TD Economics

Special Report

February 6, 2008

AUTOMAKERS BRACE FOR A DIFFICULT YEAR

Over the past year, the challenges facing the Canadian auto sector have intensified. The outlook for U.S. sales has deteriorated markedly as the risks of U.S. recession have increased. But, while the U.S. sales picture should begin to turn the corner in 2009 – setting the stage for a modest bounce back in North American output – other structural impediments threaten to weigh on the Canadian auto and parts sector over the medium term. Most importantly, Canada's eroding cost position has come onto centre stage in light of the surging Canadian dollar, moves by the Big Three in the U.S. industry to lower costs and rising competition from China. This negative swing in relative cost position has raised concerns about Canada's ability to secure investment. Increasing environmental measures by governments also present a major longer-term challenge for the sector as a whole.

HIGHLIGHTS

- **U.S. sales to tumble by 5% this year; Canada's impressive sales' winning streak to come to an end**
- **The weaker demand environment to set the stage for an 8% drop in Canadian assemblies in 2008**
- **Next year, the start-up in operations at Toyota's Woodstock plant should underpin a moderate recovery in production**
- **Real output in the Canadian parts sector to follow suit, with significant cuts this year to be followed by a partial bounce-back in 2009**
- **New environmental regulations and the recent drop in relative competitiveness vis-à-vis the U.S. present key medium-term challenges for the sector**

AUTOMOTIVE SALES AND PRODUCTION

	Per cent Change			
	2006	2007E	2008F	2009F
SALES OF LIGHT VEHICLES				
NORTH AMERICA	-2.1	-2.2	-4.4	3.4
Canada	1.8	2.4	-0.9	1.2
United States	-2.6	-2.5	-5.2	3.6
Mexico	0.6	-3.5	2.0	4.0
PRODUCTION OF LIGHT VEHICLES				
NORTH AMERICA	-3.2	-1.6	-3.5	3.8
Canada	-4.8	1.8	-7.6	5.9
United States	-6.3	-3.1	-3.6	2.8
Mexico	21.8	2.1	2.7	6.1

Forecast by TD Economics as at January 2008
Source: DesRosiers Automotive Reports, Ward's, TD Economics

U.S. sales to tumble by 5% in 2008

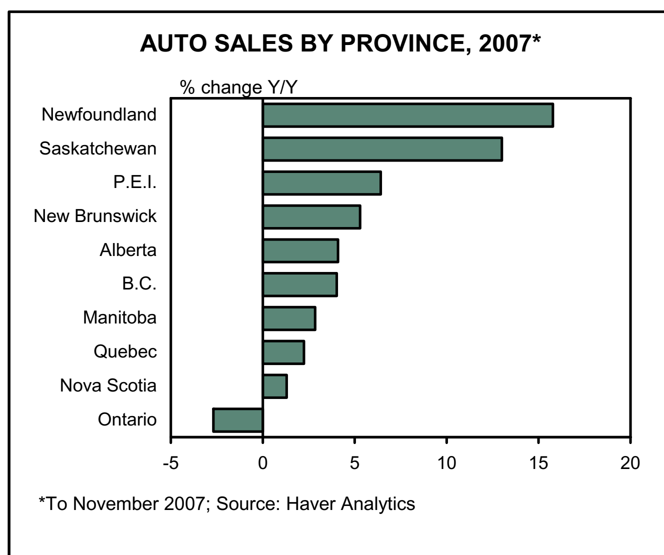
Sales in the United States, which account for 85% of North American sales, have been trending downward for the past 3 years. In 2007, total sales of cars and light sales were dampened in part by elevated gas prices and a reduction in manufacturer incentives. And the near-term outlook is even bleaker, with U.S. sales expected to tumble by 5% in 2008, to a ten-year low. Consumer fundamentals have continued to deteriorate in recent months, as the U.S. subprime housing woes broaden from the real estate market to the economy as a whole. Employment growth is likely to limp along at a mere 0.5% in 2008, compared to its trend rate of roughly 1.6% over the past few years. We expect the U.S. to avert a full-fledged recession, but only by the narrowest of margins. Still, with consumer confidence eroding, lending standards being tightened and

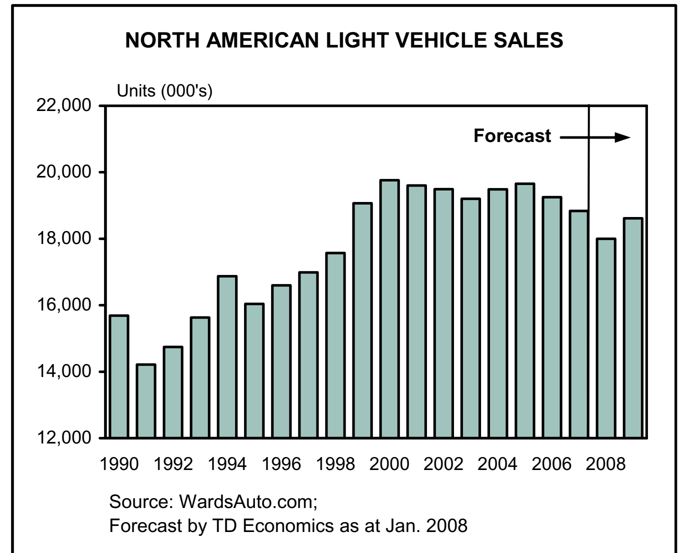
little price relief in sight at the pumps, demand for motor vehicles will be hit harder than most other consumer goods. While we expect the U.S. economy to improve somewhat in 2009, the recovery in auto sales will be relatively modest and only partially recoup the loss suffered this year.

Canadian auto sales' winning streak to end

Canada's gain in sales in 2007 – to the second highest level on record – was among the big surprises of the year, since sales were already at elevated levels in 2006. Sales growth was strong across the country, with the sole exception of Ontario, which posted a 2.7% decline. Newfoundland & Labrador and Saskatchewan outpaced the other provinces, with stellar gains of 16% and 13% respectively. But after a 5-year run of robust sales – with more vehicles sold than any other 5-year period on record – Canadian sales will likely fall from their peak. Looking ahead, even though Canada's economy and job market don't face the same downside risks as those in the United States, we expect a significant slowdown in job growth from coast to coast in 2008 and into 2009.

In addition to weaker job growth and a lack of pent-up demand, Canadian motor vehicle sales will likely come under some further pressure from cross-border competition, which is accounting for a relatively small but growing share of total Canadian vehicles sales. The pressure intensified in the autumn when the Canadian dollar rose to parity. While the consumer price index (CPI) shows that the price of new vehicles in Canada fell in 2007, some analysts estimated as recently as November that automobiles in the U.S. were $5,000 cheaper on average. By November, the number of vehicles brought across the border had surged

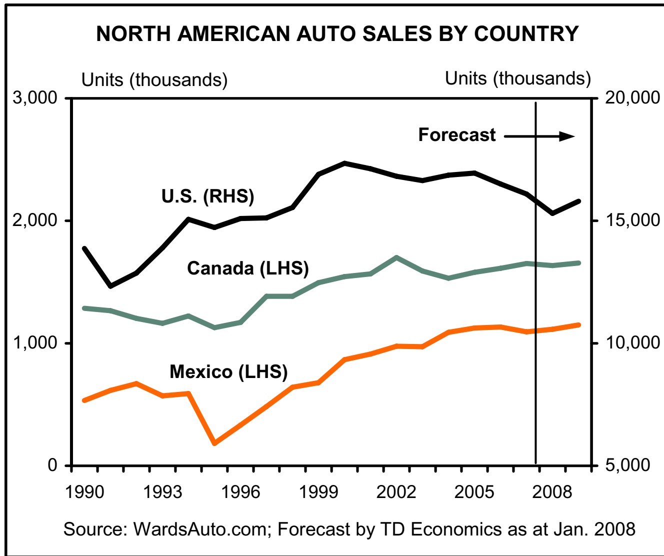




to twice their year earlier levels. And although the majority of these vehicles were used, most were only a year or two old. As such, dealers in Canada have since moved to close some of the price gap in order to keep residents shopping at home. At first, these dealers were reluctant to slash sticker prices to match those across the border. Instead, they introduced cash incentives as well as attractive lease and financing rates in order to closer match their prices with those of their American counterparts. Even the foreign-based automakers, which rarely offer incentives and low interest rates, provided substantial discounts for Canadian-bought vehicles. But recently, some Canadian dealers have announced that they will cut retail prices and bring them closer in line with U.S. prices. Nonetheless, the elevated loonie could keep U.S. imports at above-average levels over the forecast period. Overall, we expect Canadian light vehicle sales to decline by about 1% this year, before edging up by a similar magnitude in 2009.

Mexico to outperform in 2008

A surge in cross-border shopping from the U.S. also weighed on new vehicle sales in Mexico, which, after 3 years of growth, fell by an estimated 3.5% in 2007. In addition to the influx of U.S. imports, the decline in sales was magnified by weakening consumer confidence, and a slackening in the rate of job growth. Among the three NAFTA countries, only Mexico is headed for a sales gain this year. The Mexican government has budgeted for heavy investment in highway construction and repairs in 2008, which could encourage consumers to step-up their new vehicle purchases. Nonetheless, the projected gains of 2-3% over the next couple of years pale in comparison



to the ten-year average of 12%, further signaling maturation of the market.

Overall, North American sales are likely to drop by more than 4% in 2008, which would mark the worst continental performance since the mid-1990s. In 2009, continent-wide sales should improve, but remain at a relatively depressed level.

A bumpy road ahead for producers

For Canada's auto and parts producers, the weakening demand climate only adds to a number of longer-term structural challenges facing producers, notably, the restructuring of the Big Three, the impact of the rising Canadian dollar on competitiveness and increased Asian competition. Most of these challenges are not new – indeed, they were at the forefront of our 2007 *Auto Outlook*, released a year ago. But since they will continue to drive both the short- and medium-term performance of the Canadian auto sector, we would like to first review the major developments in these areas over the past year and take a look ahead over the next few years.

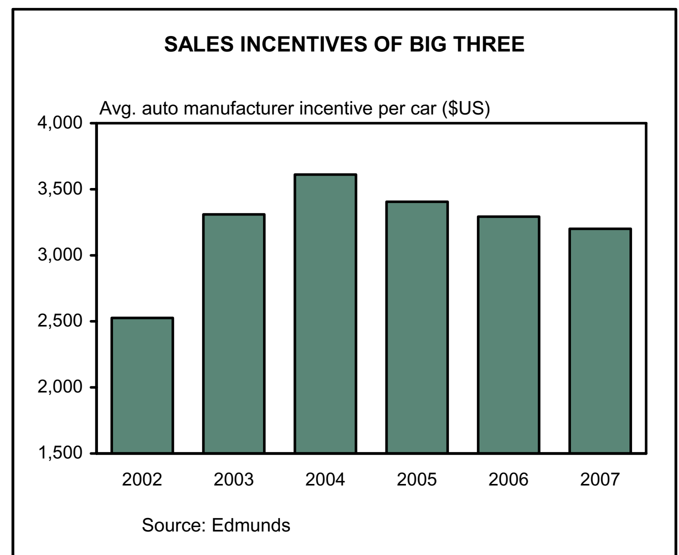
Big Three restructuring is underway

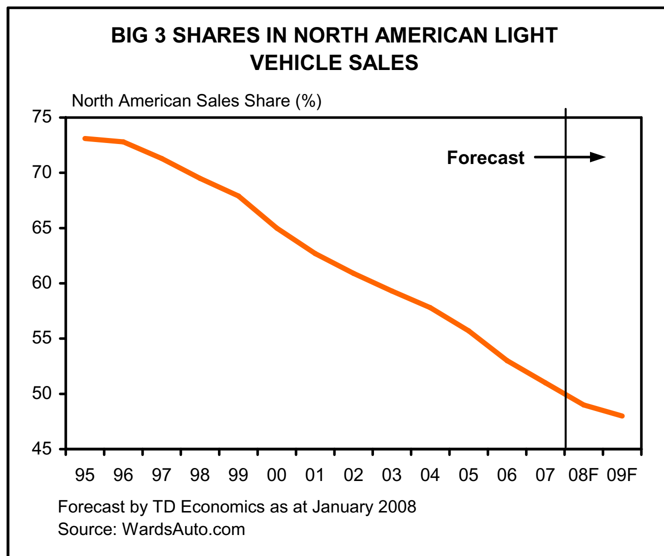
Over the past 2 years, much attention has been cast on the restructuring plans of the Big Three, which have set out to improve their product mix, increase focus on fast-growing global markets, and ultimately restore profitability. Chrylser's plan, which was announced in February 2007, consisted of 13,000 in job cuts during the 3-year horizon, in addition to the integration of parts and platforms with Daimler. GM's intention was to cut costs through assembly and parts plant closures and labour force reductions through 2008, and to reduce its global cost base to 23% of revenue by 2012. Ford revealed an accelerated plan in 2006, in which the workforce would be scaled back and 14 plants in North America will be idled and cease production through 2012. These cost cuts were intended to restore the company to profitability by 2009.

With these plans well underway, it is clear that progress by the Big Three has been made. Rather than integrating with its German counterpart, Chrysler split from Daimler last year, and is now owned by a private equity firm, Cerberus Management LLC. While Chrysler no longer reports financial results, the company is said to be meeting, if not exceeding its financial targets. The Big Three together cut production by an estimated 5% and shed nearly 100,000 jobs in North America in 2007, with further cutbacks announced for 2008. GM and Ford shut down a total of 7 facilities in 2007 and both companies appear to be on track to achieve their multi-year profit objectives.

Big Three market share fell further in 2007

With the Big Three focused on implementing their restructuring plans and reducing incentives to restore profitability, sales volumes remained under pressure last year. Another challenge for the U.S.-based automakers continued to be product mix. The Big Three have traditionally been superior in the North American light truck market. However, as consumer tastes have gradually shifted toward lighter/smaller vehicles, U.S. based companies have been struggling to attract and retain customers. Indeed, the Big Three watched their market share tumble another 2 percentage points last year, to 51%, right in line with the drop in the year prior.





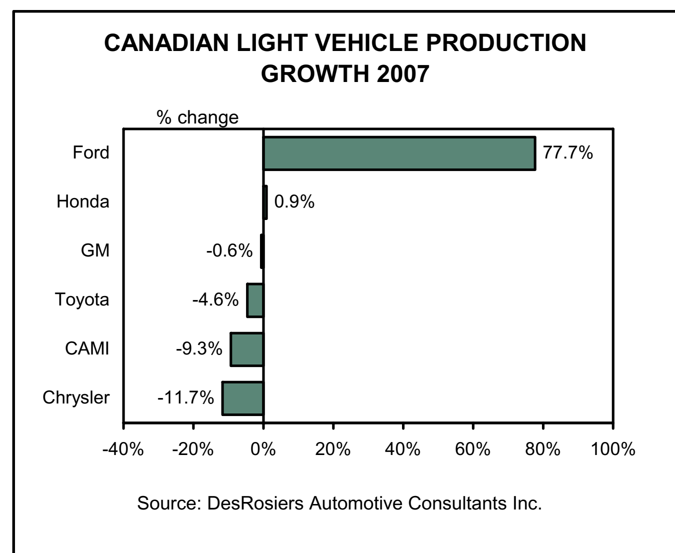
On a brighter note, although North American consumer tastes have shifted away from domestic nameplates, the Big Three have become successful globally, capitalizing on fast-growing markets such as Russia and China. Chrysler reported record sales outside of North America last year, with growth of 15% and GM is the first automaker to sell over 1 million vehicles in China. GM and Ford rank number one and two in the Russian market, and Chrysler recently signed a deal to increase business in Russia via an alliance with Magna. The weakening U.S. dollar also helped to buffet foreign earnings for the Big Three.

U.S. hit hard by Big Three production cutbacks

As the Big Three scaled back output, most cuts were focused on U.S. operations, where total production fell 3.1% last year. Ford closed two plants, one in Norfolk, the other in Wixom, and GM closed a plant in Spring Hill. As a result, the Big Three were able to trim down inventories from an average of 79 days a year ago, to just 76 days in 2007. North of the border, Chrysler and GM's reduction in output was more than offset by an increase at Ford. In fact, Ford's production jumped by an eye-popping 78%, as robust demand for the Canadian-built Ford Edge and Lincoln MKX provided a boost. Elsewhere, Honda's production rose modestly, while Toyota and CAMI both experienced declines. As a result, overall production in Canada actually rose by 1.9% last year.

UAW agreement a key development in 2007

While increased global presence is certainly providing support for the automakers, the biggest sign of headway among the Big Three was last year's settlement with the UAW, which was a major milestone that provides them with some much-needed relief on the cost side. The agreement transfers the automakers' healthcare liability of retired workers to a Voluntary Employee Benefit Association (VEBA). Each company must contribute to this healthcare fund which won't kick-in until 2010, thus it will take some time for the automakers to see the full benefit of the agreement. The deal also includes a two-tier wage system, which distinguishes between assembly workers (Tier 1) and non-assembly workers (Tier 2). New Tier 1 hires will be paid the same wages as existing workers, but on the benefits side, they will receive $1 per hour in lieu of post-retirement healthcare benefits – which will save the automakers over $10 an hour. New Tier 2 hires will be brought in for $14-$16 per hour, reducing total labour cost for these workers – benefits included – from between $73-82 an hour to about $26-31 an hour. The automakers can reclassify a maximum of 20% of existing employees to Tier 2, although companies can get around this limit by insourcing operations that are currently outsourced. And with a slew of early retirement and buyout offers, the automakers will be able to bring in new workers at a lower cost, and within ten years, these workers will represent 80% of the entire workforce. GM and Ford have already announced buyout and early retirement options for 46,000 and 54,000 union workers respectively, to take place in the first few months of the year. Once the agreement is fully implemented, the reduction in labour costs puts the domestically-owned automakers on a more level playing field with their foreign-based counterparts.

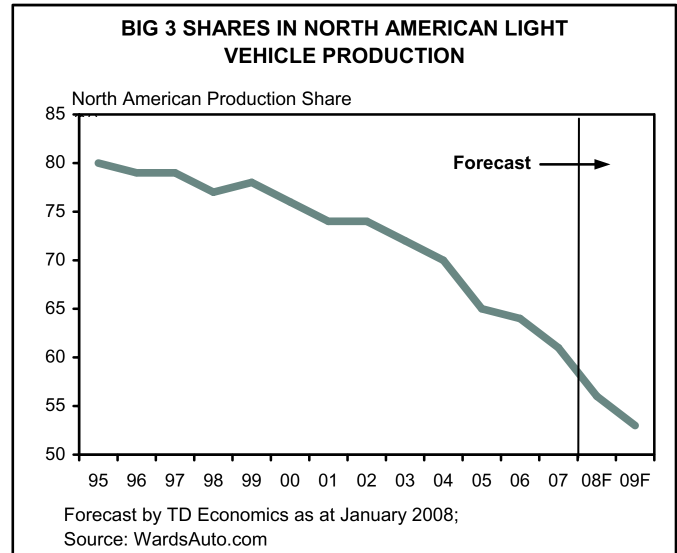


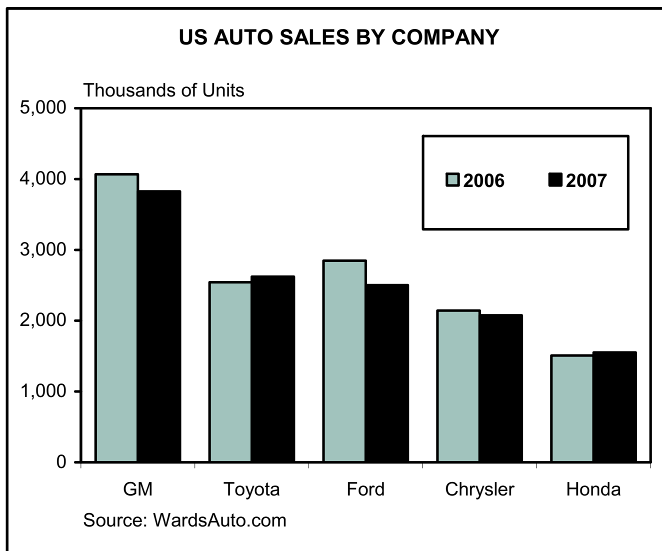
Toyota creeps up on GM as top seller

As indicated by growing market share, the North American market became even more dependent on foreign brands last year, which were resilient in the face of an ailing market. Sales of import nameplate vehicles increased by 3.4% and 2.6%, in Canada and the U.S. respectively, in contrast to a 2.9% and 3.9% decline for the domestic nameplates. Nonetheless, GM retained the number one spot in North America, though Toyota was not far behind. Indeed, after surpassing Chrysler in 2006, Toyota sailed past Ford to become the number two seller in the U.S. in 2007. In Canada, however, it was Chrysler who stole the second place finish from Ford, with a stunning 5.5% rise in sales. Interestingly, GM and Ford were the only major automakers to suffer a loss of market share in Canada, with the rest either up or unchanged. While GM won the race in North America, it was not so lucky on the global front. After 76 years as the top selling automaker in the world, GM ended 2007 in a virtual tie with Toyota.

Current trends to continue in 2008

Looking ahead to the next few years, we expect these trends to remain intact. The Big Three still have much work to do to improve their longer-term viability and must do so in a declining sales market. Moreover, there is likely to be a slowdown in sales worldwide, given the knock-on effects of weaker U.S. growth to other industrialized economies and emerging markets. Whereas the U.S. suffered the brunt of the Big Three production cuts last year,Canada is poised to be heavily impacted in 2008. (See textbox on page 6 for announced production cuts by the Big Three) Output from GM's Oshawa plant will put the largest dent in Canadian production, as the company cuts production of the Chevrolet Silverado and the GMC Sierra, both of which were overproduced last year, and drops a truck assembly line. Chrysler will no longer produce two Canadian-made vehicles, the Chrysler Pacifica and Dodge Magnum, and plans to eliminate a shift at the Brampton plant.





The steady decline of the Big Three's share of the North American market is likely to continue in the near term, as each company remains focused on profitability rather than sales volumes. The automakers have vowed to continue slashing fleet sales, which currently make up about 30% of total sales and generate very little, if any, profit. This will take a significant chunk out of the number of vehicles sold by the Big Three, leaving some slack for foreign-based automakers to pick up. At the same time, the U.S.-based manufacturers are hoping to draw in more consumers as they bring new products into the mix. There are also likely to be further efforts made to trim inventories.

While the sales outlook for the Big Three remains bleak in the near term, foreign-based producers won't be immune to the weakening sales environment in both North America and, to a lesser extent, globally. Toyota still expects U.S. sales to grow in 2008, though by only 1%, much lower than the 10% growth rate experienced in 2004-2006. Still, Toyota will likely surpass GM as the top seller in the U.S. this year. Honda is forecasting a rise in sales of about 2% in 2008 despite the sour market outlook, since their vehicles are typically more fuel efficient, a characteristic that is increasingly influencing demand.

Although production is likely to weaken in tandem with

North American sales, the introduction of some new plant facilities by foreign-based automakers in 2008-09 will help to cushion the blow. In the U.S., Honda expects to begin production at its new plant in Greensburg in mid-2008 and Kia will open a plant late in 2009. In Canada, Toyota's new plant in Woodstock is set to fire up by the fall of this year. Volkswagen has indicated its desire to build another plant in North America, though the location will not be determined until the summer. But, despite Toyota and Honda starting-up new plants, we will not see the full effect on production until 2009, at which time Canadian and U.S. output will be boosted by 5% and 1%, respectively.

Loonie erodes Canadian competitive advantage

A key downside risk to Canada's medium-term production prospects has been the country's declining competitive position. In 2007, the Canadian dollar rallied from 84 US cents to around parity, and our view is that while the currency may lose ground in the coming months, it is likely to remain above 90 US cents. The negative impact of the higher Canadian dollar has been offset to some extent by cheaper imported parts from the United States. But since most output is priced in U.S. dollars, profit margins of producers in Canada are still being squeezed.

CAW in for a tough fight

The increased competition extends beyond the currency-related issues. The agreement between the UAW and the Big Three in the U.S. last year, while great for the viability of the automakers, appears to have swung the cost advantage even further in favour of the U.S. Prior to the settlement, wages, benefits, pensions and healthcare paid to workers in Canada and the U.S. were more or less equal, at an hourly wage of $70 and $73 respectively – the lower private healthcare costs in Canada were offset by higher wages and other benefits. As a result of the new settlement, it is estimated that the U.S. will have a $20-25[1] cost advantage over Canada by early in the next decade, diminishing Canada's competitiveness on the investment front. Recently, GM's decision to switch scheduled production of the Buick Lucerne and Cadillac DTS from the Oshawa plant to Lansing, Michigan raised eyebrows. Since this leaves the Canadian plant producing only one model, the Chevrolet Camaro, the CAW has stated that workers will strike if GM does not add additional models to the Oshawa plant. One advantage that Canadian plants may have over their U.S. counterparts is higher productivity – for example, the CAW has argued that productivity is 10% higher north of the border. And with the loonie hovering around parity, a higher relative productivity performance would place auto producers in a better position than most other Canadian manufacturers that have inferior relative productivity.

In order to combat this loss in competitiveness, the pressure is on the CAW to make significant concessions as union negotiations are set to ramp up in the fall of 2008 – and it is sure to be one of the biggest events in the auto industry this year. While the biggest concession in the U.S. was retiree healthcare costs – which is not an option in

North American Production Cuts Announced by the Big Three

GM

Closures

- Pittsburgh, Pa. metal centre (2007)
- Saginaw Malleable Iron, Mich. (2007)
- Doraville, Ga. assembly plant (2008)
- Flint, Michigan engine facility (2008)

Shift cuts

- Delta Township Lansing, Mich. (2007)
- Hamtramck assembly, Mich. (2007)
- Pontiac Truck assembly, Mich. (2008)
- Oshawa Truck assembly plant (2008)

FORD

Closures

- Windsor, Ontario Essex engine plant (2007)
- Norfolk, Virginia assembly plant (2007)
- Windsor, Ontario castings plant (2007)
- Wixom, Michigan assembly plant (2007)
- Leamington Foundry casting plant (2007)
- Batavia, Ohio transmission facility (2008)
- Maumee, Ohio stamping plant (2008)
- Twin Cities assembly plant, Minnesota (2009)

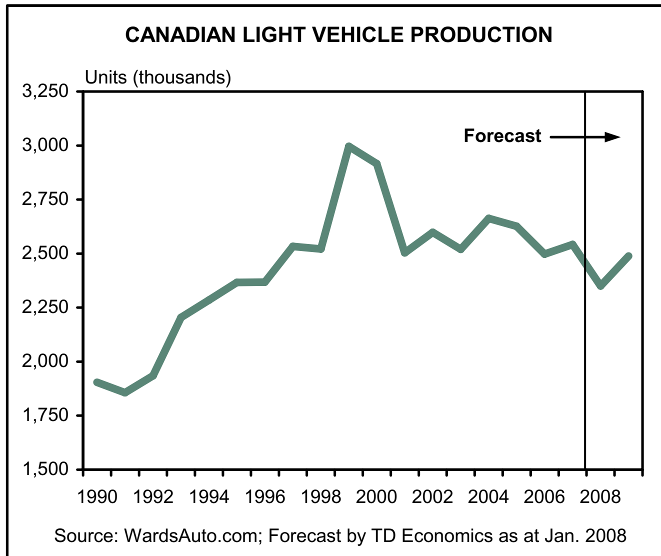
CHRYSLER

Closures

- Newark assembly plant, Delaware (2009)

Shift Cuts

- Brampton assembly plant, Ontario (2008)
- Belvidere assembly plant, Illinois (2008)
- Jefferson North assembly, Detroit (2008)
- Sterling Heights assembly plant, Michigan (2008)
- Toledo North assembly Plant, Ohio (2008)



Canada – it will not be easy finding ways to reduce costs that will close the gap between the two countries and allow Canada to remain a competitive industry player. On the plus side, the operations of foreign-based companies in Canada – which now account for a third of production, and growing – are not faced with the same extent of competitive challenges as the Big Three, although the strength of the loonie is still a factor.

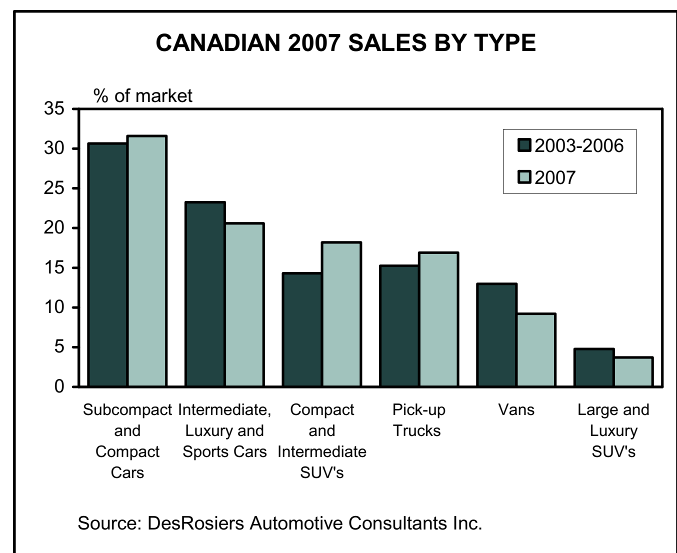
Competition from China will also heat up in the coming years, as China has already begun producing low-cost vehicles and is optimistic about bringing its product to the North American market later this year. There is much skepticism about whether the Chinese automakers will actually meet their current timelines. However, in time, the Chinese auto producers will likely establish a presence in the North American market. One China-based company, Chamco, has indicated its intent on building vehicles in North America. So even though the presence of Chinese vehicles in the North American market would eat away at the market share of established players, it could bode well for the assemblies industry and provide opportunities for parts makers.

Governments providing some support

Governments have been looked on to assist in improving the cost environment. And they have been responding in kind. Building on its Auto Strategy which received recognition for spurring some $7 billion in investments in recent years – including Toyota's investment in Woodstock – the Ontario government has introduced a $500 million advanced manufacturing investment strategy (AMIS). The strategy aims to encourage investment in leading-edge technologies and processes, by granting companies an interest-free loan of 10% of eligible project costs, with a $10 million limit. In the 2007 federal budget, the government announced a temporary measure allowing manufacturing companies to write off the capital cost of investment over two years. In the December 2007 Fall Fiscal Update, the Ontario government followed suit. While the accelerated capital cost provision was initially supposed to last until the end of 2008, it is likely that the federal government will extend it until 2011. Moreover, in the fall, the federal government announced further reductions in the corporate income tax rate, to 15% over the next five years, while the Ontario government eliminated the capital tax on manufacturing. Still, auto producers have been requesting more assistance in upcoming 2008 federal and provincial budgets, including requests from Ford to help reopen the Engine plant in Windsor which was shutdown last year, and GM to help consolidate the two plants in Oshawa into one leading edge flexible plant.

New environmental regulations a challenge

If those challenges weren't enough, the North American auto sector is also facing pressure to adopt technologies in response to new environmental regulations. Although signs of a major switch in consumer tastes towards environmentally friendly vehicles are not overwhelming, there has nonetheless been some evidence in recent market trends. The light truck segment is still outpacing the passenger car segment in the U.S., maintaining a 53-47 split, and continues to increase market share in Canada (now a 48-52 split). However, dissecting these segments, there is more evidence that consumers have trended away from



the heavy gas guzzlers – larger and luxury passenger cars and large SUV's – in favour of subcompact cars and intermediate and compact SUV's. One exception to this rule is sales of pick-up trucks, which actually experienced a rise in market share in 2007. While the elevated price of gasoline is likely the main driver of this shift to more fuel-efficient vehicles, some encouragement has stemmed from government policy changes.

Canada's Feebate program yet to show results

In Canada, a Feebate program was introduced in early 2007 – whereby fuel efficient vehicles qualify for a rebate and fuel-inefficient vehicles are subject to a tax. Details of the program are outlined in the textbox. While the Feebate initiative has the goal of swaying consumers toward purchasing more fuel efficient vehicles, it has yet to have a significant impact on buying patterns since very few 2007 vehicle models qualified. Proponents of the program feel that Canadian government had good intentions when implementing the Feebate initiative. However, it received a great deal of criticism on release. (See textbox) This year, results of the program may become more evident as more vehicles will meet the requirements.

New U.S. regulations to take effect by 2011

In the U.S., a bill was passed in late December outlining new regulations that require a 40% hike in fuel-efficiency – to an average of 35 miles per gallon – by 2020. The first set of mileage requirements will be implemented in the 2011 model year. The new regulations will force automakers to build more fuel-efficient vehicles, such as diesels and hybrids, and turn the focus to smaller cars versus big vehicles with large engines. These new requirements in the U.S. could soon be enacted in Canada, as the Canadian government has suggested harmonizing nationwide vehicle emissions regulations with the U.S. B.C. and Quebec have already announced their desire to adopt the emissions standards in California, which are stricter than those proposed by the federal government. These provinces will likely hit some of the same barriers that California encountered (i.e., law suits with automakers and the Environmental Protection Agency), but are willing to step up to the challenge.

As noted earlier, these fuel efficiency requirements will pose a particular challenge for Canada's assembly sector, which is home to many factories building larger and less fuel-efficient vehicles. In fact, more than two-thirds of all vehicles produced in Canada are large fuel-thirsty vehicles, with over half falling under the light truck category. And as environmental standards tighten, the risk of weakening demand for Canadian-built vehicles intensifies. Just recently, GM scrapped plans to build the rear-wheel-drive Chevrolet Impala in Oshawa, as the vehicle was stricken from the production line-up once the new U.S. regulations

The Feebate Program

ecoAUTO rebate program

- Rebate between $1,000 - $2,000 for cars with 6.5 litres/100km or light trucks with 8.3L/100km.
- 10 car and 9 truck models are eligible for 2006 and 2007 model year.
- Rebate for fuel-flex vehicles as well – gas and ethanol combo – 4 2006 and 2007 models qualify.

Green Levy

- Tax of $1,000 for 13L-14L/100km, and increases by $1,000 for each extra L/100km
- Capped at $4,000 for 16+L/100km

Common critiques of the Feebate initiative:

- The program took effect immediately without any pre-announcement, so automakers did not have time to adapt to the new requirements.
- There is arbitrariness as to what qualifies and what doesn't. For example, small Toyota models such as the Yaris, Corolla, and Prius qualified, but the Honda Fit didn't over a difference of 0.1 L/100km – and only because it had better safety equipment and thus was a bit heavier.
- Vehicles that border the threshold limits can be tweaked just slightly in order to become eligible for the rebate (or avoid the tax), which defeats the purpose of trying to substantially improve emissions.
- The tax does not apply to pick-up trucks, on the grounds that they are used for commercial purposes – but even light trucks for personal use are exempt. Consumers in the large car or SUV market may then choose to buy a pick-up truck instead, in order to avoid the tax.
- Mileage limits vary by vehicle type – so some SUV's may still qualify for a rebate, even though they are clearly polluting more than small cars.
- The program does not take into account used vehicles, which are typically less fuel efficient, and may now stay on the roads longer as a result of this tax.
- Concerns have been raised about the costs of administering the program, while the first rebates were slow to be issued.

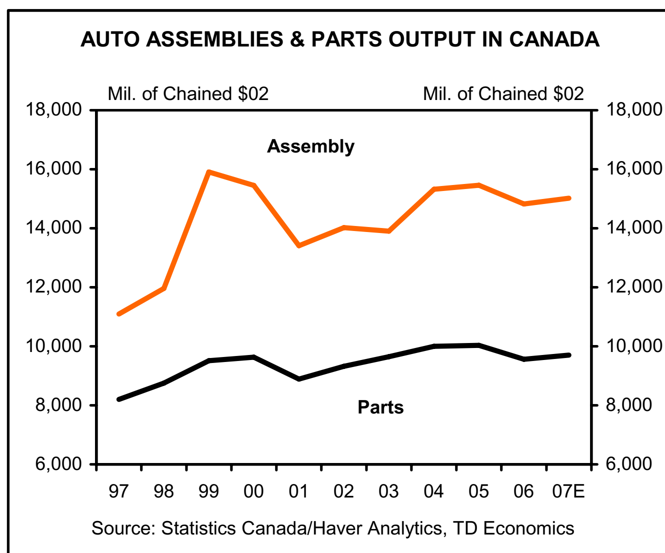
were announced. This will certainly hit Ontario hard, as the Impala was scheduled to account for half of the output at that assembly plant.

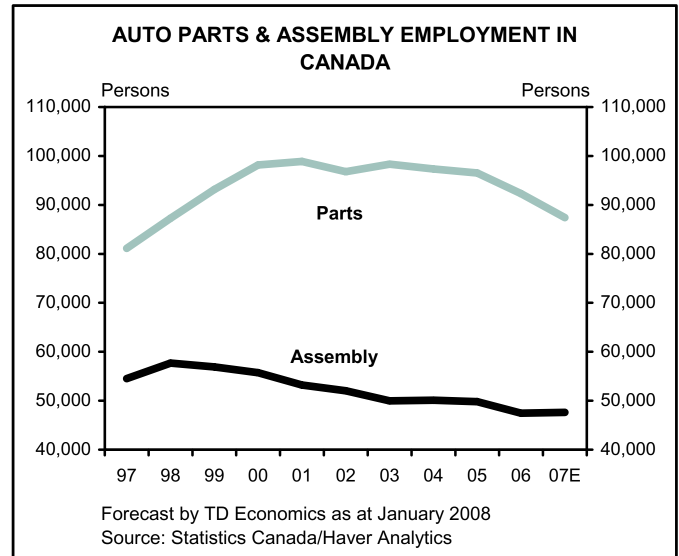
Big Three turning green

However, in order to begin closing the gap with both the environmental leaders Toyota and Honda, the Big Three are beginning to introduce more fuel-efficient vehicles, and production of these lines could potentially move to Canada. Indeed, at the Detroit Auto Show, they unveiled new and improved models to be added to their lineup beginning in 2009. Ford's new F-150, among other vehicles, will have an EcoBoost option by 2010, which provides a 30% increase in fuel economy and lower emissions. Chrysler has modified the Dodge Ram, making it the most aerodynamic pick-up in the market – which improves mileage more so than a lighter vehicle weight. GM showed a concept Hummer that runs on biofuel, which will be available by 2010. Several concept cars with electric motors were revealed as well, setting the tone for the future direction of the auto industry in North America.

Parts sector fears 2008 to be the worst year yet

Consistent with growth in light vehicle production in Canada, parts producers managed to increase output by an estimated 5% in 2007 (as measured by real GDP at basic prices). Still, this increase concealed the ongoing difficulties that many parts companies faced in 2007. In an attempt to raise productivity, the sector shed nearly 5,000 jobs, marking the 4th consecutive year of declines. But while employment in the parts sector fell at an accelerated rate,





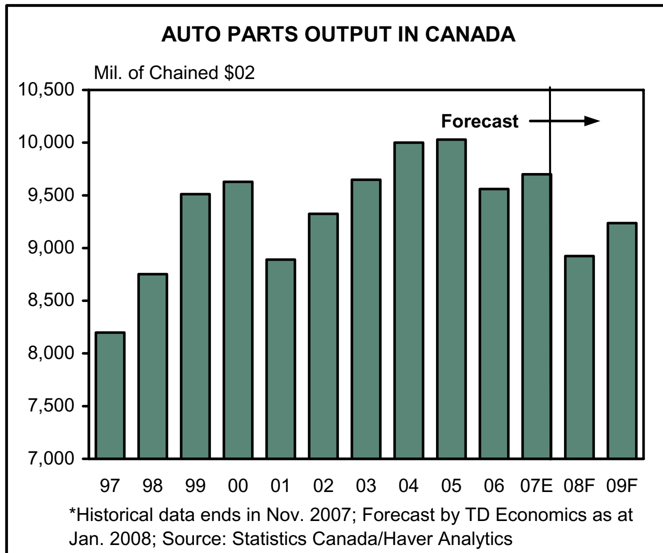
job growth in assembly production remained relatively flat last year.

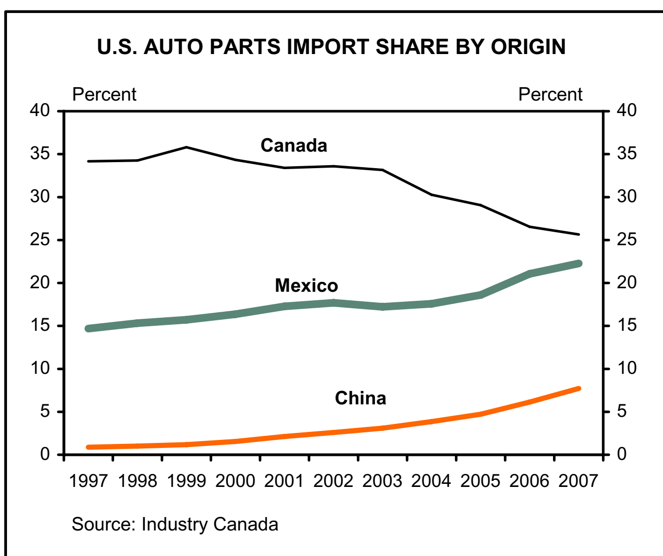
In light of the prospects for the assembly sector, it will likely be a particularly challenging year for Canadian parts producers in 2008, with output projected to drop by about 8%. In 2009, the industry is expected to record a tepid rebound of 3%. In last year's *Auto Outlook*, we focused on some of the longer-term challenges facing the Canadian parts producers – challenges that we believed were even more significant than those facing assemblers. Chief among them include, their strong ties to the Big Three, the small scale of most producers and fierce competition from Chinese parts companies. While some companies, namely Linamar and Magna – who supply both domestic and foreign brands – recorded earnings growth in 2007, those parts manufacturers who derive all sales from the Big Three didn't fare as well.

A key development in the parts sector in 2007 was the collective agreement struck between Magna and the CAW, which provides unionized workers with increased job security but no right to strike. The deal involves 18,000 workers or about 25% of all parts workers in Canada. While the agreement certainly opens the door for the CAW to negotiate similar collective arrangements with other parts suppliers, Linamar (11,000 employees) has indicated that they have no intention of becoming unionized.

China steps up competition

China is increasingly becoming a major competitor in the North American market, as parts can be produced there at a much lower cost. In 2005, GM alone increased pur-





chases of parts from China by 25%. That 25% rate has since continued each year, and is expected to persist through 2010. Currently, GM imports 20 million parts per month from China. China's total exports of auto parts rose nearly 37% in the first 10 months of 2007, to $9.9 billion. While ten years ago North America did not import any parts from China, these parts now account for 8% of the U.S. market. Toyota, on the other hand, has increased its purchases of North American parts and materials.

U.S. parts producers get back in the game

The high Canadian dollar has left Canadian producers vulnerable to competition from the U.S. as well, especially since American parts companies are beginning to emerge from bankruptcy with a new, lower wage and cost structure. Among four major parts makers who filed for bankruptcy protection, Federal-Mogul was the first to exit court protection. Dana and Delphi have set up funds and expect to emerge early this year. However, Dura is struggling to find adequate financing, as it cannot afford the high interest costs associated with borrowing. While wages in Canada are over $20 an hour, the new cost structures adopted by these companies will allow them to pay workers between $14 and $18 an hour. Thus, the parts industry in the U.S. is also gaining a cost advantage relative to Canada.

The bottom line

All in all, 2008 will likely see a significant drop in Canadian production of both light vehicles and parts. Sluggish demand for new vehicles in the U.S. – which is where 85% of Canadian output is sent – coupled with further efforts by the Big Three to trim inventories, will translate into sizable production cutbacks. Toyota's Woodstock expansion will underpin a healthy rebound in 2009, although the sector's long-term fortunes in Ontario depend on continued progress in the Big Three's restructuring plan and further improvements in the overall business climate for automakers. As such, all eyes will be on the upcoming CAW negotiations, which will set the tone for the assembly sector in Canada.

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Endnotes

1 DesRosiers Automotive Consulting Inc.

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