What the Automobile Manufacturers are Not Telling You

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If one were to describe the automobile industry in terms of the human anatomy, the manufactures would represent the skeleton (framework), the lenders the blood (money) and the dealers the heart that pumps the blood to the vital organs (the businesses and consumers).

Manufactures cannot retail cars to the public – only dealers can. Manufacturers are "wholesalers." They wholesale their vehicles to dealers and dealers retail them to the public.

Consequently, in order to revive the economy, manufacturers need a healthy dealer body to purchase their products and sell them to the public. The dealers will circulate the money; heal the factories; profit the lenders and nurture the economic recovery.

The Facts

The automobile industry is responsible for approximately 16% of the total Gross National Product of the United States. While several reputable sources may appear to give different percentages, they each describe different facets of "the industry".

The ***New York Times*** reported on November 3, 2007:

> THE automobile industry's share of the American economy has fallen to a historic low, the government reported this week, a few days before Chrysler announced another round of layoffs.
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> During the third quarter, the government reported, spending by Americans on autos and auto parts fell to **3.1 percent of the total gross domestic product**. "Off the Charts: Auto Sector's Role Dwindles, and Spending Suffers," by Floyd Norris. [Emphasis added.]

The ***Wall Street Journal*** reported on November 10, 2008:

> America has two auto industries. The one represented by GM, Ford and Chrysler . . . . the other Japanese, European and Korean. . . .
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> . . . . Diminished as they are, the Detroit Three still account for **about 4% of U.S. gross domestic product.** They also represent a way of doing business that has run its course. GM's plea for a federal bailout makes that official. [Emphasis added.]

The different views of the impact of the auto industry on the American economy reflect each authors' definition of the "auto industry." Many people limit the "auto industry" to only the companies that actually manufacture and/or distribute vehicles. But, when talking about the effect of the industry upon the US economy, the definition needs to be expanded to include the related businesses that are affected by the sale of vehicles.

See, for example, the November 24, 2008, ***Los Angeles Times*** :

> When it comes to the U.S. automakers and their financial troubles, politicians and the public tend to think about the . . . Big Three's assembly lines in Michigan and nearby Rust Belt states.
>
> Yet suppliers provide about 70 percent of the content in most automobiles, from the seats to specialized bolts on the suspension — everything except the sheet metal and the motor assembly. So when Ford, Chrysler or General Motors Corp. sneeze, 600,000 workers in places as widely scattered as Peachtree City, Ga., and Pittsburg, Kan., are likely to catch cold.
> . . . .
> The Big Three spend about $300 billion a year on equipment, supplies, tooling and parts ranging from transmissions to shop rags.
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> GM spends $7 billion a year transporting parts to factories and hauling finished automobiles to dealers. That makes railroads and trucking companies huge clients of the Big Three. No wonder that with car sales down, Norfolk Southern Corp. reported a 30 percent decline in rail car business in the third quarter compared to a year earlier.

New car dealers (exclusive of the manufacturers and related industries) account for over 18% of America's retail sales, which in 2007 represented over 693.5 Billion Dollars.

In 2007 new car dealers alone accounted for 13% of all the retail wages and salaries paid in America, employed 1,114,500 people (7% of all jobs), having a total payroll of approximately $54 billion and their expenditures, excluding costs of goods sold, topped $84 billion. **[Sources: NADA, Automotive News, the Wall Street Journal.]**

If America's dealer body is not healthy and cannot sell cars the industry stops and with it, so does the economic recovery.

It does not matter how many vehicles the factories produce. It does not matter how much financial assistance the lenders receive. It does not matter how cheaply Detroit produces its vehicles, or what kind of vehicles they produce. Only franchised new car dealers can purchase vehicles from the manufacturers and distributors and retail them to the public. Without a healthy dealer body, the recovery is cannot happen. Do the math. The country cannot survive a hit on 16% of its gross national product without a deep recession.

Why is the US dealer body in jeopardy?

In past recessions, problems in the auto industry were limited to not producing the correct vehicles (as existed in the oil crises of the 1970s); stimulating the consumer (as existed with the high interest rates of the early 1980s); or the lack of consumer demand (as existed in the early 1990s.) Today, however, the industry is confronted with stagnant inventory, tightening credit and lack of consumer demand – all at one time.

Unlike the 1970s, 1980s and 1990s, today crisis finds many consumers not buying, those wanting to not meeting the tightened credit requirements, and America's dealers (including the "import" dealers) caught with mostly the wrong vehicles on their lots.

What is the real problem we face in reviving the automobile industry?

Because of the economic crisis and the previous spike in gasoline prices, dealerships (both domestic and import) are overstocked with millions of new, carryover models (2007 and 2008). As a result, based on today's depressed sales many dealers have over a year's supply of vehicles in stock.

The carryover vehicles are on the dealers' books at invoice (what the dealers paid the factories for them), but are already listed in Kelly Blue Book or NADA Black Book at far below invoice. Therefore, every time dealers sell a carryover vehicle they show a loss and the lenders require them to contribute additional capital in order to maintain their store's "working capital standard".

This problem is exacerbated by dealers paying millions of dollars in "flooring" interest on these aged, overstocked vehicles. In addition, the lenders are decreasing dealers' wholesale flooring line limits to compensate for the overstocking of carryover vehicles, thus further hampering dealers from ordering any newly produced 2009 vehicles.

The Consequences

Unless the above problems are addressed, dealers will not be ordering the 2009 vehicles the manufacturers must produce and sell in order for the them to survive, thus helping them produce more vehicles would only intesify the economic crisis, not improve it.

Recommendations

First, Congress and the Federal Accounting Standards Board should work together and develop amendments to the FASB rules and the Internal Revenue Code to allow dealers to accrue losses from the sale of their "stale" inventories, without having to reflect losses on their financial statements, except to the extent of profits; something akin to what they are talking about with respect to helping lenders out of the mortgage crisis.

In other words, if a dealer sells a carryover at a loss, in order to be able to order current model vehicles, the dealer should be allowed to put the loss into a "special asset" account until it can be written-off against a profit. Without that relief, dealers would be forced out of business by working their way out of stale inventory and would not order new production.

Next, Congress should provide customers with additional incentives (such as reinstating the write-off for vehicle loan interest) to buy both new and used vehicles.

In addition, lenders should be prohibited from cancelling wholesale floor lines if dealers are not in default. Dealers that have been in business for years and never in default of a loan are currently being forced out of business because lenders are caught-up in the current credit freeze and refusing to renew floor plans.

Just as Richard Nixon order a price-wage freeze and Franklin Roosevelt ordered a Bank Holiday, Congress or the President should order a moratorium on cancelling flooring lines of dealers that are paying their debt to the lender.

To help maintain the liquidity of dealerships, factories should be required to lower capital requirements to reflect today's market, instead of using mythical sales potentials that strain a dealer's cash liquidity. Such an action would ease the pressure on lenders and, thus relieve pressure on the dealers.

Another lender requirement should reward "good customers". Currently, customers that have religiously made lease or purchase payments cannot get financing for new vehicles because lenders have excessively raised credit requirements. For example, GMAC will not finance a buyer with less than a 750 credit score. If a customer has made timely payments for 36 or 48 months, requiring a FICO score of 750 is not going to improve the lender's credit risk. On the other hand, requiring such a score will slow down vehicle sales and hence, slow down the economic recovery.

Congress should consider amending the Federal "Dealer Day in Court Act" to require manufacturers to repurchase all new and unsold, original manufacturer inventories upon the closing of a dealership. Current state laws vary widely. California, for example, requires only that current model year vehicles be repurchased, while Texas requires that all new vehicles with less than 6,000 miles be repurchased – even carryovers.

Expanding manufacturer's repurchase requirements would help ease the pressure on floorplan lenders because in states like California, lenders are requiring the dealers to payoff (or curtail) the carryovers because the value of (the lenders) their security is impaired without the factory standing behind the repurchase of its inventories. In other words, if a lender repossessed, the lender would have to auction the inventories at a reduced price instead of the factory refunding what the dealer actually paid.

Postscript

Despite the myths and the movies, according to a story in *Automotive News*, the magazine found that nearly 90 percent of respondents were satisfied with their vehicle buying experience at the dealership and 96 percent thought they got at least a fair deal. Sources: *Consumer Reports* NADA and the Associated Press and Automotive News

Years ago Bob McCurry was given the reins of Toyota Motor Sales U.S.A. At that time Datsun (now called "Nissan") was "king of the hill." Datsun outsold Toyota in every market segment: cars, trucks, parts and accessories. McCurry openly stated that Toyota would eventually catch and outperform Nissan and, when asked how he intended to have Toyota dominate the industry, he responded: "By developing a strong dealer body." "If you want a successful manufacturer, you need successful dealers." And, as history shows, McCurry went on to do just that.

In summation, addressing the problems of the manufacturers and lenders, without addressing the problems and needs of the new car dealers, will not revive the economy.

The new car dealers are the heartbeat of the economy. They are the ones that keep the wheels turning and the money circulating. They are the ones that support the local charities and schools; and they are generally the ones that contribute the most money to their city's sales tax base.

In dealing with the industry, the Congress should keep their eye on the donut (the American dealerbody) and not the hole (manufacturer and lender losses).

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Mr. Cox is a partner in the global law firm of K&L Gates and has counseled automobile dealers and lenders to the automotive industry. You can view his biography and learn more about K&L Gates at www.klgates.com.