

The Outlook for Small Cars Gradually Strengthening

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Areas of enthusiasm in the auto industry last year were few and far between, but one of the segments that caused some excitement was small cars. As prices for a gallon of regular gasoline exceeded \$4.00 in June and July of 2008, consumers were thinking twice about the appeal of sport-utility vehicles, minivans and pickups. Seeing this, the automakers ramped back production of those light truck segments to 45% of total North American units from what had been 55-60% for the previous seven years. They also started implementing longer-term changes to serve this market shift, looking at how to accelerate or expand their small car offerings. For example, Ford announced in July 2008 that three of its truck plants would be converted to car production: Michigan Truck (Wayne, MI) to build a Focus-type C-segment-car in 2010; Louisville Assembly to build a C-car in 2011, and Cuautitlan, Mexico to build Fiesta small cars by 2010. Of course, when gasoline prices fell to a weekly U.S. average of \$1.61 for a gallon of regular by the end of December in the course of the global economic downturn, all this accommodation of the small car segment began to look like a not-so-hot idea.

The results of a recent study by the Insurance Institute for Highway Safety (IIHS) might throw more cold water on small car fever. The study reported that in crash tests between minicars and their mid-sized brethren (the Toyota Yaris vs. the Toyota Camry, Honda Fit vs. Accord, and SmartForTwo vs. Mercedes C-Class), the minicars experienced intrusion into the occupants' space from windshield pillars, instrument panels, toe boards and steering wheels. The IIHS recommended considering purchase of the most fuel-efficient among larger vehicles, as opposed to these small, very cool, but less protective options.

Should we expect to see interest in small cars wither away due to the general American drivers' preference for safe and roomy vehicles? Not so fast. The correct answer is somewhere in the middle, as it always has been.

New small car programs that are executed well are always popular. Remember that the redesigned Honda Civic was named 2006 North American Car of the Year by a panel of automotive journalists. The compact car was highly recommended for its styling, handling, features, and the performance of its 2.0-liter engine as well as its 30/40 city/highway mpg. As *Motor Trend* magazine advised its car enthusiast audience, "Forget what you think you know about this Honda. The outgoing 2005 Civic was a quality automobile – well crafted, capable, a strong value – but it didn't tingle the fingertips, never moved the 'gee' meter. The new 2006 Civic does.... The automotive joy that Honda Motor Company was founded on radiates from these new Civics." A model like the Civic resonates well with buyers that already favor compact and subcompact cars. In addition, it can attract new buyers to the segment, whether because they are looking for automotive joy or because the Honda Civic offers just the right combination of quality, affordability, and design.

Another factor in the level of interest in smaller models comes from buyers that are more focused on environmental benefits than affordability. With the tightening regulations on fuel economy and emissions reduction, there is further incentive for automakers to get it right with small cars.

The latest round of stronger standards began in March 2006, when the Bush administration increased the Corporate Average Fuel Economy truck requirement to an average of 24 mpg for model year 2011, and changed the methodology to calculate a target for each vehicle based on a measure of its size called its “footprint,” instead of using categories of sizes. This was the first change to the CAFE program in over 25 years. Subsequently, the energy bill passed in December 2007 further required a 40% increase in car and truck fuel economy standards by 2020, to a 35 mpg fleetwide average. In March of this year, the National Highway Traffic Administration rolled out the first standards associated with that mandate. And if that wasn’t challenging enough, the recent Environmental Protection Agency ruling that greenhouse gas emissions are a public health threat signals that automakers and suppliers will need to be aggressive in designing vehicles that meet national objectives for reducing dependence on foreign oil and also burn as cleanly as possible (which are sometimes conflicting objectives).

Oil prices will certainly rise again as the economy recovers, and regulations designed to implement the common good will inspire small car solutions. Additional strategies for increasing consumer receptivity to environmentally-friendly choices (e.g. the current consideration of cash-for-clunkers stimulus) will also be part of the landscape. Putting all this together with changing U.S. demographics suggests a future in which small car segments play a more prominent role. But offsetting factors such as safety, comfort for drivers and passengers of generous girth, and longstanding tastes mean that this will be gradual growth for small cars, not a sea change.