AUTO RETAIL RESILIENCY – 2035 AND BEYOND

AutoTeamAmerica

Presented by the member firms of Auto Team America

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I. INTRODUCTION

Taking a step backward to review the broader landscape, the forest from the trees, so to speak, is often a luxury in which many dealership operators rarely have time to indulge. "Retail is detail" is a mantra of many a successful operator and often times this dedication and focus on minutiae gets in the way of long-term strategic thinking and planning. At its core, this gap in long-term planning among dealership operators is what led to the foundation of Auto Team America (ATA).

Formed in 1993, ATA is an amalgam of CPA firms and auto industry solution providers that serve thousands of auto retailers nationwide. It is ATA's goal to provide data-driven, in-depth analysis and perspectives on key themes and trends likely to impact auto dealers in the decades ahead, rather than months.

As an update to ATA's prior white papers "The Evolving Dealership – 2030 and Beyond" published in 2020, "2030 Dealership Vision: The Road Forward!" published in 2017, "2025 Dealership Vision: What Lies Ahead!" published in 2014 and "A Strategic Vision of Dealerships in 2025" published in 2012, ATA has collected data among auto retail leaders to (1) take stock of performance trends to date in order to validate and/or invalidate original predictions posited in prior papers while (2) formulating new perspectives on the evolving auto dealership model for your consideration and future planning in the period 2035 and beyond.

Key themes from our prior reports that continue to ring true in 2023 include (1) sector consolidation, (2) OEM-required facility upgrades, (3) the digitization of customer communications in sales and fixed operations, (4) a greater focus on driving process improvements in F&I, and (5) managing to a leaner cost structure while also remaining focused on limiting employee turnover.

What is clearly new to our discussion in post-pandemic 2023 has to do with global supply and demand of new vehicles and parts. While it remains clear that other existential crises, like electrification and direct selling may take longer to negatively impact automotive retail than prior reports anticipated, public and private dealers alike are now wondering when and how rising supply will set unprecedented current high profitability back to pre-pandemic levels. Will OEMs "get religion" and maintain a lower production rate relative to demand than they have in the past? Or rather, will they simply revert back to producing as many vehicles as quickly as possible and then as needed, utilize broad and complex incentive programs to sell excess inventory?

There are some other issues that have seemingly faded into the background given COVID's negative impact on ride-sharing and the much longer path than anticipated related to developing, testing and implementing autonomous vehicle technologies. Looking ahead to "2035 and Beyond", this paper hones in on three special focus topics, referred to herein as "The Big 3." These topics include (1) OEM Direct & Online Selling, (2) Consumer Acceptance of Alternative Powertrains, and (3) Alternative Powertrains' Impact on Fixed Operations.

As highlighted in our Executive Summary herein, Auto Team America believes that while the big disruptors to auto retail may not have occurred by 2035, they will likely be well on the horizon. Dealerships will likely have to evolve to diversify and have solutions in place to respond to the effects of electrification, autonomy, digital sales, and changing personnel expectations by that point in order to thrive in the coming decade.

Among other items, ATA sees smaller staffing requirements as the use of technology rises and more customers opt to communicate digitally rather than face-to-face. The pace at which consumers adopt electrification remains in question, though dealers will have little choice but to make calculated guesses regarding fixed operations investments as virtually all OEMs' have stated clear goals of increasing EV production in the next 10+ years.

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. This would include, but would not be limited to other nascent stage technologies potentially impacting the auto retail environment long-term, such as solid-state batteries, hydrogen-fuel cells, complications regarding the sourcing of raw materials for next generation powertrains and related global geopolitical implications. Instead, we will concentrate as much as possible on our core expertise, retail dealership operations, using our best, most experience-informed judgments to make predictions as to how retail operations may evolve and how operators may choose to address the opportunities and challenges that lie ahead.

II. SPECIAL FOCUS TOPICS ("THE BIG 3")

a) OEM Direct & Online Selling

Over a decade ago Tesla began to challenge the automotive retail franchise model as we knew it, opting instead to sell directly to consumers. Trade associations quickly scrambled to lobby their state legislators and in many cases, would overcome Tesla's direct-selling challenge. However, with over 20 states still allowing Tesla to carry-out its company-owned retail strategy today, the damage, if you will, has been done.

Fast forward and now many of the largest automotive manufacturers have publicly stated that they would consider a direct selling alternative to the franchise distribution model, particularly in the case of promoting electric vehicle line-ups within brands. In the case of Mercedes-Benz, there are new sites opening all over the world promoting their EQ electric vehicle brand, one of which is pictured below in Yokohama, Japan. Various GM-brands are also exploring EV-dedicated dealer networks of their own. While some of these facilities are impressive to look at, whether the internal rate of return will pencil for OEMs over time remains to be seen.

Figure 1: Mercedes-Benz Factory Owned EQ EV Dealership in Yokohama, Japan

Source: InsideEVs.com

In addition to EV-branded initiatives, manufacturers have stated publicly their intent to reimagine vehicle profitability. Consider that almost all new EV entrants have expressed interest in a direct-sell model, including Rivian, Lucid and VinFast, among others. In a move that should be quite concerning to existing franchise dealers, incumbent manufacturers such as Ford have also indicated their interest in moving away from traditional invoice pricing to offering flat rate "agency-type" fees to dealerships for arranging customer deliveries. In a move that again, seemingly focuses on EVs, it appears manufacturers are interested in rethinking existing franchises more as delivery centers by moving the sales and financing process away from the physical dealership.

However, as has been the case for over one hundred years in automotive retail, manufacturers' envisioning dramatic, whole-scale change of the existing retail model is nothing new. One of the testaments to dealers' resiliency is in their ability to weather, on a global scale, the countless initiatives, re-branding exercises, and direct-to-consumer schemes that manufacturers have tried, and failed, to cement into the retail landscape. Take for example, Mercedes' recent decision to divest company-owned dealerships in Canada and Australia. In other words, disrupting retail is harder than it sounds. There is tremendous investment, years developing expertise, and a painstaking attention to detail required to drive and maintain profitability in automotive retail. There are also real estate considerations as dealership zoning does not usually rank high on the priority list for most U.S. local governments, which only makes disrupting more difficult. The same can be said in the EU or Japan, where access to land is an even scarcer commodity. While many tout Tesla's retail successes as a basis for formulating their own direct-sell retail model, perhaps OEMs should look at Tesla as more of a cautionary tale in light of tens of billions invested across a retail channel that has done little to chip away at virtually 50% of state franchise laws across the U.S. Tesla also benefitted from its (a) first mover advantage in (b) an extraordinarily low rate environment that (c) contributed to record investment in equities and (d) ultimately drove record high valuations / investor patience for unprofitable business models with long-term promise. Such a market no longer exists today and as such, the runway afforded to Tesla by its investors is considerably shorter for new EV entrants. The EV market is getting crowded very quickly.

To the degree manufacturers are seriously considering what would amount to considerable retail sector disruption the likes of which the industry has not seen in generations, remains the key question. There is some conjuncture that these statements are no more than public relations stunts, which have little practical chance of success. But regardless of their intent, the rhetoric on a company-owned retail

strategy is increasingly prevalent, not less. There is no doubt that auto manufacturers globally seem more focused today on alternative forms of distribution than any time in recent history.

b) Consumer Acceptance of Alternative Powertrains

Since our prior white paper, published in early 2020, manufacturers have introduced hundreds of new electrified vehicle products. Whether due to relatively high demand, supply chain constraints, or some combination of the two, order backlogs for new EV models remain months or in some cases, years long at this point in time. Below is a summary illustration (more affordably priced vehicles in green), though not a fully comprehensive list, of just how many different BEVs have come or are scheduled to come to market among virtually all manufacturers across price points.

Figure 2: BEVs Coming to the U.S. Market

2021

Make & Model	Range (mi)	Base Price
MX-30	100	$34,654
Ariya	300	$40,000
Ioniq 5	274	$45,000
Q4 e-tron	250	$45,000
RIVIAN R1T	300	$70,000
RIVIAN R1S	300	$75,500
LUCID Air	406	$77,400
EQS	315	$110,000
GMC Hummer (Pickup)	350	$112,595

2022

Make & Model	Range (mi)	Base Price
F-150 Lightning	230	$39,974
Cybertruck	250	$39,990
EV6	300	$45,000
GV60	TBD	$50,000
i4	300	$56,395
EQB	TBD	$57,000
C40 Recharge	210	$59,845
Lyriq	300	$59,995
EQE	300	$65,000
iX	300	$84,195
FF91	378	$180,000

2023

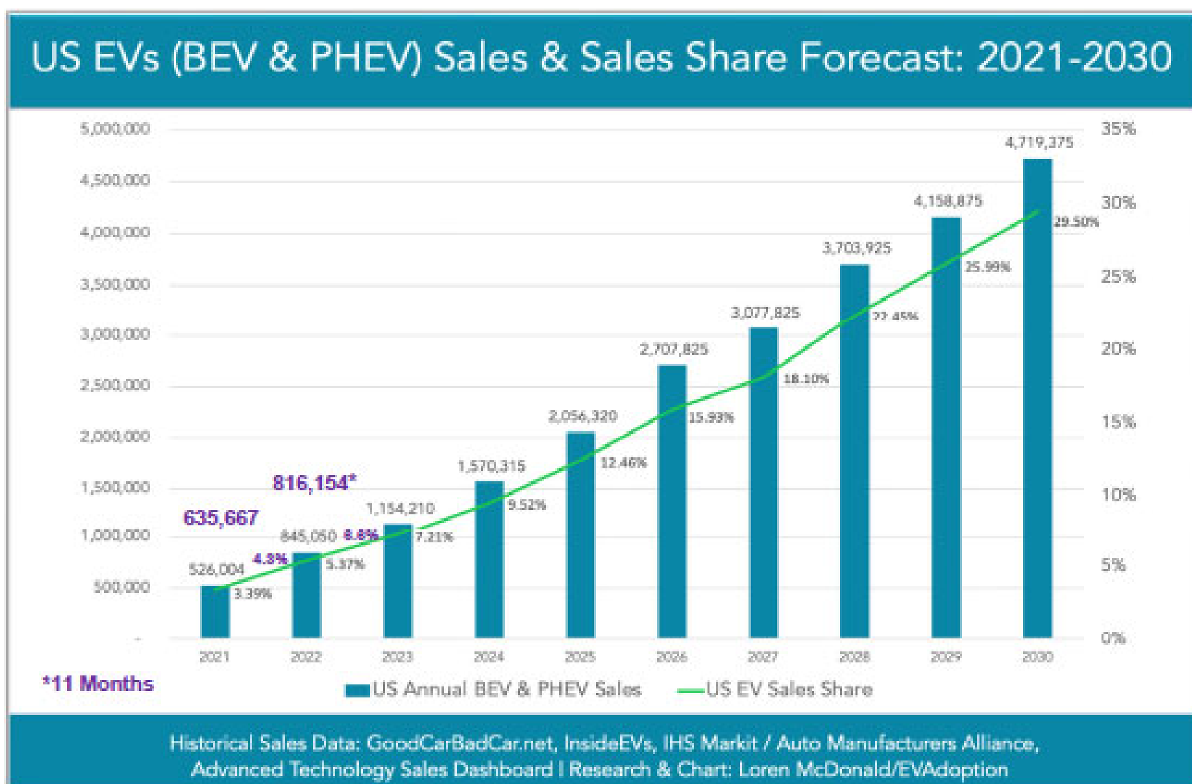
Make & Model	Range (mi)	Base Price
Ocean	300	$37,499
ID. BUZZ	200	$40,000
Prologue	300	$45,000
GMC Hummer (SUV)	300	$105,595
B1	200	$125,000
B2	200	$125,000
Roadster	620	$200,000

Source: EV Adoption and Capital Automotive (CARS) research. Base model pricing and range presented, where applicable. Reflects launch model pricing and range.

While it is true that the volume of EVs among units in operation remains quite low, EV adoption continues to stretch well beyond densely populated, high median

income urban markets throughout the greater United States. The types of electrified vehicles are also expanding beyond midsize and compact sedans to larger SUVs and pick-up trucks, the latter of which includes Ford's Lightning, a fully electrified F-Series pick-up with a substantial order backlog.

Figure 3: BEV and PHEV Sales Projections



Source: Historical sales data – GoodCarBadCary.net, InsideEVs, IHS Markit / Auto Manufacturers Alliance, Advanced Technology Sales Dashboard. Research & Chart – Loren McDonald / EVAdoption.

There is little question that fully electric, or at least electrified vehicles, are here to stay based on the near-term model line outlook across manufacturers, which is clearly a result of increasingly stringent environmental regulations globally. However, manufacturers' investment in EVs remains at odds with electrified vehicle supply chain concerns, namely that there are too few available materials at this point to support internal combustion engine fleet replacement for decades.

There also remain many questions and potential global geopolitical concerns left unanswered given China's control of a substantial portion of the existing supply

chain, to include natural resources as well as proprietary EV technologies, related to electrified vehicles. Current U.S. electric utility grid supply is insufficient to support the kind of EV growth the OEM's are forecasting. Charging infrastructure is also woefully underpenetrated across most metro markets and will be unable to support conversion from ICEs to EVs, even with billions of dollars of investment earmarked by the current administration, for some time. Moreover, there are many consumers whose living circumstances are not suited for EV ownership, such as apartment or condominium dwellers, where EV charger applications are simply impractical.

Figure 4: OEM Plans for Electrified Vehicles

Original Equipment Manufacturer	2025	2026	2027	2028	2029	2030
BMW Group						50%
Daimler	50%					100%
Ford		100%				40%
GM Group						40-50%
Cadillac						100%
Honda						40%⁝
						40%⁝
Hyundai-Kia						30%⁝
Jaguar						100%*
Land Rover						60%*
Mazda						25%
Nissan						40%*
Stellantis						70%
						40%
Toyota Group						15%~
Volkswagen	20%*					50%*
						70%*
						50%*
Volvo	50%*					100%*

% of Sales Electric (Global)

% of Sales Electric (Europe Only)

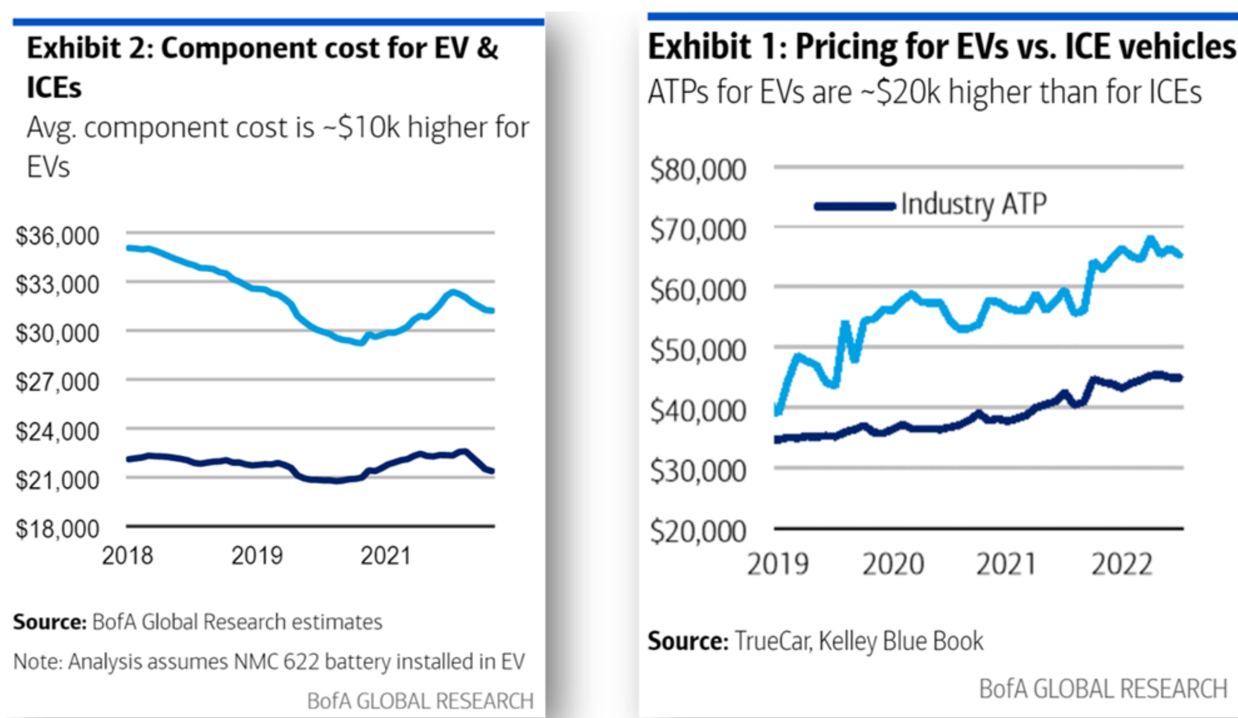
% of Sales Electric (US Only)

Source: Capital Automotive (CARS) Research.
Notes: This table is based on the authors' understanding of OEM announcements and may not be complete. Unless noted, it includes only announcements related to electric light-duty vehicles (PHEVs and BEVs) and it excludes announcements related to hybrid vehicles and those that do not provide a clear indication of EV share.
⁝ - Includes fuel cell electric vehicles.
** - Includes fully electric (BEV) only.*
~ - Includes BEVs and FCEVs only. Excludes HEVs and PHEVs.

c) Alternative Powertrain Impact on Fixed Operations

As noted above, it seems unlikely that we will witness a full replacement, or at least the replacement of a majority of the internal combustion powered vehicles in operation, by electrified vehicles for many years. However, it is nevertheless important to consider the risk that rising EV penetration holds for dealers' fixed operations businesses.

Figure 5: EV Costs and Average Transaction "Prices"



Sources: Capital Automotive L.P., BofA Global Research, TrueCar, Kelley Blue Book.

Over the past several decades, the nature of fixed operations has changed dramatically, even without massive EV penetration. For example, many vehicle related service issues relate to onboard software malfunctions, which require dealers to essentially "plug-in" vehicles to diagnose error codes requiring their attention. Modern vehicles are also able to run significantly longer between maintenance intervals as manufacturing standards have, generally speaking, improved over time. However, vehicles still require a substantial amount of fluid-related maintenance that is a fixture among internal combustion engines. There are also far more moving and therefore, breakable items in ICEs relative to the admittedly simpler EVs. The

combination of these two factors is what has auto retailers concerned about their fixed operations businesses as EVs grow in popularity.

At the moment, existing data on ICE vs. EV service levels remains scarce. However, it does not seem obvious that EVs are (a) less likely to break and/or (b) cheaper to maintain. For the moment, there are a lack of qualified EV techs and EV replacement parts making it difficult to compare "down-time" between ICEs and EVs. EVs are also "new-tech" and therefore likely to have more initial launch year glitches potentially relative to the existing stable of ICE vehicles. Again, this makes current data difficult to compare. Regardless though of existing statistics, it is certain there are fewer moving pieces able to break in EVs vs. ICEs. Whether they break frequently or cost more to fix due to more hours or more expensive parts remains to be seen. In the short-run, dealers will be forced to change / expand their service and parts departments to handle both ICEs and BEVs.

III. THE DEALERSHIP OF THE FUTURE

Auto Team America began its task by performing a survey of the dealership body and what we have found supports the primary changes in the dealership business model. The result of these surveys, analysis by industry experts, past research and interviews conducted for this paper have all been synthesized into our conclusions below.

Relative to predictions raised in our prior reports, it is fair to say that some have never materialized. However, store closures related to the COVID pandemic and unprecedented regulatory focus on electrification are forcing auto OEMs and retailers alike to entertain new strategies. For example, many dealer groups have begun to embrace virtual F&I processes, allowing the deployment of personnel across a broader platform based on consumer demand in each store across various markets. Vendors have also adapted by providing technology platforms that enable such communications and early indications are that virtual F&I customers are not only as profitable, but could be more profitable to dealerships vs. those in-store. Regardless of the why, it is without doubt that automotive retail is evolving at the fastest pace in nearly a century, driven by shifting appetites for how customers consume and how dealers supply the most seamless, efficient sales process as possible. Many public dealers have remarked in recent quarters how many COVID-era personnel expense cuts are likely to remain permanent as a result of such evolution, targeting a normalized SG&A of 60% of gross profit vs. the traditional 70% targets historically.

a) Sales Environment

Dealers are entrepreneurial at heart. They are competitive, demanding of their employees, and have an innate desire to win. In the past two decades, dealers have perhaps had to test their innovative limits, in particular given the rise of the internet leading to increasing online shopping in automotive retail. However, while some predicated this shift in consumer shopping habits would render dealers obsolete, operators have reacted to this change in a very positive way, by evolving their go-to-market strategy to center around the internet.

Looking ahead, we see new and dynamic changes across the automotive industry that may have varying impacts on dealer operators. Some of these changes are well within and some well outside a dealer operator's control. Within a dealer's control would be personnel concerns. This includes motivational considerations of younger employees. It seems, relative to their older peers, younger employees are less motivated by compensation and more motivated by work-life balance. Retail is relentless. It demands employees arrive early, stay late, and often to work on holiday's. Automotive retail is even more relentless, as pay plans generally remain commission-based. Figuring out how best to motivate employees that are less compensation-focused will be a major challenge for dealers in coming decade.

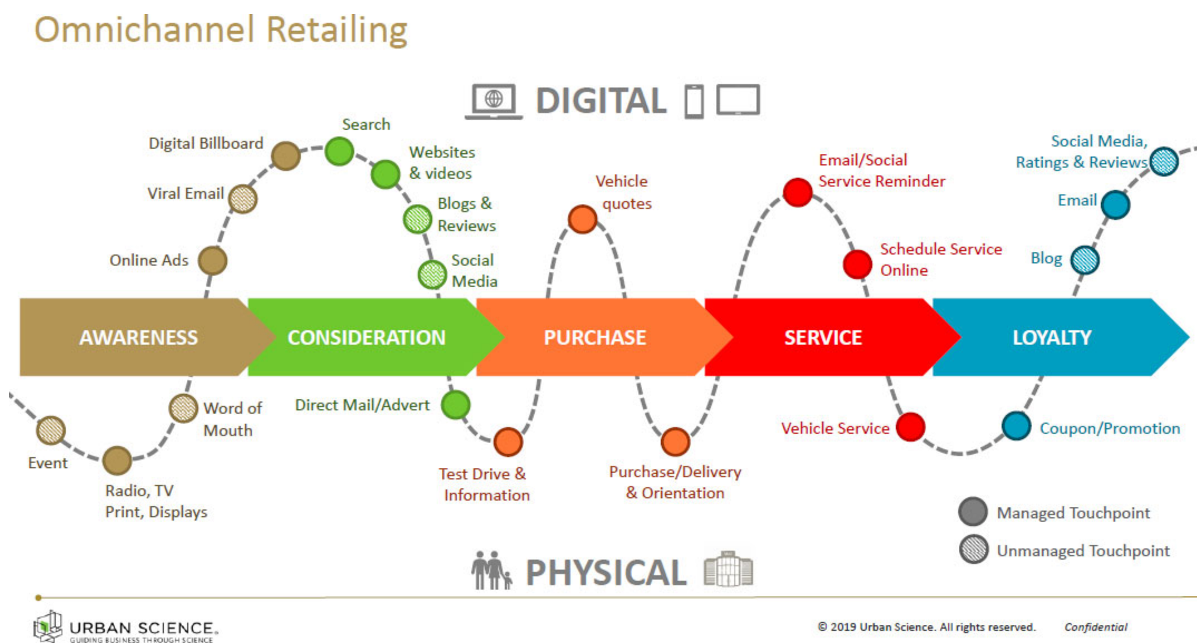
There are also changes occurring well outside of a dealer's control. Interest rates have now risen faster and moved higher than any time in the past 20 years, which has meaningfully impacted the affordability of new and used vehicles. Regardless, it is likely the result of rising rates will be to falling demand and rising floorplan costs. There are also M&A implications, as real estate values will likely shift given rising borrowing costs.

Supply-chain issues of recent years ultimately led to record high transactional profits per unit for dealers. In effect, this reduced the U.S. seasonally adjusted annualized rate of sales (SAAR) to a level more typically seen during economic recessions. In some ways, this provided a glimpse into the automotive retail utopia that dealers have sought throughout their operating lives, where demand outweighs supply. In addition, this may provide for a soft landing in the event of a recession, because supply is already approximating recessionary demand. The question remains, have manufacturer's learned their lesson and will they seek to limit supply in the future? While provocative, the better question is whether or not it even matters, as vehicle production is a cumbersome process requiring significant lead time. Even if

manufacturers want to limit supply as demand falls, can they react fast enough to prevent widespread discounting and profit erosion?

These are the types of considerations that "keep dealers up at night", so to speak. However, the one governing truth remains, dealers at their core, are resilient. They have incredible experience reacting, assessing and pivoting within an ever-changing economic environment. We would expect dealers to further evolve in the coming decade as they continue to refine their online presence, perhaps how they attract and retain personnel, and ultimately how they will continue to deliver the best available customer experience to a new generation of automotive buyers. Some may consider, as have operators across essentially all other retail sectors, an "omni-channel" solution that marries brick and mortar operations with a more robust suite of online/digital retailing tools. This can, but does not necessarily need to, include mechanisms that allow for home pick-up and delivery services, though these are features currently offered by a growing number of auto retailers today.

Figure 6: An Illustration of Omni-Channel (Cross-Channel) Retailing



Source: Urban Science.

b) Fixed Operations

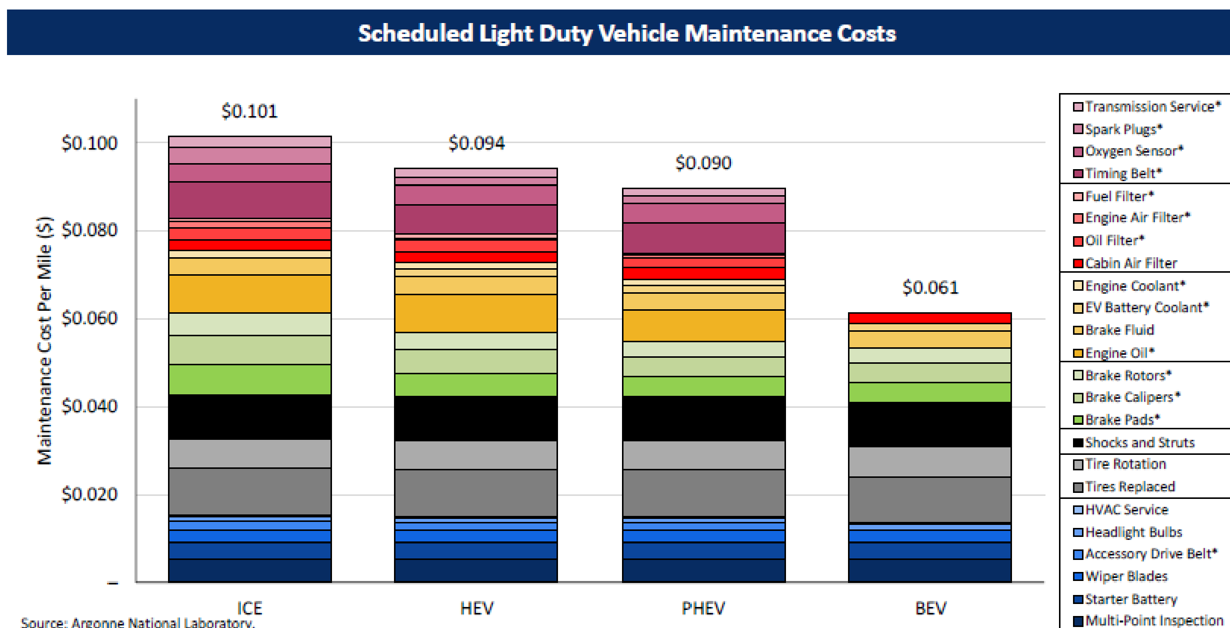
We have touched on several key topics in this report that have significant implications for service, body and parts businesses. Perhaps most important on that list is electrified vehicles.

EVs come in many different forms, whether mild-hybrid, plug-in hybrid, or fully electric. In the case of fully electric, they have fewer moving, and therefore, replaceable parts, which poses a long-term risk for traditional automotive service shops. There is also a significant amount of training required to service EVs and capital investment in facilities related to charging EVs. In some cases, manufacturers require dealers to outfit facilities with charging capabilities designed to service demand 10+ years into the future. This also requires in some cases that dealer's choose to sacrifice existing, profit-generating service areas for internal combustion vehicles in order to make space for EV-service and charging.

However, there are also many positive considerations of EVs for service operators. These vehicles tend to be quite heavy, which results in faster wear and tear on consumables like tires and brakes. They represent new technology for manufacturers, one that is likely to require several stages of iteration before approximating the quality and durability of their existing internal combustion vehicle line-up. Initial data also suggests that there is no discernible difference in EV profitability when compared to an ICE vehicle over a five-year period and in fact, EVs may actually be more profitable to dealers relative to ICE vehicles (especially during times of high demand). Legislative rebates or tax incentives may interfere with the natural pace of adoption.

While EVs will demand dealers make significant investments in training and facilities, it remains unclear whether profit impacts will be negative. Rather, we continue to see EVs as an opportunity for dealers to evolve with the market, not unlike past shifts in demand. It is possible growth in EV demand drives market share to the franchise service shops and away from the aftermarket, given systems and expertise required to properly service EVs. Also, as the pricing gap between franchise operators and the automotive aftermarket has closed dramatically, we believe consumer perceptions are also shifting in favor of dealers. We expect this could present an opportunity for dealers to further differentiate on service and quality relative to their aftermarket competitors as EVs become more widely owned across the U.S. As illustrated in the chart below, Argonne National Laboratory (U.S., DoE managed) found that alternative fuel vehicles, especially BEVs, are projected to have lower maintenance costs relative to ICE vehicles.

Figure 7: Powertrain Maintenance Cost Comparison



** Indicates service intervals that vary by powertrain.*

Source: Comprehensive Total Cost of Ownership Quantification for Vehicles with Different Size Classes and Powertrains report, Argonne National Laboratory, April 2021.

However, as illustrated in the chart below, the projected lower operating cost (especially fuel and maintenance) is not sufficient to offset the higher incremental cost of purchasing the BEV. For the non-combustion vehicles, the cost of ownership is high due to batteries (for plug-in electric vehicles).

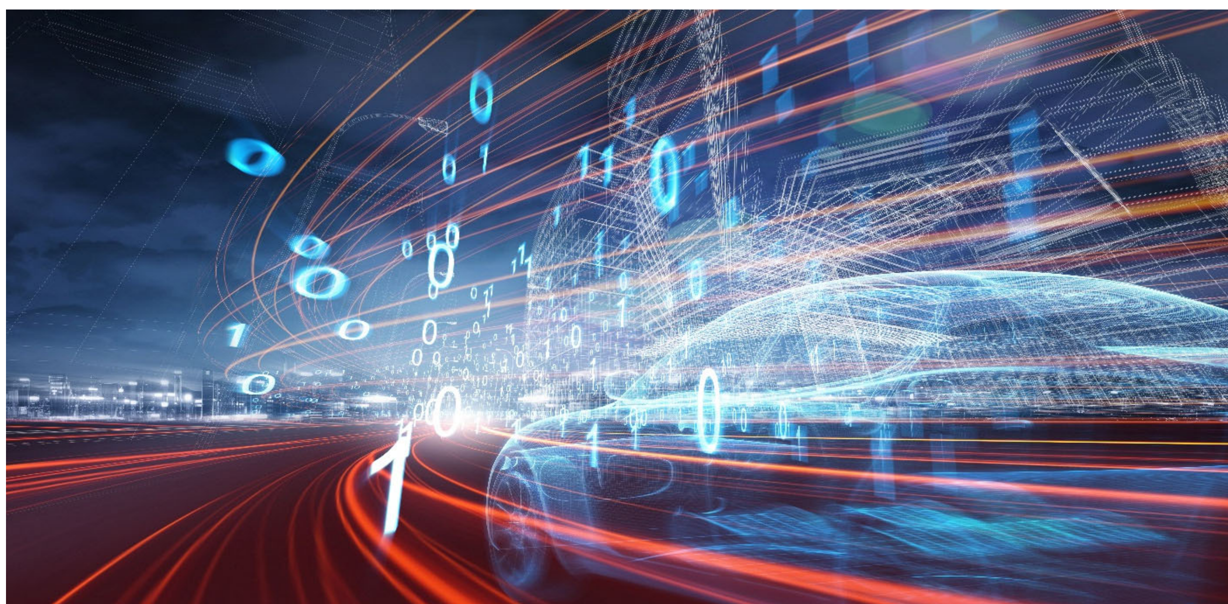
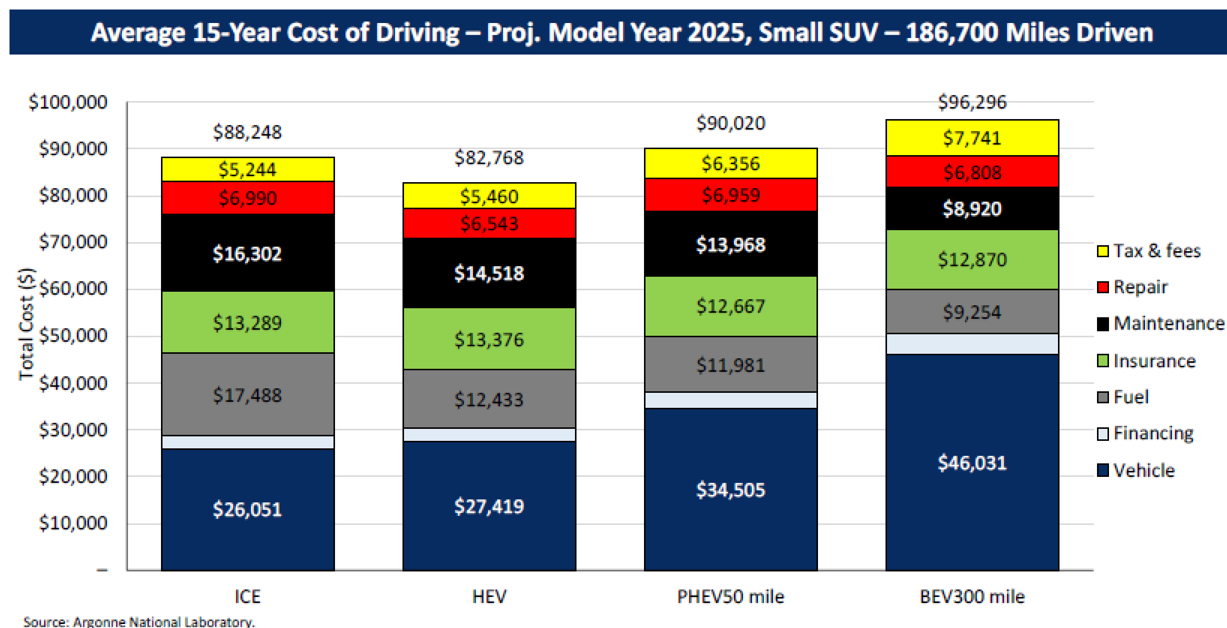


Figure 8: Total Cost of Ownership (TCO)



Notes: PHEV50 = PHEV with all-electric range of 50 miles; BEV300 = BEV with all-electric range of 300 miles. Presented in constant 2019 dollars.

Source: Comprehensive Total Cost of Ownership Quantification for Vehicles with Different Size Classes and Powertrains report, Argonne National Laboratory, April 2021.

IV. INFLUENCES ON FUTURE DEALERSHIP OPERATIONS

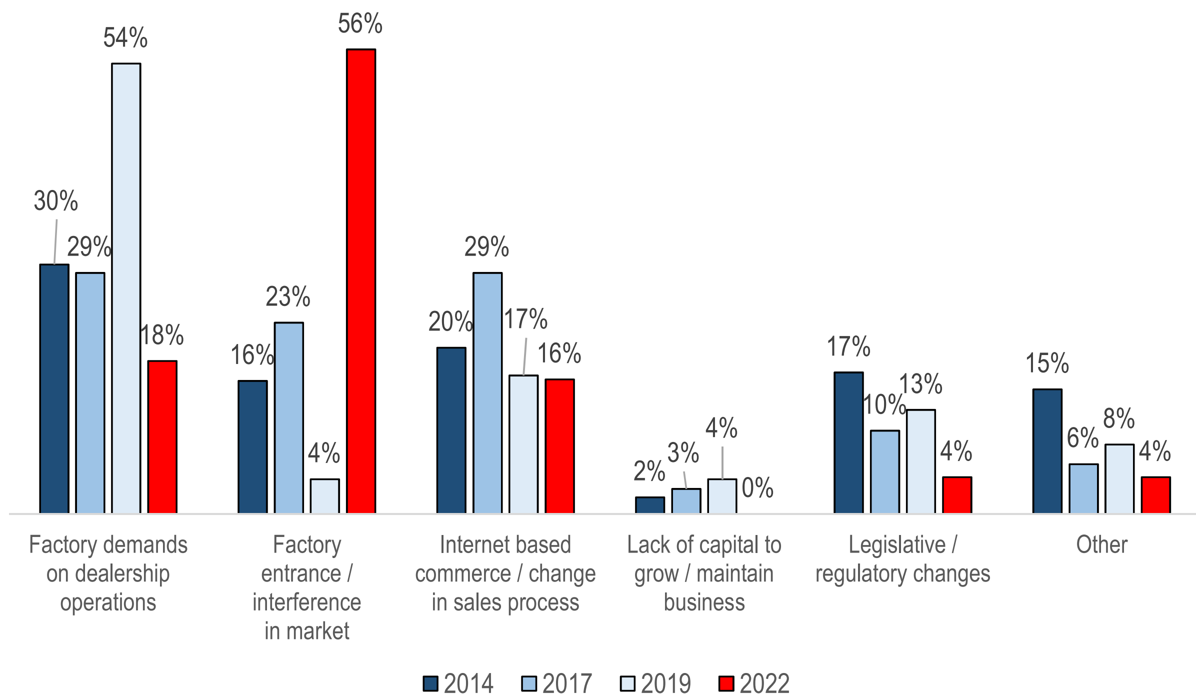
Factory Entrance into the Retail Market

Different this year relative to prior surveys is the growing risk dealer operators perceive of manufacturers' entering the retail market in a direct-to-consumer sales capacity. Undoubtedly, public comments by Ford management, among other OEMs are stoking significant concerns among dealer principals. In addition, Tesla's success in side-stepping franchise laws across nearly half of U.S. states begs the question as to how long the dealer body can defend against this threat.

On the positive side, the sheer investment dollars, in addition to the workforce and operating expertise required to stand up a competitive direct-to-consumer business model casts at least some doubt on the practicality of an OEM direct selling model. Case in point, perhaps, again is Tesla, which has had difficulty finding, building and staffing suitable sales and service locations in recent years and as a result has had

difficulty meeting delivery targets quarterly as demand for its products continues to grow. Some may argue that the recent plateau of Tesla's retail growth strategy is testament to the value and durability of the existing franchise network.

Figure 9: What is the greatest threat to the current automotive franchise and your way of conducting business?

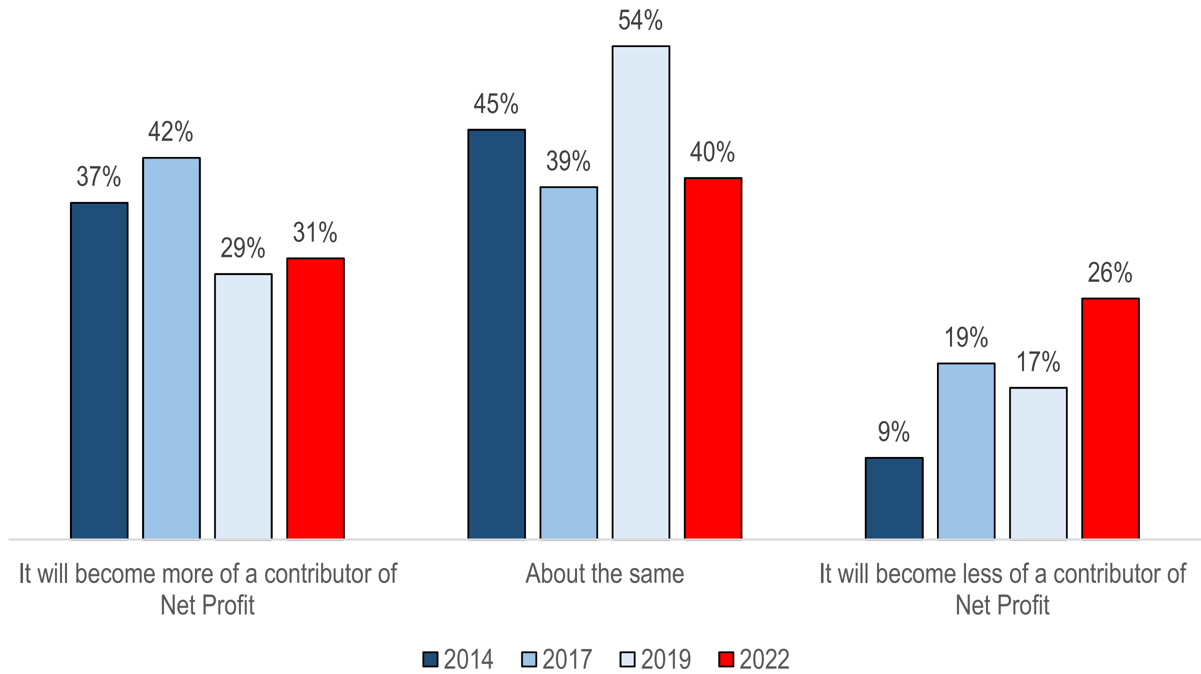


Source: Auto Team America dealer survey (2022).

Reliance on Factory Incentive Programs ("Other Income")

Approximately three-quarters of dealers polled in our recent survey believe factory incentives programs will be the same or bigger contributor to net profitability in the next decade. While transactional profitability has improved dramatically exiting the pandemic, there are great concerns among dealer principals regarding the inherent reliance of franchise operating profits on manufacturer incentive programs, which can be highly volatile in terms of magnitude and unpredictable in terms of timing. Bluntly, dealers are growing concerned about controlling their own fate when it comes to bottom line earnings.

Figure 10: Do you see the impact of "other income" changing in the next 10-15 years?

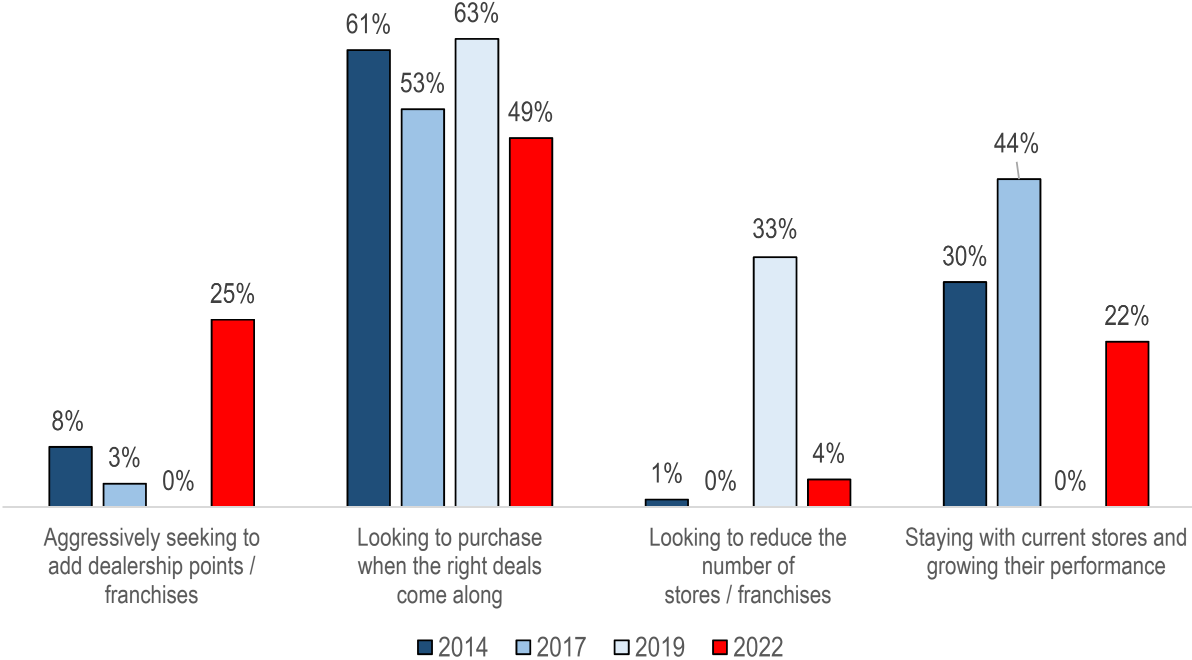


Source: Auto Team America dealer survey (2022).

Acquisition Activity

Private equity and family offices will continue to look at investing in retail dealerships, however certain OEMs are becoming more cautious with these types of investors. There will still be a place for family owned businesses with significant experience that are well capitalized. While there were differing opinions regarding the nature of those changes in our paper three years ago, we did find a near unanimous agreement that dealership ownership was going to contract. For well over two decades, the narrative of dealerships has been one of consolidation. From the early days of growing regional groups, to the publics, the factory and now large private groups, it appeared there was nothing that would slow a progression of group consolidation.

Figure 11: What would best describe your dealership group's activity in the coming decade?

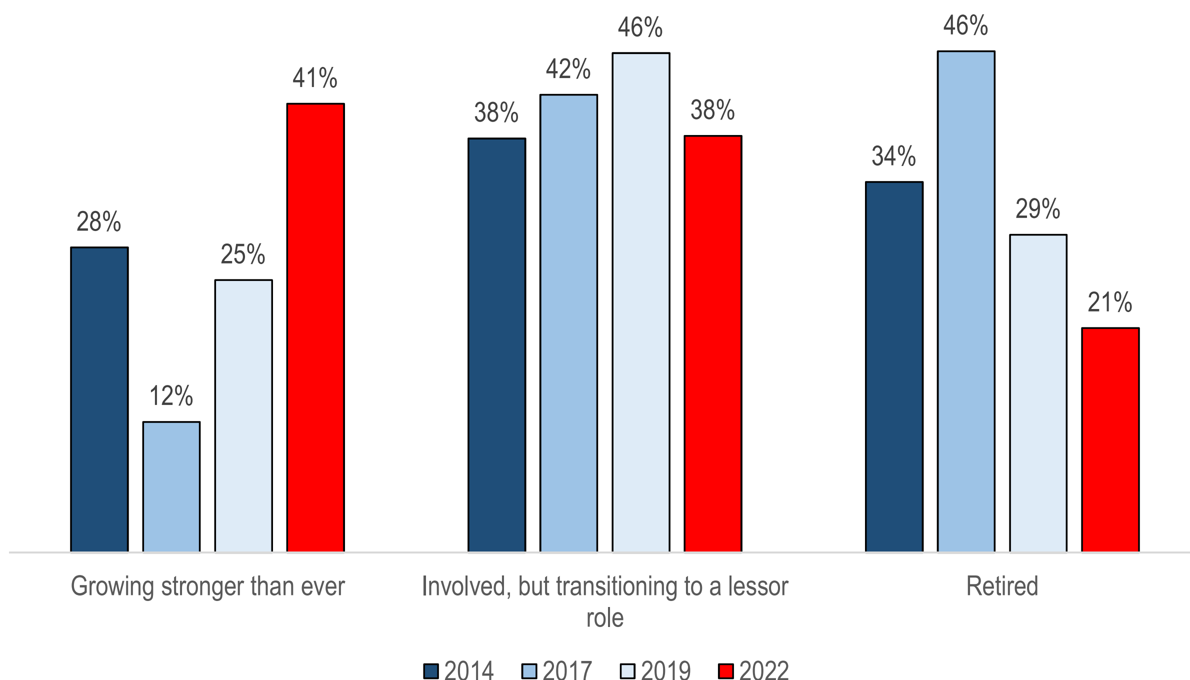


Source: Auto Team America dealer survey (2022).

Dealer Profitability Outlook

Among certain brands, primarily luxury and key midline imports, it remains a seller's market. More dealers are going stronger than ever and fewer are looking to retire. This is likely to continue putting pressure on acquirers and perhaps push prices up in the future. Conversely, there are expectations throughout the industry that OEMs will return to their typical tendencies of over-producing relative to demand, which in turn could drive significant margin compression. There are also increasing capital expenditure requirements across most brands, particularly those seeking to separate certain brands (Hyundai/Genesis) by rooftop and those seeking to build a more robust image centered on electrification. Arguably, a generally aging ownership base may be less likely to "wait out" another economic cycle, which could drive further consolidation. As shown in figure 12 below, it appears dealers' confidence is on the rise relative to our prior reports, however, a more pertinent question in light of rising rates, falling demand and certain OEMs rushing to bring back supply will be when will and how far will profitability fall as the auto retail sector approaches its post-COVID, "new normal."

Figure 12: In 2035, will the current dealership / majority owner be:



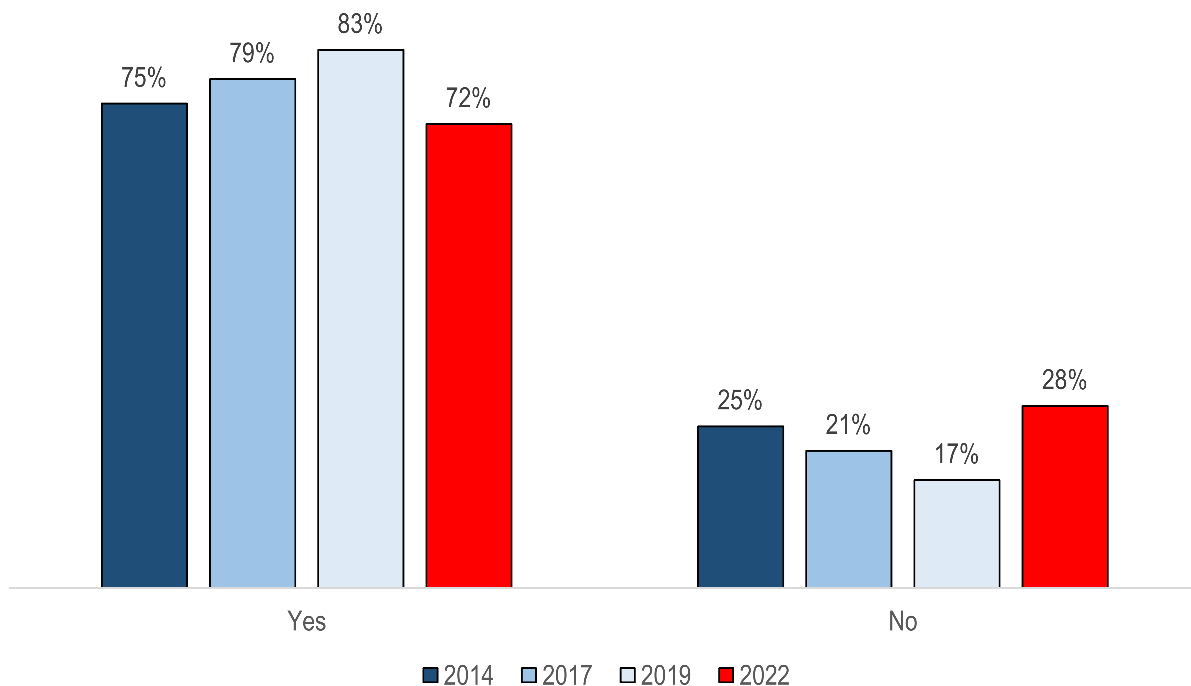
Source: Auto Team America dealer survey (2022).

Real Estate Ownership Trends

It seems that years of historically low interest rates coupled with unprecedented dealership profitability may have led more dealership operators to, at the margin, buy rather than lease their properties when possible. As such, we note from our recent survey an increase in non-dealer principal owned property, which jumped to 28% from 17% in our last survey and topped the recent high of 25% in our 2014 survey.

The outlook for real estate however is complicated by the recent surge in the federal funds rate, which is now approaching levels not seen in two decades. It is fair that dealership M&A is "generational" and as operators take much longer-term views on business planning, perhaps rising rates will only have a modest impact on the sector. However, rising rates, when coupled with rising vehicle inventory and falling margins, undoubtedly will contribute to increased dealer uncertainty in the coming years. While it remains difficult to surmise how, if at all, this will impact dealers' desire to own real estate, it is clear that the cost of ownership has increased tremendously while the benefit of owning vs. leasing with respect to selling dealership assets is less certain.

Figure 13: Is the dealership property owned by a related party?

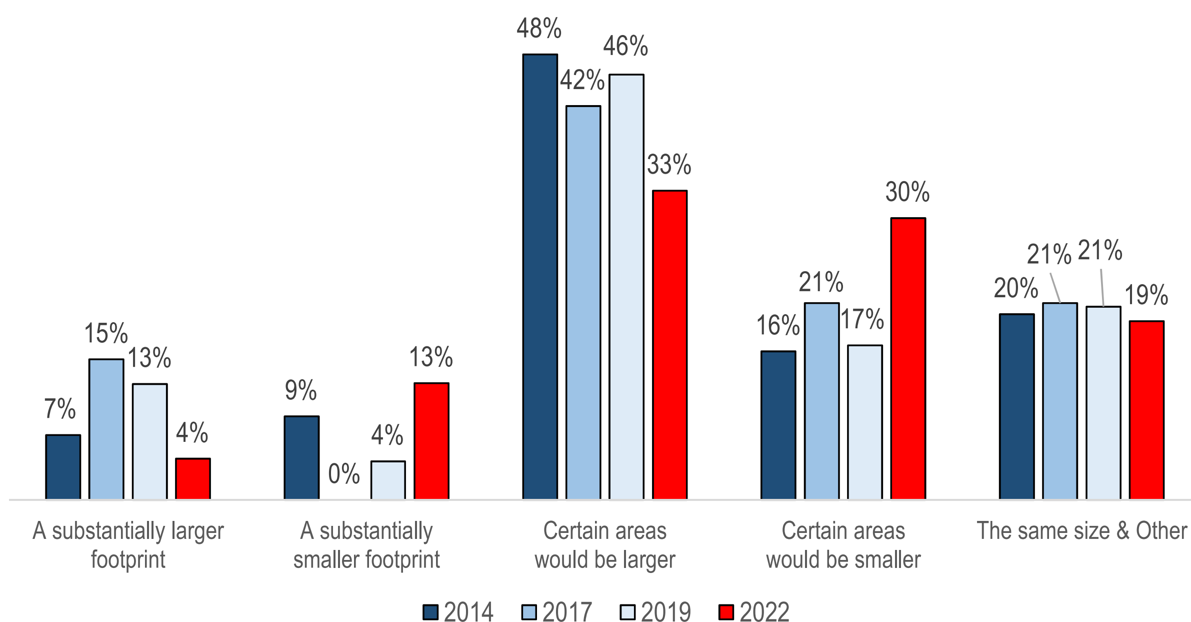


Source: Auto Team America dealer survey (2022).

Dealership Footprint

Facilities must balance the desires of the manufacturers and the needs of customers all while complying with property size and zoning limitations and still pencil financially for dealership principals. To complicate matters further, manufacturers typically require complete renovations/re-imaging every 10-15 years.

Figure 14: Will the size of your facility change in the next 15 years as compared to today?



Source: Auto Team America dealer survey (2022).

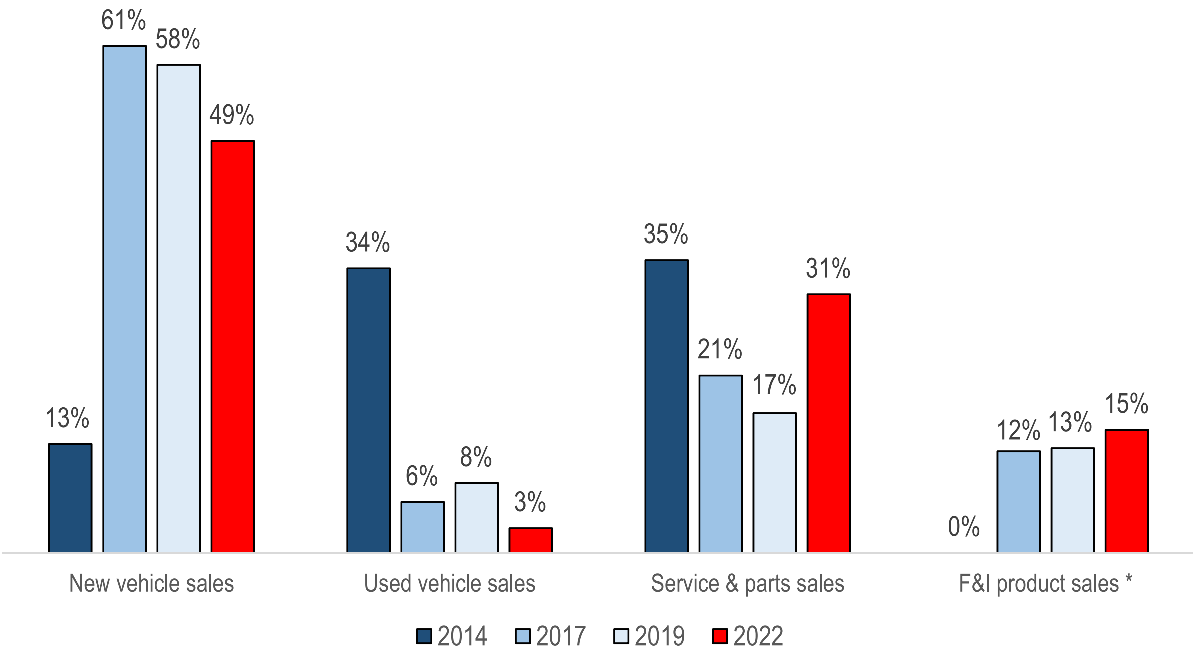
Again, learnings from pandemic may impact the future "dealer image" in the eyes of both retailers and manufacturers. The trend of bigger is better does not necessarily hold true as dealerships look to drive faster inventory turns and "omni-channel" strategies. If future dealerships must sell more vehicles with fewer salespeople at lower operating costs, the logical conclusion is that dealership locations may re-allocate their footprint away from sales to service and may seek to reduce their overall property size, given less inventory to store, as well. Increasing inventory turnover would result in lower carrying costs and reduce the need for sheer acreage, which may be reallocated accordingly to a more robust used vehicle inventory. As for facility, likely space for service that produce formidable margins will continue to be

desirable and the possibility of body work done by franchised dealers may increase facility usage.

Change in Dealership Operations

Compared to our 2019 survey, more retailers expect greater change in the coming decade within their fixed operations and F&I profit streams and less change in new and used vehicle businesses. It would seem greater EV adoption may be driving such sentiment, given the unknown and potentially dramatic impact EVs may have on service and parts businesses given fewer moving parts. Also unclear is the impact of EV retail strategies across OEMs and residual values, which are likely to remain in flux as units in operation expand in the next decade.

Figure 15: What area of the dealership operations will experience the greatest change in how we conduct business in the next 10-15 years?



Source: Auto Team America dealer survey (2022).

New Challenges for Finance & Insurance

Dealer concerns of increased regulation have become more subdued in recent years relative to our prior surveys. This is perhaps, in part, due to dealers' shift in focus to improving F&I product penetration rather than relying on financing reserve income. Moreover, the types of products and value such products provide has improved in the eyes of consumers, especially given the increased cost of maintenance and repairs.

Dealers are reporting record high net F&I PVRs, further amplifying net profitability when combined with record high transactional gross profits – a result of significantly reduced inventory supply of new vehicles and MSRP/near-MSRP pricing persisting post-pandemic. The latest challenges to F&I stem from the rising interest rate & economic environment, resulting in reduced affordability for consumers, greater charge-backs for dealers, and generally throws the OEM lease/finance incentive market into turmoil. Absolute rates are the highest they have been in nearly three decades and stand to continue rising well into 2023-2024 based on recent Federal Reserve commentary.

Taken together with the growing likelihood that new vehicle transactional grosses will return to more normalized levels in the next 1-2 years, rising rates cast doubt on dealers' ability to offset falling new vehicle gross profits with higher F&I PVRs.

Shifting Ownership Base

Similar to prior reports, we continue to expect greater investment in dealerships from private equity and family office investors. The auto retail market enjoys substantial franchise law protections, which in and of itself makes dealership investments attractive to a broad slate of investors. However, there are also high barriers to entry in the form of manufacturer approvals, operator track records and dealerships that often only come for sale once in a generation. In recent years, private equity and family office investors have had greater success breaking into the automotive retail sector. We would expect this to continue and perhaps even accelerate in the coming years, as declining net profitability results in more reasonable valuation expectations, when compared to historical goodwill valuations across brands.

New Market Entrants Less Likely, Subscription Models for EVs

The idea of many new brands entering the U.S. market seems less likely today than in prior years. The sheer investment required to fund a retail build-out strategy for sales

and service precludes even well-funded start-ups from embarking a “Tesla-like” retail build-out strategy. The lack of suitable, auto retail-zoned sites and a rising interest rate environment make this harder, not easier, for those new entrants. We expect brands like Tesla, Rivian, and Polestar, among others, will seek to partner and/or otherwise utilize existing retail footprints as they embark on their expansion strategies. There may also be a growing acceptance among OEMs and consumers for an EV subscription model. This could be favorable for OEMs looking to drive production and acceptance of new EV products while also leveraging existing dealers’ expertise and physical footprint to increase units in operation.

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 and Z employees may have a different value system relative to prior generations and may hold work/life balance as a higher priority relative to income. This could be a significant risk to auto retailers broadly, given the high pressure of a commission-based salary structure in an environment demanding substantially more hours beyond a typical 9-to-5 work day.

Dealer operators have taken a hard look at personnel expense as a result of the pandemic. Newer technologies, enabling virtual test drives and walk-arounds, also enable, perhaps, a more streamlined sales process that would include a greater percentage of the process to be handled away from the dealership as opposed to in person. It would seem as dealers accept and embrace the omni-channel model, they may also be able to navigate shifting demands of employees, which are likely to become bigger hurdles in the next decade.

V. YOUR 2035 AND BEYOND FINANCIAL STATEMENT

Financial performance results can be dangerous to examine myopically. One manufacturer might have a blockbuster year while others falter, market forces could push the economy higher or into a recession, and a certain regions or states might face unique weather events that materially impact supply and demand for certain dealers. In light of these variabilities, we utilized NADA data from 2017 (converted to 2022 dollars) and estimated 2022 results based on mid-year 2022 NADA data to construct what we expect to be the average dealership financial statement for 2035. In order to make an easier comparison, the following is shown in current (2022) dollars.

Figure 16: Average Dealership Financial Profile

(All columns in 2022 USD)	2017	2022*	2035
New Vehicle Department Sales	$39,322,407	$36,881,968	$38,725,000
New Vehicle Department Gross Profit	$2,241,377	$6,343,698	$1,995,000
New Vehicle GP %	5.7%	17.2%	5.2%
Used Vehicle Department Sales	$18,760,744	$16,545,251	$25,125,000
Used Vehicle Department Gross Profit	$2,195,007	$3,759,081	$2,255,000
Used Vehicle GP %	11.7%	22.7%	9.0%
Used / New Retail Ratio	0.77x	1.00x	1.40x
Service & Parts Sales	$8,225,498	$8,225,252	$8,925,000
Service & Parts Gross Profit	$3,807,097	$4,212,152	$4,275,000
Service & Parts GP %	46.3%	51.2%	47.9%
Total Dealership Sales	$68,224,516	$61,652,471	$72,775,000
Total Dealership Gross Profit	$7,769,586	$14,314,931	$8,525,000
Total GP & of Sales	11.4%	23.2%	11.7%
Total Dealership Operating Expense	$7,667,194	$8,937,670	$8,000,000
Net Operating Profit	$102,393	$5,377,261	$525,000
Other Income	$1,492,247	$904,270	$1,075,000
Total Dealership Net Profit	$1,594,639	$6,281,531	$1,600,000

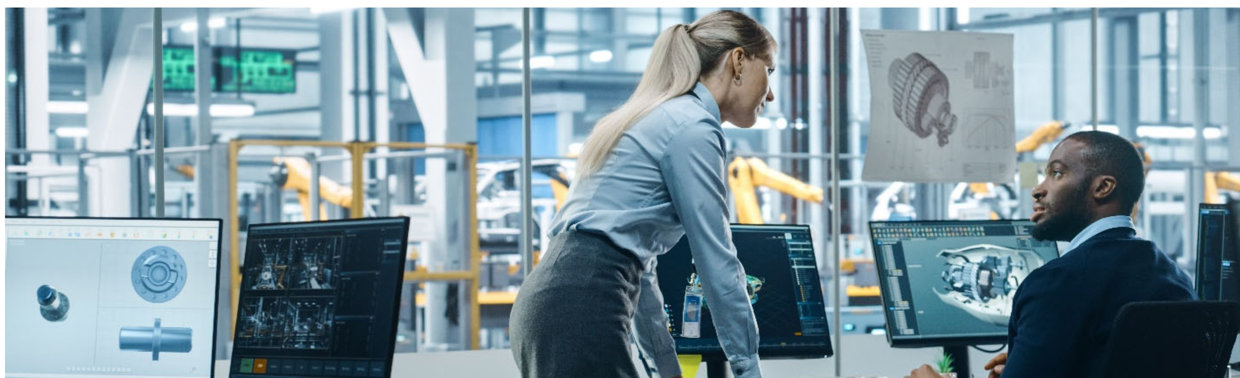
Source: NADA average dealership profiles & Auto Team America estimates.
** Note 2022 estimates based on mid-year 2022 NADA data.*

Predicting dealership returns forward from the financial anomalies of 2021 and 2022 is difficult. Such considerations impact valuation multiples, remodeling decisions, and even retirement plans for dealers across the country. Nevertheless, the supply chain will recover, supply will rise to demand, and as the old Persian adage tells us, "this too shall pass."

As this paper has discussed, concerns about the interference of manufacturers in the market directly impact dealership profitability. Even if the manufacturers do not enter the market directly in competition with franchised dealerships, they will continue to dictate in further reaching ways how dealerships operate. A majority of dealers polled believe that Other Income items will grow as the factory's favorite carrot dangles out rewards for volume bonuses, facility money, customer satisfaction rewards, dedicated support staff, and a seemingly never-ending list of behavior controls. At the same time, legacy programs that dealerships have relied on, such as floorplan assistance and advertising credits, show signs of disappearing, increasing expenses.

For the 2035 Average Dealer Financial Profile, we expect gross margins will compress for new vehicles while throughput continues to climb due to consolidation. In addition, pre-owned vehicles will become a more significant profit center (collectively contributing to used gross, F&I gross and both internal and customer facing fixed operations gross) for franchised dealerships as the vehicle complexity pushes reconditioning costs and technical ability beyond the average independent. As a result, in the decade leading to 2035, franchised dealers will begin to sell more used units than new ones. As a result, the ratio of 1:1 of new-to-used will rise to 1:1.4.

Service maintenance sales will decline, while repair work will remain the same as the U.S. fleet migrates to HEV and BEV vehicles. However, like the independent dealership, independent repair facilities will struggle to offer a full line of repair services. Additionally, the increased cost of the parts and capturing greater share of maintenance, repair and potentially collision work from the aftermarket in 2035 will help dealers maintain typical profitability within their fixed operations businesses.



VI. CONCLUSION

As in our prior papers, we have again attempted to diagnose and dissect key issues facing automotive retail operators today as well as those that will potentially impact in the next decade-plus ahead. While past performance is no guarantee of future success, it often serves as a good foundation upon which we can assess how, if at all, dealer principals will choose to pivot operations to evolve with the broader market. Moreover, this is not intended to be a complete list of potential disruptors to automotive retail, but based on our extensive survey and years of experience serving, studying, and otherwise analyzing automotive retail, these seem to be the key items at the forefront of dealer operators' minds today as they plan for the future.

Change is and has always been inevitable in automotive retail and the next decade will be no different. There will be leaders that evolve more quickly and perhaps accelerate the ongoing consolidation of market share among the approximately 18,000 rooftops in the sector. There will be laggards that are squeezed out of the market due to manufacturer plans for reducing dealer footprint, required investments in facilities and/or staffing, or simply just a lack of scale needed to properly compete in an ever-changing market of alternatively fueled products. Additionally, there will be operators that for various reasons, whether estate-planning or otherwise, look to exit the market completely. But for whatever underlying motivation, needless to say change continues to be a key theme in automotive retail in the years ahead.

That said, whatever the challenge, we believe at Auto Team America that auto retailers, who are entrepreneurial to their core, will find a way to successful absorb and adapt to the changing operational and economic conditions, as they have for nearly a century. There will be shifts in demand, shifts in profit drivers, and shifts in personnel in the coming decade. There will be challenges brought by manufacturers, financing partners and consumers alike. But we believe that automotive dealers, as they always seem to, will positively respond to the shifting land under their feet, and will remain the most effective, most efficient channel for selling, financing and servicing vehicles in the future. The most thoughtful, well capitalized, committed, and openly adaptive to change dealers will have the greatest upside to their future.

VII. EXECUTIVE SUMMARY

Our focus is on events occurring within the retail automotive space that the dealers will be able to influence, the most significant changes that may occur in the retail automotive business over the next 10 to 15 years and which industry disruptors will have the most influence in reshaping dealerships.

As we see it, the "Big 3" disruptors to retail automotive stores as of late are (1) OEM Direct & Dealer Online Selling, (2) Consumer Acceptance of Alternative Powertrains, and (3) the Impact of Alternative Powertrains on Fixed Operations.

Direct & Online Selling. Now more than ever before, dealers face challenges from OEMs debating how to sell directly to consumers (e.g. adopting the "Tesla retail model") and consumers shopping more freely online in and out of market for new and used vehicles. Dealers also face the challenge of appropriately staffing sales and service as younger generations appear less interested in automotive retail career paths. Balancing the risks of a rapidly evolving auto retail model will be a top priority for operators in the coming decade.

Alternative Powertrains. All OEMs are shifting resources to electrification as regulators demand it. Electrified vehicle sales are also growing at a staggering pace. However, the vast majority of consumers still have yet to test much less abandon ICE vehicles completely in a switch to electric powertrains. This will take some time to play out, but while 100% penetration may never occur, it is clear that EV penetration is likely to continue climbing in the next 10-15 years.

Long-Term Fixed Operations Profitability. Dealers must consider how electrification impacts their fixed operations business over the long-term. Conventional wisdom would indicate that EVs are less expensive to maintain relative to ICE vehicles, simply due to their having fewer moving parts. However, the data to date does not bear this out. EVs are highly complex, require substantial training, and in some cases sophisticated equipment to properly service. EVs are also relatively early stage and will likely have to work out "operating bugs" as the industry works toward its long-term production steady-state.

Dealership Evolution. Auto retailers are facing mounting challenges, generally rooted in their customers desire to interact and consume more online rather than in-store.

Factory Involvement. It is clear a growing percentage of dealers believe factory influence over the day to day operations of the dealership will continue, though far fewer believe OEMs can effectively transition to a direct-to-consumer strategy.

Consolidation. Private equity and family offices will continue to look at investing in retail dealerships though there will still be a place for family owned businesses with significant experience who are well capitalized

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VIII. FOOD FOR THOUGHT / PREDICTIONS

While our primary analysis and long-term outlook offered herein is predicated on dealer survey results, our own industry expertise and a typically more gradual, evolutionary change that has occurred through automotive retail history, we thought it might be informative to add a new section to this year's report highlighting some of the more striking predictions for the long-term auto retail landscape that come to mind include, but are not limited to:

- Amazon pivots to retailing used vehicles in the U.S.
- Tesla (or Apple) acquires a midsized import OE as a platform for EV development
- Tesla offers franchises to dealers and abandons factory to customer model
- What happens if hydrogen is the final solution and BEVs only a stepping stone?
- Electric grid blackout frequency in California materially delays government ICE to EV mandates
- Expansion of nuclear power (to include California?) in order to generate sufficient electricity to support EV demand
- Amazon acquires Lithia and/or another large franchise dealership group
- Berkshire Hathaway acquires another large dealership group
- The majority of late model collision repair moves from the aftermarket to franchise-owned collision repair centers
- Amazon acquires full control of Rivian
- Nissan acquires Hertz

IX. ACKNOWLEDGEMENTS

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