MANHEIM CONSULTING

Auto Industry Brief

February 2007

Accelerate ***Your Business***

METRICS THAT MATTER

SUMMARY

Retail sales rose in January on the back of gift card redemptions, a cold snap that boosted apparel sales and growth in discretionary income produced by higher wages and lower gasoline prices. Outside of subprime mortgages, consumer credit performance remained solid. Growth in revolving credit, although accelerating, remained low by historical standards. All of this suggests a continuation of near-term momentum heading into the important spring used vehicle market.

EMPLOYMENT, EARNINGS AND EXPENDITURES EXCEED EXPECTATIONS

Recent gains in retail sales have been spread across a wide spectrum of businesses. Retail sales, excluding autos, rose only 0.3 percent in January, but December's gain was revised up sharply to 1.3 percent. With individual companies reporting strong sales last month, it is likely that the government will also need to eventually revise up its January tally.

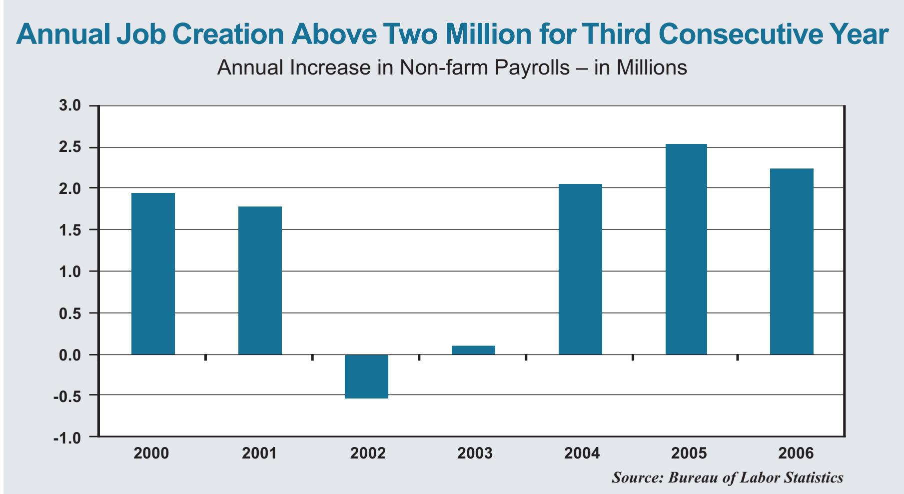
Although gift card redemptions played a significant role in January purchases, it is clear that high levels of consumer confidence and growing wages spurred many shoppers to spend considerably beyond the value of the gift cards they were redeeming. And, several months of gasoline in the $2.25 range, as opposed to the $3.00 range, helped spread January's sales gain more evenly across both discount and high-end stores. The only weak sector recently has been restaurants, but, unfortunately, a slowing in restaurant activity is often a leading indicator of consumer retrenchment or wariness.

Higher employment propels wages higher. Non-farm payrolls grew a less-than-expected 110,000 in January, but benchmark revisions put the employment gain for all of 2006 at 2.2 million. The employment revisions explain why previously reported wage gains seemed out of sync with the payroll numbers. Total wages and salaries grew by 6.6 percent in 2006 and 5.1 percent in 2005. Last year's growth in wages was the strongest since 2000.

MANHEIM CONSULTING
6205 Peachtree Dunwoody Rd.
Atlanta, GA 30328

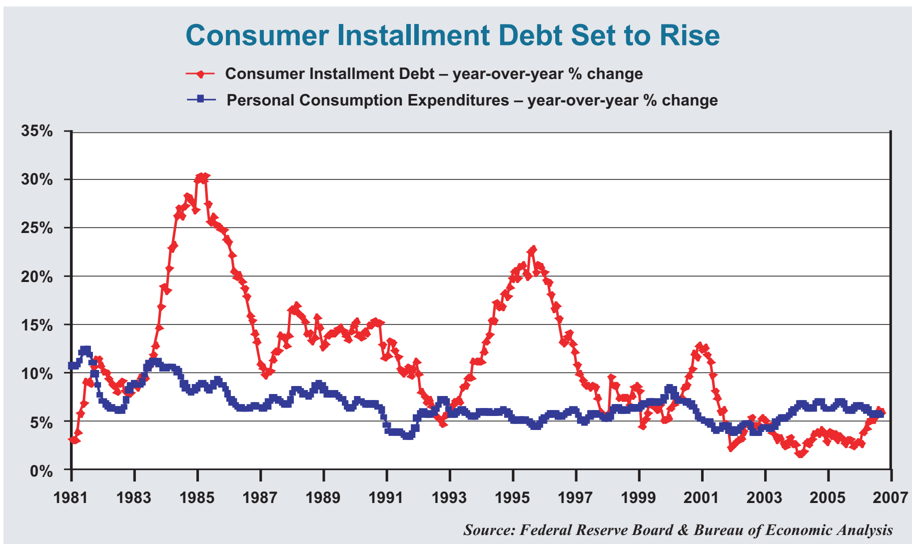
678-645-2377
800-777-2053

www.ManheimConsulting.com



Credit card debt—restrained so far, but set to accelerate. Income growth, and the earlier ability of consumers to extract equity from their homes, allowed personal consumption expenditures to grow faster than consumer installment debt from mid-2003 until recently. This is a rare and generally positive event, in that it suggests that households have not overextended themselves in maintaining their lifestyle.

That condition changed in the fourth quarter of 2006. Even with only a modest rise in December, revolving debt for the full year 2006 was up 6 percent. More importantly, there has also been a significant decline in the percentage of households that pay their credit card balances in full every month. Thus, outstanding balances are set to continue to grow faster than personal expenditures in the months ahead.



Tax refunds might already be committed to past purchases. Tax refunds are a major driver of the spring market for used vehicles. Forecasting the level of tax refunds and, more important, the distribution between specific demographic and regional segments of the population is a difficult proposition. Early estimates suggest, however, that tax refunds in early 2007 will grow less rapidly than in recent years. With the recent rise in credit card debt, it is reasonable to assume that a smaller slice of the refunds will end up directly supporting used vehicle purchases.

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METRICS THAT MATTER

Our ongoing series is designed to discuss economic variables, surveys and company statistics that help in understanding, and anticipating shifts in, the used vehicle marketplace. Past issues of Auto Industry Brief have reviewed initial jobless claims, Wal-Mart same-store sales, consumer confidence, wage and salary income, the interest rate yield curve, overtime hours and debt service burdens. This month we look at the labor force participation rate.

Labor Force Participation Rate

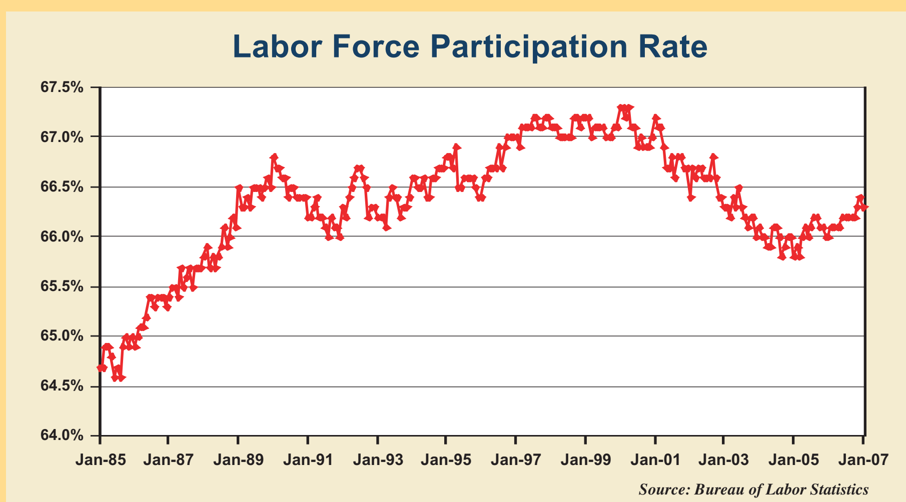
What it is. Simply the number of people in the civilian labor force (defined as those employed or actively seeking work) divided by the non-institutionalized population 16 years of age or older. Data is available monthly and is released along with the overall employment report.

Why it is important. Declines in the labor force participation rate (adjusting for age, sex, and other factors) is often considered an indication of a rising number of "discouraged workers," that is, people no longer counted in the labor force because they have stopped actively seeking work. Similarly, a rise in labor force participation can be indicative of a strong labor market, and presumably rising wages, attracting people back to the workforce.

The longer-term importance lies in the fact that labor force growth (largely driven by the participation rate) determines (along with productivity gains) the potential non-inflationary growth rate of the economy.

What is the measure telling us now? The cyclical upturn in the participation rate that occurred in the 1980s and 1990s was driven almost solely by a 14.2 percentage point increase in the labor force participation rate of women. And, although many blame the subsequent fall in the participation rate on the 2001 recession and the 2002 "jobless" recovery, we suspect demographic shifts were also in play there—notably the aging of the labor force and a slowing in wage growth. Knowing the reasons for past movements is important because it enables analysts to better project future trends in the participation rate and thus, the economy's potential growth.

As the Baby Boom generation reaches or moves further into their retirement years, labor force participation rates will likely become more volatile and difficult to predict. That's because the participation rate of older workers will be greatly influenced by changes in wage rates, tax policy, health care benefits and equity prices. The decision of many Baby Boomers to remain in the workforce will likely involve a close tradeoff between retirement and leisure. Fewer will be working as a necessity.



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Seasonally-adjusted wholesale prices ease in January. Wholesale used vehicle prices (on a mix, mileage and seasonally-adjusted basis) ticked lower in January. Before the seasonal adjustment, average wholesale used vehicle prices rose between December and January (as they invariably do), but the increase was less than historical patterns would indicate and thus, the Manheim Index declined by 0.2 percent to a reading of 113.3 for the month. Wholesale prices were off a relatively large 2.6 percent on a year-over-year basis, as the comparison was being made against the cyclical peak in pricing that occurred in January 2006.

A reduction in new vehicle inventories supported used vehicle prices in January, and will continue to do so going forward. Days supply, calculated off of a 12-month rolling average of sales, remained steady in December at 65 days, but the unit count declined by 92,000 units. Those that made much ado about how fleet sales impact the days supply calculation should note that fleet sales were off substantially in January; thus, the comparative improvement in days supply was significant. Along with new vehicle inventories, incentives have also come down. GM incentive spending has shown the biggest decrease, down some 30 percent on a per unit basis.

Wholesale Prices Slip in January

Manheim Used Vehicle Value Index – January 1995 = 100

Source: Manheim Consulting

Prices strong for the growing volume of rental risk and commercial fleet units. In a trend that will continue for some time, the volume of risk vehicles sold at auction moved higher in January. The pricing for these units remained unchanged from their strong year ago performance. Likewise, commercial fleet volumes continued to rise, as did pricing for these units, in spite of the already strong gains achieved over the past two years.

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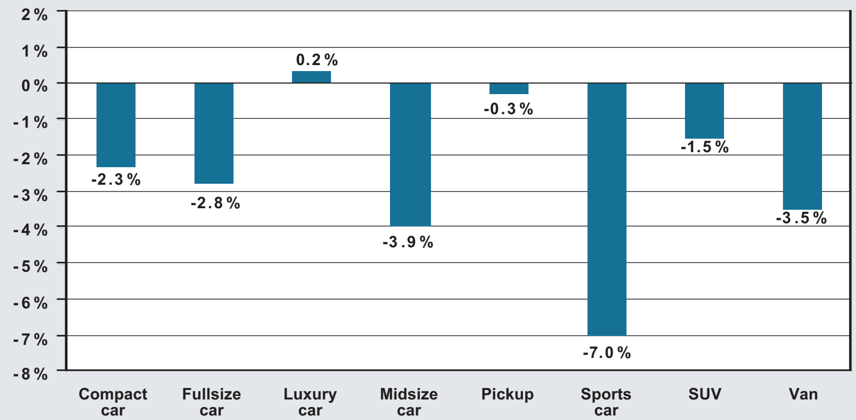
All market classes of vehicles had year-over-year price declines in January, as the comparison was against last year's cyclical peak in wholesale pricing. In recent months the pricing for many SUVs and full-size pickups has improved—helped in part, no doubt, by lower gasoline prices. Indeed, for some SUV models the wholesale market in January was quite active, showing both an increase in the number of vehicles offered and a higher sale-through percentage. Luxury model SUVs, however, suffered a further easing in wholesale pricing in January.

Luxury Cars Up, All Others Down, from Last Year's Cyclical Peak in Pricing

Percent change in wholesale prices – January 2006 to January 2007



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800-777-2053

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Q & A WITH TOM WEBB

Thomas Webb
Chief Economist
Manheim
(540) 349-2860
Thomas.Webb@Manheim.com

Q. I hear domestic manufacturers complaining that the yen/dollar exchange rate is putting them at a competitive disadvantage. Is that true? Is it a situation subject to change?

A. The yen recently hit a four-year low against the dollar, and that certainly does provide Japanese nameplates with a certain competitive advantage (even though the bulk of their U.S. sales are either manufactured or assembled here). And, in a turn of events, European and American auto manufacturers are on the same side of the exchange rate issue now that Japanese nameplates are making further inroads against the Europeans both here and abroad.

But U.S. monetary policymakers—and even politicians—express little inclination to impose any corrective action. In part, that's because the recent fall in the yen came as a surprise—economists had been expecting it to rise. The reason was a weakening in the Japanese economy that precluded an increase in interest rates there (in fact Japanese market rates have fallen). In the larger picture, it should be remembered that the domestic manufacturers' biggest competitive disadvantage comes in the form of pension and health care legacy costs, not exchange rates.

Q. I hear that most public dealer groups have released fourth quarter and full year financials. How did they do?

A. As you might expect, 2006 posed some challenges, most notably higher floorplan costs due to excessive inventory levels and higher flooring rates. Nevertheless, most dealer groups posted higher profits due to revenue growth (both organic and acquisitions) and better used-vehicle operations. Many had higher same-store used retail unit sales and, in some instances, noticeably better margins. CarMax, whose last reporting quarter includes September to November 2006, had a 13 percent increase in same-store used retail unit volumes. United Auto, reporting on a traditional calendar year basis, had an 8 percent increase in fourth quarter same-store retail used unit volumes. Asbury was up 7 percent. Group 1 is scheduled to release earnings on February 21; Sonic on a yet-to-be-announced date.

Q. Any update on the housing industry? Do you still consider housing the biggest long-term drag on the economy?

A. The housing correction is playing out as we expected. Some analysts are taking too much solace in the fact that the negative impacts of housing are not rapidly spreading throughout the economy. We have always considered it a long-term story—one that will affect the structure of household balance sheets for years to come.

Recent news on the housing front has not improved. A Census Bureau report put the vacant home inventory at its highest level in the 40-year history of the measurement. That implies that other measures of housing inventory (which include both vacant and owner-occupied units) improved in recent months simply because owners pulled their homes from the market—not because they actually sold them.

The subprime mortgage market remains in an unknowable disarray. Citing no-doc loans and appraisals based on simple computer searches, one subprime mortgage underwriter said, "We don't know what the guy makes, or what the house is worth." In that kind of environment it is impossible to predict future loan performance, but one can assume it will not be good.

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