KGI CHINA DEVELOPMENT FINANCIAL

Automobile Industry

Automobile industry report Part 2: Risk of auto debt

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- In the second of our automobile industry report series, we continue making inroads into understanding the various headwinds that the sector faces.
- Focusing on the US auto market, we discuss three main issues that the industry is facing: low affordability and rising subprime auto loans, and trading in cars with negative equity.

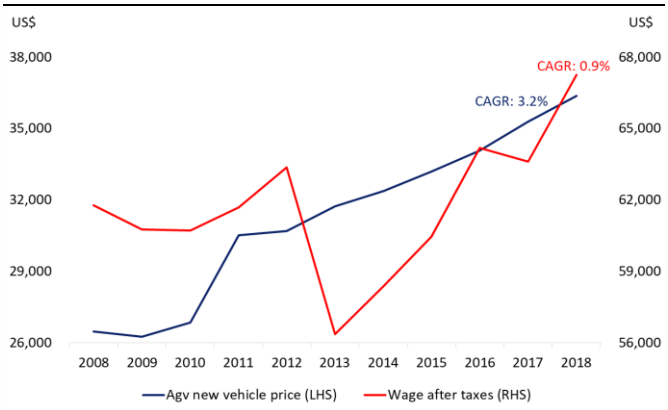
Low affordability increases debt burden

Vehicles are an indispensable asset to the American family. As of 2018, the US has 0.84 vehicles per household, which is the fifth highest auto ownership in the world. However, purchasing power in the US has stagnated, creating a headwind for future auto sales.

One of the reasons is that US wages growth with a CAGR of 0.9% has fallen behind the average selling price (ASP) growth (CAGR of 3.2%) over the past decade. In other words, new cars are relatively more expensive than they used to be. Consequently, we can observe that other private transport alternatives such as leased and used cars wane and wax inversely.

However, the preference for owning a brand new car is undeterred even though individuals may have to pinch their wallets further to afford one. Their purchasing decisions have been aided by car dealers offering attractive term loans, which enables instant gratification, but at a future cost.

Figure 1: US new vehicle price and wage growth comparison



Source: CEIC, KGI Research

Figure 2: Used vehicle and lease substitute new vehicle sales in US

Source: CEIC, KGI Research

Subprime nightmare looming

It has been more than a decade since the subprime crisis that was caused by many overestimating their ability to afford a home. Yet, many seem to be forgetting the catastrophic consequences it had on the economy, as we are beginning to see almost a replication of events in the US automobile market today - and 'those who cannot remember the past are condemned to repeat it'.

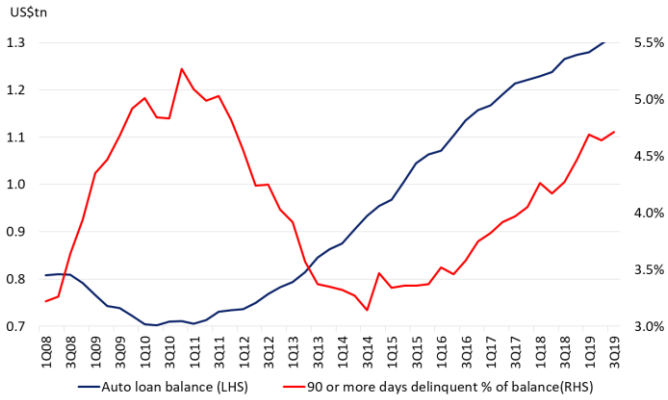
As of 3Q19, the total auto debt grew to a new high of US$1.3tn (78% growth compared to 3Q09). More worryingly, the delinquent rate is rallying again. The 90-or-more-days delinquent percentage hit an 8-year high, since 4Q11 when the total auto debt was US$700bn.

The number of subprime* auto loans are now increasing at an accelerated pace - loans originating from vehicle buyers with low credit scores* in 2Q19 exceeded US$50bn, a three-year high since 2Q16. It is worth noting that in the US, the average driver replaces his car every 71.2 months (about six years). However, it could be shorter for younger millennials and fad chasers, and these are usually also the groups with lower credit scores. Since the last peak of loan origination was in 3Q15, we may expect another peak season of replacing cars in the near term.

**A subprime loan is a type of loan offered at a rate above prime to individuals who do not qualify for prime-rate loans. Quite often subprime borrowers have been turned down by traditional lenders because of their low credit ratings or other factors that suggest they have a reasonable chance of defaulting on the debt repayment.*

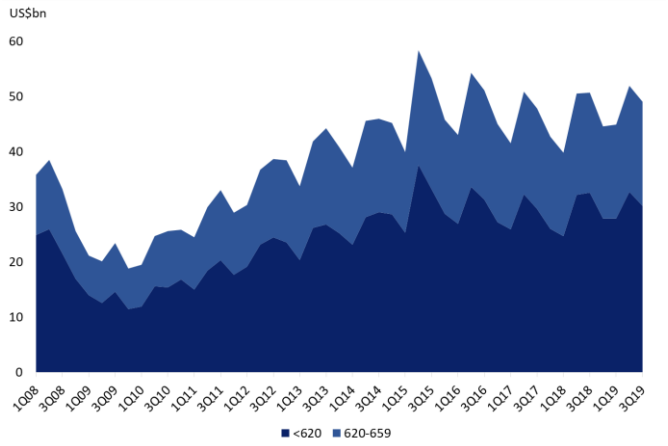
**Credit score lower than 620 is bad, 620-659 is poor.*

Figure 3: Inflated auto debt and rising delinquent rate



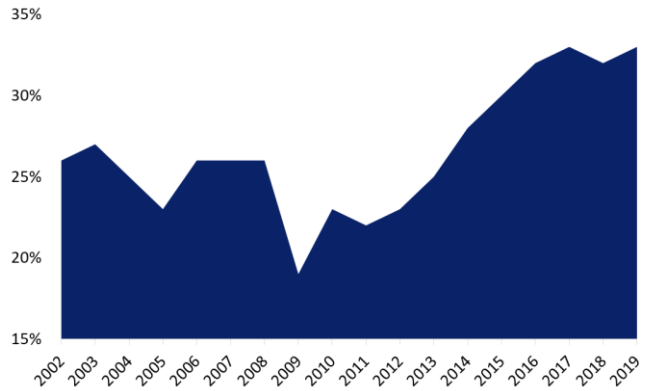
Source: New York Fed, KGI Research

Figure 4: Auto loan origination with credit scores of 659 and below



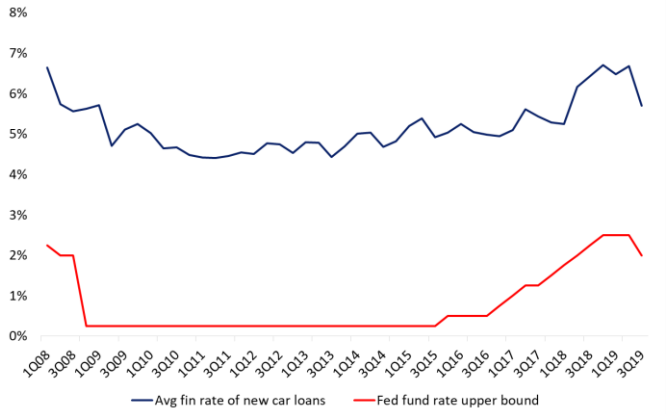
Source: New York Fed, KGI Research

Figure 5: Percentage of people who have negative equity when trading in vehicles for new ones



Each year shows January to September period only
Source: Edmunds, KGI Research

Figure 6: Rising financing rate of new car loans



Source: Bloomberg, KGI Research

Tentacles of the debt trap: trading for a new car with negative equity

Negative equity is a situation where the car's resale value is lower than the outstanding loan amount. In 2009, 19% of those who traded in their cars for a new one, faced negative equity. However, the proportion has been rising such that for the nine months ending 30 September 2019, 33% of those who traded for a new car had negative equity.

These buyers, who trade in with negative equity, usually incur higher interest rates and monthly payments, which results in a debt cycle as it leaves them even deeper underwater. They are, more often than not, subprime borrowers who might not have the means to pay off the remaining balance on their loans before purchasing their next vehicle.

It is also worth noting that car loan terms are increasing - about a third of loans taken for new vehicles in 1H19 had terms longer than six years, compared to one-tenth ten years ago, according to Experian PLC. The longer term loans have unfortunately created an illusion of affordability as it enables car purchases that would ordinarily be out of reach.

The increasingly unmanageable debt size points again to another headwind for the auto sector. Even though interest rates on car loans are expected to decline amid the rate cut cycle, the floor remains at c.4.4% when the Fed fund rate was close to 0% during the GFC.

Yet, the effect of a 2+% drop in the current financing rates (3Q19: 5.7%) will only be able to partially offset the higher transaction prices for new cars. The ballooning debt size and the rising delinquent rate could certainly bode a gloomy outlook for the auto sector.

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