CANADIAN AUTO MANUFACTURING: RUNNING AGAIN, BUT HOW MUCH FUEL IS LEFT IN THE TANK?

Highlights

• The resurgence of U.S. auto sales has translated into increased vehicle production across North America, which reached a 7-year high in 2012. The outlook for sales remains quite bright, which will bode well for continent-wide production going forward.

• While auto production in Canada has nearly returned to pre-recession levels, there is not much fuel left in the tank. Much of the new investment is going to Mexico, and to a lesser extent, the United States, suggesting that Canada’s share of North American production is set to shrink. The same holds true for the auto parts sector.

• Although some headway has been made through new labour contracts and government support, competitiveness remains a key challenge for Canadian auto manufacturers.

• Parts producers perhaps have more upside potential, given that global auto production is expected to expand, and there are pockets within the auto parts industry that offer opportunities for growth.

A sharp rebound in U.S. auto sales – in addition to growth in the Canadian and Mexican markets – led to an 18% increase in North American auto production last year, with double digit gains seen in all three countries. The number of vehicles produced throughout the continent totaled close to 15.4 million units, reaching the highest level seen since 2005.

To a lesser extent, unfavourable exchange rates around the world – in Japan especially – also helped to give North American production a boost, as automakers have been shifting more production here, moving toward a ‘build where you sell’ model. In fact, while the Detroit-3 automakers lost market share of sales last year, the production-to-sales ratio across the continent was 90%, up from the 80% that was typically seen in the years leading up to the recession, and the highest level seen since 1997. Consequently, foreign automakers now represent roughly 45% of auto assembly output in North America.

The good news doesn’t stop there. With the outlook for U.S. auto sales over the next few years rather bright – reaching the 16 million unit mark by the end of next year – auto manufacturing in North America is likely to continue to grow as well, albeit, like sales, at a slower pace than was seen in 2012. The increase, however, will not be spread evenly throughout the continent. In both Mexico and the United States, production of light vehicles is expected to record further healthy gains over the next few years. In contrast, the number of vehicles assembled in Canada is likely to hold relatively steady compared to last year’s turnout.
Mexico to be the big winner

Just prior to and during the recession, North American capacity was consolidated – particularly by the Detroit-3 – with several plant closures. The move was intended to bring production more in line with demand so that hefty incentives were not needed to move vehicles off dealer lots. However, given the combination of smaller capacity with rising sales, several automakers are bumping up against capacity constraints, with utilization rates at assembly plants rising to 97% in 2012, from 83% during the year prior. In Mexico, capacity utilization was running at a whopping 124%, followed by 100% in Canada and 91% in the United States. Utilization rates above 100% were made possible by adding a third shift and crew, as well as improving 2-shift capabilities at some plants. With sales on the rise and foreign brands planning to move more production to North America, capacity will ultimately need to expand.

Much of the increased capacity will be in Mexico, where several automakers have already announced plans to build new plants, while others are upgrading facilities to accommodate new models. Lower labour costs and access to several markets – Latin America in particular – through free trade agreements has made Mexico an attractive place to locate. This will help make North America more of a global player, exporting to markets outside the continent as well. In the U.S., some automakers plan to expand existing capacity – largely in the southern states, including Alabama, Tennessee and South Carolina – although every expansion that has taken place there over the past few decades has come with incentives from the government.

In Canada, Toyota recently announced plans to expand capacity at its Cambridge plant, and while no decision has be made as of yet, Ford is considering an expansion of its Oakville plant. GM, despite recently announcing plans to invest in its CAMI plant in order to convert it into a flexible facility, is closing a plant in Oshawa by mid-2014 and moving production of the Camaro south of the border in 2015-16. The plant closure will more than offset any increase at Toyota, likely leading to a slight decline in auto production over the next two years.

As a result, Canada’s share of North American production is set to shrink. Indeed, coming out of the recession, Canada accounted for over 17% of continent-wide auto production, slightly higher than the 16.6% average seen over the last decade. However, by 2014, that share is likely to slide below 15%, reaching the lowest level seen since 1989, and about 2 percentage points below the historical average.
A closer look at the Canadian auto manufacturing sector

Auto production in Canada peaked in 1999 – at just under 3 million units – and began to trend down thereafter. The Great Recession exacerbated the downtrend, with output falling to less than 1.5 million units. However, like sales, auto production was a bright spot in 2012, with output up by 15.5% during the year. In turn, this gave exports a much needed boost, with auto shipments out of Canada jumping 15%. In fact, automobile and light-duty motor vehicle manufacturing ranked 2nd among the top exporting industries last year. Overall, since bottoming in 2009, assembly production has bounced back by 67%, falling just shy of 2007 levels. Auto parts manufacturing has followed a similar trend, with record growth in output last year and top suppliers registering record sales and earnings.

However, employment in both areas has been slow to recover. Combined, assembly and parts producers shed nearly 45,000 jobs during the recession, and after increasing slightly in 2010, employment has flattened out. Accordingly, roughly 35,000 fewer jobs are held in the motor vehicle manufacturing industry now than was the case in 2007, which amounts to employment being down by 25% from pre-recession levels. Looking a little deeper, employment in the parts sector has been slower to come back, gaining only 10% since bottoming, compared to 15% in the assemblies sector. Given that parts manufacturing is more labour intensive than assembly production, it is likely that this underperformance was due in part to suppliers feeling hesitant to rehire workers until they were certain that demand had improved.

Not much fuel left in the tank

Competitiveness is likely to remain the number one challenge facing Canada’s auto assembly sector as it vies for a slice of North American investment. The same holds true for the parts sector, as Mexico is becoming a bigger player there too. U.S. auto parts imports from Mexico reached a record high in 2012, accounting for about a third of total imports. Meanwhile, U.S. imports from Canada were 16% below the peak reached in 2007, and its share of total imports was at a record low of 13%. That said, Canada still ranks number three on the list of U.S. auto parts imports, behind Mexico and Japan, who surpassed Canada in 2012 for the first time since 1996.

One positive development for the Canadian automotive manufacturing industry, however, is the agreement that was reached between the Detroit-3 automakers and the Canadian Automotive Workers (CAW) union in September of last year. The union agreed to a two-tier wage structure, with second tier workers starting at a lower rate and taking 10 years (previously 6 years) to reach the top rate, and to award workers annual bonuses rather than wage increases over the next four years. This will bring the wages of autoworkers in Canada more in line with their U.S. counterparts.

Prior to the agreement some automakers cited Canada as the most expensive country to build vehicles. The new labour agreement is a step in the right direction and will certainly help, but other cost pressures remain. Chief among them is the high-flying loonie, which will continue to be a competitive challenge going forward. This highlights the need for manufacturers to continue to focus on finding ways to improve cost competitiveness.
The Harper government has taken some action on this front. It recently renewed the Automotive Innovation Fund for another five years, meant to provide funding for companies that are working to develop fuel efficient automotive technologies and reduce greenhouse gas emissions. This can be a useful tool in the coming years given that the CAFE standards in North America are pushing automakers towards more fuel efficient technologies. Toyota has already taken advantage of this program, as it is planning to build a Lexus hybrid model at its Cambridge plant – the first hybrid model to be produced in Canada. These CAFE standards also present a great opportunity for parts producers, as automakers will be looking to them for innovative products and ideas that will help improve fuel efficiency.

In addition to the innovation fund, the 2013 Federal Budget included an extension of the accelerated cost of capital allowance for another two years, to provide some tax relief for manufacturers. While there is some concern that tax incentives could be reversed as the government fights its deficit, it is a move that would help both assembly and parts manufacturers. Further supported by the accelerated cost of capital allowance, Ontario is quite competitive on the tax front. The federal corporate income tax rate has fallen to 15%, while the rate in Ontario has dropped to 11.5%. Combined, the corporate income tax rate in Ontario is lower than the 35% federal rate seen in the United States. The capital tax in Ontario has also been eliminated, which has benefited the manufacturing sector.

For parts producers, there is, perhaps, slightly more upside potential going forward. Just as foreign automakers are moving assembly production to North America, many – Japanese automakers in particular – are also looking to diversify parts suppliers and production as well. This became quite notable in 2011 after supply chain issues stemming from natural disasters in Asia impacted production around the world for some automakers. The desire to diversify parts production presents a great opportunity for Canadian suppliers if they are able to capitalize on the situation. Moreover, with global demand for autos set to rise – with much of the growth driven by emerging markets – there will be increasing opportunities for Canadian parts producers to expand their businesses. The free trade agreements that Canada is in the midst of negotiating – including the Trans Pacific Partnership and the European Union – could be beneficial for suppliers moving into these markets. That said, expanding into new markets may require the manufacturing to be done closer to the end destinations. In addition to location, there are pockets within auto parts production that look promising. For example, the rapid growth in the amount of electronic content in vehicles seen recent years is expected to continue, suggesting that this is one area of the market that still has a great deal of growth potential.

**Bottom Line**

Overall, the resurgence of U.S. auto sales has translated into increased vehicle production across North America. With sales stateside expected to remain on an upward trajectory over the next couple of years, continent-wide production of autos should follow suit. This, in addition to some automakers looking to shift production to North America will require an increase in capacity on the continent. Unfortunately for Canada, much of the new investment in auto production will be in Mexico, and to a lesser extent, the U.S., suggesting that overall production on this side of the border is likely to flatten out, leading to a decline in Canada’s share of continent-wide production in the coming years.

As a result, employment in the sector is likely to remain well below pre-recession levels. The auto parts manufacturing sector may have more upside potential, as higher North American and global production could lead to increased demand for Canadian-made parts. It will be up to parts suppliers to build their relationships with foreign automakers, develop innovative products and maintain competitiveness, in order to keep the sector growing at a healthy pace.

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