The US automotive industry has been enjoying some of its best years ever, with 17.5 million new vehicles sold last year, which approached the previous peak of 17.8 million in 2000. However, we expect 2016 sales to be in line with 2015 sales, making this the first flat year for new vehicles since the Great Recession, even as used-vehicle sales year to date are up 5%,¹ according to the National Automobile Dealers Association (NADA).

Moreover, the cyclical nature of the industry suggests that even this peak is unlikely to continue for long. Our latest forecast predicts new-vehicle sales will likely drop meaningfully in 2018 and by more than 2 million units by 2019² versus 2016. One big reason? Increased used-vehicle sales will likely deflate the market.

Several factors account for this conclusion. The recession of 2008 to 2009 forced many consumers of volume brands to delay purchases or buy used vehicles. The subsequent years of slow new-vehicle sales then tightened the supply of late-model used vehicles later hitting the market, pushing the prices of those used cars to record levels, as shown in the commonly used indexes: Manheim Used Vehicle Value Index, NADA’s Used Car Guide, and ADESA’s Wholesale Used Vehicle Prices by Vehicle Model Class.³ Because it takes about three years for a significant percentage of new vehicles to reappear on the market as used, late this year will be the first period of the economic recovery that’s seen what’s considered a “normal” supply level of used vehicles.

¹ NADA Used Car & Light-Duty Truck Guidelines, October 2016.
² AlixPartners analysis, based on suppliers and automakers globally.
³ NADA Used Car & Light-Duty Truck Guidelines, October 2016; ADESA Wholesale Used Vehicle Prices by Vehicle Model Class.
The net effect is that the phenomenon of high used-vehicle prices in turn supporting strong prices for new vehicles—and thereby bolstering profits for automakers, suppliers, and dealers—is likely fading. In fact, falling used-vehicle prices could well be the canary in the coal mine presaging the end of this automotive recovery.

WHEN MIGHT THE WHEELS COME OFF?

In fact, this virtuous cycle of the past several years has already started to unravel. Today’s record new-vehicle sales—coupled with recent higher vehicle-leasing penetrations (leasing as a proportion of all vehicle sales reached a record high of about 31% in the second quarter of 2016, topping the 1997 record of 27.4%)—are conspiring to put as many as 800,000 more used vehicles on the market this year versus last year (figure 1); and that number is set to grow higher in 2017 and 2018. As a result, we’ll be seeing signs of pressure on used-vehicle prices—especially for smaller cars—as seen in the Manheim used-car values (figure 2). At the same time, automakers’ new-vehicle sales targets for dealers continue to rise year over year, averaging increases of 5 to 10% for 2016, according to a dealer

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**FIGURE 1:** Leased vehicles become used vehicles, 1998 to 2018

**OFF-LEASE VOLUME (MILLIONS)**

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Source: Manheim 2016 Used Car Market Report

**FIGURE 2:** Used vehicle value index, 2008 to 2016

**INDEX**

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Source: Manheim Used Vehicle Value Index

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4 AlixPartners 2016 Global Automotive Outlook and Market Forecast.

survey we did at the beginning of the year. Obviously, something has to give. In fact, to use an age-old automotive saw, it’s possible “the wheels could come off”—for players at all levels of the industry but starting with the automakers.

It’s possible to prepare for the coming decline in used-vehicle prices and its knock-on effects to account for the fact that the hundred-plus-year pattern of industry cyclicity will repeat.

**PRICING SHIFT: GEARING DOWN**

Years of high used-car prices sowed the seeds for the coming dip in new-car prices, and several events are likely to push used-vehicle prices down. New-vehicle sales are likely past the peak levels for this cycle. Passenger-car-segment sales are down 9% year to date, as consumers buy 8% more crossovers and SUVs, motivated in large part by low gas prices (figure 3). As a result, automakers are offering more incentives on cars to bridge the supply-and-demand gap.

In September 2016, incentives increased to $3,690 per vehicle in the passenger car and truck segments, an approximately 17.4% increase year over year (figure 4) and close to 10.7% of vehicle manufacturers’ suggested retail prices (MSRPs). It has hit the rule-of-thumb limit to keep incentives under 10% of a vehicle’s MSRP, but further increases could indicate automakers are more likely artificially boosting sales than matching supply to natural demand. That appears especially true for the car segment where sales have reduced by 9.7% (YTD October 2016 versus 2015). According to the NADA, every $1,000 increase in new-vehicle incentives could
Used cars: the canary in the coal mine for auto?

reduce used-vehicle residuals by $563—an approximately 56% pass-through rate. It’s worth noting that automakers’ incentives essentially destroyed the used-vehicle values in both 2001 to 2002 and 2006 to 2008. In addition to an increase in incentives, overall retail sales have reduced by 1.2% (YTD October 2016 versus 2015), while fleet sales have increased by 5.4%, indicating a further shift by automakers to push demand through.

Recent figures indicate lease incentives and subventions are at a record high of about $5,500 for a typical midsize sedan, according to Kelley Blue Book data. Leasing as a proportion of all vehicle sales more than doubled from about 14% in 2009 to a record high of about 31% in the second quarter of 2016, topping the 1997 record of 27.4%. That increased leasing will likely complicate the used-vehicle market further because the number of vehicles coming off lease will more than double from a 2012 low of 1.5 million units to a 2018 estimate of 3.7 million units. The expected used-vehicle glut is bound to have a significantly negative impact on used-vehicle prices and a carryover effect on new-vehicle pricing. Certified pre-owned-vehicle (CPOV) sales set an all-time high of about 22% of used vehicles sold by franchised dealers in 2015 and are up 3.7% this year, according to the NADA; but expansion in this segment

may not offset the pricing pressure from the coming wave of off-lease used vehicles, which are up 35% this year and continuing to rise.

Factor in possible interest rate hikes from the US Federal Reserve Board, and vehicle buyers may have higher borrowing costs starting later in the year. Recent financing trends indicate potential trouble spots that compound that risk. Consumers are financing a greater proportion of used-vehicle purchases with longer-loan terms. Financed used vehicles amounted to about 56% of sales in the second quarter of 2016, from about 51% in the fourth quarter of 2010. And average loan terms rose to 63 months in the second quarter of 2016 from 58 months during that time (figure 5). If used-car loan rates rise 150 basis points based on today’s average used-vehicle price of $18,850 and an average loan term of 63 months, consumers will have to pay about $800—a 4.4% increase from the original price.

It’s likely that a combination of factors will lead to lower prices in the used-vehicle market, which will then pull sales from the new-vehicle market in addition to hurting the residuals of new leases and driving up consumers’ lease costs.

Source: Experian Automotive, AlixPartners analysis (annual numbers are for Q4, except 2016, which is for Q2)

![Figure 5: Used-vehicle auto loan rates and terms, 2009 to 2016](image-url)
GETTING TRACTION ON THE ROAD AHEAD
We suggest that industry players answer the following questions.

• How can automakers better pinpoint incentive spending to minimize the coming impact on residual values?
• How can automakers prepare for these pricing pressures and increased used-vehicle cross-shopping?
• What alternative actions can automakers and dealers take in their CPOV programs to handle used-vehicle pricing pressures?
• What steps can captive-finance organizations take to keep new-vehicle payments as low as possible?
• How can automakers differentiate themselves through customer experience and after-sales support in the area of CPOVs?
• Is there an opportunity for players in the used-vehicle business to reposition themselves—perhaps through mergers and acquisitions—to take advantage of this situation?

Like it or not, players up and down the automotive chain are about to witness the effects of the changing used-vehicle market. The difference between the winners and losers will come down to being prepared, being thorough, and making courageous decisions now.

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