A Strategic Vision of Dealerships in 2025

Study into the evolution of the retail automotive industry

Auto Team America | February 2012

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Auto Team America

Auto Team America is a network of eleven CPA firms that serve over 2,000 auto dealerships nationwide. Auto Team America meets regularly to share dealership industry information and solutions to most effectively meet the needs of automotive dealers. This allows our member firms to deliver proven, industry-specific expertise in accounting, tax, estate planning, dealership succession planning, and profitability analysis and cost containment. The combined resources of the Auto Team America members allow more in-depth and specialized training for our personnel. The goal is to help dealerships become more efficient and profitable.

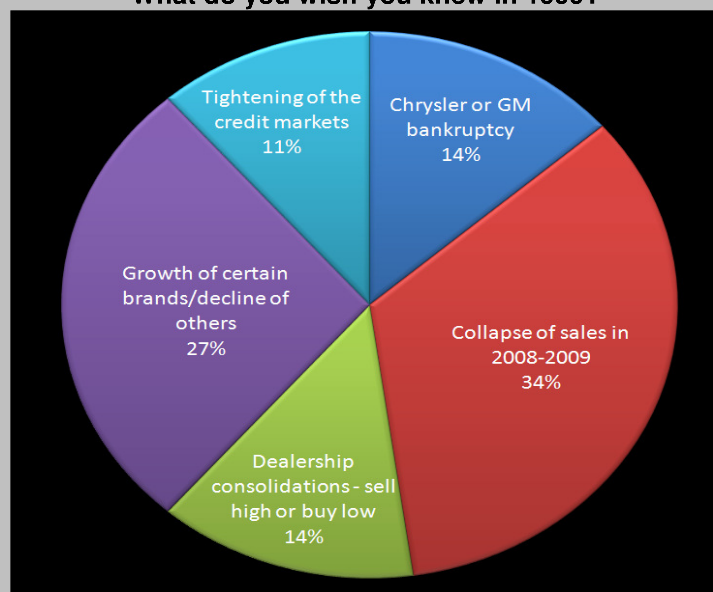
Beyond traditional accounting services, member firms have the specialized industry expertise to assist their dealership clients in navigating the rapidly changing landscape of retail automotive dealerships. The following study and report is the product of research, input and interviews of retail automotive experts from across a range of disciplines. Dealership principals and managers were also interviewed to provide feedback on the direction and changes they see transpiring in their dealerships and of their peers. The development of the report was led by a steering committee that included the following individuals:

- Richard Sox, Partner, Bass Sox Mercer
- Jay Ferriero, President and Chief Operating Officer, Capital Automotive
- Mike Hoin, Senior Vice President, Comerica Bank
- Karl Schmidt, Chief Operating Officer, Morrie's Automotive Group
- Dale Pollak, Chairman, vAuto
- Bradley Nicklin, CPA, Partner, Baker Tilly Virchow Krause, LLP
- Scott Gorden, CPA, Managing Partner – Dealerships, CliftonLarsonAllen LLP
- David Wiggins, CPA, Partner, CliftonLarsonAllen LLP
- Jodi Kippe, CPA, Partner, Crowe Horwath, LLP
- George Berry, CPA, Partner, The Mironov Group, LLC
- Rob Campbell, Analyst, The Mironov Group, LLC
- Ernie Tyler, CPA, Partner, Tyler, Simms & St. Sauveur, P.C.

Introduction

After surviving what was quite possibly some of the worst economic conditions in automotive retailing in modern times, dealerships are regaining their footing with solid profitability and are now looking forward to the future. To begin looking at what the future may hold for dealers, it is always helpful to examine the past and the connections and events that have created today's retail automotive environment. The AutoTeam America member firms started out with a basic question, "What do we wish we knew in 1999 that would have helped our dealership clients in 2008-2010 as the retail automotive market and the overall economy collapsed?" We asked dealerships nationwide this question and received some consistent responses (see chart to right).

What do you wish you knew in 1999?



Source: Auto Team America Survey, May 2011

While the answer to that question is immediately evident based on a person's individual experiences over the past decade, it is much harder to make a U-turn and begin to look forward; which brings the next guiding question, "Based on what we know today, what is the retail automotive landscape going to look like for dealerships in the year 2025?"

That question opens up a wide range of possibilities and an even greater array of potential answers. There are some experts that see continued doom in the industry while others see a return to the glory days of big new vehicle grosses and a return to the traditional business model of the distant past. With such diametrically opposing outlooks, it can be difficult to reach a consensus of opinion.

Overall, we believe that operating profits for dealerships in the Year 2025 will be driven by three main factors:

- The ability of a dealership group to expand their brand portfolio by leveraging greater economies of scale with geographic regions.

- Technology advances that will greatly expand vehicle throughput and reduce personnel costs.
- Changing real estate requirements as a result of faster inventory turnover and relocation of some departments to lower cost locations.

The best way to see how these factors will impact the dealership operations is to follow them through each department and the overall atmosphere that dealerships will face in the future.

The following white paper is intended to not only to voice our outlook but also to state the case behind the final conclusions reached in the report. While outside influences will certainly impact operations, they are beyond the scope of this paper. This includes influences as varied as the recent catastrophic natural disasters that have crippled manufacturing operations and the supply chain; to more traditional issues of the general economy, interest rates, unemployment and related macro-economic conditions. Instead, we concentrated on dealership operations as they continue to evolve and to focus on addressing the opportunities and challenges that lie ahead within the industry.

Dealership Sales Environment

"Nothing happens in a dealership until a car is sold" might be an oversimplification, but it is the best starting point as we tour the dealership of the future.

There are two major categories of customers in the sales funnel – shoppers and buyers. The dealership's goal has always been to turn a shopper into a buyer, or to push the customer down the sales funnel. Stepping into the New Vehicle Showroom of 2025, the foundation of the sales process has been transformed.

As a dealership operates in 2012, customers come into the showroom further down the sales funnel than fifteen years ago due to internet research, lead generation communications, and the ability to shop inventory and price vehicles electronically. With increasing availability of various research tools, consumers continue to be closer to a purchase decision before they walk into the dealership showroom.

Technology Advances

We expect this trend to accelerate into the Year 2025 with most of the shopping experience and vehicle research – both in and outside of the dealership - being primarily driven by technology with minimal interaction required with the dealership sales staff. It is no great leap to see that the sales process will be much shorter with the proliferation of technology in every facet of daily life.

The advances in technology will involve a variety of sources, including those available today and also include sales kiosks placed in dealerships and in multiple retail environments, such as malls. Smartphone applications, tablet computing and ubiquitous high-speed Wi-Fi are just now gaining momentum and will play a significant role in the dealership of the future. In a general sense, the dealership will adapt from the current showroom model into a more modern retail environment and the business will be managed as such – using a much greater array of technology tools to target and reach the new generation of consumers.

Generational Shift

While much more of the early vehicle sales process will happen with minimal salesperson contact in the Year 2025, it does not mean the showroom floor will be void of skillful salespeople. A significant challenge dealers will need to address is that there will be three distinct generational/ shopping preferences in the marketplace. Just because Generation-Y (1985 to 2005) members might shy from interpersonal communication with a salesperson, Generation X (1964 to 1984) and Baby Boomers (1947 to 1963) will still be active in the marketplace. Additionally, there will always be exceptions to the generational stereotypes that prefer interaction with a salesperson.

Training staff to be sensitive to all three generations and the flexible sales approach will be crucial to a dealership's success in the Year 2025. This will require sophisticated training. However, since a large portion of the consumers coming in are further down the sales funnel it will be inefficient for the same sales staff to handle all types of customers and buying habits. Segregation of duties from product introduction, research gathering and inventory assistance will be performed either through technology or via "product specialists" in the store.

Obtaining a financing source will be conducted during the pre-purchase decision process. Consumers will continue to be able to leverage the wide array of bank choices that the dealership can provide at a single point. The application will be done in the dealership or through the lending institution websites. Again, consumers will have a choice to either go through the entire buying decision, right up to delivery, with limited interaction with dealership sales personnel or through traditional methods.

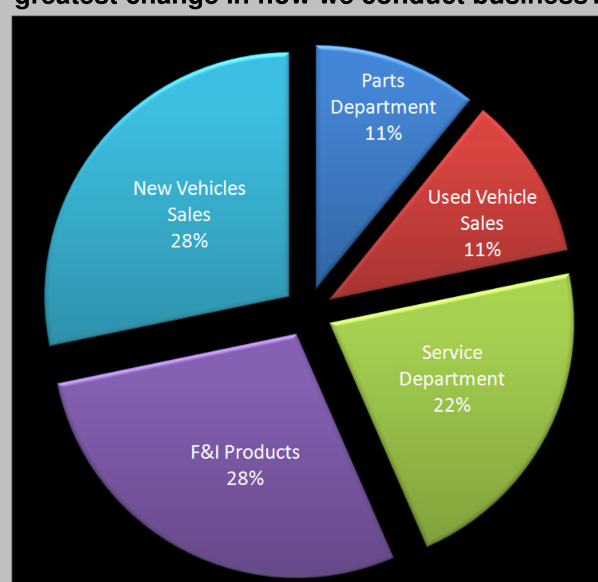
Changing Job Responsibilities for Salespeople

When the consumer reaches the point of purchase and is signing on the dotted line, we believe the actual sales transaction, at its core, will be the same in 2025 as it is today. At the end of the day, someone still has to close the sale. Regardless of how willing a consumer is, the purchase is still a major one and it takes a skillful salesperson to guide the customer so that they are making decisions comfortable to them. Additionally, due to regulatory and manufacturer requirements the actual closing process will still take place in the dealership, with all the required forms being completed electronically and vehicle delivery occurring at the showroom location. (State franchise laws may vary to allow delivery outside the showroom, but the predominance of states will continue to restrict sales to the dealership location.)

However, the salesperson will not be occupied with pushing the consumer down the sales funnel – they will already be there. Therefore, the pace of transactions in a dealership will accelerate. Whereas, today a monthly sales rate of 12-18 vehicles per salesperson might be acceptable, in the future the rate will be double. Some will get their customers via a referral from the product specialist, but most will be a "technology turnover."

The salesperson will have to heavily utilize technology to guide their work and the consumer through the purchase process. There will be a continual build-up of regulations and policies aimed at fair and secure transactions. The only efficient way to address compliance on every transaction will be by leveraging technology. Since the technology will ease some of the burden on the dealership, and due to consumer-oriented legislation and regulation, the Finance & Insurance department will once

What area of dealership operations will experience the greatest change in how we conduct business?



Source: Auto Team America Survey, May 2011

again be absorbed in to the salesperson position. Items currently determined as “aftersale” will migrate to “pre-sale” or be part of the overall buying process.

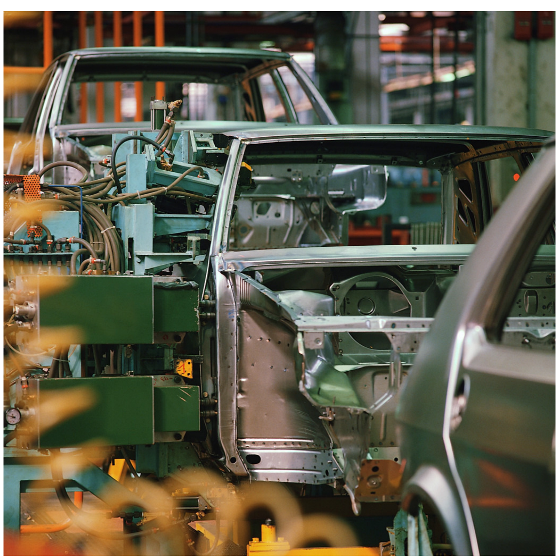
Evolving Vehicle Types

What types of vehicles consumers will be purchasing continues to be a lightning rod of debate involving two diverse topics; the penetration rate of hybrids or Zero Emission Vehicles (ZEV) and the ability of the manufacturers to build vehicles to order. Due to production constraints and the speed of technological advancements, we see hybrid propulsion systems being no more than 25% of the total market with ZEV (pure plug-ins) at 5% to 8%. While CAFE standards will continue to push manufacturers to develop fuel efficiency and cut emissions, we believe a modified version of the current internal combustion engine will still be around in the year 2025.

Vehicle Customization, “Build-to-Order” and Distribution

An observation of the current market had two opposing forces – increased vehicle personalization comes up against the production needs of the manufacturer. In reality, build-to-order has existed for many years. It just takes the manufacturer several months to complete the process which is beyond the patience of most customers, especially the new Generation Y that will be in the market in the year 2025. Even a wait of several weeks will be unacceptable for the Now Generation. What would be the acceptable wait time for a consumer ordering a “custom made” vehicle?

Typical build-to-order production instead relies on standard platforms with limited, readily swappable parts. Such an example would be Dell Computers, which as of this writing has an average 10 days wait time for nearly every produced desktop or laptop. Since few things are as complex as an average automobile, the ability to customize will be limited to those items that can easily be added or removed. In a vehicle of growing complexity and interoperability, those choices will be increasingly less. While there might be some components that could be added to a base platform to accommodate some vehicle customization, it will not rise much beyond the current level of accessory types of additions available today.



In order to fulfill customer demands, vehicle locators have for decades allowed dealerships to acquire from each other’s available inventory. The challenge related to this process relates to finding a dealer willing to go through the hassle and expense of a dealer-trade/purchase. In the future, the distribution method will utilize redirected inventory in transit, pooled inventory by market area, limited market/distribution point customization of vehicles or a combination of several solutions to get the consumer’s desired vehicle with minimal dealership involvement. While dealerships always prefer to sell out of their inventory, one of the main reasons consumers cite for not purchasing a vehicle is the dealership did not have the vehicle they wanted. For the most aggressive manufacturers, customization could come from a virtual dealership website that would locate and automatically pull a vehicle out of any dealer's inventory and direct the customer to their local dealership to complete the transaction.

Of course, before those wheels are set into motion, the customer must have already qualified for any required financing and come to a specific purchase decision. If vehicle customization and acquisition trends continue, then it offers further proof that much of the F&I sales process will be flipped to the other side of the purchase decision.

Increasing Regulations with F&I

This brings up the next significant structural change within the dealership sales process that will be in place in the Year 2025. Increased regulation will erode dealership profitability and make the transactions even more complex than they are today. The complexity will be reduced through technology that will provide some relief to dealership staff and consumers through the process. Since much of the customization of after-sale products and finance qualifications will happen prior to the close of the sale, the function of F&I will be reduced to compliance. New technology innovations will make compliance easier, so the final compliance items will be performed with a delivery specialist or salesperson at lower cost to the dealership.

In some regards, such a vision paints a challenging outlook for the potential of profits for new vehicle sales in the Year 2025. In the back-end, F&I profits will continue to evolve from variable gross based on what the transaction will bear to a fixed "per-unit" basis with flat fees/commissions on F&I products. In the front-end, the transparency of the market will continue to erode gross profits on per unit basis. While dealership consolidation will limit competitors and diminished production will keep many vehicle products scarce for a period leading up to 2025, the manufacturers have never had the discipline to maintain scarcity to inflate profitability percentages. That lack of discipline will result in increasing production over the period between 2015-2025, until once again the norm will be too many vehicles chasing too few buyers.

Greater Factory Influence

The manufacturers will compensate for the excess production levels by offering greater dealer cash and rewards to their dealers. As the long trend of non-existent front-end gross continues, the manufacturer incentives on the back-end to the dealer will increase which will allow for profitability on sales. With greater payments from the manufacturers comes greater influence and control on how the dealership conducts business. Since the dealer incentives are the difference between being in business or not – facility requirements, business practices, advertising requirements, stocking guides and more will make the Blue Oval-esque requirements of the distant past seem docile. The only hold against the tide of manufacturers looking to micromanage the dealership without taking any of the responsibility or capital risk will be increasingly specific state franchise laws to protect the dealership's investment.

Commoditization of Used Vehicles Sales

Moving to the pre-owned vehicle department we see similar changes in the sales process and inventory. The first change is the final acceptance that technology has resulted in the commoditization of used vehicles and no longer is any dealership's inventory unique. That 2-year-old blue sedan with 22,000 miles is not so special when within a couple of clicks consumers could find dozens of similar if not identical vehicles. While 2010 – 2017 was unique in the used vehicle market due to a low trough of production and availability, by 2025 there is normalcy in used vehicle availability and pricing.

While that commoditization has eroded gross retention on used vehicles, the same technology has made the department much more efficient. Physical auction visits are rare, as program/remarketed vehicles are sold via online bidding. Outside wholesale buyers likewise bid on vehicles in an online marketplace, allowing the dealership to maximize wholesale profits.

Auctions, the manufacturers, and other large remarketers of vehicles will be able to acquire more products for specific market demands. The market will continue to push manufacturers to maintain high residual/pre-owned wholesale values – forcing more vehicles into their branded Certification process. Manufacturers will begin to recapture the dealership's internal repair order gross profit by reconditioning vehicles to certification status before remarketing them. Pre-reconditioned vehicles will be priced $1,500 - $2,000 higher than their peers and will offer a greater warranty against appearance and maintenance items. A few manufacturers, especially those with a high penetration of hybrids or low mileage leases, will take the next step in "certification" and begin to offer "refurbished" vehicles. These vehicles will have more components inspected to a greater degree and replaced as necessary. Complete system modules (propulsion, suspension, entertainment, etc.) that can be swapped out of the vehicle with inexpensively rebuilt modules offer more credibility to the "refurbished" label.

With control over the flow of first remarketed vehicles (off-lease/off-fleet) and encroachment on reconditioning, once again the factory will be expanding their influence over dealership operations in order to gain access to those vehicles. To counter this, the dealership has the ability to go outside the factory channel to acquire used vehicle inventory. While the vehicles might not be of the same quality, they can be made so. That will make the pre-owned vehicle department one of the key business segments where dealerships will continue to be able to chart their own path and be responsive to their individual market needs and business goals.

Dealership Fixed Operations

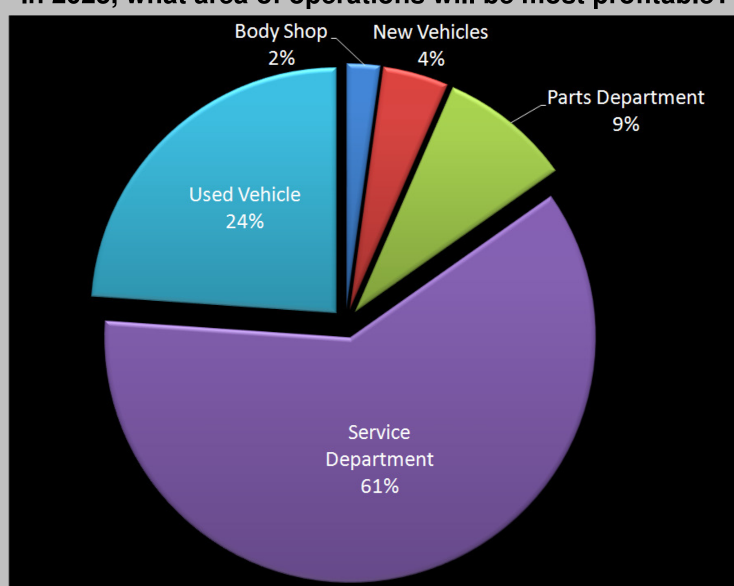
The transformation continued through fixed operations as vehicles and customer habits changed. The easiest changes to see are in the parts department. The past several years leading up to 2012 have seen the manufacturers work on perfecting stocking guides and improving automatic replenishment of dealership inventories. Better logistics, improved demand analysis, careful selection of strategic warehouse locations and more common vehicle systems in 2025 allows even more efficient control of inventory. Dealer-to-dealer transactions through the manufacturer parts locators will also improve movement between dealer inventories. Overall, manufacturers will control 90% of dealership inventory with guaranteed buybacks, eliminating much of the past obsolescence issues.

Parts Department

With timely delivery of parts improving, the average turn of dealership inventory will improve to six to eight times a year. It could climb as high as twelve, but manufacturer demands to keep more breadth in their managed part numbers will hold the average lower.

Parts gross profit will remain highest on most non-maintenance parts. The lack of aftermarket competition on many specialty parts, the relative high cost of shipping with OEM/dealership internet sellers, and a decreasing Do-It-Yourself market will help maintain gross profit percentages.

In 2025, what area of operations will be most profitable?



Source: Auto Team America Survey, May 2011

Dealerships will need this revenue stream from retail customers as the viability to remain in the wholesale parts market will erode. The OEMs and local Warehouse/ Distributors will look to compete more effectively in the wholesale and collision business.

Service Department

The service department will continue to be the most profitable department for dealerships. This is in spite of a reduction in the maintenance requirements, extended maintenance intervals, and more manufacturers covering maintenance items under the new vehicle warranty. The growth over the next decade will be in customer repair work. This will not be due to a decrease in quality but an increase in the average vehicle's age, the complexity of systems and several new propulsion systems that will have limited repair expertise in the market place. The aftermarket simply will not be able to keep up regardless of the final results of so-called “right-to-repair” legislation as the cost of entry for the training, tools and knowledge will be too high.

Also assisting service department profitability will be increasing reliance on remote diagnostics, where vehicle monitoring systems will alert the driver of an error and automatically upload data files to the manufacturer and dealership. Such systems will not only directly encourage the use of the dealership service facilities, but it will also passively encourage it as the diagnostic information is already there and ready for the customer, making a more efficient service visit.

Such systems will also develop to a point that under warranty repairs, required parts will be automatically sent to the dealership. While it makes sense with the reduced costs of distribution and automatic buyback guarantees to ship small cost parts to the dealership in preparation of the repair, this will actually be truer of complete assemblies. As discussed with vehicle reconditioning, systems will grow in complexity making it common for complete systems to be swapped out as whole “modules.” These modules will then be returned to the manufacturer for rebuilding. If a major fault is detected with a large assembly, the most efficient and cost effective repair will be to swap out the easily replaceable and rebuilt module.

Having a stream of information being fed to the service department directly from the vehicle will also aid the write-up process. This will allow the dealership to not only have electronic communication with the vehicle but also the customer. Much of the repair order will be pre-populated upon arrival at the dealership that will free up time for the service advisors to build a relationship with the customer.

Dealership Facilities and Structure

With so many changes to the sales and service transactions, it follows suit that the dealership physically has to change as well. Dealership facilities are more complex than they appear on the surface. Facilities have to balance the desires of the manufacturers, the needs of customers, reasonable capital expenditure by dealers, state franchise laws, existing dealership property, and the normal regulatory environment of the community.

Yet, there are some forces that will work towards shaping the look of future dealerships. While the current trend is bigger is better, that does not necessarily hold true as dealerships look to have faster throughput of inventory, cleaner “retail” environments and more efficient operations. If future dealerships must sell more vehicles, with fewer salespeople at lower operating costs, the logical conclusion is that dealership locations will shrink in physical size and footprint. The high price rents and real estate frontage on desirable highway and premier retail locations will be cost prohibitive.

While it might be tough to see in today’s “mega-store” mania, as margins on many dealership products shrinks or at least fail to grow, the economics of the dealership will dictate that a more skillful use of space and capital resources will be key to survival. Efficient vehicle inventory management and service operations will curtail the need for storage space. The showroom filled with salesperson desks and F&I offices will be consolidated down to fewer desktops. Test drives will be accomplished by a true “demo” fleet, and vehicles will be sold out of the dealership’s limited inventory or through more sophisticated locator programs. To better serve customers and to have a an improved cost structure, satellite facilities for service will become prevalent in lower cost spaces where allowed by the manufacturer or state regulations. When allowed by state franchise regulations, there will also be small satellite sales facilities for demonstration and presentation purposes only.

One of the energizing forces towards the smaller footprint will also be continued consolidation of dealership groups. This will allow consolidation of vehicle preparation, reconditioning and business offices into central, low cost facilities. This will allow customer exposure to new vehicles in an unobtrusive environment; however the final sales transaction will still need to be completed at the primary dealership location.

Given the current marketplace environment, with the capital requirements and needs for professional management, there is no doubt consolidation will be the largest factor impacting the face of dealerships by 2025. Consolidation will accelerate dealership buy-sell transactions over the next ten years. As ownership condenses into 80 to 100 mega-dealer groups owning hundreds of dealerships initially the pool of selling dealerships to potential purchasers will be disproportionate, creating a buyer’s market and stagnating prices. However, as the selling pool diminishes by 2020, a seller’s market will take over. By 2025, the mega-dealer groups will control a significant number of dealership points.

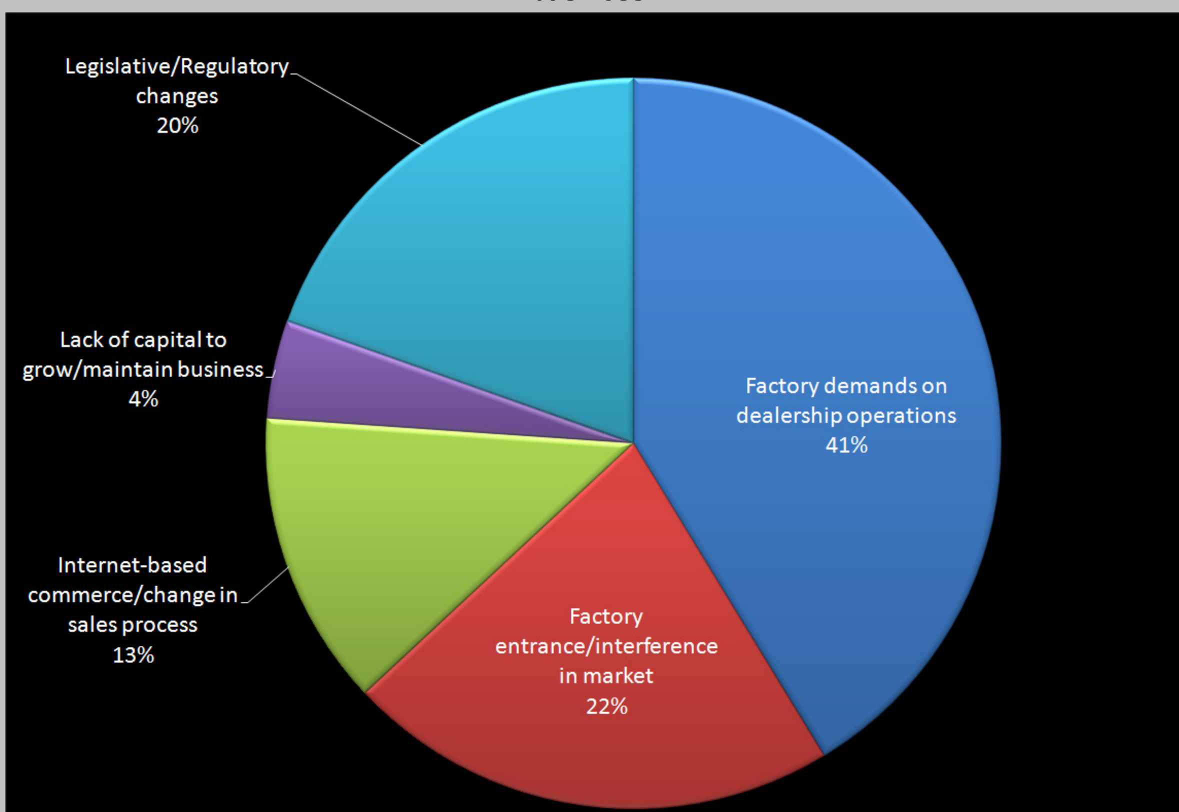
Other Influences of Dealership Business

Dealerships do not operate in a vacuum of only selling products and services to customers. There are pressures from government regulators, consumer organizations and the manufacturer. These pressures cannot be discounted as they shape the way the dealership conducts business.

In the recent Auto Team America survey, 63% of respondents believe that the factory will become more involved in daily dealership operations. This includes the manufacturer actually attempting new ways to enter the retail marketplace in apparent competition with its dealerships.

While strong state franchise laws prevent this in most parts of the country, the single most effective way the manufacturers have found to guide dealership behavior is through direct cash incentives based on its goals. Payments for increased sales volume, facility appearance, and customer satisfaction scores are common place in 2012 and the expectation is this trend of growing manufacturer influence will increase in the future.

What is the greatest threat to the current automotive franchise system and way of conducting business?



Source: Auto Team America Survey, May 2011

By 2025, manufacturers will recognize that those that overstep the bounds of interference in the retail environment will harm their relative value of the franchise brand. Meddling in dealership operations will only be tolerated by sophisticated dealerships up to the point where the franchise is profitable and desirable (such as some import highlines today). For the less desirable brands, overtly oppressing dealerships with expensive and unnecessary requirements will not increase their brand image but rather cause it to fall as the franchise will become less viable and less valuable. This will deter the brand from investment from the well-managed dealership groups they hope to attract.

Higher Earnings Multiples in the Future

Regardless of the future value of an individual franchise brand, as the decade progresses the multiple of earnings for the valuation on dealerships will increase. If the current multiple ranges from three to five times earnings (with thousands of factors influencing valuation to an individual buyer and seller), by 2025 the multiple will be four to six times earnings or greater. The injection of private equity against public companies, the ability of large groups to have a lower cost of capital and the ability to leverage their presence in the marketplace will cause values to rise.

Besides, or in some case in spite of, the franchise brand, the dealership's real estate position (i.e., not overly built-out or burdensome) and purchasing group's ability to economically assimilate the store into its other operations will be key to the dealership's valuation.

New Entrances from Foreign Automakers

One question for the future of franchise values is the possibility of brand entrance to, and exit, from the market. Chinese and Indian brands are expected most, but one cannot discount the possibility of a technology player (e.g., Tesla) entering the market as well. However, for the foreseeable future those countries domestic demand will outstrip the need to export into the U.S. In an age where experienced, well-organized manufacturers are fighting to maintain fractional market share (e.g., Suzuki, Mitsubishi, Volvo), the entrance of yet another maker into the market does not look positive. The more likely, and profitable route for manufacturers and distributors, is to arrange a production agreement with rebadged vehicles.

Greater Regulation and Consumer Protections

A given trend in the retail automotive industry is increasing regulation and consumer protections. Few industries are as heavily regulated as retail automotive and no participant or observer of the industry expects that to change. As noted previously, as new regulations come into play dealerships will have to increasingly rely on technological solutions to assure compliance. Technology will not be free, and only dealership groups of a certain size or scale will be able to economically comply. Such regulations will also certainly come at a cost of compliance and potentially reduced gross. Flat rate finance reserves and limited grosses by statute will compress the traditional F&I product's revenue.

Beyond the retail transactions, other governmental policies will impact dealerships. Environmental regulations, including increasing CAFE standards, will mandate new vehicle systems, hazardous containment and recovery systems and strongly encourage the use of renewable energy for dealership facilities. Energy saving lights, heating, cooling and computer use will help defray the dealership's environment footprint costs.

Executive Summary

As a result of the shift in consumer demands, desires and habits regarding retail and specifically, new vehicle shopping and purchasing, we anticipate the following will occur by 2025:

- The average dealership will triple throughput and sell 175 new units a month.
- Smaller staffing requirements will result from the use of technology to be more efficient.
- The F&I department will face the greatest transformation from technology and regulatory changes.
- The top 80 – 100 mega-dealer groups will own a significant portion of the dealership points in major metro-areas.
- Variable gross margins will be compressed and compensated by direct dealer payments from the manufacturers.
- Shrinking gross profit margins will be offset by a lower cost structure.
- Service and parts will change their business but profits will remain relatively consistent.
- Factory influence over the day to day operations of the dealership will be expanded.
- Increasing consumer regulations will continue to shape the dealer's business model.
- Smaller footprint stores in prime retail areas, with remote storage and/or satellite repair centers.
- Technology advances will drive significant changes to the dealership operating model.