

## 2025 Dealership Vision: What Lies Ahead!

**AutoTeam**America<sup>★</sup>



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# Introduction

Two years ago, AutoTeam America member firms started a project with a simple premise – what should dealers and automotive professionals know today to prepare them for the reality of 2025 and beyond. With so much effort in retail automotive being occupied with completing a strong month, it is a welcome break to look a dozen years ahead and begin strategic planning now.

Our original white paper was tinged with the lingering effects of recession, manufacturer bankruptcies, and massive reductions in the dealership head count. Still the vision put forward was one of “dealers continuing to be dealers” by adapting to the changing landscape but still very much in the business of selling and servicing vehicles.

While there were differing discussions about the nature of those changes two years ago, we did find a near unanimous opinion that dealership ownership was going to contract. Consolidation that accelerated through the recession showed little signs of slowing. The compression of gross margins, the increased capitalization requirements and other factors all pointed to fewer dealership owners if not fewer rooftops.

Two years later, consolidation continues, but our eyes have been reopened to many varying visions of the future of ownership. We conducted an opinion survey of dealerships across the country to help focus on some critical issues that may occur over the next dozen years related to ownership. One question we asked is, “What would best describe your dealership/group’s acquisition activity in the coming decade?” Given four choices:

- Aggressively seeking to add dealership points/franchises
- Looking to purchase when the right deals come along
- Staying with current stores and growing their performance
- Looking to reduce the number of stores/franchises

69% of respondents said they are looking to grow, 30% said they are looking to grow their current store’s performance and only 1% said they were sellers. Such results would fly in the face of consolidation.

Clearly, there is a survey bias at work here as estimates of annual ownership change range from 3-5%. Still it would seem unlikely that there would be a tectonic shift in attitudes to put more sellers into the Buy/Sell marketplace.

But we are getting ahead of ourselves. The issue this paper seeks to address is, “what will the face of a typical dealership in 2025 look like.” Will they be part of a large group? Will they be factory owned? Or will it be a traditional locally owned and operated store? With such diametrically opposing outlooks, it can be difficult to reach a consensus of opinions.

Does there need to be consensus and a singular vision? There are several paths to profitability, stability and longevity. Which one taken will be based on franchise(s), market area(s), and the dealer’s personal desires.



A brief note before we begin about the limitations of this paper. While outside influences of the general economy, interest rates, unemployment and related macroeconomic issues will certainly impact dealership operations, those items are beyond the scope of this paper. Instead, we wanted to concentrate on retail dealership operations as they continue to evolve and to address the opportunities and challenges that lie ahead.

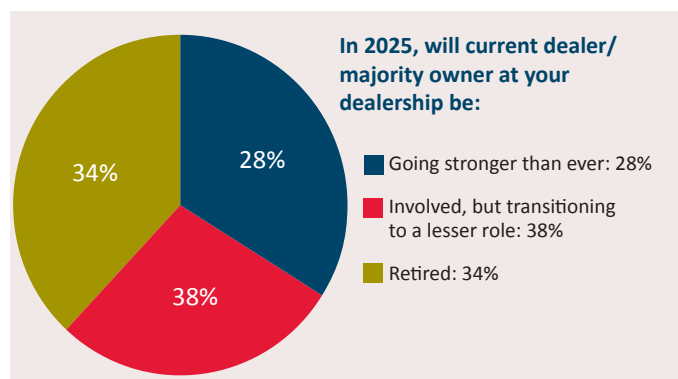


## The Consolidation Conundrum

For well over two decades, the narrative of dealerships has been one of consolidation. From the early days of growing regional groups, to the publicly held, the factory and now large private groups, there appeared to be nothing that would slow a progression until we were down to 80-100 individual organizations owning all the stores.

There is still a strong case to be made for the continued consolidation of dealerships. Simply recognizing that there are so many willing buyers as previously mentioned should be evidence enough. But where are the willing sellers going to come from?

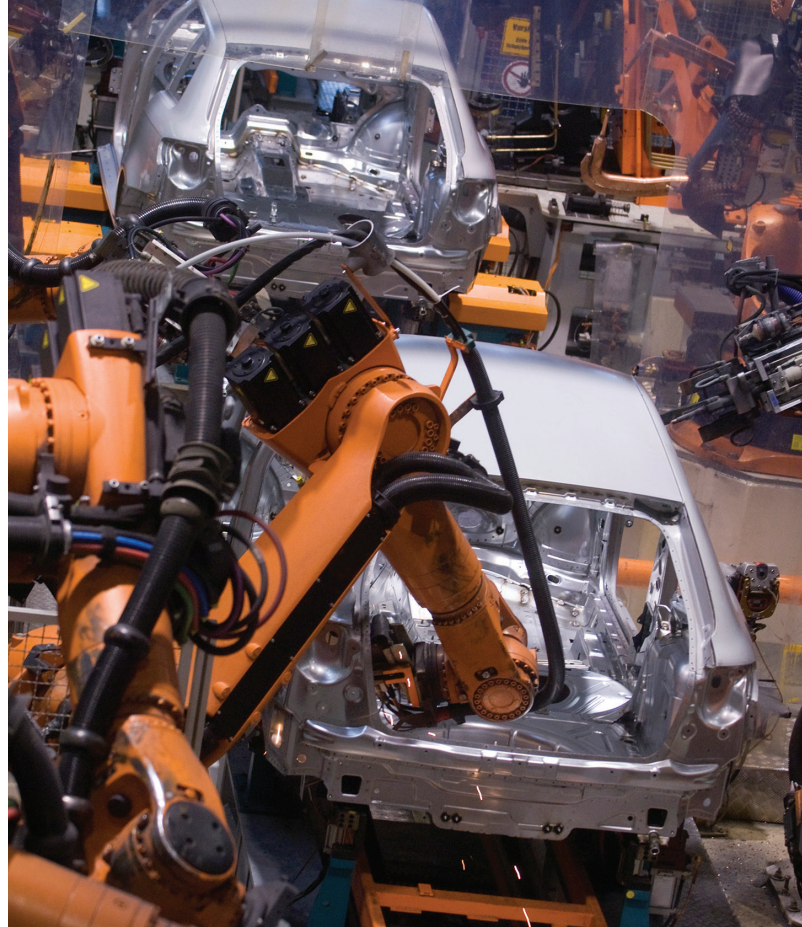
Back to our survey, we asked about the status of the dealer/majority owner in the year 2025 and received responses shown.



34% of dealers said they will be retiring in the next 12 years and 38% will be looking towards transitioning to a lesser role. Dealerships are often family operations that will likely be passed on to the dealer's heirs. The talent and desire of the next generation to run a dealership will be mixed thus causing some to consider selling. This is expected where a majority of transactions will likely occur in the next decade.

Couple this with the factory's increasing demands for facility upgrades along with the true need for some dealerships to relocate and rebuild; we will find more dealers who are unwilling to commit the capital needed to undergo major real estate renovation projects that will take decades to pay off.

These factors would point to more consolidation of regional and national dealership groups. Due to the compression of grosses, large successful groups have the economies of scale to maximize net profits. They can centralize some operations and purchasing to wring out a few extra percentage points of gross retention. They also are likely the ones with cash available and access to the capital necessary to make and complete acquisitions.



In this future marketplace, private groups will likely have the edge over publicly held groups (the publics). While publics have access to more capital for acquisitions, these potential acquisitions have to satisfy their shareholders as well as their own internal governance and policies. Over the past few years, well-heeled privates have been able to out-bid the publics simply because the deal did not pencil using the publics' internal metrics.

If you carry these forces out into the next decade, we should see the concentration of 80-100 dealer groups owning an average of 135-150 stores. Given the history of transactions over the past twenty years, it would be hard to argue against such a rapid consolidation – as was our prediction two years ago.

However, the conundrum and difficulty of such a predication is, "Can this level of growth be sustained over the life of the dealership group?" Currently, there are only five groups that would meet the definition of 100+ stores. Remove these stores from the Top 125 Dealer Group listing, and the average group currently has 16 stores. This would require a "super consolidator" to acquire ten stores a year for a decade. Not only would that be unduly capital intensive, the talent pool of getting the right person in the right store often takes years to work out. These transactions are not created in a vacuum. There are factory considerations as well that might lessen the available inventory of dealerships.

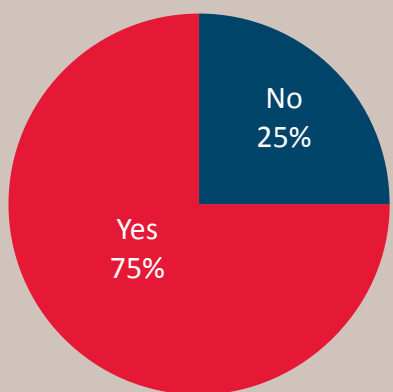
Capital may be available from private equity money but it is currently sitting on the sidelines. Equity investors want to get into the game but that comes with its own restrictions. Most equity fund managers need an exit strategy that is shorter than what would allow the dealership groups to acquire new capital. They, like the publics, have financial guidelines that might prevent acquisition of most available stores. Dealer operators would also have to abide by the investor's financial reporting policies.

To accomplish such accelerated growth, larger groups would have to begin acquiring each other. As with many things, often times the parts are worth more than the whole. This would be particularly true if parts of the selling group do not fit the acquiring group's brand or location strategy. This will likely result in large groups being splintered during a buy/sell transaction rather than swallowed whole. When a dealer group gets large, the pool of willing and capable buyers shrinks.

While consolidation of stores into ever larger groups is easy to see, these will likely be regionally based groups of 30-40 stores. Those are the dealer groups that have shown to be the most efficient in growth, management and staffing.

This leaves plenty of room in the market for the one or two store operator. In fact, they have certain advantages over the larger groups. Locally owned businesses have cachet with a growing segment of the population. These are the dealers who enjoy more than just a return on investment. They enjoy being part of the foundation of a town, being an employer, and servicing their community. If the operator is successful, these types of stores are incredibly expensive to purchase as the dealer has no motivation to sell.

### Is the dealership real estate owned by a related party?



## Fixing Facilities

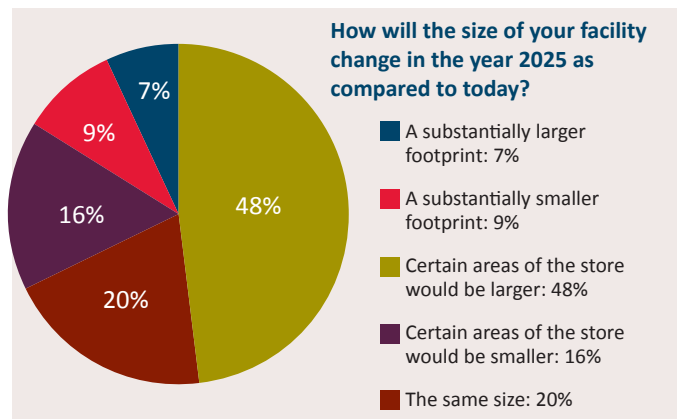
Dealership facilities are more complex than they appear on the surface. Facilities have to balance the desires of the manufacturers, the needs of customers, reasonable capital expenditure by dealers, state franchise laws, existing dealership property, and the normal local regulatory environment.

Yet, there are some forces that will work towards shaping the future look of dealerships. While the current trend of bigger is better, 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 make it cost prohibitive to have a large facility and footprint.

Since rent and occupancy expense is a big budget item, it will need to coincide with the revenue structure of the dealership. So, why has there already not been a greater movement to reduce facility costs?

Dealership real estate has not changed in retail automotive for a big reason – the dealer is often his/her own landlord. This is opposed to most retail operations, where space is rented from a mall or other retail marketplace locations.

Additionally, changes to a smaller footprint are counter to most manufacturer goals. For obvious reasons, when you do not have any costs of building ownership you want the biggest one you can force on the dealership body, with the most storage, parking and access. And maybe that is for good reason. We asked dealers if they had to consider new construction today that will serve their needs for the next ten years and beyond what would its size be in comparison to the current facilities. Surprisingly, 55% of dealers said their new store would be in some way larger, while 25% of dealers said smaller, and the remaining are happy with their current size. That does not indicate the factory is correct in many of their imaging programs, but does indicate that dealerships are not necessarily getting smaller in physical footprint in the next ten years. See chart on page 5.



In the same survey, we found that 89% of dealers are bullish about their franchise; expecting that increasing sales are going to be a challenge in their current facility. Those increased units of operation will also put a strain on their service department but that should be minimized by other factors that will be discussed later in this paper.

Therefore, the only tactic to chisel away at the dealership's occupancy costs is marginally at specific operations. For example, off-site storage facilities have allowed dealerships to reduce costs. In the next decade, we should see improvements in efficient vehicle inventory management curtailing the need for storage space. Dealership consolidation does allow for the grouping of operations such as vehicle preparation, reconditioning and business offices into central, lower cost facilities. In some cases, off-site service facilities allow the dealership to service many makes in a lower rent district.

When allowed by state franchise regulations, there will be more small satellite sales facilities for demonstration and presentation purposes only. The main "rooftop" will likely remain unchanged. While many may want to point to other retail markets as indicators of the dealership business, they often fail to account for the complexity of automotive transactions. As opposed to a refrigerator or patio set, an automobile is a titled piece of property which requires compliance to perfect the lien, register and operate. Many state franchise laws and territory encroachment rules require that the sales transaction be completed in a very specific showroom location. These two factors alone minimize the chance for a sweeping change in the dealership facilities other than continued image programs pushed by the manufacturers.

## Your 2025 Financial Statement

While financial performance varies widely by manufacturer, location and size we know there are trends that compose the average dealership. Like everything in the dealership, we begin with new vehicle sales. The projected 2025 annual vehicles sales vary depending on the source, but 17.9 million units seems to be the median

prediction. Historically, the dealership body has eroded at a pace of two percent per year, but due to the deep cuts during the recession, this has reversed. If not for the 2012 exit of Saab and Suzuki, the dealer count would have grown. It is projected to grow modestly 0.1 to 0.2 % per year according to Urban Science. If those two factors hold true, the average store would sell 990 vehicles per year compared to the current 890, or an 11% increase.

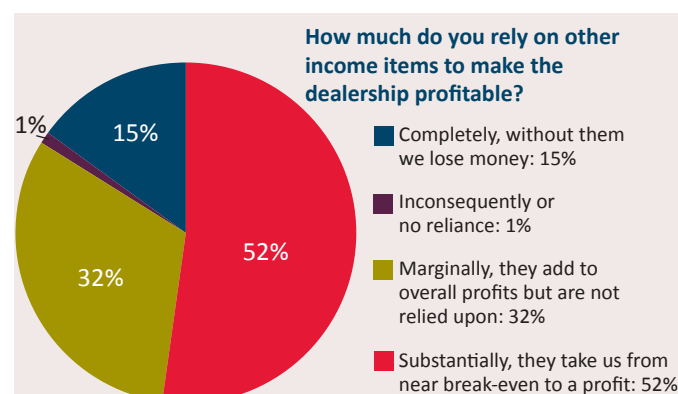
In order to make an easier comparison, the following projected chart is shown in current (2013) dollars.

Average dealership profile		
	*2013	2025
Total dealership sales	\$38,359,930	\$42,721,120
Total dealership gross	\$5,266,535	\$4,926,434
Total dealership expense	\$4,422,838	\$4,303,984
Net profit before taxes	\$843,697	\$622,450
New-vehicle department sales	\$21,567,325	\$23,714,109
New-vehicle department gross	\$1,279,190	\$1,097,085
Used-vehicle department sales	\$12,179,364	\$13,701,785
Used-vehicle department gross	\$1,188,055	\$1,109,347
Service and parts sales	\$4,613,241	\$5,305,227
Service and parts gross	\$2,068,574	\$1,926,876
Other Income	\$730,716	\$793,126

\* based in part on NADA Data 2013 Report

As we will explain further in this paper, the projection calls for compressed grosses in every department. The saving grace for dealership profitability is that higher sales per store will help defray fixed costs bringing them down as a percentage of total gross. Increased use of technology will also allow for lower departmental expenses.

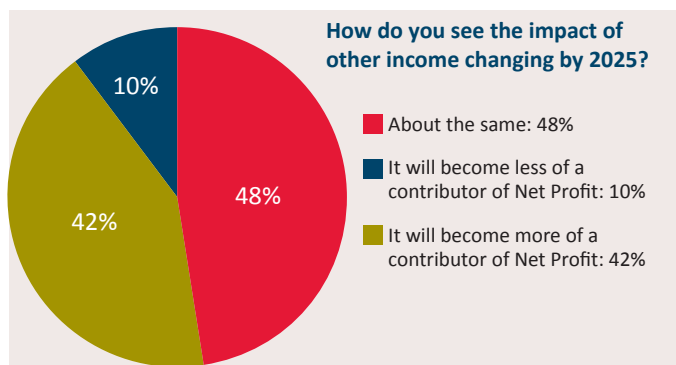
The item in this projection showing a significant increase is the Other or Non-Operating Income. We asked dealers, "Today, how much do you rely on 'Other Income' items (doc fees, factory cash, etc.) to make the dealership profitable?"





The impact of Other Income items certainly varies between franchises. Volume bonuses, stair step programs, facility money, customer satisfaction rewards, and a seemingly never ending list of behavior controls from the factory have supplanted earning profits from the general public. Essentially, in our survey 67% said they make their income from the dealership below the line. While accounting practices vary, our observations would place that percentage closer to 75.

While Other Income may include dealer produced income such as documentary fees, rental vehicle income, packs against the selling gross, etc.; for many dealers it means factory-to-dealer payments. The fear for some dealers is that program cash is forever at the whim of the manufacturer. If the store relies on Other Income for its net income, then it is in a precarious position when working with the factory relationship. Further, even if the factory payouts remain the same but are changed from monthly to quarterly or semi-annually, the dealership has to be sufficiently capitalized to survive the dry season in between the incentive payments.



The follow-up question in our survey asked, “How do you see the impact of ‘Other Income’ changing by 2025?” Of course those who responded that they rely heavily on Other Income today are much more likely to see its continued growth in the future. Currently, some franchises are cultivating a “race to the bottom” on selling gross as dealerships are encouraged to move more units and hit another stair step or earnings program. Of course, facility money and similar programs are noted as the most contentious by dealers and face challenges due to revisions to state franchise laws and two-tiered pricing challenges.

Regardless of what form they take or demands they place on dealers, our survey clearly indicated that Other Income money will continue to be a major factor in dealership profitability.



## Dealership Sales Environment

We now have a sense of how many dealers will exist, their size and financial performance; it is time to turn to the actual changes in the day-to-day transactions of the dealership. New vehicle sales drive the rest of the dealership, so it is always best to begin there.

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 2014, 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. Yet, even with all this information the percentage of customers who change their minds and select a different vehicle remains high. That is why dealerships and a professional sales force will be important to consumers.

## 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 greater array of technology tools to target and reach the new generation of consumers.

We asked dealers, “What area of technology do you think will have the greatest impact by 2025?” Almost half said customer communications and another 20% saw it making the sales process quicker and more efficient. Dealerships are looking to have multiple touch-points with consumers and their customers. What those methods of communication might be in a dozen years from now are unknown to us. The iPhone has only been in existence for six years as of the end of 2013. Quick integration of whatever is imagined between now and 2025 will be part of a dealership’s and the manufacturer’s DNA in order to meet the desires 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. Generation-Y

are actually hyper-communicative, so much that they are woven into social networks online and off. Additionally, there will always be exceptions to the generational stereotypes that prefer direct interaction with a salesperson. We are also beginning to see the creation of customer relationship specialists that can better handle and direct the consumer.

Training staff to be sensitive to all three generations and have a flexible, yet structured, 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 on the dealership’s website 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.

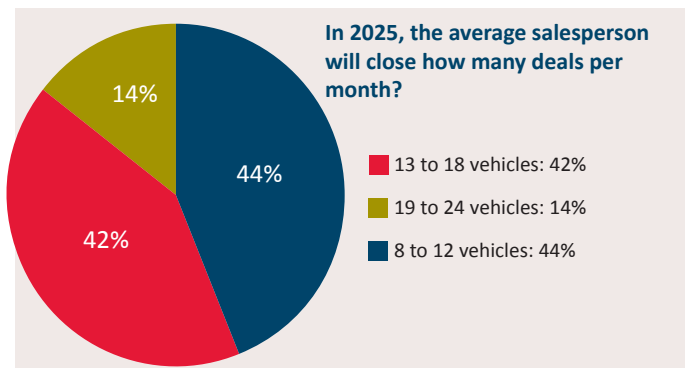
### Changing Job Responsibilities for Salespeople

When the consumer reaches the point of purchase and is signing on the dotted line, 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 to make him/her comfortable with the purchase. 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 vary allowing delivery outside the showroom, but the predominance of states will continue to restrict sales to the dealership location.)

The goal of any successful business is to profitably provide the consumer with what they want and when they want it. Current lead management systems are designed on getting the consumer to the lot so they can be sold by a salesperson. This has resulted in hesitancy in quoting prices, in having extended dialogue with customer, or in allowing off-site demonstrations. The majority of lead follow-ups employed today are scripted, formulaic and often automatic – and they look that way. To move

shoppers down the sales funnel and get them on the lot is going to require skilled persons in the dealership's Business Development Center (BDC) or Internet department.

In 2025, the skill levels between the BDC and sales floor will be reversed or the two will be merged into a single sales process. Highly skilled people (like the customer relationship managers previously mentioned) will need to interact with the customer early. That does not mean everything will be handled via email and text. Human beings still matter. It is tempting to project that technology will make the sales process perfect but it will be the stores with the best people who can connect with customers that will win.



The salesperson will not be occupied with pushing the consumer down the sales funnel – consumers will already be almost there. Therefore, the pace of transactions in a dealership will accelerate. Whereas, today a salesperson might have an average sales rate of 8 -12 vehicles per month, we would expect that the rate will increase significantly. However, dealers responding to our survey disagreed when asked. Notice in the chart that 44% of dealers do not believe the sales rate will change and another 42% of dealers say it will accelerate a tick to 13-18 vehicles a month. Many salespeople are at that level today without the help of advanced technology. Only 14% of dealers saw a doubling of the sales rate.

Therefore technology will serve to assist in customer communications but may have little influence on the average sales rate. Again, human connections still take time and effort. More effort on demonstrating vehicles, getting in front of customers where they want to do business and working the various leads will always be a time consuming process.

A salesperson will have to heavily utilize technology to guide their work and the consumer through the purchase process. There will be a continual buildup 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 again be absorbed into the salesperson position. Items currently determined as “aftersale” will migrate to “presale” or be part of the overall buying process. This will further slow the rate of transactions for the individual salesperson.

### Evolving Vehicle Types

What type 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 at a cost acceptable to consumers. Assuming the current EPA standard for 2025 is left unchanged, the Corporate Average Fuel Economy (CAFE) a manufacturer's fleet will have to obtain is 54.5 miles per gallon. With current technology, that would mean that all vehicles will either use hybrid propulsion systems with an increasing market share of ZEV (pure plug-ins). The concern of manufacturers and dealers is the premium cost of a hybrid system will push buyers out of the market. However, technology costs have always fallen over the life span of innovations and the total SAARs estimate for 2025 was not changed when the new standards were announced in 2012.

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

An observation of the current market has 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 a significant presence in the market in the year 2025. Even a wait of several weeks may 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. 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 that 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 continue to be in place in the year 2025. Increased regulation will erode dealership profitability and make the transactions even more complex than they are today. However, the complexity will be reduced through technology that will provide some relief to dealership staff and consumers.

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 technical innovations will make compliance easier, so the final steps of the sales process should 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 profit per unit. 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 from 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 incentives and rewards to their dealers. As the long trend of weakened front-end gross continues, the manufacturers will continue to increase back-end payments to the dealer, which will maintain profitability on sales. With greater incentives from the manufacturers comes greater influence and control on how the dealership conducts its 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 also see 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 should be unique in the used vehicle market due to a low trough of production and availability, by 2025 there will be normalcy in used vehicle availability and pricing.

While commoditization has eroded gross retention on used vehicles, technology has made the department much more efficient. Physical auction visits are rare, as program/re-marketed 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.

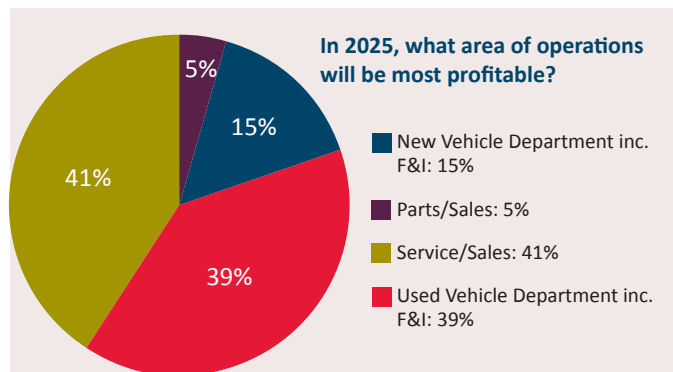
With control over the flow of first remarketed vehicles (off-lease/off-fleet) and encroachment on reconditioning, once again the factory will be expanding its influence over dealership operations in order to gain access to those vehicles. The dealership has the ability to go outside the factory channel and instead use traditional auctions to acquire used vehicle inventory. While the vehicles might not be of the same quality, they can be reconditioned to bring them up to standards. 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

Before we discuss the individual departments there are a few noteworthy things about fixed operations in 2025. Dealerships might still own body shops but they will more likely be off-site facilities that are operated as a separate entity. Therefore, we will not include predictions about body shop operations other than to say the insurance companies will continue to want to reduce their costs by directly supplying parts and open their own repair facility where allowed by law.

Second, the lines between departments will further erode. Fixed operations will become more of an extension of

the sales process than they are now. Pay plans might even extend to overall dealership performance than an individual department.



## Parts Department

The transformation continues through fixed operations as vehicles and customer habits change. The easiest changes to see are in the parts department. The past several years leading up to 2014 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 will allow 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.

With timely delivery of parts improving, the average turn of dealership inventory will improve to above twelve times a year. It could climb as high as twenty depending on the dealership’s wholesale business, 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.

Part pricing and gross will be compressed on maintenance and light repair items. Factory pricing to the dealership will need to fall on high volume parts to be competitive with aftermarket alternatives.

Dealerships will need this revenue stream from retail customers as the viability of 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 according to respondents to our survey. 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. In the past seven years, the average maintenance interval has gone from 3.5 times a year to less than two. At the same time, vehicle dependability has gone from 216 problems per 100 vehicles to 126. Half the maintenance and half the repair work does not paint a rosy picture for service departments.

Profitability will also be further hindered by the manufacturer's recommended maintenance. If vehicles begin to know when they are operating in normal or extreme conditions and can report directly to the consumer which services are required it would effectively end "dealer recommended" services. If the manufacturer ends up covering the maintenance, it would put more suppression on the suggested services. There will be more transparency in the service transaction just as there has been on the vehicle sales side. The upside to transparency is that it will reinforce the trust that the consumer places in the service advisor and shop.

The growth over the next decade will be in customer repair work due to 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 marketplace. 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. Independent shops will continue to shrink in numbers. More new vehicles being sold will also help keep dealership shops busy.

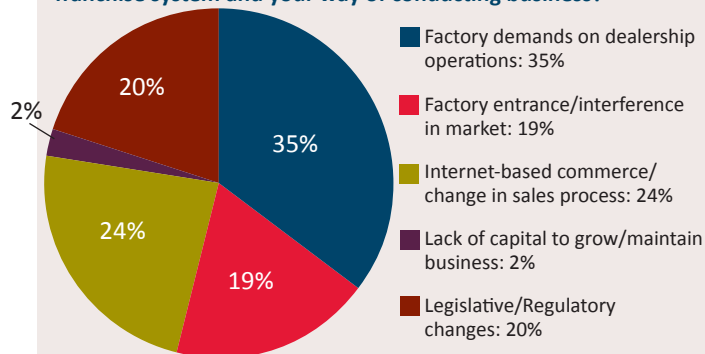
Also, assisting the service department will be increasing reliance on remote diagnostics, where vehicle monitoring systems will alert the driver of an error and automatically upload data files to the manufacturer and dealership. Such systems will not only directly encourage the use of the dealership 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, the 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 lower value 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, which will free up time for the service advisors to build a relationship with the customer.

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



## 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.

When asked what is the greatest threat to the current automotive franchise system and your way of conducting business, dealers responded in our survey with a wary eye on the factories. This includes manufacturers 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 2014 and the expectation is that the trend of growing manufacturer influence will increase in the future.

By 2025, manufacturers will recognize that those that overstep the bounds of interference in the retail environment will harm the relative value of their 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 well-managed dealership groups they hope to attract from investment in brands with onerous requirements.

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

### New Entrances from 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., Land Rover, 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.

### Human Resources and Staffing

Not only will dealerships be selling to a new generation of consumers but they will be hiring them as well. Indicators show that Generation Y employees are more risk adverse and prefer security in employment over pure dollars. That would make most commission-based plans difficult for them to accept. What they will likely respond to is an improved benefits package and a clear job path. This group of workers also values their time and is less willing to work 60 hours a week that is often required in sales and F&I.



Because of the specialized nature of the transaction and the business development, training at dealerships will also need to be increased to both comply with laws but also maximize the individual's results.

### 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. Good 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. The prediction of regulation requiring 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 environmental 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:

- There will continue to be different paths to profitability in the dealership. While consolidation will continue, there will still be room in the market for single-point operators.
- There will be a high turnover of stores in the next decade as current ownership retires.
- Factory influence over the day-to-day operations of the dealership will be expanded. The most costly facility requirements will cause some ownerships to sell.
- 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.
- Smaller staffing requirements will result from the use of technology to be more efficient.
- Technology will continue to allow greater communication to occur with the consumer.
- The F&I department will face the greatest transformation from technology and regulatory changes. Increasing consumer regulations will continue to shape the dealer's business model.
- Customer relationship specialists will be highly skilled people necessary to navigate the various communication and vehicle needs of consumers.
- If current CAFE standards remain, nearly all vehicles in 2025 will be hybrids or ZEVs.
- Dealership value will increase as the earnings multiple will continue to climb.



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John Darvish	DARCARS Automotive Group	Dealer
Jeff Merriam	Key Auto Group	Dealer
Karl Schmidt	Morrie's Automotive Group	Dealer
Joe Shaker	Shaker Automotive Group	Dealer

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### Industry Professional and Specialists

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David Braun	Comerica Bank	Banker
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