The Ruggles Report™

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Pre-Owned Leasing – ***The Greatest Area of Unrealized Potential in the Automotive Industry Today!***

The Current State of Leasing

The automotive world has been jolted in recent months by the pullouts of certain lenders from the leasing business. Wells Fargo has exited leasing altogether, while 5th 3rd Bank and US Bank have left the pre-owned space. Ford and GMAC announced they will take a much more conservative approach to leasing. On the heels of these announcements, and with the entire industry taking major hits to the wholesale/residual values of vehicles that used to be the "cash cows" of the manufacturers, the announcement of Chrysler leaving the leasing business came as no surprise. After all, Chrysler / Cerberus bought 49% of GMAC's portfolio of mortgages AND leases, as well as Chrysler credit's entire finance portfolio. What do these recent events really say?

In this writer's opinion, it says the domestic manufacturers, Chrysler in particular, are running out of cash fast. Are they really telling us that it is better for them and their dealers to put their buyers into of 60 – 72 month retail finance contracts? Toyota and Honda must be licking their chops! And so are certain lease lenders who now find themselves in a marketplace with fewer competitors.

Certified Pre-Owned was supposed to be a plan to bolster the wholesale/residual values of a manufacturer's pre-owned vehicles. The fact that the Imports could offer much lower lease payment programs because of their higher resale residual values has always chafed the Domestics. And the low resale values of most domestic vehicles, compared to the Imports, means a buyer of an Import will probably have an easier time trading their vehicle earlier in the ownership cycle because they will have to deal with comparatively less negative equity. Now, all the Domestic's CPO programs can hope to do is bolster their resale values while they promote their new vehicles with more and more rebates, "buy down" interest rate financing, and various give-away programs, all financed for longer and longer terms.

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The Imports have rarely had to advertise public rebates. While they have offered substantial "trunk money," usually in the form of "stair step" programs and mildly sub-vented short term leasing programs, they have rarely had to cheapen their products with advertising that says, "Our cars are so good, we have to pay you to take them off our hands." This is reflective of the "pull marketing" approach used by the Imports versus "push marketing" employed by the Domestics. I can remember my Chrysler reps telling me, "Inventory pressure sells cars," but at what long term cost?

All the while the Domestics have been trying to bolster their resale values, they have pumped more and more units into fleet service. Ford took a wonderful short term leasing program and buried themselves with residual losses because they couldn't restrain themselves. They flooded the market with fleet cars to go along with the short term Red Carpet Lease turn-ins they had planned for. It was as if one department didn't talk to the other, or no one in the executive offices took Econ 101. Only recently have the Domestics tried to get "off the drugs" by somewhat curtailing fleet units. And now they run right into a "wall" caused by an oil crisis, as if this hadn't happened before. When I lived through similar previous crises, the public lost money trading in their gas guzzlers and paid high prices for a smaller vehicle, which they typically hated. After the oil market stabilized, they took another hit trading in their small vehicle, which were no longer popular, and paid a high price to replace the large vehicle they had only recently traded in. I doubt the script will go exactly the same, but watch and see if we don't see at least a brief oil glut in the coming months followed by another "whip lash" reaction by the public and the manufacturers.

This oil crisis has affected the Imports as well as the Domestics, but certainly not to the same degree. Toyota will shut down production of Tundras for a while, but in many cases their assembly plants can build more than one type of vehicle. They can stop building what's not in demand and change the production to what is. The Domestics can not commonly do this. So despite a bump in the road, the Imports press on. They will retain their resale advantage. Their advantage will probably widen! They will be able to offer short term leasing at attractive payments while Chrysler will be left to offer big rebates, cheap interest and long term finance contracts to get people

to take their vehicles off their hands. It makes you wonder how the cost of subventing a long term finance contract compares to a short term lease.

As the Domestics credit rating has dropped to near junk status, their money costs aren't competitive with the Imports. When you factor in the fact that their buyers will not be in a position to trade until quite late into the finance contract, it looks like they are left with a loser strategy. Despite their protestations, I am sure they would prefer to stay in the leasing business but can't manage their business in such a way as to control their resale/residual risks.

Certain independent banks have also taken some significant residual hits. It makes one wonder why a bank would even take the risk of guaranteeing vehicle values in an uncertain world. Here's why: Banks/Lessors can make profit on the interest/money factor portion of a lease, collect acquisition and disposition fees, and even make money at times on certain residuals. Even now some Lessors are experiencing gains on the more economical off lease turn-ins. They can also introduce their lease customers to their bank and perhaps gain a new checking, savings or credit account customer. Because a lease customer tends to be more loyal, there is an increased likelihood that a lessee will lease another vehicle after their current term ends. But a primary value to the Bank/Lessor is the fact that the vehicle stays in the Bank/Lessor's name for the life of the lease, which gives them the advantage of the depreciation associated with a lease. The savviest banks don't compete with the OEMs where there is a manufacturer subvention. They pick their spots and spread their risks. For this reason, there are many Banks/Lessors who are happy to hear the recent announcements of Chrysler and certain lenders pulling out.

However, the pullout from pre-owned leasing by US Bank and Fifth Third Bank is somewhat of a surprise. A recent study discovered that the residual for most pre-owned one year old vehicles, on 36 months, is less than it was for the same vehicle leased for 48 months as a new vehicle the year before. Think about that. Both vehicles come back off lease at the same time but the residual on the pre-owned vehicle was consistently lower, often by more than $1,000! This shows the residual risk for Lessors is substantially less for pre-

owned leasing than for new. Fortunately, there are players who realize this and are expanding their operations to pick up the slack left by the other Lessors' departure.

This was discussed recently at a Pre-Owned Leasing Summit held in Cincinnati. Participants included Tarry Shebesta, of ACS and affiliated companies, Jeff Cook, President of CyberCalc, Curt Webster, President of Car Lease USA, David Funderburk of Standard Finance and Rusty Platt of Do A Lease.com.

Despite the fact that there have been serious losses suffered on trucks and SUVs, all participants agreed this is a natural cyclical occurrence and does not change the positive fundamentals of the business going forward.

So where does this leave all of us in the leasing industry? Sadly, there are currently fewer options to choose from and Dealers will have to look at regional Lessors as a means to put Customers into short term deals. But there are still some great deals out there and other Banks/Lessors will be entering the market to fill the current void. Leasing has, and always will be, a viable means of allowing Customers to pay for only that portion of the car they plan to drive. Lower payments and shorter terms will drive the retail auto business for the most sophisticated Dealers in the coming decade and there is no better way to facilitate this than through pre-owned leasing.

In the meantime, Dealers and Leasing Companies who "get it" are awaiting the beginning of the next ALG book period, which is September 1. It is guaranteed there will be opportunities. They might not be quite as compelling as what we have seen over the last ninety days but there will still be substantial value in this market!