

# U.S. Structured Finance Newsletter

Volume 4, Issue 52, December 22, 2008



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## WILL THE AUTO MANUFACTURERS' LIFELINE REACH AUTO ABS?

On Thursday, December 10, the United States House of Representatives passed a \$14 billion aid package for the U.S. auto manufacturers. The measure was subsequently rejected by the U.S. Senate the next day. On Friday, December 19, President Bush announced that General Motors Corp. (GM) and Chrysler LLC (Chrysler) will get \$13.4 billion in initial government loans to stay afloat as they retool their businesses, with another \$4 billion to be available in February. The funds will come from the Troubled Asset Relief Program established under the Emergency Economic Stabilization Act. Although this financial aid is positive news for the auto manufacturers, given the complex financial and organizational challenges they face and unique interrelationships with captive finance companies and dealer networks, questions remain as to the future performance of existing asset-backed securities (ABS) associated with these entities.

Among the three major auto ABS subsectors—retail loan, auto lease and wholesale—it is the lease and wholesale areas that are most vulnerable to the declining financial health of the auto manufacturers. This is due to the ongoing influence of the manufacturers' reputation, availability of financing incentives, productivity on the residual values of off-lease vehicles in addition to the ability of dealers to sell vehicles in order to repay wholesale loans.

For auto lease ABS, the residual value of the vehicle at lease maturity is a critical factor. Vehicles associated with a manufacturer which is in financial distress become less desirable, which leads to an increase in the number of vehicles returned to the dealers at maturity and delays in vehicle sales once returned to dealers. These factors depress the used car market and drive down the residual values of off-lease vehicles. Reduced proceeds at auction sales can have a significantly negative impact on the cash flows of auto lease ABS.

The wholesale auto ABS market relies heavily on car sales to repay wholesale loans. Unfortunately, this market continues to be weak because of the recession and lack of available credit from finance companies for potential buyers. Additionally, dealers' abilities to sell vehicles in order to repay wholesale loans can be detrimentally affected by the uncertainty regarding manufacturers' future ability to contribute subvention payments on new vehicle sales. These incentives are a powerful marketing tool to bring customers to the showroom and close sales.

The terms of the President's loan package require quick responses from the auto manufacturers. By March 31, 2009, the companies must demonstrate that they can remain financially viable or the loans will be called. A failure in this regard would return the companies back to "square one" and certainly heighten the probability of bankruptcy filings. Under a bankruptcy scenario, the circumstances described above for auto lease and wholesale ABS are magnified.

The compressed timeframe for making substantial and difficult changes to their business models places severe pressure on the ability of GM and Chrysler to reverse the weakening trend of their financial health and does not ensure future viability. While the vast majority of auto lease and wholesale ABS connected to these companies are currently performing within expectations, because the fundamental challenges for the auto industry are larger than the immediate liquidity crisis facing the manufacturers, the loan package does not ensure that the future performance of lease and wholesale ABS will remain stable.

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