AUTO RETAILING: WHY THE FRANCHISE SYSTEM WORKS BEST

Executive Summary

For manufacturers and consumers alike, the automotive franchise system is the best method for distributing and selling new cars and trucks. For consumers, new-car franchises create intra-brand competition that lowers prices; generate extra accountability for consumers in warranty and safety recall situations; and provide enormous local economic benefits, from well-paying jobs to billions in local taxes.

For manufacturers, the franchise system is simply the most efficient and effective way to distribute and sell automobiles nationwide. Franchised dealers invest millions of dollars of private capital in their retail outlets to provide top sales and service experiences, allowing auto manufacturers to concentrate their capital in their core areas: designing, building and marketing vehicles.

Throughout the history of the auto industry, manufacturers have experimented with selling directly to consumers. In fact, in the early years of the industry, manufacturers used three methods to sell vehicles, sometimes concurrently: (1) factory-owned stores, (2) independent distributors under contract and (3) independent franchised dealers. Manufacturers quickly learned that the franchise system worked best. Franchise agreements ensured adherence to brand standards and consistency. Manufacturers also realized that independent, entrepreneurial franchise owners—all of whom had made significant financial investments into their businesses and communities—were much more highly motivated and successful retailers than factory employees or contractors.

That's still true today, as evidenced by some key findings of this study:

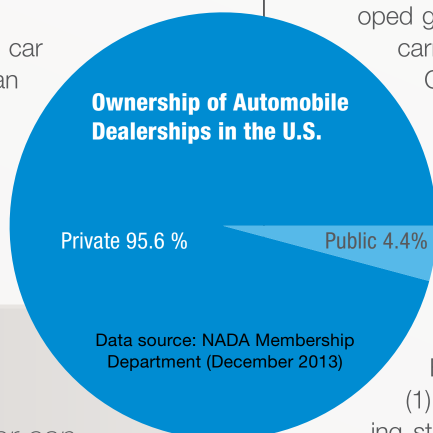
- Today, the average dealership requires an investment of $11.3 million, including physical facilities, land, inventory and working capital.
- Nationwide, dealers have invested nearly $200 billion in dealership facilities.
- Annual operating costs totaled $81.5 billion in 2013, an average of $4.6 million per dealership. These costs include personnel, utilities, advertising and regulatory compliance.
- The vast majority—95.6 percent—of the 17,663 individual franchised retail automotive outlets are locally and privately owned. They generate billions in state and local taxes annually and provide significant employment opportunities that help build goodwill in the community.
- Manufacturers benefit from the high return on capital invested in manufacturing vehicles, as opposed to the low margin of retailing them.
- Dealers bear the cost and risks of these investments—at virtually no cost to the manufacturers—and provide a vast distribution channel that benefits the consumer.

> *"We need people in the individual communities to serve those customers. We couldn't do that from a central location. And so our dealers are the embodiment of Ford Motor Company in their local communities—both in how they sell and service our vehicles to the consumers … The system works well because there are entrepreneurs—dealer principals—investing in the facilities and the people locally, to serve customers. And it's served us well for over 110 years and will continue to serve us well in the future."*
>
> JOE HINRICHS, FORD MOTOR CO. VICE PRESIDENT AND PRESIDENT OF THE AMERICAS

Overview

"The prejudices of some political writers against shopkeepers and tradesman are altogether without foundation. So far from it being necessary to tax them or to reduce their number, they can never be multiplied so as to hurt the public though they may be so as to hurt one another." (Adam Smith, The Wealth of Nations)

These words remain as true today as when Adam Smith wrote them 200 years ago: retailers compete fiercely for customers, and that competition is good for everyone, not just consumers. There are few industries with as aggressive or economical a retail model as the automotive franchise system. Far from being mere "middlemen," franchised dealers provide a wide range of services that are essential to the effective and efficient distribution of motor vehicles and, in support of those services, invest millions of dollars of private capital into retail outlets. Most of these retail outlets are privately owned, representing not large corporations but individual, family-run businesses that are locally based.



In the U.S., virtually every new car or light truck is purchased through an independently owned and operated franchised automobile dealership. The automotive original equipment manufacturer (OEM) makes no investment in these retail outlets. Dealerships are financed completely independently by owners and operators who combined have invested tens of billions of dollars into thousands of independent retail locations. In addition, dealers employ more than 1 million workers in some of the highest-paying retail jobs available.

Moreover, the lion's share of the 17,663 individual franchised retail automotive outlets are locally owned, atypical given the rapid consolidation in the retail sector. Indeed, private ownership accounts for 95.6 percent of the dealerships in the U.S.

Evolution of the dealer model

This fragmented ownership structure is not the result of market inefficiency or regulation, as some would claim. Far from being a burden on the public, the sales and service process that dealers provide is a natural evolution of the marketplace that has continued to serve customers for over 100 years.

While the earliest automobile dealerships existed before 1900, the modern system of franchised dealerships developed gradually. In the earliest days of the horseless carriage, there simply was no need for a dealer. Customer demand for vehicles was so high that there were often waiting lists for companies that had yet to produce a single vehicle. This was a customer-pull model, where demand exceeded supply and companies were virtually assured of selling out their production runs.

This system changed rapidly with Ford's introduction of the mass-produced Model T. By the 1920s, three separate systems existed: (1) a branch system with automotive OEMs owning stores (2) independent distributors under contract with an OEM and (3) independent franchised dealers. All three methods were used to sell directly to consumers, but the factory-owned outlet was quickly being eliminated, out-competed by independent dealers.

OEMs learned early on that ". . .even a man who makes a 'fair to middling dealer' lies down and quits completely when put in charge of a factory branch—where the urge of actual personal incentive is less strong." (Epstein, 1928). This was particularly important as the market for motor vehicles fundamentally changed. Most significantly, by the 1920s an OEM could no longer count on its cars selling out a production run. The intensity of competition had increased dramatically, particularly between Ford and General Motors. Motor cars had changed from being a toy of the wealthy to a mass-produced household utility. The change meant that consumers now required financing and service.

Just as the market for selling vehicles became more difficult for OEMs, the methods of manufacturing cars also became more capital-intensive. In 1910, a plant would employ 500 to 600 workers and manufacture a few thou-

> *"Our dealers know their markets better than we ever can. They compete against one another to provide Toyota customers with the best buying and service experience possible. Toyota, Lexus and Scion dealers are among our most valuable business partners. They are the experts at every aspect of selling and servicing our products. Our dealers have invested so much of their hard-earned money — and sweat equity — into their businesses. When they succeed, we succeed."*
>
> JIM LENTZ, CEO, TOYOTA NORTH AMERICA

> *[GM dealers] are an asset … Think about it. They understand the communities, they have relationships with customers … We are seeing a great partnership, we're seeing great service, working together.*
>
> MARY BARRA, CEO, GENERAL MOTORS

sand cars a year. But by 1930, Ford's Rouge River complex in Michigan employed tens of thousands of people and produced hundreds of thousands of cars a year. (Rubenstein, 2001) This new level of investment and production meant that by the 1920s consumers had significant choice in the automotive market and OEMs needed retail sales outlets that could push these vehicles out to consumers.

These market changes—combined with the simple realities of increasing competition—meant that selling directly to the public was increasingly a distraction and a hindrance to OEMs. Manufacturers were fixated on design and production, on increasing labor strife and on product cycles that had become ever more complex to manage. The additional burden of finding suitable retail locations, funding thousands of them, and then recruiting and incenting sales staff was simply too cumbersome. This was especially the case when independent dealers were ready, willing and able to handle all these functions in addition to funding inventory and constructing retail outlets, most often out of their own pockets. The use of independent dealers also afforded OEMs another advantage: speed. It was not only simpler but far faster to set up franchised dealers in exclusive sales territories.

Current status

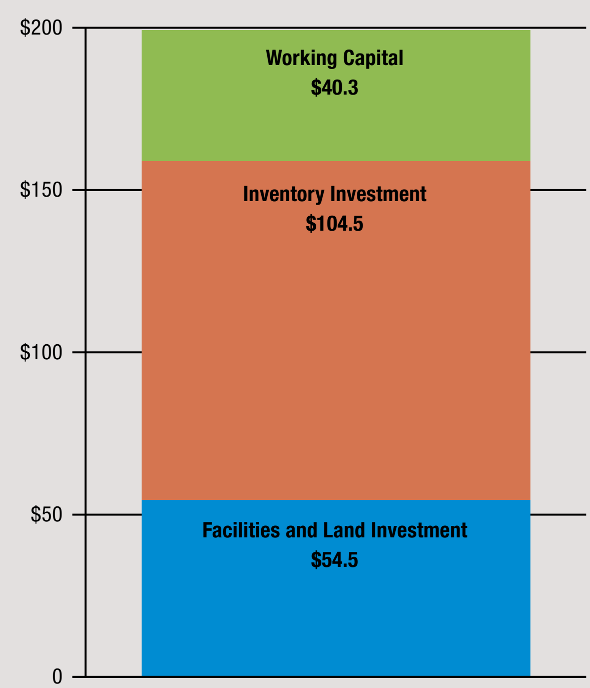
Competition was and remains intense among independent retailers and is best illustrated by both the lagging profits of automobile dealers and the steady decline in automobile retail outlets. Automotive industry profits rose steadily, from $38 million in 1914 to $1.3 billion in 1956. Meanwhile dealership profits declined, from about 33 percent in 1914 to 5 percent in 1956. (Rubenstein, 2001). By 2007, profits at dealerships had declined to 1.5 percent, before declining further to 1.0 percent during the recession and then rising slightly to only 2.2 percent in 2013. (NADA, 2014).

Dealer investments to facilitate these sales are considerable (see chart at right). Dealers invest an average of $11.3 million in each individual dealership. These investments can be broken down into three categories: (1) the actual physical facilities and the land on which dealers operate, (2) inventory and (3) working capital.

- Most dealerships require several acres of land in addition to a retail store, service bays and storage areas. These OEM requirements are fully funded by the individual dealers at an average per-franchise cost of just under $3.1 million.
- Dealers also carry all of the inventory costs of the vehicles on their lots. Dealers pay immediately for their inventory at the railhead. The costs to carry this inventory are not born by manufacturer and amount to an additional $5.9 million.
- OEMs have specific requirements for dealer working capital. Typically, an OEM will require that dealers carry net working capital investment equal to two months' parts inventory plus the value of two months' new- and used-vehicle inventory. In addition, more working capital is required to fund receivables due from the OEMs, customers and finance companies. The average dealership has just over $2.2 million in working capital.

These investments by dealers represent only the capital required. In addition to these costs, dealers also incur large operating expenses (see chart at bottom of page 4). Personnel costs for dealers in 2013 averaged over $1.9 million per dealership, over $33 billion collectively. In addition, training for these employees, whether sales staff, or back-office operations, was over $800 million nationally.

Total U.S. Dealership Investment (in billions)



Data source: NADA Industry Analysis Division (Tuff)

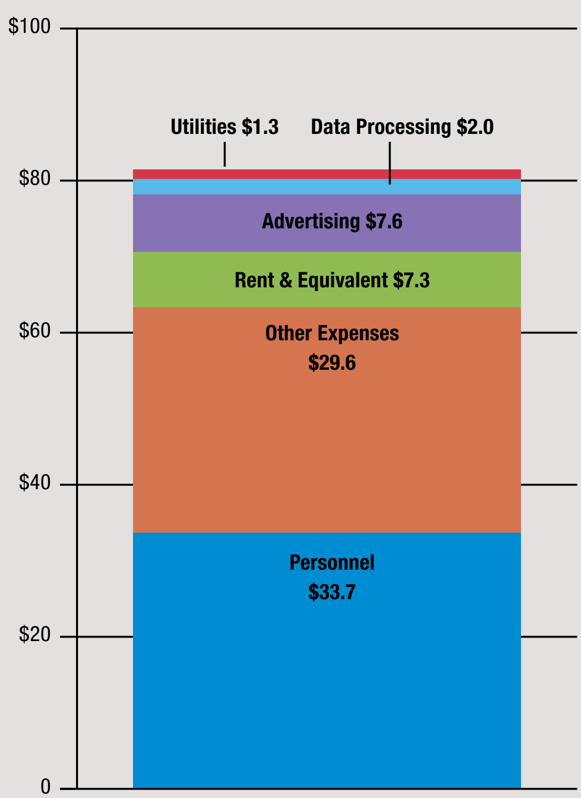
Dealers also advertise heavily. In addition to the spending by OEMs, dealers spent $7.6 billion on advertising in 2013—more than $21 million per day.

Finally, there is a regulatory cost burden faced by dealers. This includes complying with local and state ordinances, federal trade regulations and occupational health, safety and environmental requirements. These costs are estimated to be nearly $3.2 billion for all new-car dealerships.

The costs of owning and operating a dealership are separate from the costs of operating an automobile OEM. Indeed, the total investment by dealers in property, facilities and working capital exceeds the total investment by each of the OEMs themselves. This is not a matter of happenstance. As the vehicle-distribution channel developed over time, the OEMs learned the advantages of being inherently occupied with achieving high returns on invested capital by making cars over investing in low-margin retailing.

On occasion, a glamorous idea grips the mind of automotive executives and lofty ideas of dealer inefficiency and rent capture captivate their expectations. Yet dealer margins are slim, and the operations themselves require large-scale investment and careful planning. OEMs that have attempted to launch branch systems or pooled vehicle-distribution centers have failed miserably.

Total U.S. Dealership Expenses (in billions)



Data source: NADA Industry Analysis Division (Tuff)

The most cited case—the Chevrolet Celta program in Brazil—was a dismal failure for GM. Selling directly to the public proved a burden on corporate offices, and it suffered from constant resource allocation issues, something with which no independent dealer ever struggles. There were also questions about the management of financing, delivery and inventory carrying costs. Indeed, the program proved so costly it was abandoned within only a few years. In contrast, dealers voluntarily take on these burdens from automotive OEMs. Dealers are in the business of selling, so resource allocation is never an issue. Inventory of new vehicles is merely a cost of doing business, and dealers represent the largest single point chain of financing anywhere.

Conclusion

Efficiency and efficacy are constant questions for consumers and retailers: is the current system of independent dealers efficient and effective? Clearly, dealers take on a large financial burden to run stores, create pleasant retail environments and train staff. Is it more efficient for an automotive OEM, burdened by the capital-intensive needs of large-scale manufacturing operations, to recreate such a system? Historical evidence suggests the answer is clearly "no."

Few, if any, OEMs make good retailers; the businesses require vastly different skills, investments and incentive structures. Manufacturing lends itself well to the system of scientifically measured quality, quantity, and safety. Retailing lends itself to the inducement of consumer behavior melded with the irrational and unscientific emotional buying experience.

The success of some OEMs in operating retail outlets should not be confused with a renaissance of efficiency in the marketplace for cars. Anyone can sell an item where demand exceeds supply. The true test of a retailer comes when competition leads to supply exceeding demand. The U.S. has a free automotive market where competitive forces inherently come to bear in all segments with time. The question should not be about what inefficiency a committed dealer brings to her or his brand but rather what inefficiencies and overhead does an OEM bring to its retail operations.

Selected References

Rubenstein, J. M. (2001) *Making and Selling Cars: Innovation and Change in the U. S. Automotive Industry*. Baltimore: The Johns Hopkins University Press

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Data for this report was derived from dealer financial statements that are provided to NADA on a monthly basis from several OEMs as well as directly from dealers themselves. The numerical figures in this report are derived from direct line items contained in the financial statements as well as from composite calculations from several individual metrics.