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Industry Trends

One of the big themes we've touched on in our analysis over the past couple of years has been the upscaling by many buyers to higher trims and larger, luxury vehicles. With that in mind, a good share of readers may be familiar with the following market experience: after roaring ahead at breakneck speed, vehicle sales appear to be downshifting to a comfortable cruise. By all indications, it appears as if we're moving past peak cycle in North America and are now approaching a more sustainable rate of sales. To their credit, auto manufacturers have been fairly nimble in responding by cutting production accordingly, as inventory levels—particularly those of small cars—have swelled. Should this nexus hold, the vehicle market could be primed for a sustained period of healthy sales activity. Despite growing headwinds, 2016 looks set to surpass last year's 19.3 million **combined U.S.-Canada sales**, thanks to a late-year incentive fuelled ramp-up in sales. Our 2017 outlook calls for a downshift to just below 19 million units – still a very strong result by historical standards (Chart 1).



After enjoying the gusting tailwind of pent-up demand, the **U.S. market** is now facing growing headwinds in the form of rising interest rates, plateauing ownership rates, and market saturation in some segments. Dealership inventories have touched record levels and, while they remain fairly contained on a selling-day basis for light trucks, there are signs that passenger car inventories are becoming bloated (Chart 2). Oversupply has prompted aggressive incentives which, combined with strong prospects of another December rate hike from the Fed, have juiced sales numbers through the past few months. As always, these post-peak sales tactics are likely pulling forward activity. Thus, we expect a considerable step-down in sales by next spring, albeit to the vicinity of the still-healthy seasonally-adjusted annual rate (SAAR) of 17.0 million units.

Canadian sales appear to be gently drifting down from their Icarus-like heights (November's outlier notwithstanding), as consumer debt dynamics finally appear to be taking a grip on the market. The Canadian space has surpassed all traditional metrics of activity, be it sales volumes, ownership rates, or loan activity. Though the effect of record-low borrowing rates cannot be understated, we still firmly believe that there has been a fundamental shift in consumer preferences that has contributed to the outperformance of the vehicle market and we expect this effect to persist. As such, sales should still trend well above historical norms, despite a considerable downshift in consumer spending.

The Luxury Race is Heating Up

Quarterly earnings seasons can be a sobering experience for many of the larger, more-diversified OEMs when they take a peek at what the

Chart 1
Light Vehicle Sales

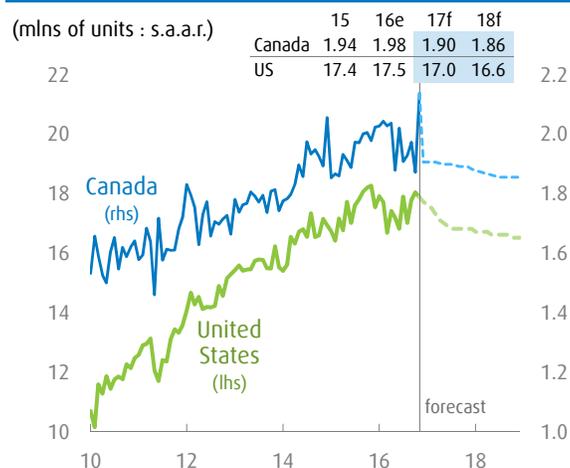
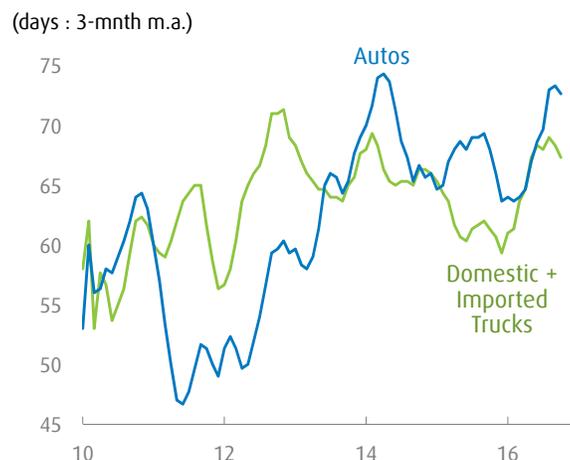


Chart 2
Days' Supply for Vehicle Industries



luxury manufacturers are tallying. To offer a recent example: a large U.S. OEM sold more than 1.5 million vehicles in its fiscal Q3, which earned it record net income of US\$2.8 billion. Meantime, a luxury German manufacturer, selling a little less than 600,000 units, cruised its way to net income of over US\$2.0 billion. It's no wonder then that most OEMs have focused on gaining a larger piece of the pie in the highly profitable luxury-vehicle segment. While it's true that the luxury class has grown as a share of total sales, there is still limited space in the upper echelons of the vehicle lineup. Therefore, any misreading of the market by an OEM can be a costly error, given the outsized research and development costs required to produce a topline vehicle. This is especially true when considering the constraints on discounting or incentivizing to push unsold units, as such actions can cannibalize the premium aura of the brand. With that in mind, we take a look at who's leading, who's gaining and who's flailing in the coveted race to that immaculately-paved driveway near you. Due to some data lag, we'll focus on the U.S. market in this piece, though the trends are mostly the same for the Canadian market, based on available data.

Table 1
U.S. Luxury Market Share

(% of total luxury sales : year-to-date)		
	2016	2015
German	42.8	43.7
Japanese	29.4	30.7
American	13.1	12.9
Other European	11.4	9.7
Korean	1.3	1.7
American Electric	1.9	1.2

In aggregate, the luxury brands have weathered cyclical downtrend in sales, posting a 1.1% year-to-date (YTD) increase in the U.S. as of November, compared to a flat performance for the rest of the market. Sales activity has differed greatly across model types, which has resulted in contrasting outcomes for OEMs, based on how well their models line up relative to rapidly shifting consumer preferences. **Luxury passenger car sales** are actually down a staggering 9.7% YTD, with declines across the board for all vehicle sizes and types. However, this has been more than offset by a 14.5% YTD increase in **light truck sales**, led by outperformance in the large and medium cross-over utility (CUV) segment.

These trends pose serious questions for those with car-heavy lineups. German import badges have typically been the most exposed to this segment and the recent shift in buying trends has started to show in their sales figures (Table 1). German nameplates have suffered a combined 2.7% decline in sales over the past year, dragged down by a 16% collapse in car sales. Thankfully for them, some furious development work on CUV and SUV models has helped to mostly offset the losses and they still remain the dominant players in the total market for upscale vehicles, with a 43% share. However, slippage over the past year hints at some vulnerability and competitors will be heartened by the 1ppt. market share they've been able to carve.

One of the most fascinating things about the luxury segment is that it offers a glimpse into the future for vehicle technology. While innovations can be hit-or-miss, the hits usually trickle down to regular trims shortly after and, in many cases, become fairly standard features within a few years. Recently, we've witnessed an acceleration of this cycle, making current-vintage vehicles an excellent value proposition. For instance, technological advances have limited the increase in quality-adjusted prices to only 3.0% over the past five years, compared to nearly 10% for the core consumer price index. It's in this technology-intensive space that the 'Other European' nameplates have chosen to place themselves and it has resulted in tremendous success thus far. Badges once considered moribund and out of date have turned the tables on the competition by developing leading-edge safety and autonomy features, while others have offered blistering performance by implementing state-of-the-art components and technology - some quirkiness and successful marketing has helped as well. The 'Other European' segment has seen an impressive 1.7ppt. increase in market share and now occupies 11.4% of the market.

Japanese luxury brands have certainly been exposed by this shift, as they typically compete with the 'Other European' segment in terms of prestige and price. Accordingly, the latter's success has caused the share of Japanese brands to erode 1.3 ppt. through November. Like the German badges, car sales have been whipsawed by the dramatic shift in consumer preferences towards larger vehicles, but in many cases the Japanese badges do not have as diverse a lineup of CUVs or

SUVs to compensate, leaving more on the table for competitors to target. As such, it will be a hard-fought battle for Japanese nameplates to maintain market share.

American luxury models suffered somewhat of an identity crisis in the past decade, prompting OEMs to invest heavily to refresh their brands. It has not been a painless process; American luxury brands' market share eroded from 16% to just below 13% over the past five years, despite significant investment. However, American manufacturers are at an advantage with regards to market trends, as the truck-heavy weighting of their lower-trim lineups allows them to leverage resources into luxury CUV and SUV model development more easily than others. The key issue is to strike the right balance in asset sharing; carrying over a lower-grade platform and slapping on some bells and whistles will no longer suffice. However, it appears as if the concerted effort by American OEMs to differentiate their luxury brands from their standard lineup is finally starting to take hold as market share has stabilized, sales volumes are up, and margins have improved. We would note that the 'American Electric' category has fared better, albeit from a very small starting point, with a 0.7ppt. market share gain in the past year. Much like the 'Other European' segment, the technology they offer has been very well received by luxury buyers.

Korean automakers have made some serious progress in producing competitive and attractive luxury cars. However, they face a steep uphill battle. As if trying to establish their premium credentials wasn't hard enough, their only offerings-large luxury cars-fall into a market segment currently in decline. Korean makers have seen their slim 1.7% share of the luxury market shaved 0.4ppt, through November. However, they may be able to live with mixed results in their fine car divisions if they produce a "halo" effect for the rest of their brand lineup.

Bottom Line: There are some very interesting developments taking place in the premium segment and the rapid pace of innovation will surely lead to further differentiation. This will be crucial as the vehicle selling cycle begins to slow and manufacturers are forced to move more on margins than on volumes. Competition is set to intensify, with important implications for both producer and distributor strategies.

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