POOR RETAILER GROSSES REQUIRE A RETHINK

Executive Summary

February 2004

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WHY ARE NEW VEHICLE GROSS PROFIT MARGINS SO LOW?

There is a common complaint from many dealership operators that new vehicle gross profit margins are too low. In many cases, the dealership average retained gross profit from the new vehicle department is less than that charged for the customer delivery fee. This is an unacceptable situation (even though some dealers seem prepared to live with it) and is unsustainable in the longer-term. Hence the cross-subsidization by the other departments within the dealership, which places excessive pressure on them to deliver a strong financial performance

It seems to matter little, whether we are talking about a volume locally produced vehicle or an imported volume brand. The problem is the same. There is a general acceptance that this is the way it has been for decades, and will continue to be in the future.

However, is it possible to extract greater profitability from the new vehicle department or should we just accept it, and attempt to maximize profitability from parts, service, used vehicles, finance and insurance?

What can we do anyway to change such a situation? In order to consider possible alternatives we need to understand the dynamics within the market.

WHY ARE DEALERS IN BUSINESS?

Apart from absolute scale and size, there are a number of differences between the operation of dealer groups and family run dealerships. These differences centre on the very reason for being, for each of these dealer types.

1. Family run dealerships

The family run dealer business was the foundation stone of the automotive franchise system. A person who was recognized in the community took on a new vehicle franchise and was able to establish and build a business based on their knowledge of the franchise, their recognition within the community, and their ability to match the needs of customers with the offerings from the franchise. The franchised dealer businesses became in many cases, a way of life for the operator. The dealer was able to build a business while enjoying recognition in the community and providing the immediate family with motor vehicles; enjoying the hospitality of the manufacturer, a finance company, insurance company; and the regular incentive trips for the dealer principal and often their spouse.

Quite often dealer principals accepted less than satisfactory performance from certain staff members, not wanting to ‘rock the boat’ of the dealership business, which on balance provided an ‘OK’ lifestyle, so long as this did not cause problems with the manufacturer - dealer relationship.

Dealerships have followed the fortunes of the manufacturer and had good years and less good years depending on the economy, the manufacturer's model line-up and levels of competition within the marketplace. Also, the desire to minimise the tax burden motivates family businesses not to record a very high level of profit. This lack of transparency can sometimes turn into a lack of clarity about the need to earn an acceptable underlying return, whether in cash or in kind.

Many dealers gradually added to their dealership real estate holdings over the years. These holdings were often in a separate property company, which received rentals from the dealership operating company.

The lifestyle dealer will accept lower profitability, from new vehicle trading – and indeed from the business as a whole – provided an acceptable standard of living can be maintained, trusting that volumes and profit will improve in the future. During this time i.e. over the longer term, returns from property investments will no doubt provide additional wealth.

2. PUBLIC LISTED DEALER GROUPS

The advent of dealer groups added a more professional approach to dealership operations. Dealer groups, by their sheer size and diversity of operation and location require more sophisticated controls and management techniques to ensure that the business runs in a profitable manner.

Those dealer groups which are publicly listed compete for equity capital in the marketplace and must deliver an acceptable return to shareholders to compensate for the levels of risk within the business and within the industry sector.

The directors of these businesses understand the shareholder return issue and operate the business in order to deliver an acceptable return to shareholders. This necessitates the various areas of the business performing on a basis such that returns on the capital employed for the business as a whole are acceptable.

While there is nothing in principle to stop a public company allowing cross-subsidy if it earns a higher overall profit, its accounting and systems will tend to question such an approach by making it explicit. Consequently, the new vehicle department will be under pressure to operate on a basis, whereby the profits generated cover the total cost of operating the business, including an appropriate return for the capital providers (that is – both debt and equity).

In addition the publicly listed dealer group needs to show returns on a regular quarterly or half-yearly basis (depending on the local financial regime) year after year. These returns are dictated by the risk reward trade-offs for shareholders investing in this industry sector. They rarely reflect capital appreciation, except when it is realised through sale of the asset involved (and even then it tends to be regarded as an exceptional item, rather than the core return).

A continuum

From the above there appears to be a continuum between those dealers who are in the business for a "lifestyle" reason to those who are in the business to generate returns for the shareholders. Herein lies the problem. The motives for these two groups are totally different.

The other difference is that private family businesses often have much more continuity of management at dealership level; because for them building the business is the satisfaction. By contrast, dealer groups have to create career structures to provide longer term motivation, often involving more frequent movement of staff for them to progress. This may be good for the individuals but is often disruptive for the business.

THE CHALLENGE FOR PUBLICALLY LISTED GROUPS

1. Economies of scale?

Those who consider dealer groups often talk of the advantages of size in the context of economies of scale. While this may be true in terms of acquiring many of the inputs for the dealership, it does not apply to the purchase of new vehicles, as all dealerships purchase new vehicles at the same price and there is no scale advantage. As a result, dealer groups are not able to use their size to extract preferential buying prices from manufacturers. This is a fundamental difference in the automotive franchise business to most other retail businesses. There are also various complexity costs, related to the management and control structures entailed in a dealer group.

As a result in a competitive marketplace between dealers with the same brand, where price is the main determinant for a customer's buying decision, the dealer group has no scale advantage over the family run business.

Under this set of assumptions the gross profits from retailing vehicles in the marketplace will be set by the business offering the lowest price. If the selling price in the marketplace is determined by a dealership not accounting for the full cost of being in business (e.g. the "lifestyle" dealership), the profitability for that franchise in that market area will be determined by the lifestyle dealership. This will have a detrimental impact on other dealerships which operate towards the other end of the continuum.

2. Vehicle retailers are not like Woolworths / Tesco / Wal-Mart.

Motor vehicle dealerships don't have the advantage of buying power scale, as do the large retail establishments, such as Woolworths, Tesco and Wal-Mart. These large retailers have a scale and power advantage, which allows them to purchase products at a significant advantage over smaller operators. This enables such large scale operators to sell products at a lower price without sacrificing margin and pass savings on to their customers and in turn provide increased market share which in turn gives increased revenues. Increased revenues give the retailers further opportunity to exert pressure on the suppliers to drive purchase costs down, and the cycle continues. This is depicted in the following diagram.

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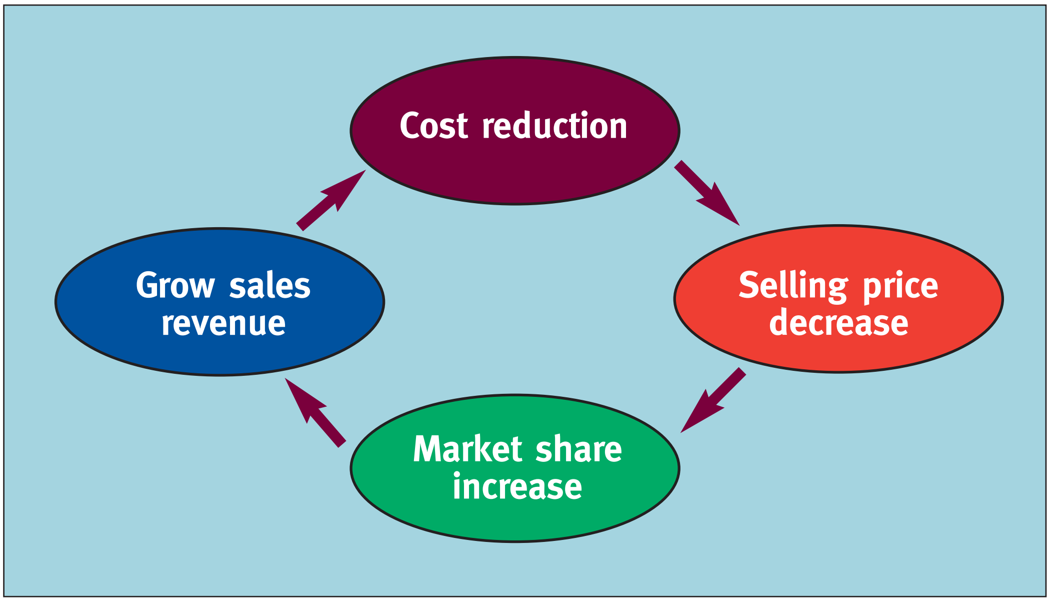

Model 1: Large Retailer Model

Scale derived from purchasing then flows into other areas, eg. building strong and trusted brands (e.g. Tesco is now one of the most trusted brands in the UK), and broadening the customer offer into a range of products and services.

Some EU dealer groups are now trying to gain scale purchasing but they do it by buying job lots of stock cars, with all the problems of selling from stock – there is an overall loss to the system. (Some small dealers are becoming authorised repairers, then buying nearly new vehicles from the dealer groups at better prices & margins than if they were buying new direct from the manufacturer). So far this has not happened in Australia.

Publicly listed dealer groups need to correctly determine where they are going to derive their competitive advantage with respect to other operators retailing the same brands if there is no buying advantage with respect to scale. There may however, be advantages in terms of quality of staff and back office processing, and this needs to be carefully assessed by the operators. There are also costs involved.

EARNING ADEQUATE RETURNS IN RETAILING

Vehicle dealerships like other businesses need to provide shareholders with an acceptable return based on the risks associated with the business. These returns need to be well understood by those operating the business. In the case of public listed companies the returns need to be commensurate with other businesses in the same sector, the risk profile and volatility of the company, and risk free rates of return e.g. from government securities.

The acceptable returns can be calculated for any business based on the composition of debt and equity in the business. The required returns when compared to the operating profit from the business determine whether the management of the business have created or destroyed value in the period being reviewed.

This concept has become widely accepted within corporations over the last ten plus years and is known by a number of titles such as shareholder value added (SVA); shareholder returns; economic value added etc.

The simplified diagram below indicates how SVA is calculated.

Model 2: Calculating Shareholder Value

While most public vehicle retail companies review their operations in this way in order to deliver adequate returns to their shareholders we are sure that many privately operated vehicle retailers do not undertake such an analysis.

Combine this lack of analysis and common buying price for new vehicles from suppliers and it is easy to see that if the privately operated retailers operate on a lifestyle basis then they place the public companies under a difficult position with respect to new vehicle margins and in turn overall profitability and shareholder returns.

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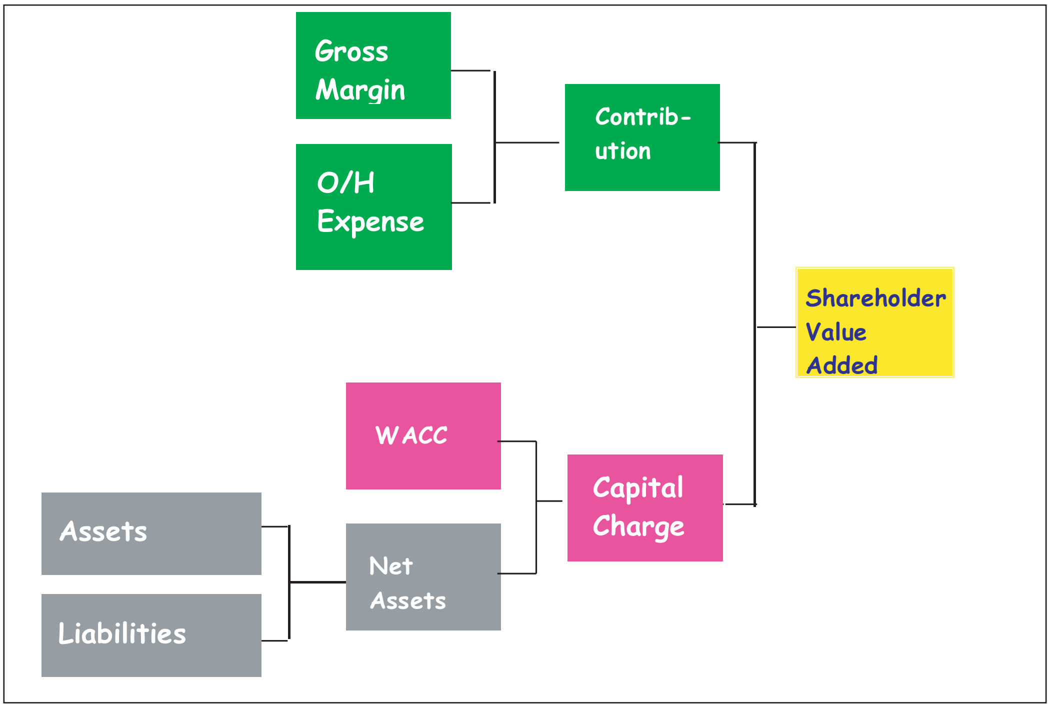

WACC = Weighted Average Cost of Capital

THE WAY FORWARD.

Having identified the problem, what is the way forward with respect to this issue?

All parties from the manufacturer, importer, finance company and retailer need to understand and address the underlying cause of the problem of low gross margins.

Education for all dealer principals with respect to understanding the true cost of capital for dealerships would be a useful starting point. It would be possible to include a simple shareholder value calculation, which includes a calculation of the weighted average cost of capital in the monthly reporting by dealers to manufacturers. The lead therefore needs to be taken by the manufacturers and importers to provide all dealerships, with a common understanding of this important aspect of their business. There is also a need to educate public company shareholders about the nature of group returns, including the role of capital appreciation.

This is not an easy problem to resolve and it raises questions about the inevitability of progression from family to dealer group to public company. In particular the assumption that groups can take on the expensive challenges (e.g. city sites) may be incorrect, as property is a particular issue for them. The conclusion may be that there is not one correct ownership model that will dominate in future. Each has advantages and weaknesses.

ICDP AND THE WORLD CAR INDUSTRY

ICDP is the world's largest research programme into all aspects of car distribution – logistics, retailing organisations and after sales: an independent project run by industry experts and academics, funded by participants from carmakers, dealers, car industry suppliers, representative bodies and governments. ICDP's work is published and is available to researchers worldwide.

ICDPA is the Australasian Associate of ICDP.

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