# OPINION

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# Leasing may counteract repo rates

**Rusty West**

Rusty West is CEO of Market Scan Information Systems.

Newton's Third Law of Motion, in the simplest terms, states that for every action there is an opposite and equal reaction. This applies to business on every level. Unlike the physical universe, the opposite and equal reactions in business are often not immediate or apparent.

Because of supply chain issues caused by a unforeseen world events, vehicle inventory levels have been at all-time lows for quite some time. This action created an opposite and equal reaction giving way to one of the best educational examples of the application of the laws of supply and demand the automotive industry has ever seen.

With supply being at a record low and demand being at a record high, profits have remained at near all-time highs for dealers, manufacturers and just about everyone else in the automotive industry. Despite the high cost of fuel, rising interest rates, sticker prices and overall inflation, record profits have been reported from several sectors of the industry.

These record profits are an action, and Newton's Third Law is ready to pounce.

## The repo problem

In 2021 and the first half of 2022, consumers paid unprecedented prices for vehicles. On average, new vehicles sold for 10 percent over sticker and used-vehicle prices shot through the roof, generating loan to values around 140 percent vs. the norm of 80 percent. While today's abnormally high vehicle prices, rate markups, F&I product penetrations and extended-length financing terms might look great on a balance sheet, they are not immune to Newton's Third Law.

Repossession rates are on the rise. The rate in the deep subprime segment is up 33 percent, the subprime segment rate is up 11 percent and, most alarming, the rate has doubled in the prime segment indicating millions of consumers are in over their heads with car payments they cannot afford. This means lending institutions are carrying more risk than ever and dealers have chargeback exposures that exceed anytime in history.

The fallout could be catastrophic on many levels.

Here's where it gets really interesting: The value of a used vehicle is dictated by several factors. The two that have the most influence are the price/payment to acquire a similar new vehicle and the supply of similar used vehicles. With new-vehicle inventories slowly coming back, the price/payment to acquire new vehicles will gradually fall back to normal levels. This dynamic will have a profound impact on the value of used vehicles. Coupled with the predicted flood of repossessed used vehicles, this poses the risk of putting the used-car market into a tailspin of epic proportions.

Here are some potential reactions:

**1.** Much like the mortgage crisis of 2007, if the value of a lending institution's portfolio takes a 20 to 30 percent dip caused by plummeting used-vehicle values, they are exposed to federal margin calls.

**2.** When a vehicle is repossessed, the selling dealership may be charged back a pro rata amount of most, if not all, F&I profits.

**3.** Consumers will hold negative equity positions in their vehicles at historically high levels.

With these dynamics coming into play, the automotive industry is entering an era of the most complex new-vehicle transactions in history. This new age brings with it many challenges and a plethora of opportunities. More well-funded technology companies are entering the digital-retailing space than ever and many dealer groups are investing heavily to address the needs of their future customers.

## Is there a silver bullet?

While there is no reset button, there may be a silver lining — and it might just be leasing. Properly structured short-term leases have many benefits for consumers, manufacturers, lenders and dealers.

While rolling a negative equity into a lease does not unbury a customer, it does solve their problem over a much shorter period of time and gives them the ability to start with a clean slate at the end of their lease. Countless studies have shown consumers appreciate transparency and brutal honesty. The "you're not going to be unburied; but, you will have a shiny new car with a warranty and you're only stuck in it for three years" pitch, surprisingly, is often well received by consumers.

There are tremendous benefits to leasing for manufacturers as well. With the average loan length exceeding 72 months, manufacturers have a shot at delivering three vehicles over that time span as opposed to one. An additional benefit is consumers who lease vehicles tend to have more brand loyalty than those who buy.

Lenders also stand to benefit from leasing. Much like the manufacturers, the shorter terms for leasing create opportunities for additional transactions versus long-term loans. Leasing, however, is not without risk. Residual value risk is one of the most important elements that must be addressed. This creates an opportunity for those lenders who think outside the box. An aggressive, properly structured lease program for off-lease vehicles can mitigate much of this residual risk.

The biggest winners are the dealers. Customers who lease trade vehicles more often and are three times more likely to become repeat customers than those who buy. One of the most overlooked benefits for the dealer is the increased value of their organization to potential acquirers. Many dealerships have received valuations with tremendously high multiples because of their robust lease portfolios.

This concept may seem like a bit of a stretch — after all, leasing accounts for a much lower percentage of all transactions than it did two years ago. This is not the first time we have seen a dramatic decline in lease penetration; leasing all but stopped shortly after Sept. 11, 2001, because of the abundance of 0 percent financing options. This same dynamic came into play during the COVID-19 pandemic. Leasing is highly cyclical — it came back in a big way after 9/11 and it is poised for a comeback in the very near future.

In fact, many players in the space are preparing for an uptick in leasing. Several lenders are getting increasingly creative with their lease offerings and with inventory levels slowly coming back, there is a resurgence of manufacturer supported lease programs. Will leasing save the world? Probably not. That being said, it is one viable method for addressing the challenges ahead.

Only time will tell how all of this unfolds. One thing for certain is changes are coming, and those manufacturers, lenders, dealers and technology companies who are investing now to address the needs of future consumers will have a big advantage over those who aren't.

## AROUND THE AUTO WORLD

Here are edited highlights from the latest episodes of "Daily Drive," *Automotive News'* weekday podcast, hosted by Jamie Butters and Kellen Walker.

**"We're a company that has worked with unions around the world for many years, so we're welcoming of the union at the battery plant."**
Mary Barra, CEO of General Motors, on union representation in its joint venture battery plants

**"When we say EVs for everyone, it's more than an advertising tag line. We've got to do this in a way where no one gets left behind."**
Barra on concerns that the move to EVs could exacerbate existing inequalities due to affordability and charging availability

**"We electrify or power everything from a bike that you can drive down the street all the way up to a semi, all the way up to an agricultural machine. ... When you look at that whole gamut of where we want to participate, we believe there's lots of opportunity."**
Paul Thomas, executive vice president of Bosch North America, speaking at the Automotive News Congress in Detroit

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