The impressive pace of development of motor vehicle industries in countries such as China and India has raised concerns that new global players might soon be able to enter the North American market. At this stage, these players primarily focus on their domestic markets — which are exploding — and probably have enough growth opportunities to keep them busy at home for some time. However, during the long-term, these players might be looking for new markets to sustain their ascent.