The Ruggles Report™

September 2008
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Pre-Owned Leasing – *The Greatest Area of Unrealized Potential in the Automotive Industry Today!*

Opportunity Abounds

A few industry "experts" have proclaimed leasing to be dead. But most see opportunity for independent lessors to expand their current offerings and for others to enter the game and fill the void left by those who pulled out. In the current state of leasing, lenders are no longer compelled to stretch their residuals to book business.

Regardless, we think the biggest opportunities are in Pre-Owned Leasing. POL represents less residual risk, less depreciation volatility, shorter terms, and lower payments. But with the pull back of some of the captives, there will be compelling opportunities for the Independents to lease new vehicles as well. A 36 month lease frequently has the same or lower payment as a long term finance contract, even considering zero percent interest for the finance deal and realistic residuals for the lease. Wouldn't a Dealer want his customers in the shorter term contract? And as always, any down payment or trade equity has a greater positive impact on a shorter term lease payment than on a long term retail contract.

A note to those on the lending side who have a well founded concern over too many short term leases: We look at "short term" as a relative concept. Short term for one lender may not mean the same thing to another. Rather, short term should be defined in the context of other alternatives. In today's market, where retail finance terms are growing well past 60 months, 36-48 month leases are considered short term. Even when combined with more conservative residuals, we have proven these types of leases are STILL better options for most consumers than their 60-84 month retail finance counterparts.

Nevertheless, if we are looking at current opportunities, a recap of what got us here is important to clarify what lies ahead. The following is a combination of conclusions on the part of this author, plus some well known facts**.**

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There are 3 distinct categories of lease lenders, over and above the private capital lessors that don't represent major volume. I also exclude major fleet leasing which is primarily open ended leasing. Each of these groups have failed or struggled for different reasons, yet the collective shortcomings are frequently lumped together to make up the supposed cauldron of consumer leasing.

1. The Domestics: The Cerberus three headed whatever (which includes GMAC and Chrysler Credit) plus Ford Motor Credit. The first two were harmed by the mortgage meltdown. Ever heard of Ditech Funding or GMAC Mortgage? That's all under the Cerberus banner. Much of these banks' struggles are due to the tremendous weight of the mortgage crisis on their financials and their attempts to sustain continuing operations. At least FMCC missed out on this mess, unless there's something there I don't know.

   Nevertheless, the big three domestic lenders ultimately serve their masters, the OEM's. The inherent lack of diversification in their portfolios, a continuing willingness to "enhance" residuals and the dramatic short-term run up in fuel prices all conspired against them. It truly was a perfect storm.

   Even with the lessons of the past, they held the belief that it made good sense to support leases with higher than realistic residual values and cheap money. The cheap money could be rationalized by the fact that there were substantial depreciation credits that could be taken during the life of each lease. The over-stated residuals could be rationalized by the fact that they were probably going to have to offer a rebate anyway, so why not put the "rebate" off for 36 months or so, rather than have it come off the books immediately? In addition, a case could be made that shorter term contracts would sell more vehicles during the long haul than 60 – 84 month financing.

   So what happened? The temptation to lower payments to drive more vehicles sales caused the OEM's to further enhance their residuals AND extend the terms to 48 months or longer. As lease programs came to term, losses were taken on the residuals. This was expected for the reasons stated above. But in most cases each manufacturing division had a new manager who was having to sustain these residual losses on his watch, so there was pressure to come up with a new program to put sales on the books to offset the current losses being taken. All of these made sense for anyone in the "push marketing" business. Then came the abrupt change in oil prices and the sudden change in consumer preferences. If the OEM's hadn't already been running at the ragged edge, they would have set up reserves to cover the potential for excess residual loss. After all, this is NOT the first time this has happened.

2. The Independent Banks: US Bank, Fifth Third Bank, Chase, Wells Fargo, etc. Here is the big question. Why would these lenders want to compete with the OEM lenders in the first place? The domestic OEM's have obviously had their own "death wish" OR were subventing their lease programs for rational business reasons. Independent lease lenders don't have parent companies that build cars. Why would they want to subsidize someone else's business? Some of the Independents dropped out of leasing completely. All of them "pulled in their horns," which is understandable. But those who simply dropped their POL program is the real puzzle. There is MUCH LESS depreciation volatility in pre-owned and the residuals are much easier to predict. We can only guess giving up the pre-owned programs was a "bone" thrown to the bank's upper hierarchy but that is such a short-sighted move. After all, if you are willing to offer a 48 month lease on a new car today, why would you not be just as willing to offer a 36 month lease on the same vehicle a year from now? Both cars will come off lease in 2012 and both will have the same remarketing responsibility at lease end. However, studies have shown that the POL vehicle coming back in 36 months is likely to have LESS residual risk!

3. The Imports: The situation at MB, Audi, and BMW is somewhat different than that of Honda, Toyota, Nissan and Subaru. Honda and Toyota are sitting in the proverbial "cat bird's" seat. They enjoy such high resale values that their subventions to move new vehicle inventory through leasing is far less painful than for the Domestics. And with high fuel prices, their resale values on most of their products are higher now than ever before, somewhat offsetting any losses on their heavier vehicles. In the case of Honda, they have historically sacrificed the profits others made on their "heavies" during the heavy heyday but now suffer little give back now that these vehicles' values have tanked. The luxury makes have historically done 60% plus in new vehicle lease penetration and we don't expect that to change. Their customer base is already trained to lease. They need to rethink whether they are luxury manufacturers or volume manufacturers and do business accordingly. The Europeans have been trying to catch LEXUS, who ran off and hid from all the other luxury manufacturers. Too many MB models on the road undermines the brand's cachet as well as its resale values. Lexus will be a victim of their own success if they do too much volume. Who will want what everyone else has? They have done fine so far, however.

So with a look at what happened, where are we headed? The Domestics who do not have access to market price money are in a real bind. Sadly, they'll need more than the 50 billion dollars they are asking the next president for. As they put more and more buyers on the street with 60 – 84 month retail contracts, their plight becomes more and more bleak, especially as the imports like Toyota and Honda put more and more of their customers out on shorter term contracts. It's an unbelievable time for these guys and their very futures hang in the balance. Will they overcome it or will they die a death of 1,000 cuts? It's anyone's guess at this point but we see some level of consolidation in the near future.

The Imports will continue to thrive. Their models are on target based on current consumer preferences, they are better equipped to meet shifting consumer demand, and they have a big advantage in overall market position. If the Imports maintain their "pull marketing" strategy there will continue to be a limited supply of these vehicles just as there is a limited supply of willing buyers.

Lastly, that leaves us with the Independent Banks. There is HUGE opportunity for these guys. Domestic dealers are desperate for sources of shorter term offerings. The more they put their customers out in long term retail finance contracts, the more they unnecessarily mortgage their future. Sustainable, repeat business over 36-48 months is the only way these guys are going to be able to compete with the imports. It is still true that the vast majority of consumers are payment buyers. And those consumers don't feel as wealthy as they did when they had equity in their homes to tap. POL is a great way to meet this economic fact of life. Independent Banks and Credit Unions who can structure a well thought out POL program stand to gain in a big way.

Obviously, we are blatant believers in Pre-Owned Leasing! The puzzling thing is that while its advantages and opportunities seem so apparent, few still get it. We stand by ready to assist the banks and the dealers during these troubled times. Our new "Guaranteed Options Plan" training program may be just the ticket you need to put your dealership or bank in a position to win in today's uncertain market.

What do you think? Are you in this to win or are you hanging on hoping things will fix themselves?

What have you got to lose? Give us a call today and we will show you how to make it happen!

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