What Fleets Need to Know About Vehicle Depreciation Post-COVID-19

LeasePlan

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Introduction

Vehicle depreciation is always a hot topic for fleet managers—and even more so now that we're heading towards a post-COVID-19 economy.

Understandably, businesses and fleet managers are concerned about losing money on their vehicles when they're sold. Many are wondering what they can do to avoid this, since tactics that worked before aren't applicable now.

And it's not so much that vehicle depreciation rules have drastically changed due to COVID-19. It's that the current economic situation has highlighted existing issues with how people were depreciating vehicles all along.

In this guide, we'll explore the nature of the used vehicle market in Canada and what to expect in the coming months and years. We'll also outline four mistakes you should avoid making during this time of economic downturn, to ensure you minimize your losses as much as possible.

The State of the Used Vehicle Market in Canada

Anyone involved in Canada's used vehicle market knows about its inherent volatility. The indices below show the dramatic changes we've seen over the last couple of decades before COVID-19 hit.

Canadian black book used vehicle retention index from January 2005 to January 2020.

ADESA Canada used vehicle price index from January 1998 to January 2020.

The COVID-19 pandemic has added yet another layer of uncertainty to an already volatile market. We've already seen dramatic shifts in March and April, and we expect further swings in the coming months.

The pandemic has created a lopsided relationship between supply and demand. Economies shut down rapidly, reducing both business and consumer spending. Vehicle auctions stopped. Car dealers closed their showrooms. And the United States border closed, cutting off a large source of demand that's normally there due to the lower Candian dollar. These individual actions cumulated in the demand for used vehicles disappearing overnight.

Meanwhile, the supply side has leases continuing to expire, which has left companies with a large amount of vehicles that need to be sold. Additionally we have the physical wholesale auctions, which are the outlet of selling the backlog of vehicles, closed for the foreseeable future.

So the challenge is on both sides of the equation. We're seeing:

1. An influx of inventory that needs to be sold.
2. A vanishing demand for vehicles.
3. Limited means for selling this glut of vehicles.

We see the new vehicle market dropping by at least 25% this year.

One thing that's important to remember about supply and demand in the used car market in Canada is that the demand side is fairly volatile, and is closely linked to the health of the economy. Whereas the supply side is dictated by how many leases were signed 3-4 years ago and is much more stable.

And when it comes to the retail new vehicle market today, we see it dropping by at least 25% this year. Which means that in 3-4 years time, there will be less supply, potentially tilting the market in the other direction of greater demand than supply.

But for now, the good news is that vehicle manufacturers are beginning to open their factory doors again. But it's important to realize they're going to have a reduced capacity and will be producing vehicles at a much slower rate than before the shutdown. So unfortunately, you should expect most vehicles you ordered in the first quarter to be delayed, and possibly even cancelled.

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So what's the solution to all of this?

Unfortunately, until the economy recovers, it's wise to expect pretty poor results on vehicle residuals. It will take the Canadian and the United States economies reopening and travel between the countries starting up again before the used vehicle market gets back to where it was—two things that are out of our control.

Until that happens, here are some tips on how to minimize your losses on used vehicles.

How to Protect Yourself from Losses During This Time

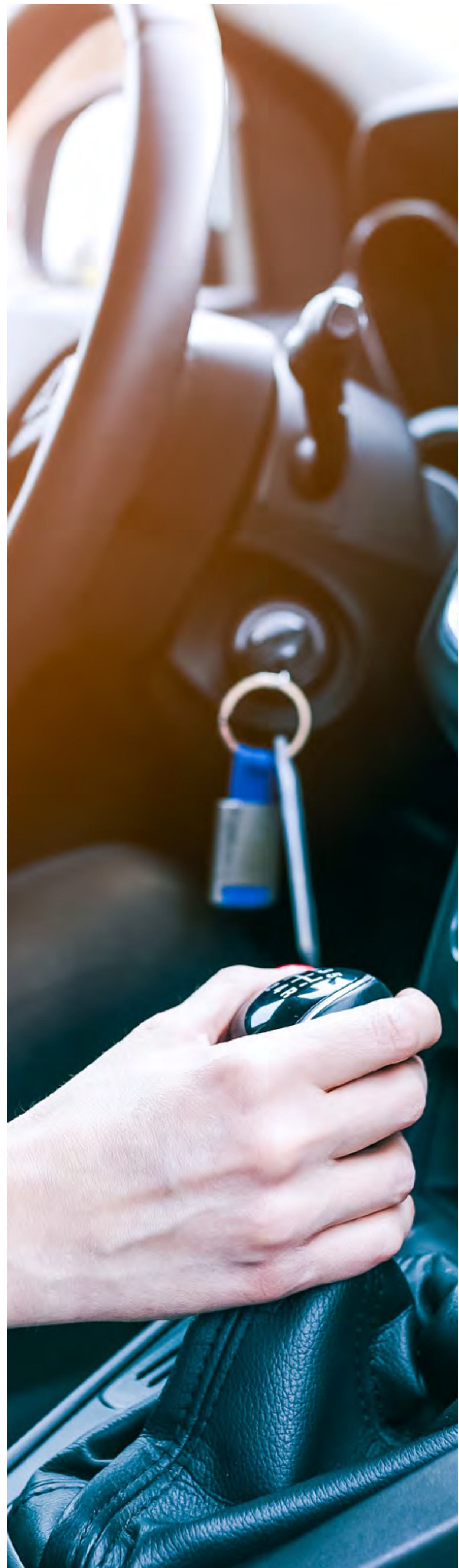
We strongly encourage you to keep your current vehicles on the road due the current state of the wholesale market. By keeping vehicles on the road and away from the used vehicle market, you'll reduce your losses.

But we understand that not all situations allow for this. If you can't avoid selling your vehicles right now, it's essential to do the proper reconditioning and repairs to ensure they really stand out at auction for the few buyers that are available right now.

So take a look at your vehicles and determine whether you can and want to extend your leases. Your answer to the question will depend on the condition of the vehicles, the make-up of your fleet, and the market for each particular vehicle segment.

This is a worthwhile conversation to have with your fleet management company (FMC). They'll be able to help you make a decision about whether you should restructure your leases to lower monthly payments by term extensions or sell them in the current used vehicle market.

Now let's take a look at common mistakes to avoid while we're in this challenging market.



Four Mistakes to Avoid When Trying to Minimize Losses

Mistake 1: Taking your vehicles off billing

Many companies are considering keeping their vehicles off the wholesale market to wait for it to improve and allow their vehicle book values to come down. This is a good thing. However, some are also thinking about taking them off their billing, which is a mistake.

Taking your vehicles off billing right now will result in some big challenges down the road. If the vehicle market doesn't improve soon, and you stop depreciating your vehicles, your losses will continue to increase. So instead, we recommend you keep your vehicles on billing for as long as you can.

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Mistake 2: Depreciating vehicles based on the current market

One thing we see over and over again is companies making decisions on depreciation based on the performance of the current market. If you make a decision to depreciate your fleet based on what's happening today, you'll end up severely over-depreciating your vehicles.

If you use average historical depreciation rates, it results in a 50/50 chance of gain or loss. One organization may be comfortable with a 50% chance of a gain whereas another may be more comfortable with an 85% chance of a gain on sale.

For example, we could see the exact same vehicle in two different fleets, both in similar operating conditions, but with different depreciation rates and residual values because the two organizations have different tolerances for risk.

From our years of experience with fleets, we know that not many organizations are comfortable with coin flip odds.
So as a fleet manager, you should spend time within your own organization trying to get a feel for your company's risk tolerance. That way you can tell your FMC what works for you.

Once your FMC has a clear understanding of your tolerance, they can come up with a probability of success that you're comfortable with—often within the 65-85% range for most companies.

This approach to depreciation ensures that you have a solid explanation for your financial department on how you picked the depreciation rates and why you're making certain decisions.

Mistake 3: Underspecing your vehicles

It's a familiar situation: When the market gets tough, fleet managers feel pressure to lower costs. One way they do so is by lowering the specs on vehicles. This makes each vehicle less expensive to purchase. And while it's important to always make sure you aren't over speccing your vehicles, underspeccing can cost you down the road.

For example, if your fleet generally uses Ford F-250s, and, in an effort to reduce costs, you switch to F-150s, you could end up with costly maintenance issues, and lower residual value 3-4 years later at auction because of the condition of your vehicles.

So take some time to discuss with your suppliers to make sure you're getting the right vehicles for your organization. Even if it costs a little bit more upfront, it will save you money down the line.

Mistake 4: Choosing diverse vehicle suppliers for your fleet

It's not uncommon for fleets to have a fairly diverse roster of vehicle brands. The problem with this approach is that it often involves receiving lower fleet incentives if you had concentrated your orders with a couple of manufacturers.

Of course, whether to go with one or several manufacturers often depends on the needs of your fleet. Perhaps no single manufacturer can meet all your needs.

But it's always worth looking at the makeup of your fleet, to see where you're being unnecessarily diverse in your purchasing decisions. Taking this critical look can save a lot on the purchase price of your vehicles.

Conclusion

Until the used vehicle market normalizes, fleets will be in challenging positions. Many may experience increased losses. But steps can be taken to reduce the impact.

- Keep vehicles on the road for as long as possible.
- If you decide to park them, keep them on billing.
- If you need to sell vehicles, recondition them well to make them shine at auction.
- Create a depreciation strategy. Take into account both average depreciation rates throughout the cycle and your organization's tolerance for risk.

Doing these things will put you in a position to be able to sleep at night during challenging markets. We wish you the best of luck during this difficult time, and feel free to reach out to us using the contact information on the next page if you have any questions.

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