# TD Economics

## Special Report

January 23, 2009

# OUTLOOK FOR AUTO AND PARTS SECTOR

## *Tough times ahead as N.A. sales plummet to 4-decade low this year*

The road for automakers has been getting bumpier and bumpier since 2007, but the worst appears yet to come. The U.S. – the world's largest auto market – has officially been in a recession since December 2007, and the economy is likely to continue to deteriorate for at least another 2-3 quarters. This certainly doesn't bode well for new vehicle sales over the next year. What's more, the economic slowdown in the U.S. has spread rapidly throughout the rest of the world, as the global economy has already fallen into a recession. Accordingly, the outlook for North American and global auto sales has weakened considerably, with any rebound not likely to begin before 2010. Even then, only a fraction of the drop in sales will likely be recouped.

Waning sales will force all automakers to slash production over the next year, leading to shift and/or plant closures in several regions, which will weigh heavily on economic growth. Indeed, we project light vehicle production in North America to fall 28% in 2009, which will undoubtedly create additional pressures on parts producers, some of which are already on the brink of bankruptcy. Undeniably the success of the Detroit Three in fending off the financial challenges on their doorstep is the number-one uncertainty surrounding our forecast. And while we make the implicit assumption that with government aid, these companies will avoid bankruptcy, the risk of bankruptcy has far from been eliminated. There is no shortage of possible outcomes in the coming months as these U.S.-based companies move to restructure their operations, including undertaking mergers, asset sales and/or strategic alliances, such as the proposed agreement between Chrysler and Fiat. A detailed analysis of these possibilities and their impact on TD's auto sales and production forecast is beyond the scope of this report. However, under virtually

**HIGHLIGHTS**

- **U.S. sales to plunge by a further 28% in 2009; Canadians to put the brakes on sales as well**
- **Deterioration in sales environment to force all automakers to slash production; Output in Canada to slide 28% this year**
- **Parts sector to follow suit, with output tumbling 24% in 2009 before rebounding 15% in 2010**
- **Government loans to help GM and Chrysler avoid bankruptcy, but many concessions to be made by all parties involved**
- **Detroit Three automakers to emerge from this downturn much leaner and with a smaller share of the North American market**

**AUTOMOTIVE SALES AND PRODUCTION**

| | 000's | Per cent Change | | | |
|---|---|---|---|---|---|
| | 2007 | 2007 | 2008E | 2009F | 2010F |
| **SALES OF LIGHT VEHICLES** | | | | | |
| **NORTH AMERICA** | 18,835 | -2.1 | -15.8 | -25.5 | 13.8 |
| **Canada** | 1,653 | 2.6 | -1.1 | -12.9 | 5.3 |
| **United States** | 16,089 | -2.5 | -18.0 | -28.0 | 15.8 |
| **Mexico** | 1,093 | -3.5 | -6.2 | -13.7 | 6.8 |
| **PRODUCTION OF LIGHT VEHICLES** | | | | | |
| **NORTH AMERICA** | 15,021 | -1.5 | -16.1 | -27.7 | 15.0 |
| **Canada** | 2,542 | 1.8 | -19.6 | -28.3 | 13.3 |
| **United States** | 10,473 | -3.0 | -19.3 | -30.4 | 16.0 |
| **Mexico** | 2,006 | 2.6 | 5.1 | -16.3 | 13.0 |

Forecast by TD Economics as at January 2009

Source: DesRosiers Automotive Reports, Ward's, TD Economics

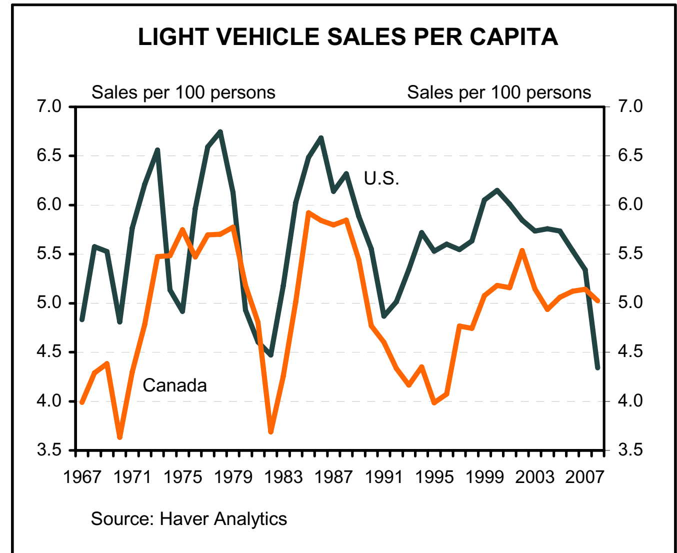
every scenario, the Detroit Three will emerge with a much smaller presence in the North American auto market – the question only remains to which degree.

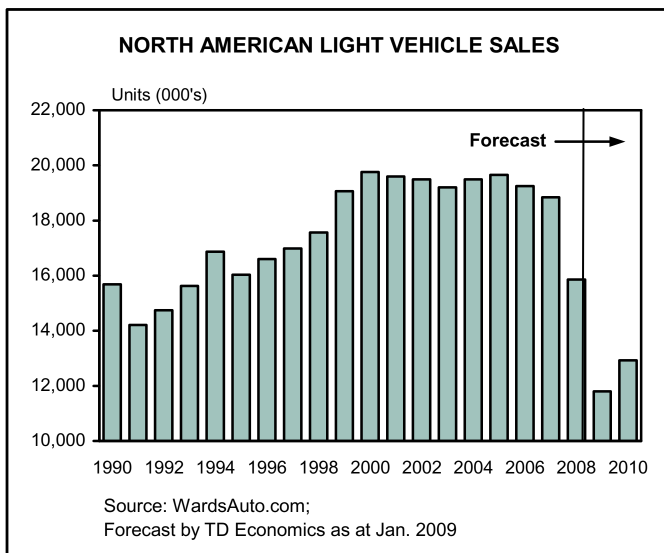
### U.S. auto sales to slide further in 2009

The decline in auto sales in the United States, which began in 2006, became steeper and steeper over the past year, with sales in October and November falling to lows not seen since the early 1980s (on a seasonally adjusted annualized rate basis). In 2008, 13.2 million vehicles were sold in the U.S. – an 18% plunge from 2007 levels, marking the worst selling year since 1992. What's more, on a per capita basis, sales fell to the lowest level on record going back to 1967. And the near-term outlook is even bleaker, with sales expected to slide by a further 28% in 2009.

U.S. consumers have been faced with several headwinds in recent months, including the ongoing credit crunch. Potential buyers – of which about 90% require a loan in order to buy an automobile – have encountered great difficulties in obtaining credit to finance new vehicle purchases. Furthermore, some dealers (namely GM and Chrysler) have reduced or eliminated leasing as a purchase option (which has cheaper monthly payments), since the deteriorating residual value of used vehicles makes lease agreements less viable.

Moreover, a net 2.5 million jobs were lost in the U.S. in 2008, further reducing the ability of these consumers to purchase big-ticket items. And that figure will only grow in 2009, as we expect another 2.8 million jobs to be lost during the year. So with the near-term economic outlook becoming grimmer and consumer confidence continuing to erode, the grip on U.S. consumers' purse strings will only tighten.



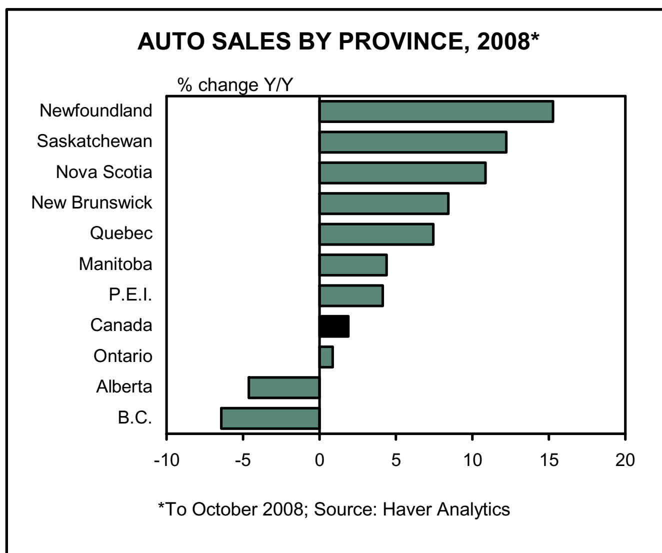

Given that new vehicle sales were booming in the early part of the decade, and that the number of registered light vehicles exceeds the number of licensed drivers, there is very little pent-up demand in the market. So while a downturn in the auto industry was inevitable, the credit crisis and employment conditions have deepened the retrenchment in auto sales. Credit conditions are expected to improve only gradually throughout the forecast period, while housing prices will only stabilize towards the end of 2009, and unemployment is expected to continue to rise through 2010. All of this suggests that autos are likely to be near the bottom of consumers' shopping lists for some time. Nonetheless, we do expect to see a modest rebound in auto sales in 2010, to the tune of 16%, as lower prices and a rosier economic picture take hold. But even with this bounce-back, sales will remain at a depressed level of about 11 million units.

### Canadians to put the brakes on sales

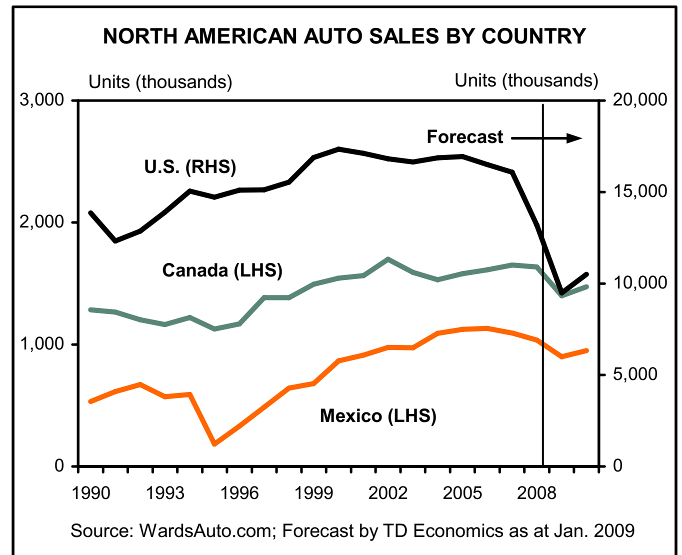
In contrast to the dire situation south of the border, new vehicle sales in Canada were holding up surprisingly well this year – at least until November. In fact, during the January – October period, sales were 1.9% higher than like-2007 levels. With the loonie hovering around parity for the first nine months of the year, Canadian dealers were pressured to lower prices in order to deter cross-border shopping. In addition to these lower sticker prices, dealers have been offering a variety of incentives, including cash

back, rebates, added features, and low lease and financing rates, creating what seems to be the best time to buy an automobile in the country. And sales were strong across most of the country, with only B.C. and Alberta bucking the trend by posting declines year-to-date as of October of 7.1% and 5.4%, respectively. Ontario, which is the largest provincial market in absolute terms, was up by a meager 0.3%. For the second consecutive year, Newfoundland & Labrador and Saskatchewan outperformed the other provinces, with sales growing at a rapid clip of 14.5% and 10.5% during the first 10 months of the year.

Nonetheless, the robust pace of sales in Canada this decade is not sustainable, particularly for an economy that is in a recession. The massive drop-off in sales in November (-10% Y/Y) and December (-21% Y/Y) – which drove overall sales down 1.1% in 2008 – is a sign of what's to come in the near term. While the risks facing the Canadian economy are not as severe as those in the U.S., falling commodity prices and weak export demand will put a dent in domestic income going forward. And combined with a weaker Canadian dollar, waning job growth and a saturated light vehicle market, auto sales will continue to flounder in 2009, despite a variety of incentives. Still, the magnitude of the loss in sales will be less in Canada than south of the border, since the employment market has, and will continue to, hold up better and the impact from negative wealth effects on spending should be softer. Overall, we expect auto sales in Canada to slide by 13% in 2009. Like the U.S., we do expect to see a slight uptick in sales in 2010 of around 5%. With all provincial economies, except Saskatchewan, expected to fall into a recession this year, employment is expected to decline in most provinces, and unemployment rates are likely to rise across the board. While the decline in auto sales will be widespread throughout the country, momentum heading into 2009 was weakest in B.C. and Alberta.



*To October 2008; Source: Haver Analytics



Source: WardsAuto.com; Forecast by TD Economics as at Jan. 2009

## U.S. weakness spreads to the Mexican market

While the Canadian auto industry managed to hold up well for most of the year, the Mexican market was unable to escape the headwinds flowing down across the border. For the second year in a row, auto sales contracted in 2008 by about 6% and we expect them to fall even lower in 2009. Like the rest of the world, economic growth in Mexico has slowed considerably in recent months, and its economy is also heading for a recession. Consequently, consumer confidence has fallen to its lowest level since 2001 and consumer credit growth has slowed dramatically. All of these factors combined point to lower sales volumes in the near term. As well, the rapid depreciation of the Peso against the U.S. dollar since October has likely pinched sales, since about 55% of new cars sold are imported. Putting it all together, we expect the Mexican auto market to follow the trend in the U.S. market, with sales tumbling 14% in 2009, before recovering around 7% in 2010.

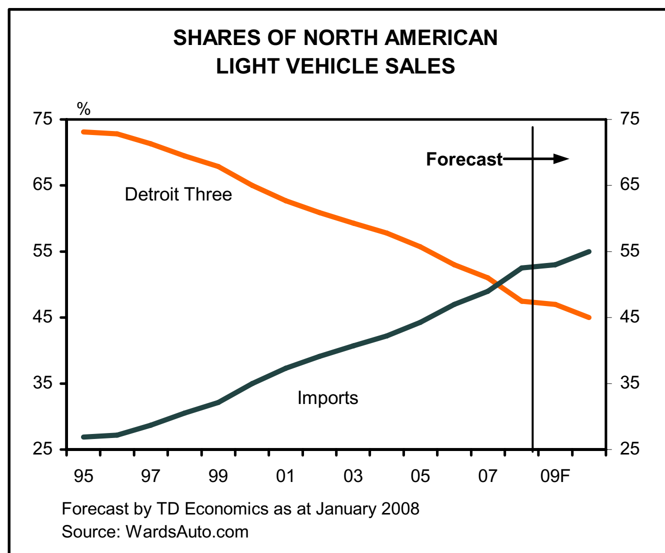
*Looking at North America as a whole, we forecast auto sales to fall 26% to 11.8 million units in 2009, marking the worst continental performance since 1970, and falling significantly below the 19.6 million units sold in 2005. And with all economies expected to recover only slightly in 2010, sales volumes are likely to improve only modestly.*

**Detroit Three market share continues to dwindle…**

Amid sliding North American sales, the woes of the Detroit Three have remained in the spotlight, partly due to the ongoing shift in demand towards smaller cars – a segment in which the domestic automakers lack competitive products. As a result, market share of Ford, GM and Chrysler combined, which was 73% in 1995, slipped below half to about 48% last year, with each company experiencing a 20-30% drop in sales during the year. Consequently, inventories on dealer lots in the U.S. have surged. Measured in days supply, vehicles in stock at the Detroit Three have jumped from an average of 78 days during the first 10 months of the year to 121 days on December 1st. Accordingly, the automakers have announced significant production cuts – both permanent and temporary – in order to bring inventories under control. During the first quarter of 2009, GM , Ford and Chrysler will reduce production by a combined 44% from year-ago levels, which will put a major dent in North American output given that these automakers account for 57% of overall production.

**…but no one is immune**

While market share of the foreign brands continued to rise in 2008, no one has been immune to the recent precipitous drop in sales. Indeed, Toyota and Honda also ended the year on a sour note, with sales in the U.S. plunging by over 30% in November and December, forcing both companies to reduce their profit forecast by 90% and 67%, respectively, for the fiscal year ending March 31st. The depressed sales environment drove inventories of foreign nameplates up as well, with stocks in the U.S. of all im-




Forecast by TD Economics as at January 2008
Source: WardsAuto.com

**North American Production Cuts by the Big Five**

**GM**

- 20 plants to close temporarily – many for all of January
- Closed 3 plants: Doraville, GA (September), Janesville, WI (December) and Moraine, OH (December)
- Spring Hill plant shut down until at least February
- Moved up the permanent closure of the Oshawa, ON truck plant from July to May
- Eliminated LaCrosse production at Oshawa, ON car plant
- Delaying production of new engine plant in Michigan

**Chrysler**

- 84,000 units to be shed from Q1 production compared to 2008 levels
- All 30 North American plants to close for 30 days
- Shut 2 plants: St. Louis, MO (October) and Newark, DE (December)
- Eliminated shift at plant in Ohio

**Ford**

- 2-week Christmas shut down of 10 plants will be extended to three weeks
- 430,000 units will be slashed in the first quarter compared to like-2008 levels
- Michigan Truck Plant and Cuautitlan plant in Mexico to be shut in 2009 while being retooled to build small cars beginning in 2010

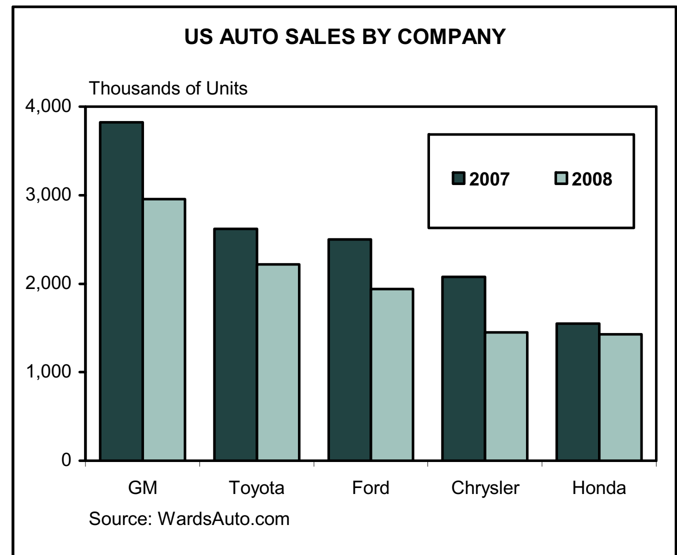
**Honda**

- Another 119,000 units (56,000 units already removed) will be shed from planned production through March at plants in Ohio, Alabama, Indiana and Canada
- Plants will be idled for 4-7 days in January

**Toyota**

- 6-10 day closures (December-January) of three plants in the U.S. and one in Canada
- The new Toyota plant in Woodstock, Ontario began production in November, but with only one shift
- Production at Toyota's Mississippi plant, which was scheduled to begin production in late 2009 or early 2010, has been delayed indefinitely

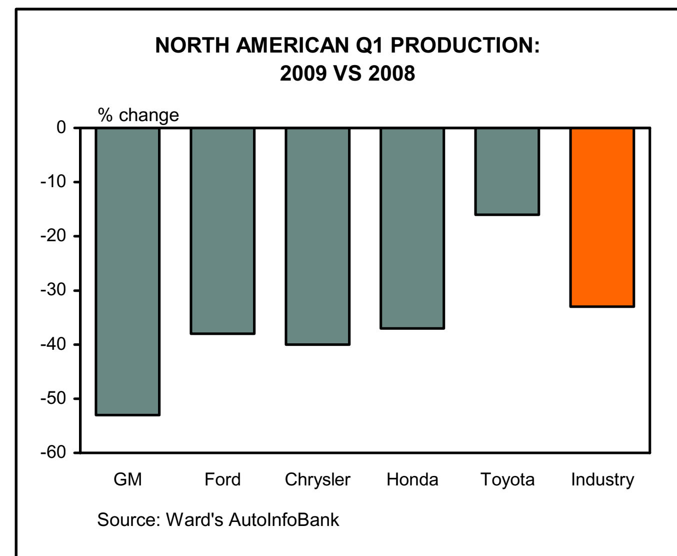
ports jumping to 100 days on December 1st, from an average of 68 days during the January – October period. Hence, near-term production curtailments will not be limited to the Detroit Three. Foreign nameplates have also announced temporary production cuts for the New Year, both in North America and their home markets. As a result, overall North American industry output will slip 33% during the first quarter of the year alone, with production sliding 28% in Canada, 37% in the U.S., and 16% in Mexico. See text box on previous page for details on North American production cuts.

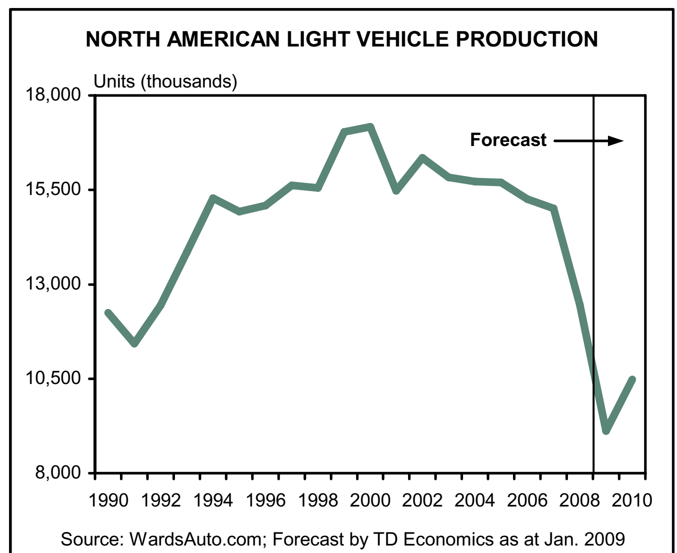


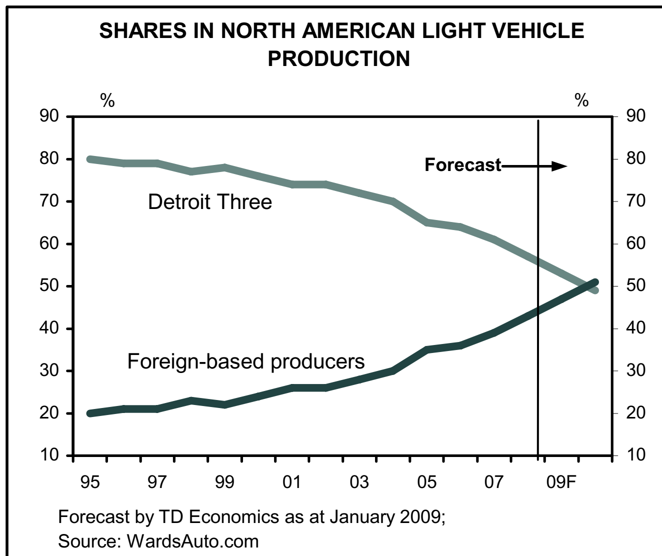

### Detroit Three restructuring plans underway…

Although a lack of demand will force all producers to continue to chop production until a cyclical pickup in the U.S. economy gains traction, restructuring by the Detroit Three will continue to leave its mark on output trends over the medium term. These moves will mark a continuation, albeit a likely accelerated one, of some positive moves in recent years to put the business models of the U.S.-based automakers on a more viable footing. These positive moves include the following:

- Since August 2007, Chrysler has reduced production capacity by 1.2 million units – at the expense of 2 plants and 12 shifts – and reduced fixed costs by $2.4 billion. Ford has already made some progress in scaling down its operations, as it sold Jaguar, Aston Martin and Land Rover, and Volvo is on the market.
- The domestic automakers have invested in product development to become more competitive with the foreign nameplates. The Ford Escape Hybrid is the most fuel efficient vehicle in its class, while the all-new 2009 Ford Flex and Chevy Malibu are receiving rave reviews. Furthermore, all three companies have additional smaller, more fuel-efficient vehicles in the works for the 2010 model year. There has been some concern that demand for these vehicles will soften since gasoline prices have fallen so abruptly in recent months. However, we do expect gasoline prices to rebound moderately in the second half of this year and into 2010, thereby reviving any lost demand in this vehicle segment. As well, government mandates in the U.S. still require this move toward more fuel efficient vehicles, so these automakers are heading in the right direction.
- The Detroit Three have also begun the process of reducing costs. Suppliers have already given way to lower






prices, and in the U.S., reductions in labour costs through the UAW agreement in 2007 were a big step forward. These moves will only accelerate going forward.

- On a global scale, the Detroit automakers have been having some success outside North America. GM sales in China rose 6% in 2008, while Ford, despite a drop in sales, continued to gain market share in Europe. Expanding into the global market has proved well for the Detroit Three, and will likely continue to be a source of strength in the future.

**…but still a long way to go**

That said, the deterioration in the sales market has brought these processes to a virtual standstill in recent months. But notwithstanding this progress, the domestic automakers were caught in a perfect storm of sluggish demand, limited availability of credit and a deep recession in their key market, at a time when they were struggling to return to profitability. While Ford stated that it should be able to make it through 2009 without any help, the fate of GM and Chrysler was left in the hands of the U.S. government, as operations of these automakers beyond the end of 2008 without financial assistance was uncertain. With automotive production in the U.S. accounting for 1.3% of GDP and about 900,000 jobs, the Bush Administration deemed the industry too big to fail, and due to the current environment, extended a $17.4 billion loan to keep the automakers running through the first quarter of 2009. The Canadian government followed suit, offering a proportional $4 billion loan to the beleaguered automakers, though ongoing negotiations regarding the loan conditions have delayed the transfer of funds to GM and Chrysler. But further government support will be contingent upon certain conditions, which are outlined in the accompanying textbox. The key goal underpinning these stipulations is to help the automakers become viable again. In order for that to happen, a lot of changes must be made – by both the automakers themselves, as well as other parties involved, including the labour unions.

**North American auto industry to look different down the road**

The bottom line is that even if both GM and Chrysler are able to meet all the terms of the loan and avoid bankruptcy, the U.S.-based automakers are going to look drastically different down the road. (See textbox on page 7 for possible restructuring efforts). They will be much leaner with respect to both products and dealerships, resulting in smaller companies accounting for a lesser share of continental production. Unfortunately, this means that the market share of Detroit Three sales will shrink further,

**Terms and Conditions of U.S. Government Loan**

***Binding conditions:***

- Automakers must have a plan to return to viability (positive net present value), or loan will be called in full.
- Restrict executive compensation
- Cannot issue dividends until loans are repaid
- Issue preferred stocks to the government and grant warrants for non-voting stocks
- Transactions of $100 million or more must be federally approved

***Targets*** *(can deviate from targets with good explanation):*

- Reduce unsecured debt by two-thirds through debt to equity exchange
- UAW work rules and wages to be competitive with foreign-based automakers (operating in North America) by the end of 2009
- Half of payments to retiree health trusts to be in stock
- Eliminate Jobs Bank

Source: Automotive News, December 22, 2008.

**Loan conditions to revamp domestic auto industry**

One of the major goals – and loan conditions – for GM and Chrysler as a part of their restructuring efforts will be to reduce their debt. Both automakers have indicated that they intend to negotiate with the UAW, suppliers and/or bondholders to try to swap debt for equity, and Cerberus has already stated that it is willing to give up its 80.1% stake in Chrysler to help meet debt restructuring needs. Nonetheless, this strategy will prove to be a challenge for the automakers, as the value of these companies continues to dwindle.

GM is the largest of the Detroit Three, holding 22% of North American market share. But that figure is likely to shrink in the coming years as the automaker is forced to reduce the number of brands under its name. Indeed, GM's preliminary restructuring plans include selling off the Hummer and possibly Saturn and Saab brands, while trimming Pontiac down to perhaps one vehicle after 2009. This would allow the automaker to focus on improving its core brands – Chevrolet, Buick, Cadillac and GMC – which are thought to have better prospects for success. As a result, the number of dealerships will also shrink – another goal that GM should be working towards.

Chrysler, with 11% market share, halted production for a least a month in order to determine how to allocate its share of the loan and has delayed several vehicle programs to save money. Chrysler is not competitive in the fuel-efficient vehicle category, and the electric cars that it plans to produce for 2010 may be delayed given the current financial environment. However, the automaker has recently agreed to trade a 35% stake in the company to Fiat for access to Fiat's small cars, although this alliance is still subject to government approval. As well, Nissan has agreed to produce small cars for Chrysler beginning in 2010, which should boost its competitiveness. Elsewhere, the Jeep line is still faring well, and the minivan and Dodge Ram are also winning products, but these are hardly enough to revitalize the entire company. The jury is still out on whether the abovementioned alliances will provide the necessary boost to sales that Chrylser needs to become profitable.

Although Ford (14% market share), who appears to be in the best financial position, was not included in the government bailout, and hence is not required to follow the same conditions set out for the other two automakers, it will likely negotiate similar contracts with the union and suppliers in order to maintain competitiveness. However, Ford too still has a lot of work ahead, including improving the Lincoln brand and perhaps eliminating the Mercury line.

along with output and employment in the sector. While the revamped auto industry will have several casualties – including a number of job losses – it is a necessary step to preserve the industry as a whole. Smaller, but profitable companies are a more favourable alternative to having large automakers that are continually struggling to survive.

This outcome paints a bleak picture for the production side. But it is important to keep in mind that at least part of the lost sales and production of the Detroit Three will be picked up by foreign-based manufacturers in the near term. And while some of the demand might be satisfied through imports from abroad, the high cost of transportation will mean that the output will be moved onshore over time, thereby creating jobs and output for the sector. We have already seen evidence of this trend in the U.S., as foreign producers' share of production rose 18 percentage points between 2002 and 2008, while their share of sales grew by 20 percentage points. Of course it will take some time for new plants to open, but overall, the majority of the cars sold in North America are almost certain to be produced in North America over the medium-to-longer term horizon.

### Canada fighting to keep its share of production

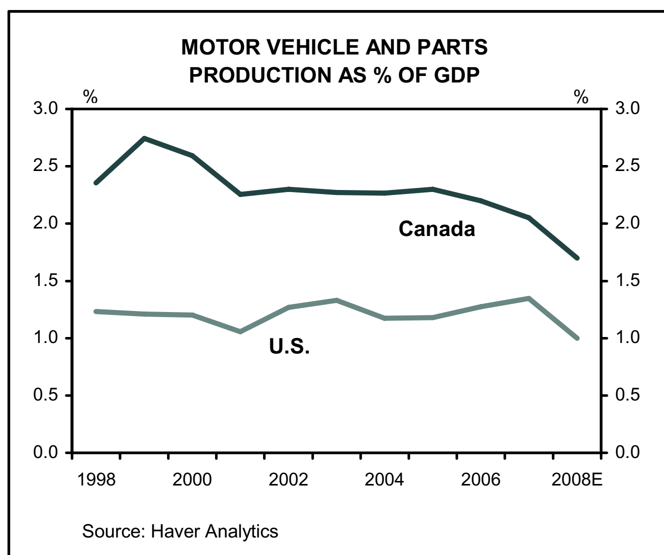
The weakening prospects for the auto sector and the Detroit Three in general are a bitter pill to swallow for Canada in particular given that the industry as a whole accounted for 2.1% of overall real GDP in 2007 – compared to the 1.3% contribution in the U.S. Moreover, the majority of this output is concentrated in Ontario. Indeed, vehicle and parts manufacturing in Ontario represented 4.7% of real GDP in 2007. Automakers also provided 135,000 direct manufacturing jobs in Canada in 2007 – most of which were in Ontario. What's more, Canada relies on the Detroit Three for over 60% of total production, with GM (22%) and Chrysler (23%) accounting for the largest shares. As such, implications of the restructuring plans could be even more dramatic on the Canadian automotive sector.

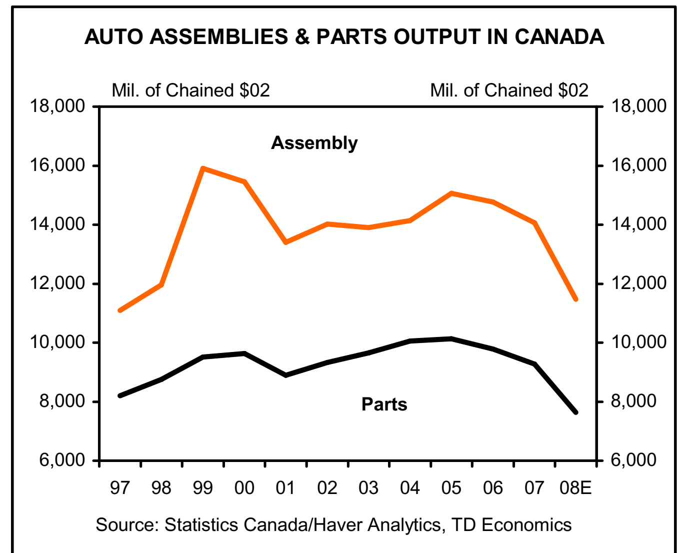
Given the massive reduction in output expected to come from these companies, Canadian operations must prove

that they are competitive or risk shifting production elsewhere. While the CAW made some concessions during the last round of negotiations, wages in Canada are still higher than wages in the U.S., thus eroding its competitiveness. Industry analysts estimate that once the new contracts come into effect in the U.S., all-in labour costs for the Canadian Detroit Three operations will be between $20-30 per hour higher (including legacy costs and assuming parity dollars)[1] relative to their U.S. counterparts. Compared to labour costs of the foreign-based producers in the U.S. – which is what the loan conditions require GM and Chrysler to match by the end of 2009 – CAW costs are at least $15-25 per hour higher than these foreign-based plants.[2] If the UAW agrees to lower labour costs in light of the loan conditions – which is a likely scenario – the CAW will have to follow suit in order to remain competitive. The fact that the Canadian dollar has declined from above parity during the first half of the year to about 80 US cents is good for Canadian producers, but at the same time, the loonie is unlikely to fall below 70 cents as it was during the early part of the decade. And while productivity may be a little better in Canada, the bottom line is that the aggressive moves by the UAW will put pressure on the CAW to make concessions if it wants to keep 20% of Detroit Three production north of the border. On a brighter note, the Toyota plant in Woodstock, Ontario began production in November, although below full capacity.

### Fate of the parts sector lies with Detroit Three

The Canadian auto parts sector faced a difficult ride in 2008 as well, with real output (as measured by real GDP at basic prices) tumbling by 18% – matching the drop in production of motor vehicles. What's more, the sector shed more than 8,500 jobs (-10%) during the first 10 months of the year, marking the 5th consecutive year of declines. Employment in the sector has fallen by more than 20% since peaking in 2001. Meanwhile, jobs in the assembly sector have been falling more slowly, with 1,500 (-3%) jobs lost during the first 10 months of 2008, after holding steady in 2007. The expected drop in production going forward implies another very difficult year ahead for parts producers.



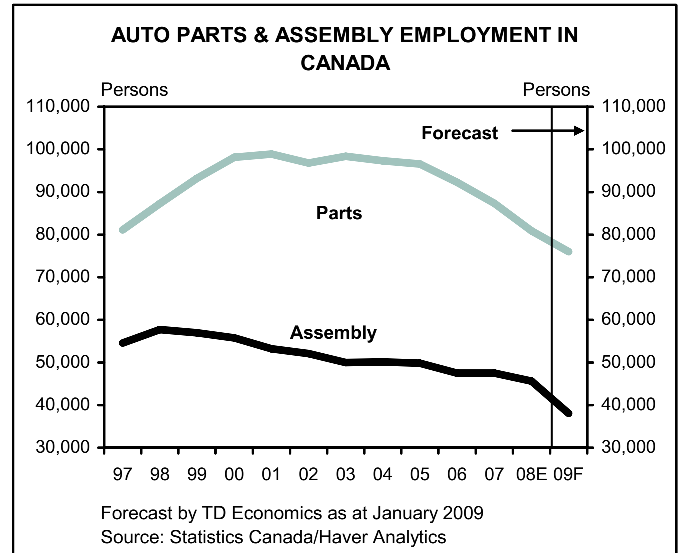

Overall, we expect the 28% reduction in North American production to drive parts output down by about 24%. As the industry is expected to record a modest recovery in 2010, parts production will follow suit, rising 15%.

While only GM and Chrysler have been forced to ask for a helping hand, the government aid was supported by other automakers in view of the fact that bankruptcy by one or more companies would significantly disrupt the supply chain. Indeed, with several suppliers highly dependant on the Detroit Three, a failure of even one company could put a number of already beleaguered parts producers out of business, leaving the rest of their customers (automakers) scrambling to find parts elsewhere. Moreover, suppliers are not immune to the deteriorating credit conditions, as some have contracts to fulfill, but are having difficulties obtaining financing to carry out the work. The parts sector is also seeking $1 billion in government aid to keep them going until the industry bounces back. Larger producers such as Magna and Linamar – who supply both domestic and foreign brands – are better positioned to weather the

storm than the smaller, more specialized suppliers, but even they have been forced to idle some plants over the past few months. In fact, last year, Magna alone closed two plants and eliminated a shift at a plant in Canada, resulting in about 1250 job losses.

Given that GM and Chrysler have yet to receive government funds – pushing some suppliers dangerously close to bankruptcy – some parts producers have requested payment in advance from these automakers. As well, Toyota and Honda are considering modifying their 'just-in-time' manufacturing strategy in order to keep some suppliers above water. As a consequence, inventories of their vehicles could build up – but that scenario is still favourable to losing suppliers.

Putting it all together, the effects of the Detroit Three restructuring efforts will not be lost on the parts sector. With their largest customers likely to reduce or eliminate brands and models, demand for parts will shrink or be destroyed altogether. For example, suppliers that concentrate on parts for SUVs and pick-up trucks will face even greater challenges going forward, as production of these models are scaled back. As well, despite progress already made over the past few years, automakers will be looking to suppliers to lower prices even more, in an effort to reduce costs. As such, parts producers will continue to endure lower revenues and to find themselves in a challenging environment. So like the assembly picture, the parts sector will likely look considerably different down the road, with a much smaller presence in the North American market.

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## Endnotes

[1] DesRosiers Automotive Consultants Inc.; Tony Faria, University of Windsor; "Auto wages to cost $27 an hour more in Canada versus U.S." Globe and Mail, November 30, 2008

[2] DesRosiers Automotive Consultants Inc.

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