Industry Outlook: Automotive

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Key Points

1. U.S. light vehicle fleet is at a record average age of 11.5 years versus the long-standing average of approximately 9 years, which, coupled with rising consumer confidence, should continue to bode well for both original equipment manufacturers (OEM) and auto parts suppliers.

2. Firm pricing continues to be vital for profits, which should continue alongside improved, albeit slower, growth in 2014 and 2015.

3. We expect growth of +4% in 2014 followed by +3% in 2015, putting the number of registrations to around 16.5 million units in 2014 and 17 million units in 2015.

Many auto companies restructured their operations, in or out of bankruptcy, during The Great Recession. As a result, the industry emerged stronger and more flexible to the current operating environment. Post-recession, the U.S. auto industry landscape has changed significantly, resulting in a leaner, more efficient sector. For example, capacity utilization has increased to a fairly healthy level of approximately 90% in North America. As consumer finances continue to improve, they are more willing to purchase big-ticket items, like homes and vehicles. Revived consumer spending, improvements in credit availability, the shift to green vehicles and Crossover Utility Vehicles (CUVs), and the aging vehicle fleet will continue to drive growth in the upcoming years.

The industry continues to recognize the shift in consumer preference towards fuel efficient vehicles, which consequently spurred competition to increase production in a cost-efficient manner. Gas and battery hybrids along with high-mileage gas engine vehicles have met better demand than plug-in hybrid electric vehicles (PHEV). Market reception for PHEVs continues to be lukewarm despite various tax incentives. This market will continue to face limited upside until prices fall to a level where the consumer can justify the purchase.

US Light Vehicle Deliveries Calendar Year-to-Date – July 2014

	2014 CYTD	2013 CYTD	%Chng.	2014 CYTD % of US Market Share	2013 CYTD % of US Market Share	Mrkt Share ∆ YoY(bps)
General Motors Corp.	1,712,028	1,654,417	3.5%	17.83%	18.09%	-26
Ford Motor Company	1,476,824	1,482,816	-0.4%	15.38%	16.22%	-83
Toyota Motor Sales U.S.A. Inc.	1,381,409	1,302,185	6.1%	14.39%	14.24%	15
Chrysler LLC	1,187,790	1,048,434	13.3%	12.37%	11.47%	91
American Honda Motor Co. Inc.	875,344	887,017	-1.3%	9.12%	9.70%	-58
Nissan North America Inc.	825,929	733,750	12.6%	8.60%	8.02%	58
Volkswagen Group of America Inc.	310,429	331,665	-6.4%	3.23%	3.63%	-39
Total Light Vehicle Sales	**9,599,284**	**9,144,335**	**5.0%**	**100%**	**100%**	**0**
BIG 3 (GM, Ford, Chrysler)	*4,376,642*	*4,185,667*	*4.6%*	*45.6%*	*45.8%*	*-18*

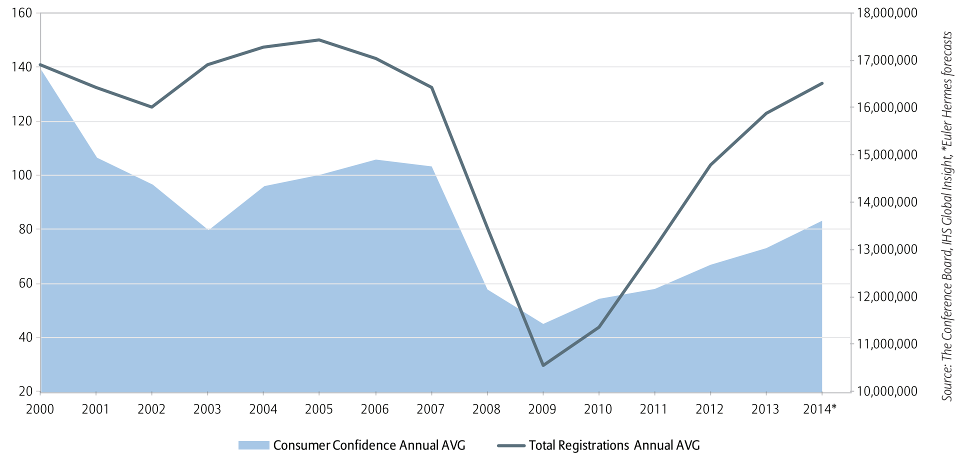
Source: Autodata Corp, Euler Hermes

Outlook – *Expect steady, though slower growth*

Overall outlook for the industry remains optimistic as consumers replace their older vehicles with new, more fuel efficient models. Growth should continue in 2014 and 2015 through stable pricing, favorable vehicle mix (particularly improved pickup truck demand, which yields broader margins and fewer fleet vehicles, which have constrained margins), and disciplined capacity utilization initiatives. We expect growth of +4% in 2014 followed by +3% in 2015, putting the number of registrations to around 16.5 million units in 2014 and 17 million units in 2015. Profitability depends on the ability of the Original Equipment Manufacturers (OEMs) to remain disciplined with firm pricing despite the continuous market share battle. Overall incentives have been relatively reasonable, driving more favorable average transaction prices. Notwithstanding, in 2014 the average profitability of OEMs is expected to decrease 1pp to 2.7%, though returning to 3.5% in 2015. This is

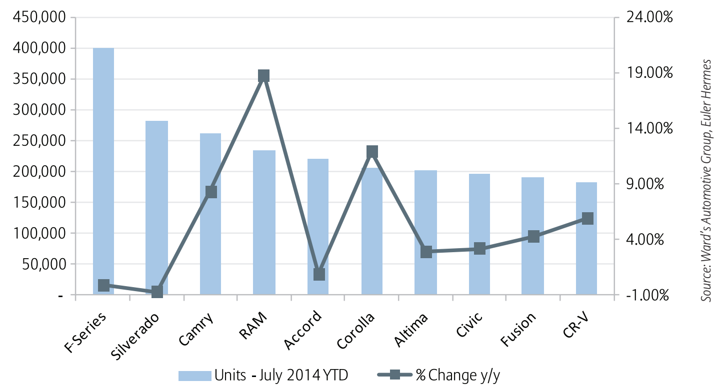
reflective of restructuring efforts in Europe, softness in emerging markets, and recall costs, particularly relating to GM. Product change-overs are also expected to dampen margins, as manufactures increase the need to turn inventory of models ending their life cycle, resulting in incentives and softer pricing, which should be anticipated and is the norm for the industry. In the next five years to 2019 the industry should benefit from improved consumer confidence and a strengthened macro-economic environment. The industry should also benefit from the growth potential in hybrid and fuel-efficient vehicle markets, however lower gas prices may stifle positive effects.

Consumer Confidence and Light Vehicle Registrations



The automotive industry is a beneficiary of a strong housing recovery, which typically results in improved pickup truck sales, leading to stronger margins. A stronger recovery with increased housing prices generally leads to increased consumer confidence and likeliness of individuals to purchase a vehicle. Light truck demand is expected to increase in 2014 and 2015 due primarily to improved fuel efficiency and refreshed product offerings, despite a possible modest increase in fuel prices. Ford's F-series remains dominate in light vehicle sales, followed by GM's Silverado, and the Toyota Camry, although Chrysler's Ram continues to gain market share, as seen in the table below.

Top Selling U.S. Light Vehicles – YTD July 2014



Challenges – *Pricing discipline and capacity utilization continues to be key*

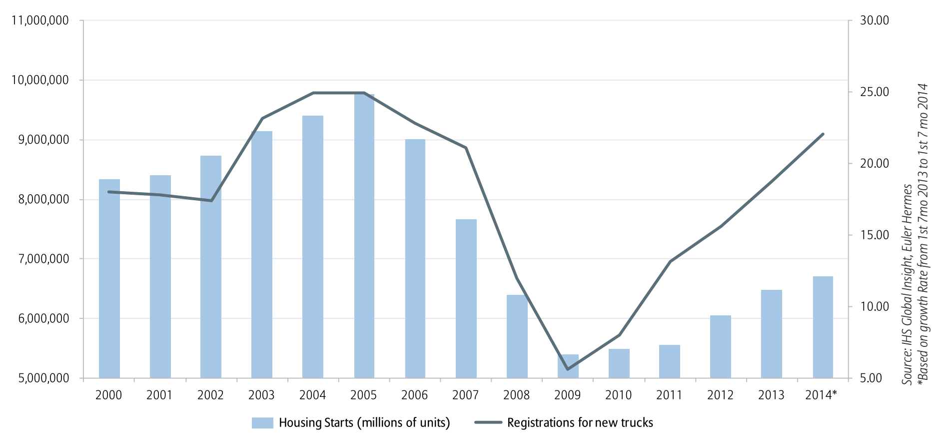
Automotive manufactures will be unfavorably affected if market share battles drive increased incentives, which would result in lower earnings. Pricing discipline and capacity utilization continues to be a key driver for industry success and profitability. An unexpected slip in the macroeconomic environment would result in softer consumer demand, lower prices and capacity utilization, weakening the overall automotive landscape. The industry would also

see overall weakness should the housing market begin to see contraction, driving lower consumer confidence and decreased support to the industry, specifically for pickup trucks. The 10-year Treasury note is analogous to the central bank interest rate, which remains at historic lows. The lower the yield, the lower the cost of borrowing, which makes purchasing a vehicle more affordable. An increase in the 10-year T-note would dampen growth prospects for the industry, though any increases are expected to be gradual and are based on the decision of the Federal Reserve. An increase in rates would also have a dampening effect on the housing market, which would also contribute to slower growth in the sector.

Opportunities – *Improved housing and consumer confidence remain growth catalysts for the industry*

The automotive industry continues to benefit from several factors, providing multiple opportunities to drive future benefits. The industry is poised to take advantage of the change in consumer preference from the more price-competitive passenger cars to CUVs, which typically yield broader margins and higher pricing. Another factor is the age of the U.S. light vehicle fleet, which is at a record average age of 11.5 years versus the long-standing average of approximately 9 years. This, coupled with rising consumer confidence, should continue to bode well for both OEMs and auto parts suppliers. A continuing housing recovery is estimated to drive growth in pickup truck sales over the remainder of 2014 and 2015. Although a hike in interest rates could dampen demand, rates are still at historic lows, increasing vehicle affordability. OEMs and suppliers that offer products which augment fuel efficiency will continue to see stronger pricing and opportunities remain as the shift to fuel efficient vehicles continues. An improving housing market, revived consumer spending, attractive financing availability, the shift to green vehicles and CUVs, and the aging vehicle fleet will continue drive growth in the upcoming years.

Impact of Housing on Truck Sales



What this means for your business – *Pay close attention to pricing, incentives, and consumer confidence*

The automotive industry is expected to see growth in the upcoming years and downside risk is currently limited. However, if market share battles start to erode pricing, the industry would become less profitable, which would increase the aggregate risk profile for the industry. Softer pricing and compressed margins could be further exacerbated by an unexpected shift in the macroeconomic environment, lower consumer confidence, and weaker housing market. This could drive possible cash flow issues and delayed payments down the supply chain. To better protect your company while maintaining sales growth and profitability, obtaining a trade credit insurance policy from Euler Hermes could be a prudent option. Euler Hermes' 120 years of credit management experience can help manage these risks and provide the confidence needed to safely expand your operations.

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