



Prepared for the National Automobile Dealers Association
by Maryann Keller and Kenneth Elias
MARYANN KELLER & ASSOCIATES, LLC
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▶ **Consumer Benefits of the Dealer Franchise System**

An examination of the consumer benefits of the franchised new-car dealer system in the USA.



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About the Authors

Maryann Keller

Ms. Keller is the founder of the automotive consulting firm bearing her name. She has over forty years of experience in the automotive industry, with the last thirteen years in her present capacity. She provides advisory services for a broad variety of clients in connection with the global automotive industry. She advises clients primarily in the role of corporate strategic actions, asset valuation and due diligence, industry analysis and advisory services, and debt and equity analysis.

Formerly, she worked as a Wall Street securities analyst for the automotive industry for over two decades where she was Chairman of the Society of Automotive Analysts from 1994 to 1999 and was named as an *Institutional Investor* "All Star" analyst twelve times. During that time, she also participated in MIT's International Motor Vehicle Program which produced two landmark books about the industry, *The Future of the Automobile Industry* and *The Machine that Changed the World*. She also authored two books about the industry including *Rude Awakening: The Rise, Fall and Struggle to Recover at General Motors* which won the Eccles Prize for Excellence in Economic Writing.

Ms. Keller served as the president of priceline.com's online new car buying service from June, 1999 through November, 2000.

Ms. Keller is widely quoted and often appears on leading business and financial media with regard to the automotive industry. She serves as a Director of DriveTime Automotive (one of the USA's largest used car dealers serving credit-challenged customers). She previously served as a Director of Dollar Thrifty Automotive Group (NYSE-DTG) until its acquisition by Hertz in November 2012, and previously in a similar capacity at Sonic Automotive (NYSE-SAH) and Lithia Motors (NYSE-LAD).

Kenneth Elias

Mr. Elias is a partner with Ms. Maryann Keller in Maryann Keller & Associates, LLC. He has over twenty years of experience in the automotive industry, with the last thirteen years in his present capacity. He provides advisory services for a broad variety of clients in connection with the global automotive industry, primarily in the role of corporate strategic actions, asset valuation and due diligence, industry analysis and advisory services, and debt and equity analysis.

Formerly, he served as dealer principal in a franchised used car store, and was recruited by priceline.com to develop its automotive services unit in 1998. His career started as a lending officer with Bankers Trust Company. He has written a number of articles on the industry, including publication in *Barron's*, *Wall Street Journal*, and *Dealer Magazine* among others.

He is a graduate of Dartmouth College and acquired an M.S. from MIT.

Executive Summary

Alfred Sloan, in his historic book “My Years at General Motors,” provides a visionary assessment of how automobiles are retailed. Sloan writes that “[t]he individual franchised dealer, usually a substantial businessman in his local community, meets the customer, often as a neighbor, trades with him, and services the product sold. The personality, acquaintance, and standing of the dealer as a local merchant are the basis to the type of franchise distribution which has become the custom in the automobile industry.” Sloan further states that “[t]he automobile is not like the usual product that customers buy ‘off the shelf’ every day. It is a highly complex mechanical product. It represents a large investment for the average purchaser. He expects to operate it, perhaps daily, yet the chances are he possesses little or no mechanical knowledge. He depends upon his dealer to service and maintain the product for him.”

Although there have been enormous changes in the automotive retailing industry since Sloan penned his words, his fundamental understanding remains true today. The franchised dealer system has efficiently and effectively served the needs of car buyers and the auto companies they represent for more than one hundred years. During this time, the responsibilities of franchised dealers have become greatly enlarged with much greater complexity than ever before. Dealers now accommodate customers across a broad credit spectrum with a wide array of financing options, promote certification of late model used cars, and invest in service facilities and equipment with continual training for technicians to properly repair and maintain today’s sophisticated vehicles. Sales personnel also receive training relevant to explaining new features and technologies. At the same time, dealers have invested in their stores to fulfill the branding objectives of auto companies and adopted software and Internet services to help manage their businesses and especially to engage with customers in buying, financing, and servicing their vehicles.

The consumer benefits of an independently-owned franchise system arise not only from each dealer’s ability to support the elements of every car purchase beyond simply determining the purchase price, but also from the fact that national franchise networks foster competition and therefore ensure fair market pricing in new and used cars and with service. Dealers compete with both same brand and competing brand dealers in their local markets and, through the Internet, with potential customers outside of their normal market areas. As a result, this gives consumers a greater ability to not only find the exact new or used car they want but to have even more dealers compete for their business.

Dynamic pricing for new vehicles in the marketplace arises from not only competition among automakers but also from competition between franchised dealers. As with most consumer products, there are a multitude of reasons for price variability that is reflected at any one dealership including demand (employment and business conditions), alternatives (competition from other makes and models), and supply (a dealer’s inventory mix or availability elsewhere). Manufacturer experiments in retailing have ignored these factors and emphasized fixed prices and greater concentration of retail outlets compared to today’s structure where automakers can award franchises to individuals that they believe will support their brand and customers without the manufacturer considering the return on that investment.

The separation of the retail sale and service functions apart from the design and production of vehicles enables free and open competition among different brands as well as among dealers of the same brand. This translates into a marketplace where national, regional, and local factors are permitted to influence transaction prices for new and used vehicles as well as for service. With a franchise system of retailers, manufacturers are paid immediately for their new cars by their dealers upon shipment; dealers then take the market risk of selling these vehicles. The marketplace has always weeded out those dealers who are ineffective in running their businesses or do not serve their customers well.

The financial performance of every franchised dealer is dependent on both the competitiveness of the brand they represent as well as their own reputation within their local markets. While dealers have little control over the former, they make tremendous efforts to achieve high customer satisfaction ratings in both sales and service. And, they generally succeed. Contrary to the uninformed criticism of dealers in the media, there is substantial evidence that car buyers today are very pleased with their dealership experiences buying a car or having their vehicle serviced.

In order to fully appreciate the value of the franchised dealer, it is first necessary to understand the needs and expectations of the typical car buyer. The average new car is now purchased for about \$32,000, requires financing, and generally replaces an existing vehicle. Although it is possible for anyone to separate the elements of a purchase transaction, most customers rely on the convenience provided by specialists in the dealership to handle all aspects of the transaction (trade appraisal, financing, registration and title paperwork and fees, and completing other regulatory paperwork, for example).

Dealers provide car buyers with the ability:

- to educate themselves about market prices and specification of the cars they are considering;
- to obtain competitively priced financing consistent with their budget and credit standing;
- to have immediate access to inventory and later to routine maintenance and fulfillment of the factory's obligation for warranty and recall repairs; and
- to sell their trade-in vehicles into a liquid market for used cars and trucks.

There is simply no other vehicle distribution system that enables every customer to be similarly accommodated throughout the car buying process and the ownership experience. To define the role of a dealer as a passive middleman whose only function is to deliver a car at a negotiated price is to not comprehend the various services provided by the dealer to enable the purchase and to maintain the car over its long life. To suggest that the dealer can be eliminated without adverse consequences is also to ignore the failure of experiments that tried to bypass dealers. Neither online models nor factory ownership or control of retail outlets has ever achieved a stated goal of increasing share and/or lowering costs.

The easiest part of the car buying process is agreeing on the purchase price with the dealer. Car buyers have broad access online to manufacturers' selling price data along with invoice pricing on each model. They can browse inventory and engage multiple dealers in price discussions and learn about

manufacturer incentives online, by phone, or in their stores. Franchised dealers have established their own websites, participate in lead generation services, and often employ specialists dedicated to answering both vehicle and price related questions online. There are no other retailers whose businesses have so completely integrated the online and real world experience.

There are more than 17,000 franchised dealers in operation in the United States. Each dealer is part of a national network for their brand that assures convenient access to service for every owner anywhere in the country. Owners can count on franchised dealers being able to maintain and repair their vehicles according to the manufacturer's servicing requirements and, especially important, to make all necessary recall and warranty repairs.

Although automakers experimented with factory ownership of retail outlets (including some initiatives to build cars to order), none of these investments survived because they neither delivered value to consumers nor reduced distribution costs. In a factory-operated system, the capital and operating costs of sales and service outlets simply shift from dealer to factory. And though factories own some dealerships in some markets outside of the United States, there is no evidence that factory-owned dealers provide lower prices and a better customer experience.

A factory-owned system would necessarily have fewer "points" or stores to provide sales and service as capital is limited, smaller communities would not provide the needed profit (in relative terms to a larger metro store), and the management of a large network entails many costs and difficulties.

Critics of the franchise system argue that consumers would be better served by what would, in fact, be a monopoly where the manufacturer sets prices for new and used cars, service and, perhaps, even financing. The assumption that the factory ownership would pass along savings, if there were any, to the customer is simply wrong. The Ford Collection experiment, for example, sold cars at fixed prices that resulted in less competition with reduced access to sales and service as some stores were closed in each consolidated market. Ford eliminated fixed prices within two years thus demonstrating that the marketplace, not the manufacturer, will set prices and that the independent dealer is best able to reflect market conditions at the store level.

Advocates for a factory-owned system assume that the manufacturer would be as objective as an independent dealer in addressing all customer complaints. However, the dealer, who is dependent on the goodwill of his customers and financially independent of the manufacturer, must advocate on behalf of his customers with the factory in disputes over defects, warranty claims, and recall repairs.

The notion that an automaker must own its sales outlets to ensure that its products are appropriately marketed is also specious. Every automaker establishes specific standards for how its cars are marketed and serviced. A brand new auto company, like the nearly dozen franchises established over the last twenty five years in the U.S., used the opportunity to define the design of all branding elements – including uniforms worn by the sales and service staffs, special training for sales and service personnel, and even required perks for service customers. Although "dualing" of brands was commonplace forty years ago, today nearly every automaker wants its vehicles sold and serviced in stores exclusive to its brand.

The emergence of the Internet was seen as the enabler for altering customer access to information and engagement with dealers in the car buying process, but it has not moved the actual purchase process online despite forecasts to the contrary. Academics, investment analysts, and automakers expounded on the benefits of alternative distribution in the late 1990s and early 2000s, creating a body of literature that is all but worthless. Nevertheless, these reports remain the fodder of modern day researchers and journalists who rely on them as if the conclusions were valid today. These researchers and journalists have forgotten that such reports were produced during the hyperbole of an era where many companies that had “dot com” in their names and promised to move real world businesses “on line” attracted (in total) billions of dollars of investors’ money only to lose it all.

Old and disproven research papers regarding the validity and value of an independently owned franchise network are still used to criticize the franchise system. For example, a Department of Justice report written in 2009 is largely based on source material from the “dot com” era. Because the paper was written by the Department of Justice, it is routinely quoted as a credible analysis of auto retailing despite its heavy reliance on flawed source material, including works by academics that lack a basic knowledge of how the auto retail industry operates.

The automotive industry, from the factory through to the store, has dramatically changed in the last twenty years. Automakers have re-engineered how cars are designed and built using common platforms, automation, and flexible manufacturing to reduce cost and derive greater control over inventories. No one has to settle for a car that is not exactly what he or she wants. However, although much has changed about cars and consumer behavior, the role of the dealer in assisting each of his or her customers to find the right car for their needs at an affordable payment and later service that vehicle throughout its life has not. The personal relationship with a local business, and often a specific individual, has tremendous value that cannot be replaced by an 800 number and a call center. The dealer acts as an advocate with the factory for the owner, especially with respect to warranty and recall claims. As a local business, the dealer knows that the goodwill of his or her customers determines success. In other words, Alfred Sloan’s original vision of the value and importance of the dealer model remains true and accurate today.

I. The Unique, Multi-Step Process of Buying a Car

Buying a new car represents a significant financial commitment for most families, second only to purchasing a house. Although shoppers begin their vehicle research online, the actual transaction is usually completed in the dealership because it has to be tailored to the specific needs of each buyer. This can involve valuing a trade-in and settling any unpaid loan, educating customers as to the financing options appropriate to the individual's budget, and completing all of the paperwork required by state agencies, lenders, and others.

The more-than-hundred year partnership between automakers and their franchised dealers has worked to create the most efficient and effective process for selling and servicing vehicles. Franchised dealers act in accordance with a manufacturer's marketing, branding, and sales goals while competing with each other not just on price but also on service and overall customer satisfaction. Their success depends not only on the popularity of the makes and models they sell but also on their own reputation for meeting their customers' expectations. Automakers are relieved of the burden of investing in and managing a retail operation that is subject to dynamic forces in the market.

Dealers Facilitate Car Purchases and Lifetime Vehicle Service

Consumers – that is the retail public – purchased approximately 13MM new vehicles in 2013 (with more than 2.5 million units bought by fleet accounts) typically with the support of dealers. With the exception of cars sold by Tesla Motors, all were retailed by franchised new car dealers – mostly in person at a local car dealership where the new vehicle is delivered the same day or within a few days. For more than a century, franchised dealers have served the public's car purchase and ownership needs while experiments in both factory ownership and online car buying have failed. State franchise laws are typically blamed for the failure of alternative models, but this has not been the case. These experiments failed because the factories realized no benefits in doing so; no cost savings were found and in reality they ended up replicating the services provided by their dealers.

Independently-owned franchised car dealers sell vehicles at market-clearing prices – and then provide service throughout the life of the vehicle. The consumer benefits most when the production and sales/service aspects are separated; when combined, the consumer is disadvantaged. Franchised dealers are efficient and effective in serving the auto companies they represent and the customers who buy new and used vehicles from them. The complexity of the purchase for most buyers, their expectations for service over the life of the vehicle, and the competition among dealers that yields market pricing are important attributes of the franchise system.

For example, more than 60% of car purchases involve a trade-in and those trades are sometimes worth less than their outstanding loan balance. This can complicate the transaction by requiring a payoff of the current loan. Furthermore, according to Experian (State of the Automotive Finance Market, Fourth

Quarter 2013), nearly 85% of all new vehicles were financed, thereby creating the need to identify a competitive financing alternative given family budget and down payment requirements.

Buying a Car is Not Comparable to Any Other Consumer Purchase

Many commentators still maintain that if cars could be bought directly from automakers through a website or factory-owned store, consumers would benefit from lower distribution costs and have a better purchase experience. Despite the fact that there is not one shred of evidence to support these claims, criticism of the present system continues.

For example, it is often remarked that the majority of consumers dread buying a new car. In a recent Boston Globe column (“Is the Auto Franchise System a Lemon?” Tom Keane, May 26, 2013), it was stated that:

“[b]uying a car is the bane of every consumer’s existence....Why is it that we can’t buy cars like every other good?”

The columnist writes that one can buy a \$25,000 television from a store or online but one can’t buy a \$14,000 Ford Fiesta the same way. The columnist complains that, unlike other retail products, new cars can only be sold through franchised dealers – a retail system enshrined by state laws. This, the argument continues, prevents alternative retailers – such as online sites like Amazon.com or retail stores like Target or Wal-Mart – from selling vehicles and blocks direct purchases from the manufacturer.

This analysis implies that auto companies would surrender brand building, customer education, and the ownership experience to mass-market retailers that would commoditize all brands by selling cars side by side as they do appliances and house wares. Or they would eliminate their dealers and sell directly to consumer in some fashion. Neither scenario meets the real-life needs of the majority of customers or the dozens of brands offered by automakers who invest billions of dollars every year to develop differentiated products to appeal to consumers.

Franchised dealers represent their automobile brands in their communities and, without their services, buying a car would impose time consuming burdens on customers to say nothing of how and where they could find reliable service for their vehicles. Moreover, automakers set standards for store design, customer satisfaction, and technician training and make many other demands for how their vehicles should be sold and serviced. The product is the brand (and vice versa) – both of which have substantial value – with a sales and service process that is more complicated compared to all other consumer purchases, except (perhaps) buying a house.

Motor vehicles are expensive, require periodic maintenance, and are often subject to warranty repairs during their early years on the road with recalls often coming well past the twelve year mark. Because motor vehicles are highly complex mechanical devices – and are a necessity to get to work, school, or

grandma's house – one cannot disassociate sales from service as the Boston Globe columnist seems to want to do. Moreover, the purchase of a motor vehicle – either new or used – is not a simple transaction. Buying a car involves multiple steps and requires professionals to accommodate the specific requirements of each consumer which could include credit issues, a trade-in worth less than the remaining loan balance, trying to match what the buyer wants with what he or she can afford, or helping the technology-challenged to overcome their aversion to all the functions controlled via a touch screen in modern cars while educating them to an increasing array of electronic safety features and alternative power plants.

Critics like the Boston Globe writer make no mention of (i) how the owner would ensure that warranty and recall repairs were quickly, conveniently, and completely done on a vehicle bought through Amazon, (ii) where and how the vehicle would be delivered, (iii) how the shopper would arrange financing or undertake the paperwork associated with licensing and registration, or (iv) where or how he could realize the equity of his trade or payoff any existing loan. To equate buying a car with buying a book is absurd, yet those comparisons are often made. Motor vehicles are not like books, shoes or clothing that can be easily ordered online, delivered by UPS or FedEx, and easily returned if damaged or, in the case of shoes or clothing, that don't fit. Furthermore, cars can weigh 4,000 pounds or more and occupy 100 square feet of floor space. Transporting them in bulk or one at a time is expensive and requires professionals using specialized vehicles and rail cars, not a small brown truck and one very busy driver.

All too often the role of the dealer is defined as merely setting the price of a car while using the word "middleman" in a derogatory manner. Critics of the franchise system conveniently disregard the services provided by the dealer which, in turn, allows them to ignore the disadvantages of a factory direct sale system. Car buyers value the convenience of being able to trade in their old cars simultaneously with the purchase of a replacement (which often reduces the sales tax obligation on the new car purchase in most states), of obtaining financing that allows them to afford the car they have test driven and now want to buy, and most importantly of having access to reliable and convenient service over the life of the car. For proponents of a factory direct system, the dealer is a middleman who adds costs. But if a factory direct system provided the same necessary services as a franchised dealer, the expenses and capital investment in such a channel would be identical.

Looked at another way, it is hard to find any savings to a car buyer who has to dispose of an existing vehicle on his own, search for the best finance terms, title and register the vehicle, and then have the car serviced through whatever arrangements made by the manufacturer.

The Purchase Process: Customer Education Requires More than Photos on a Website

We live in an exciting era where competition among automakers' more than 300 models provides a dizzying array of choices and price points to satisfy every shopper. New vehicles for sale today feature advanced technologies that must be experienced to appreciate their value. New propulsion systems (e.g., diesels, battery electrics, and hybrids), safety systems (e.g., blind spot alerts, lane departure warnings, camera systems, etc.), and infotainment systems make every new model vastly different from the model being traded in. Even something as simple as seating comfort can't be assumed from data provided online or photos. You have to sit in a car and decide whether it allows for a comfortable driving position for your body and at the same time affords visibility in all directions. No amount of consumer research done online today can substitute for the live demonstration of the new vehicle, which is why the tradition of visiting multiple dealerships to inspect and test drive selected models is still enshrined in the car buying process.

The vehicle purchase process by the consumer involves:

- research (usually started online);
- selection of a suitable product among local inventories at competing dealerships from one or more manufacturers;
- test drives; and
- budgeting a range of monthly payments and cash and trade-in value toward a down payment.

The dealer and his staff accommodate the customer needs in, among other things:

- obtaining financing for the vehicle with affordable terms subject to the consumer's credit condition;
- valuing the traded vehicle and paying off an existing encumbrance;
- determining the cash needed from the customer, if any, to consummate the transaction; and
- collecting and paying taxes owed and providing title and registration services.

The specifics of an automobile purchase are unique to each consumer because of his or her financial and credit status, his or her trade (if any), and available cash. It is truly a transacted process that requires dealership specialists to value trades, arrange financing, and structure the deal.

Buying a TV online or even at a retail merchant is not an appropriate comparison. One doesn't trade in an old TV for a new one. Financing is done via a credit card. If the TV breaks during the warranty period, it is often exchanged for a new one. An older TV, outside of the warranty period, is simply scrapped. And there are no state regulations with respect to registering, insuring, or titling a television.

For a car purchase to mimic that of a TV, one would have to know what he or she wants, be ready to pay cash, have no trade-in, be willing to arrange home delivery, agree to pay the advertised price (plus taxes,

title, and registration), sign the paperwork, and pay for shipping of the vehicle. But this is simply not the case for the vast majority consumers who are purchasing a family car and need assistance in arranging financing, valuing their trade, or even finding a new vehicle that can meet their payment criteria.

Attempts at Alternative Sales Models Have Failed

Since the late 1990s, there have been attempts by third party, non-dealer businesses as well as by a few automakers to insert themselves into the car buying process. During the early years of the Internet era, mostly from 1997 to 2001, automakers and Silicon Valley entrepreneurs and their financial backers embraced the idea that the web would change the way cars were bought and sold...that, in fact, cars could be bought online.

The goals of these efforts were straightforward enough: (1) eliminate the dealer margin thereby reducing retail prices; (2) improve the customer buying experience by a more direct process (and with lower prices); (3) gain efficiencies in the sales channel by reducing inventory (and associated carrying costs); and (4) lower customer acquisition costs through the substitution of better targeted Internet marketing in lieu of more expensive traditional media advertising. With the exception of the Internet lead provider model as a substitute for conventional advertising, none of these initiatives proved to be viable alternatives to the independent franchise system.

In the 1990s, automakers were intrigued with the Dell computer model as a way to reduce their own costs and to interact directly with consumers. The idea that a computer assembled on a bench in China could be model for something as complex as a car, on the surface, is ridiculous. But auto companies genuinely attempted to find ways to streamline their production/distribution system to save time and costs.

Ford and GM analyzed organizational requirements in the hope of achieving order-to-delivery in 15 days for some models, and several European auto companies, knowing that their buyers were already waiting weeks for a new car, launched their own customization programs. GM experimented with regional distribution centers from which dealers could pull cars rather than carrying as many in inventory. The idea behind this effort was that a large inventory could satisfy specific customer requirements quickly instead of placing an order. However, after a few years, GM abandoned the effort because it was expensive to operate the centers and did not have any impact on sales or market share.

GM in Brazil Abandons Online Retailing of the Celta

GM's experience with the Celta in Brazil is instructive on the question of the viability of factory direct sales. In 2000, GM opened a brand new assembly plant in Gravatai, Brazil where its new small car, the

Celta, would be built in approximately 20 configurations. GM used this new market entrant to experiment with various aspects of its product development, production and distribution. While some of those have worked, it is significant that GM's novel approach to retailing did not.¹

When it brought the Celta to market, GM launched online sales of the car thus bypassing local dealers. GM encouraged Celta customers to configure their cars online where they obtained an additional price discount as an incentive to order online. In doing this, GM assumed that it would have better insight into customer preferences and avoid producing cars in less desirable configurations. To expedite delivery to customers (through local dealers), GM stocked regional distribution centers with vehicles already built that would be pulled from matches with customer orders. Celtas ordered online were supposed to be delivered to customers within a week or so through its dealers so GM still relied on its dealers to handle the delivery process, value trade-ins, and provide warranty and maintenance services.

The Celta has been a success in Brazil but little, if any, of that appears to be due to the initial online ordering system.² Significantly, GM ended its direct online channel in 2006.

In an email response to our direct question as to why GM ended the experiment, GM stated that:

GM do Brasil (GMB) did have a process to sell the Chevrolet Celta over the internet from October 2000 to 2006. Due to the high costs of the infrastructure to sell online and to maintain our distribution centers, the Company decided to discontinue the initiative.

Email to the authors from GM (October 15, 2013)

Since 2006, the Celta has been sold like all other GM cars in Brazil – through its local dealers. Shoppers in Brazil (as in the U.S.) go to the GM website where they can configure the car, view the MSRP, get the name/location of their closest dealer, and if desired submit an inquiry. However, the transaction is conducted at a dealership where pricing may be discounted from MSRP based upon various incentives and market conditions.

GM made a significant six year commitment to sell the Celta online and at fixed prices. In the end, the experiment, instead of reducing costs as anticipated, saw GM simply absorb the expenses typically borne by dealers. The fact the order was placed online did not alter the overall costs of the vehicle sales process; it simply shifted most of them from the dealer to GM.

What is unfortunate is that the initial hype about Celtas being sold online is still being used to support criticism of the franchised dealer network today. Authors of reports critical of the franchise system, especially the oft-quoted report by the U.S. Department of Justice (entitled "Economic Effects of State

¹ Some of GM's Celta-based changes were aimed at its manufacturing processes. For example, unlike at GM's other plants globally at that time, key parts suppliers to the Celta were located within GM's newest automotive industrial complex. Although this was a common practice in Japan, as it reduced buffer inventory and shipping costs, it was new to GM at that time and important due to the low entry price point of this new vehicle for Brazil.

² Chevrolet is a strong brand in the country and the Celta, a derivative of the German Opel Corsa, beat its rivals in styling, engineering, and features.

Bans on Direct Manufacturers Sales to Car Buyers” and published in June 2009), cite the Celta online order system as proof of the cost reductions of such a sales and distribution model. Clearly, this reliance is unfortunate.

Gerald Bodisch, the economist within the Economic Analysis Group of the DOJ’s Anti-Trust Division who wrote the DOJ report, never bothered to confirm if indeed the Celta was still sold online directly to consumers. In fact, as GM indicated, the online experiment with the Celta ended in 2006 because of the high costs, **three years before the publication of the DOJ report in 2009**. Contrary to Bodisch’s conclusion, the Celta experiment proved that whether online or in a dealership, selling cars is complicated and involves costs that must be absorbed and cannot be eliminated, regardless of the sales and distribution system utilized.

Early Internet Car Selling Models Also Failed

In the late 1990s, Internet start-ups saw the car buying process as ripe for transformation, and companies such as CarOrder.com, Greenlight.com, and CarsDirect.com (among others) were organized to bypass the dealer entirely. In the case of CarOrder.com, the company aimed to acquire enough dealerships in each brand to source new vehicles from automakers and then sell to buyers all over the country online. The goal of these alternative systems was to use the Internet to transform a complex process into a few clicks followed by delivery of the vehicle to the purchaser’s home or office, presumably at a price lower than if sold by a dealer.

Venture capitalists theorized that there were huge cost savings to be had through the elimination of inventory, stores and personnel, and they even assumed that automakers would permit the transfer of franchises to these entities or provide volume discounts. But auto companies would never sell vehicles through unaffiliated start-ups over which they exercised no control. Manufacturers see dealers as their partners in supporting brands, providing service, investing in their facilities and personnel, and advertising to local consumers in ways that enhance their national advertising campaigns.

Silicon Valley entrepreneurs then (and perhaps even now) do not relate to the car buying experience of the vast majority of Americans who cannot simply write a check for their cars. These early ventures, and even more recent ones, focused on selecting a car online and then buying it at a price that presumed to reflect the savings wrenched out of system efficiencies. These business models failed because of the naiveté of the founders in their understanding of the economics and complexity of the vehicle distribution system, the needs of the consumers in car buying process, and the mutual dependence of automakers and dealers. Vehicles must be experienced prior to purchase for most shoppers. And no one bothered to figure what to do online with a seven year old, 80,000 mile trade-in that was part of the down payment for the new car.

II. Benefits to Consumers of an Independent Franchise System

The operations of the franchised dealer facilitate the vehicle purchase while supporting the manufacturer's brand. Collectively, there are more than 17,000 franchised dealers engaged in selling and serving vehicles in a manner that promotes competition in new and used car sales, service, and financing while promoting the manufacturer's brand and customer experience.

Competition among dealers promotes liquidity in the wholesale used car marketplace and rewards those dealers that provide the best customer experience. Factory control of retail outlets would reduce access to sales and service locations while moving the market toward fixed prices. Most importantly, the dealer, dependent on his or her reputation in the local market but financially independent of the manufacturer, advocates for the customer in terms of disputes with the factory and complete resolution of warranty and recall repairs.

Vehicle Pricing is Market Driven

A vehicle distribution system of independently owned franchised dealers ensures competition among brands and dealers. Every auto company (except Tesla) derives its profits from sales of its vehicles to its dealers, not to consumers. It is the dealer that takes the responsibility for selling those vehicles to customers and therefore assumes both the expenses associated with the business and the impact of market forces on the prices paid for vehicles and services.

Automakers set suggested retail prices (as required by law) but new cars transact infrequently above but more often below the manufacturer suggested retail price or MSRP. It is simply not possible for dealers to sell vehicles at prices – on average – greater than what the market will bear at any point in time. When the supply of a particular model exceeds demand nationally, regionally, or even locally, dealers along with the manufacturer will discount until the surplus eases through reduced production and sufficient markdowns to restore normal inventory. At the other end of the spectrum, there can be high demand for a limited supply of vehicles which can drive pricing temporarily above MSRP. Consumers are savvy about market prices (as we saw in 2000 when the new Honda Odyssey and Chrysler PT Cruiser were launched). During our tenure at priceline.com's auto business, shoppers for hard-to-find models consistently offered to pay more than MSRP for these two models. They knew that the models were in short supply and were essentially outbidding other buyers for the chance to immediately own one of these vehicles. A few months later, transaction prices on both cars dropped below MSRP as production ramped up and initial demand was satisfied.

The dealer's current inventory and local market conditions can influence price as does competition within a vehicle segment. Auto companies might sponsor regional marketing programs that can temporarily impact demand for a specific model. Rival automakers or their dealers will respond if they lose market share. And in the last few years automakers retreated from cash rebates and other incentives that damage residual values in favor of so-called "stair step programs." Stair step programs

reward dealers with cash for achieving a volume sales target. The programs pay stepped bonuses that increase as a dealer’s sales exceed specific “stairs.” These programs are not visible to consumers but can foster competition among local dealers as they try to exceed target levels for bonus awards.

Although one might argue that an auto company-controlled retail system would be subjected to the same market pressures, price adjustments would likely not come fast enough to reflect local market conditions (as demonstrated by the Ford Retail Network experiment described later). It is hard to imagine that an auto company would post different prices on the same car throughout the country even when the many variables of local and regional competition demand it. But that is exactly what happens across the broad spectrum of same brand dealers every day.

The fact that dealers earn little on new car sales – or even lose money at certain points in time – reinforces the reality of competition in the marketplace. NADA Data, consolidated from member dealers, shows that over the past 15 years profits on the sale of new cars (including financing revenues) never exceeded one percent of revenues, and for several years (surrounding the period of the financial crisis of 2008) dealers lost money in their new car departments. In 2012, the margin increased not because dealers were able to keep more the spread between wholesale and retail prices but because low interest rates reduced their floorplan inventory carrying expenses while inventory turnover rebounded.

Approximate Average Dealer Profit - New Car Department

Year	New Car Department Only		
	Revenue	Profit (incl. F&I) - See Note	
	<u>PVR</u>	<u>PVR</u>	<u>Margin</u>
1998	\$23,600	\$144	0.61%
1999	24,445	224	0.92%
2000	24,923	115	0.46%
2001	25,797	153	0.59%
2002	26,163	220	0.84%
2003	27,565	189	0.69%
2004	28,060	180	0.64%
2005	28,381	63	0.22%
2006	28,451	-32	-0.11%
2007	28,797	-45	-0.16%
2008	28,350	-212	-0.75%
2009	28,996	-302	-1.04%
2010	29,793	-138	-0.46%
2011	30,659	23	0.08%
2012	30,910	111	0.36%

Note: Profit for new car department is based on average dealer profit including F&I revenue divided by average new vehicles retailed. Profit is pre-tax but after department expenses.

Source: NADA, MK&A

Franchise Networks Facilitate Competition In Vehicle Pricing

While each franchised dealer provides the same types of services related to the purchase and servicing of vehicles, the density of dealerships throughout the country facilitates competition at every level of the business. Every automaker identifies market areas that are assigned to a franchisee. Twenty or more years ago, a dealer drew nearly all of his or her customers from the surrounding area. Today the Internet enables dealers to reach out of buyers well beyond the historic definition of their market areas. Whereas competition among dealers was in the past primarily local, today it is regional and, for some dealers, even national.

Even with the decline in the number of dealerships due to (1) natural consolidation, (2) the elimination of brands, and (3) dealer and manufacturer bankruptcies that occurred during the recession, the majority of consumers can do business with more than one dealer of a given brand within their local market. This means that customers have convenient access to a system that supports competition among same brand dealers and those of competing brands. Since many car buyers don't settle on a specific make and model until well into the buying process, competition exists among brands at the dealership level just as it does among the manufacturers.

Data developed among selected Dealer Marketing Areas across the country for Chevrolet, Ford, Toyota, and Honda illustrates the extensive intra-brand choices that shoppers have to buy and service cars even in the 175th DMA (which has fewer than 95,000 TV homes):

Dealer Counts by Selected Market Areas and Brands

Rank	Market Area	Zip	TV Homes	% USA	Dealer Count Based on OEM Website by Zip Code			
					Chevrolet	Ford	Toyota	Honda
25	Charlotte, NC	28201	1,136,420	0.995%	21	20	9	12
50	Jacksonville, FL	32201	659,170	0.577%	12	10	5	5
75	Omaha, NE	68101	414,060	0.363%	17	15	4	3
100	Greenville - New Bern, NC	27833	303,280	0.266%	13	15	7	5
150	Albany, GA	31701	150,110	0.131%	9	11	2	2
175	Lake Charles, LA	70601	94,610	0.083%	6	6	3	1
200	Ottumwa-Kirksville, IA	52501	46,730	0.041%	5	8	1	0
All US DMA			114,173,690	100.000%				

Nielsen Local Television Market Universe Estimates by DMA as of 1-1-13

210 Total Markets = 100% Coverage of US TV Homes

Dealer counts limited to identified franchises within 50 miles of submitted zip code.

Source: The Nielsen Company, US Brand Websites (Chevrolet, Ford, Toyota, and Honda), MK&A

Moreover, Internet lead generators and auto company websites allow visitors to determine how far from their zip code they want to search. With 80% of more of car buyers using the Internet to access information about vehicles as well as engage dealers, this tool has placed buyers in control of the

transaction while fostering competition across greater distances than possible in the past. For reference, the combined TV households in the 151st through 210th market represent only 4.4% of the total US TV homes. Said another way, the top 150 ranked markets encompass 95% of total US TV homes giving the majority of Americans access to multiple dealers of each major brand.

Franchised Dealers Provide Access to Financing at Competitive Rates

Most vehicle purchasers – around 85% on new cars – require some form of financing to acquire their vehicles, and the lion’s share of that financing is placed through dealer arranged loans³ or leases. When obtaining credit to acquire a vehicle, purchasers may get their financing either *directly* (from a bank, credit union, or other financing source) or *indirectly* (at the dealership) where the dealer helps to arrange the financing (and legally originates it) but ultimately sells the paper to a third-party financing source such as a manufacturer captive finance company or a bank or credit union that buys such paper. The indirect financing model is a very efficient and effective means of distributing credit and has been enormously successful in reducing the cost of – and increasing access to – credit for millions of Americans.

In fact, a recent analysis of data collected by J.D. Power and Associates and the Federal Reserve Board indicated that interest rates charged to consumers for new car loans by dealers, even after excluding factory-sponsored incentivized rates, are lower than the rates offered by banks directly to consumers. In particular, a comparison of overall average interest rates charged by dealers for 48-month new car loans with the average rates charged for the same loans by direct lenders revealed the following about dealer-assisted financing:

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Commercial banks ⁴	7.02%	6.72%	6.21%	5.73%	4.91%
Dealers ⁵	<u>6.25%</u>	<u>5.50%</u>	<u>4.40%</u>	<u>3.70%</u>	<u>3.20%</u>
Average Consumer Savings:	0.77%	1.22%	1.81%	2.03%	1.71%

As noted in footnote 5, this analysis included a review of loan rates obtained through dealer indirect financing from commercial banks compared to comparable loans placed directly with commercial banks.

³ The term “loan” is used for ease of reference. However, automobile dealers do not issue loans. Instead, they engage in three-party financing, whereby they engage in a credit sale with a consumer related to the sale of their own goods and services (a retail installment sales contract, or “RISC”) and then assign the RISC to a third party lender.

⁴ Federal Reserve, G19 (“Interest rates are annual percentage rates (APR) as specified by the Federal Reserve’s Regulation Z. Interest rates for new-car loans and personal loans at commercial banks are simple unweighted averages of each bank’s most common rate charged during the first calendar week of the middle month of each quarter”). Found at <http://www.federalreserve.gov/releases/g19/current/g19.htm>

⁵ J.D. Power and Associates data. The numbers are an average of rates across all credit tiers and include only indirect loans made through banks. Because it does not include captive finance sources, any effect of subvented rates is dramatically reduced.

There are many reasons why indirect lending is so beneficial to consumers. First, the dealer provides a service to the customer by accessing the lenders most likely to fund a specific loan on the customer's behalf. Most dealerships have finance specialists, referred to as "F&I" managers, who help to arrange loans or leases. F&I managers maintain direct relationships with a variety of lenders and submit each deal based upon the circumstances of the transaction. Every lender has its own underwriting criteria, credit decision process, and advance terms along with rate structures, and many specialize in particular credit segments of vehicle consumer financing. Accordingly, the F&I manager needs to consider which lenders, based upon the customer's credit status, funding needs, and vehicle, would be interested in a particular loan application. (It is significant that even after the customer accepts the dealer financing, the customer may at any time and at virtually no cost refinance his or her loan and replace the financing if he or she is able to obtain better terms elsewhere. However, there is generally very little refinancing that occurs in the auto loan sector, and this absence of a high volume of auto loan refinancings is further evidence that the rates available to consumers through the indirect financing model are highly competitive.)

Indirect lending has also proven to reduce loan acquisition costs for lenders and some of those savings are typically passed along to customers. By doing business through dealers, lender efficiency in acquiring assets (loans) is improved to the benefit of the customer. Simply put, indirect lending through dealers is a cost effective way for commercial banks to acquire large numbers of loans that meet their lending criteria with low acquisition expense when compared to soliciting business from car buyers directly. The data suggest that competition for loans among lenders takes place within each dealership to the benefit of consumers. Dealer arranged financing is also convenient for consumers for obvious reasons. Financing can be arranged during the purchase process saving the buyer time while obtaining competitive rates compared with direct lending. If the transaction involves a trade, with its own loan encumbrance, the dealer pays off this lien as part of the overall transaction so all of the paperwork is completed at the dealership. Without the services that dealers provide in helping to arrange financing, consumers would have to obtain loans directly from lenders thus requiring more time and effort by the consumer.

Finally, it should be noted that dealers utilize their own capital to cover the time lag involved when taking vehicles in trade and when selling new vehicles with financing. Often, trade vehicles require a payoff of an existing encumbrance which the dealer makes with his own capital resources; if the unit is wholesaled or even retailed, the dealer must wait until receiving the title from lender which can take several days to several weeks.

[Dealers Compete Against Each Other and Independent Repair Providers for Service Business](#)

Networks of franchised dealers provide consumers with access to service across the country. And many car owners have service work performed at a dealership different from where they bought their cars.

This is a convenience to the owner at home or while traveling and enables the owner to schedule both routine repairs and warranty work within a reasonable driving distance. Having so many franchised dealers is especially important to government agencies and corporations that operate fleets ranging from a few units to rental companies with hundreds of thousands of cars and trucks in operation. Many depend upon local dealers to provide courtesy delivery of vehicles ordered through the automaker's commercial fleet department as well as access to original equipment parts, routine service, and especially warranty and recall repairs.

Each dealer strives to satisfy service customers knowing that a positive service experience correlates with future business. Automakers monitor every service experience through feedback surveys sent directly to customers. Dealers aim to score high on these surveys to receive recognition from their manufacturers. But a high score usually means that a dealer is providing a high level of service that builds loyalty for the brand and the dealership.

The service department of a modern American dealership is filled with state of the art equipment and staffed by highly trained technicians. Service customers, whether waiting for their car in a comfortable lounge or driving to work in a loaner car, have access to a wide range of services to make the experience as pleasant as possible. To handle demand for specialized and routine repairs for the convenience of the owner, dealers, for example:

- have expanded service hours into the evening and on Saturdays (and, in some areas, Sundays);
- provide shuttle service and vehicle pickup and delivery (which is especially important if the car is disabled);
- send text messages to owners when their cars are ready; and
- offer on-site loaner cars, free car wash with service, fast service lanes for lube and oil changes, and comfortable customer lounges equipped with WIFI, computers, daily newspapers and even separate play areas for children.

An often forgotten advantage of a broad network of franchised dealers is immediate access to factory parts. Each dealer stocks parts applicable to local demand and obtains additional parts from other franchised dealers that have large wholesale parts inventories. In addition, franchised dealers sell factory original parts to vehicle owners for D-I-Y repairs as well as independent mechanics, rental and commercial fleets, and others.

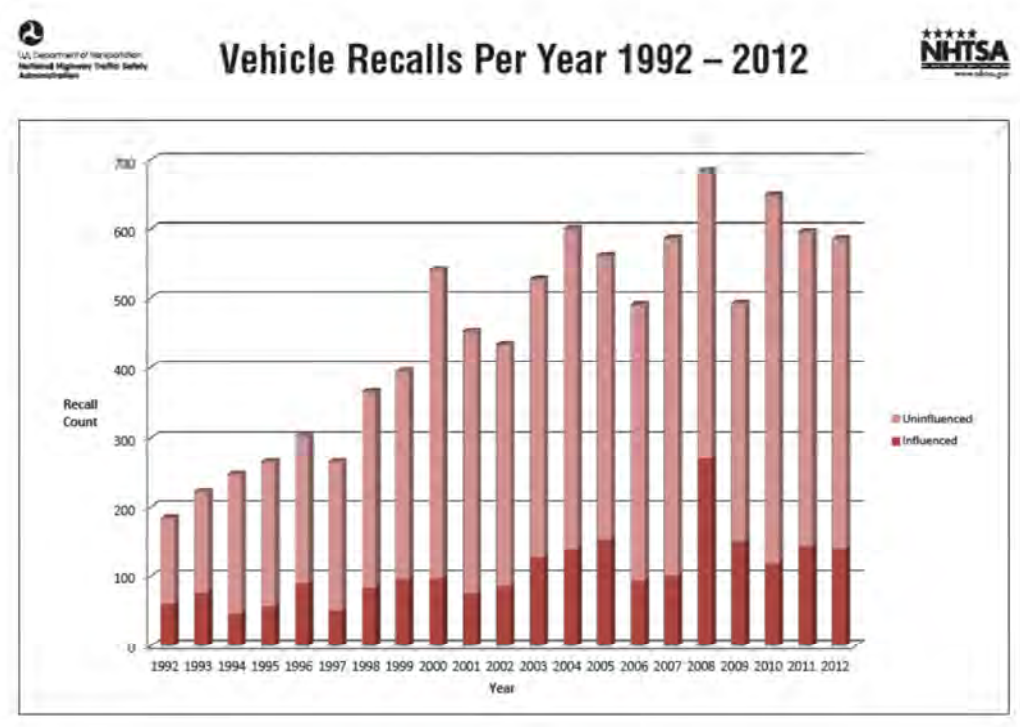
Franchised Dealers Perform Warranty and Recall Work on Behalf of Automakers

Customers expect prompt attention from their franchised dealer to warranty claims or when a recall is issued for their vehicles. They expect that such work will be done expeditiously and correctly using factory parts. Warranty periods generally apply to the first few years after a car is purchased new and later for certified pre-owned units but recalls, as evidenced by a recent Jeep recall involving 1.56 million

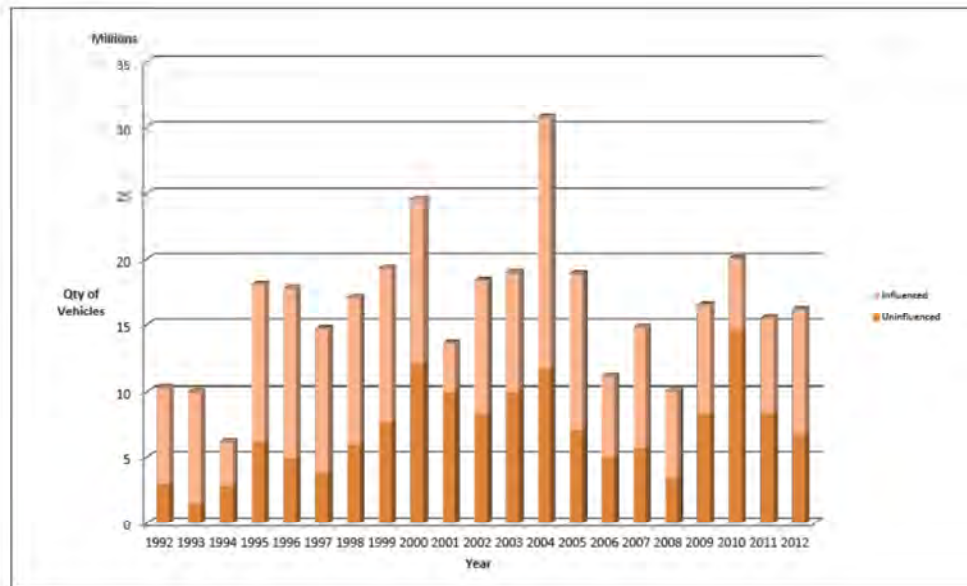
vehicles, can include very old vehicles – in that case up to 20 year-old models and the General Motors recalls involving more than four million cars, many of them more than 10 years old.

When so many units are recalled by once, they present a challenge that can only be handled by a national network of dealers that is capable of making repairs as soon as the manufacturer provides parts and establishes the repair protocols with the National Highway and Transportation Safety Agency (NHTSA), the agency within the Department of Transportation which has oversight of vehicle safety.

As the first of the two following charts shows below, the number of recalls has increased beginning in 2000 mostly due to voluntary manufacturer recalls (uninfluenced recalls), although the count of vehicles impacted is more variable as shown in the second chart:



Quantity of Vehicles Recalled 1992 – 2012



In 2013, approximately 22 million vehicles were recalled in 632 campaigns, up from 2012 when 16.2 million vehicles were recalled in 586 campaigns. (Note: recall data includes light and heavy duty vehicles, trucks, busses, motorcycles, and RVs.)

Because manufacturers compensate dealers for warranty and recall repairs, dealers have an independent interest in providing this work which benefits consumers. Often vehicle owners ignore recall notices if they think the repair is not critical; dealers, however, virtually always confirm that vehicles brought in to them for service are up-to-date on recall repairs.⁶

Recalls and warranty repairs represent a cost for the manufacturers. As a result, the factory's economic incentive is to do the minimum (subject to concerns about safety liability and consumer loyalty). In contrast, dealers are paid to perform this work on behalf of the automakers. Accordingly, not wanting an unhappy and angry customer, the dealer is going to fully repair a warranty problem and search VIN records to ensure that all outstanding recall work is completed, all to the consumer's benefit.

Dealers Serve as Advocates between the Customer and the Factory

The dealer – as the franchisee of an auto company – must conform to the standards expected by the franchisor. Yet, unlike other franchise systems such as McDonalds or Dairy Queen, the automobile

⁶ Recently NHTSA, out of concern that too many cars with potentially dangerous conditions were not being repaired after being recalled, mandated that automakers provide consumers with an online tool to search for recall notices by VIN starting in 2014. This will enable both consumers and dealers to quickly check vehicles to determine whether repairs have been completed on any vehicle.

dealer also has his own local, regional, or even nationwide brand to support and maintain. In this manner, the dealer both represents the automaker as well as his or her own brand. Think of the local car dealers in a community. One likely does not think of them as just the “Ford” or “Nissan” store but that of “John Doe Ford” or “Jane Doe Nissan” owned and operated by businesses distinct from their manufacturers. They and their employees are members of the community where they continue to represent the automaker’s brand as well as their own.

A consumer’s relationship with a new car dealer extends well beyond the initial purchase, and maintaining a customer’s satisfaction with his or her ownership experience is the responsibility of the dealer. Dealers are different from other franchise operators in that there is a business attached to the franchise brand that carries its own reputation separate and distinct from the vehicle brand.

It is in the dealer’s interest to ensure customer satisfaction with the operation of their vehicle – and this may involve resolving warranty claims, performing repair work as goodwill from time to time (for vehicles out of warranty), and expeditious handling of recalls and technical service bulletins as they arise. Although the higher build quality of today’s cars has reduced warranty claims related to fit and finish issues, dealers still confront the challenges of solving problems which exceed the limits of current diagnostic equipment.

The franchised dealer often advocates for the vehicle owner with regard to vehicle-related disputes. In a factory controlled system owners would have fewer outlets where they could get service and the local manager, as an employee of the automaker, would be less likely to advocate on behalf of the customer.

As noted above, there also is an inherent conflict of interest in a factory controlled distribution system when it comes to determining the extent of repairs for warranty and recall services that are to be performed. Anyone who has spent time with a manufacturer’s call center trying to get a service representative to come to their home to assess a defective appliance knows the time and effort that requires, saying nothing of the likelihood of an incomplete repair that requires additional service. In a franchise system, the dealer will advocate for the customer to ensure the all repairs are done completely.

[Dealers Offer Market Values on Trades and Provide Liquidity in the Wholesale Marketplace](#)

As new car margins declined over the past decade, franchised dealers have placed greater emphasis on selling used cars. Not only do used cars represent additional retail revenues, they also bring in more service work. As a result, franchised dealers have been able to diversify their businesses compared to twenty years ago. Their presence in the used car industry has improved the liquidity available to the wholesale market while boosting competition in both the wholesale and retail used vehicle markets.

The general public is largely unaware of the wholesale used car market and its importance in nearly every aspect of the automotive industry. The financial underpinning of rental companies, insurers, lenders and auto makers depends upon the liquidity of the wholesale market to place a fair value on any vehicle regardless of age, make, or condition. This is critically important in determining the trade in value on any car.

This marketplace is dominated by live and online vehicle auctions owned and operated by Manheim, Adesa, and other large independent companies where the vast majority of buyers are franchised and independent dealers. Although there are more independent used car dealers than franchised dealers, the latter are larger, better capitalized, and retail and wholesale more vehicles per store than the average used car-only retailer. Franchised dealers typically retail later model, higher value used cars and often stock not only their own brand but also those of competing makes which encourages more competition in the auction creating liquidity which, in turn, enables sellers to realize fair values for their vehicles.

The auction efficiency that franchised dealers help support is of great value to the vehicle financing and insurance communities. Automotive lenders, whether captive finance companies or independent banks, credit unions or other sources, base loan and lease terms on assumptions of wholesale, residual, or collateral values derived by used car valuation companies such as Black Book, Kelley Blue Book, ALG (formerly known as Automotive Lease Guide), and the NADA Used Car Guide Company. Similarly, automotive insurers base their decisions to total or repair a damaged vehicle on the same values. The values published by these valuation companies are not arbitrary but are based upon recent auction values for like makes and models adjusted for other market and vehicle conditions.

Finally, used car customers are assured of fair prices by virtue of competition among franchised and independent dealers in the retail marketplace. Franchised dealers not only compete with other franchised dealers but also with independent dealers that range from large chains like CarMax to small, single point independent dealers specializing in a type of vehicle or those at a particular price point. Although every used car is somewhat unique, the Internet now plays a crucial role in allowing shoppers to find the exact model they want and to view not only condition reports and other relevant information but also compare prices online for each unit offered for sale.

Only Franchised Dealers Can Sell Manufacturer Certified Pre-Owned (CPO) Vehicles

Every automaker has established standards for late model used vehicles that qualify for factory certification. The process of selecting, inspecting, reconditioning, and retailing these vehicles is the responsibility of the franchised dealer. CPO vehicles have allowed automakers to broaden their customer base with a used vehicle that comes with many of the same protections from the factory as a new car. Sales trends indicate the customers appreciate the expanded supply of these late model fully

reconditioned vehicles. By working with the manufacturers, dealers have made CPO vehicles an affordable and attractive option for more consumers.

In 2013, CPO sales likely exceeded 2.1 million units, or roughly 20% of all used vehicles sold by franchised dealers, an increase of nearly 16% from 2012 results:

Certified Pre Owned Sales

(Units in Millions)

<u>Year</u>	<u>Units</u>
2013	2.1
2012	1.8
2011	1.7
2010	1.6
2009	1.5
2008	1.7
2007	1.7
2006	1.6
2005	1.6
2004	1.6
2003	1.5

Source: Automotive News DataCenter

In general, dealers pay their manufacturers a fee to certify a vehicle that meets age and mileage criteria, has undergone inspection and reconditioning, and is deemed worthy of a factory warranty. CPO vehicles are often supported with factory financing because automakers recognize the value to the brand and their bottom line from dealer and customer demand for their late model units. CPO units have bolstered the franchised dealers' presence in the used car market by enabling manufacturers to offer lower price points to a broader group of buyers. It also means that dealers are servicing older, higher mileage units under warranty in their service departments.

III. Disadvantages of a Factory-Owned Retail System

Factory-owned dealerships, where they exist, do not offer a better customer experience or lower system costs. In fact, the opposite appears to be true. The evidence that exists demonstrates that factory-operated dealerships have not been as effective as dealers in satisfying customers, reducing distribution expenses, or lowering retail prices.

Although it is possible to quantify the costs associated with the various elements of the vehicle distribution process, it is not possible to eliminate these expenses. Every attempt to do so has failed because the costs are dictated by the nature of the product and the needs of the customer, not the location of the transaction or the corporate identity of the transactor. To provide the same level of customer service and convenience, a factory-owned network would have to replicate the billions of dollars of dealer investment in an identical national footprint and employ the same number of personnel to facilitate the services provided in the dealership. For any automaker aspiring to sell large numbers of cars in the United States, the only rational and economical distribution structure is the independently-owned, but factory-directed, franchise system.

Factory ownership of sales and service outlets would not provide lower prices or better service compared to the franchised system. Arguments in support factory-owned store are based on hypothesis; the proof that exists clearly demonstrates the value of the present franchise system.

Franchised Dealers Provide Immediate Access to Millions of New Vehicles

The franchise system provides consumers with access to more than three million new vehicles across the U.S. at any time. These vehicles are available for immediate purchase, the preferred option for most consumers. Although it takes time for customers to decide on the car, once that decision is made and terms agreed upon with the dealer, they want the car as quickly as possible.

Automakers have toyed with the idea of building “cars to order” to avoid inventory carrying costs. A factory-owned system might therefore seek to minimize its stock of vehicles at its stores but that would limit selection for customers in order to extract these savings. In contrast, a franchised dealer wants to stock as many vehicles as needed to maximize sales. Independent franchised dealers often accommodate overproduction by manufacturers with dealers immediately paying for the extra units and then having to find the market clearing price irrespective of the potential profit in those vehicles.

Competitive Pricing Is the Foundation of Franchised Dealer Networks

Dealers compete with same and competing brand dealers. Thus, consumers derive the benefits of market pricing whether buying a new or used car. By contrast, a factory-owned store system would try to sell at fixed prices rather than allowing the market to set transaction prices. This would prevent intra-brand price shopping and would deny consumer the benefit of competitive pricing.

Although franchised dealers emphasize same brand used cars, they also sell competing makes thereby enabling competition in used cars as well as new. Factory-owned stores would be likely to retail only their own brand used cars resulting in less competition especially in late model units.

Dealers Facilitate Purchases by Competitively Addressing the Financing Requirements of Buyers

Matching buyers' credit status to available financing options is a critical element of vehicle affordability. Franchised dealers have the expertise to source credit from a vast network of lenders that they work with. By contrast, factory-owned stores or direct sales channels would have a natural preference to sell their own captive loans and leases rather than the products of other financial institutions.

Service and Parts Readily Available at Local Dealerships

Nearly every car owner in the United States has access to more than one dealer offering service supplemented by independent repair shops that depend upon dealers for parts. Dealers compete with each other and with independent repair shops based upon price and convenience.

A factory-owned system of service centers would not have competition from other dealers to compete with which could result in higher prices.

Performing Recall and Warranty Claims Completely and Quickly is Important to Owners

As discussed previously, the franchised dealer has strong motivation to ensure that all warranty and recall work is done correctly and fully. By contrast, with a factory-owned service system there is an obvious conflict between fully addressing the warranty issue and managing associated costs. This is not to suggest that the factory would be unresponsive or unethical; however, the factory's economic incentive would still be to manage warranty and recall expenses as it would any other cost. Moreover, without independent dealers who can fully assess a problem, customers would have to press the factory for full repair on their own. The same is true for government-mandated recalls which can easily overload a service network lacking the capacity to address the issue while still supporting routine service business.

Experiments in Factory Ownership in the United States and Elsewhere Reveal the Weaknesses in the Direct Sales Model

Although there are countries outside of the United States where factory ownership of retail outlets is permitted, the vast majority of cars throughout the world are sold through franchised dealers. In France and Germany, as well as in other European countries, factory ownership is permitted alongside franchised dealers. Factory stores are typically concentrated in major cities where land, facilities, and personnel expenses are too high to attract an independent operator. Recently, the recession in Europe forced some manufacturers to take over bankrupt dealers, but the goal has been to find an independent buyer for these businesses as quickly as possible. For example, Daimler, which owns more of its sales and service facilities than its competitors, recently sold off several stores in Germany and France; the company mentioned low margins of retailing versus higher margins for vehicle production as a motivation for the sale.

The debate about factory ownership is often couched in terms of better customer experience, but exactly what that is has never been defined. The assumption that factory-owned distribution would yield savings of thousands of dollars per vehicle is simply not true but based on hypothetical speculation from more than a decade ago that continues to find its way into contemporary comments about auto retailing despite facts to the contrary.

What has been proven by past experiment is that factory ownership disadvantages buyers by reducing competition in new and used car and service (with fewer outlets) leading to fixed prices rather than allow the market to determine pricing. The dealer's motivation to build his business, even at the sacrifice of short-term profits, is not consistent with the behavior, capital requirements, and longer-term product focus of the manufacturer.

Further, a factory-owned distribution network is likely to focus on larger metro areas due to market size potential and would likely bypass smaller, more rural communities where total return on capital invested in absolute terms would be much smaller than that of larger metro stores. Capital is not unlimited even for a well established auto company which, naturally, would seek to allocate capital dedicated to a retail network as efficiently as possible. Small communities could thus lose access to local sales and service.

Ford's Failed Experiment in Consolidating Dealerships

In the late 1990s, several auto companies examined what they referred to as the post-factory value chain – that is, those companies and industries that profit from the automobile after it leaves the factory. It was a time when manufacturer profit margins in North America were eroding so the desire to capture the profits earned by dealers and others off of their vehicles was appealing. At the same time, the hypothetical models projecting huge savings arising from a smaller dealer body with less inventory and build-to-order fulfillment approaches gained adherents.

In 1997, Ford established the Ford Retail Network, later renamed the Ford Auto Collection, in five cities: Oklahoma City; Tulsa; Rochester (NY); Salt Lake City; and San Diego. Ford consolidated individually-owned stores in these markets under common ownership and management. (Each of the initial cities for the experiment was believed to have more Ford dealers than necessary, so consolidation would improve the scale economies for surviving stores without loss of sales.) Ford also believed consolidation would lower advertising and inventory management costs as dealers didn't compete with each other for the same buyer. Vehicles would be sold at non-negotiable prices with sales employees paid salaries rather than commissions. Participating dealers received 80% of the equity in each local entity in exchange for their stores with Ford as a 20% partner. But Ford set the standards for store operations overseen by a new headquarters staff and, as a 20% owner of each dealer group, the automaker exercised considerable control over the dealerships. Although never implemented, Ford hoped to be able to incorporate a build-to-order fulfillment process as part of the Ford Collection that was supposed to provide additional savings.

Ford believed that fewer stores would boost sales and profits in the existing stores by reducing price competition in a city, offering a consistent customer experience, and enhancing the brand image in the market through coordinated advertising.

Ford never consolidated another city beyond the original five and after two years abandoned fixed prices and salaried sales staff. Although the investment generated ill feelings between Ford and its dealers, there were financial reasons that precluded expansion. Instead of higher profits, the consolidated dealerships earned less or posted losses, and Ford, after accounting for its additional overhead, lost money. Furthermore, Ford brand share fell in each of the five cities despite the “learning labs” set up in the stores to unlock the keys to a better customer experience. Most importantly, Ford lost the entrepreneurial spirit of the independent owner. It became difficult to recruit top talent while the burdensome controls, including having to sell at fixed prices, frustrated store management who were unable to respond quickly to the competition.

Ford failed to understand that when dealers compete with each other and with competing brand dealers on price, service, and personal pride, independent dealerships are more effective at selling cars on behalf of the companies they represent. Ford abandoned its experiment in 2001, selling back the stores mostly to their original owners.

[GM Consolidates Chevrolet Stores in the San Fernando Valley](#)

In 1999, GM announced that it wanted to acquire up to 10% of its dealers in an entity named GM Retail Holdings. Unlike Ford, GM aimed to acquire the stores outright and operate them in competition with its own dealers, possibly with the intention of eventually taking the retail company public. Outrage from the dealer body, and perhaps seeing the poor performance of the Ford experiment, resulted in GM scrapping its plans in 2000.

In a separate effort, GM consolidated its dealerships in California’s San Fernando Valley. By the late 1990s, GM’s market share in California was roughly 20% and in the San Fernando Valley it was 13%, compared to 30% nationally. Like Ford, GM believed that it had too many dealers struggling with intra-brand competition. GM attributed its market share loss to its dealers and not the greater appeal of Japanese makes in the hyper-competitive Southern California market.

In 1998, GM partnered with an established Midwestern dealer to acquire GM dealerships in the San Fernando Valley using an investment from GM’s Motor Holdings, its dealer development investment entity designed to foster minority- and female-owned dealerships. With \$2 million from the Midwestern dealer and \$18 million from GM, nine stores were acquired and four were then closed. GM owned 90% of the venture with the Midwestern dealer eventually having buy-out rights of GM’s stake. Following the consolidation, GM trended lower in terms of market share in keeping with its national market share decline.

Ford's Online Used Car Sales Experiment

In 1999, Ford decided to sell selected off-lease and program rental vehicles directly to consumers online in specific markets. Ford believed that it could sell the cars at a price somewhere between wholesale and retail and make a profit on the cars while avoiding auction fees and other costs associated with remarketing these vehicles.

The process seemed simple enough and relied upon Ford dealers to deliver the car to the customer after the online commitment was obtained (although the buyer could reject the vehicle upon presentation without further obligation). The selected vehicle was shipped to the dealer who received a fee for preparing and demonstrating the vehicle and completing paperwork. In effect, Ford proposed to use its dealers as passive delivery locations, similar to the way GM Brazil used them in its Celta experiment.

The program ran into legal difficulties in Texas where state laws forbid manufacturers from selling direct to consumers as Ford was doing in Houston. But legal challenges aside, the model never worked because traffic to the site was low; often customers "ordered" a vehicle and then found another before their car arrived at the designated dealership, or rejected the car when they came to inspect it. If anything, Ford proved that online selection with no obligation to purchase did not mean a sale and that the purchase process was much more complicated than clicking on a photo. And Ford still had to pay its dealers to provide the services essential to completing transactions.

Subsequently, other start-ups have attempted to sell used cars online on the premise that buyers want to avoid the dealership. But once again, despite creative websites, quality cars, and competitive prices, car buyers want to see and experience the car before they commit and they want to trade in their old car and obtain financing. There are always some shoppers who will support such start-ups but never enough to sustain a profitable business model. The vast majority of car buyers, whether shopping for a new or used car, want to physically experience the vehicle, and in the case of the used car, the exact one they buy before making a firm commitment.

New Brands Set their Own Franchise Standards

Some have argued that existing franchised dealers are not suitable for selling advanced technology vehicles. They contend that the traditional dealer has no reason to invest the time and effort to educate prospective customers versus simply selling internal combustion powered vehicles.

But this argument suffers from two significant flaws. First, it fails to recognize all the dealers which today effectively sell both vehicles powered by internal combustion engines and those powered electrically. (Examples include Nissan dealers who sell both traditional Nissan vehicles as well as the Nissan Leaf.) Second, the argument assumes that any newcomer would have to award franchises to existing dealers who would then sell those cars alongside the brands they already represent. But there

is no requirement for any new manufacturer to sell vehicles through existing dealers or within existing dealerships. In fact, most automakers require exclusive showrooms for their brands, and they would prohibit the sale of a competing brand. So a new brand would have to identify its own franchisees who would meet the automakers criteria to support that brand.

Since the late 1980s, there have been at least 10 examples of new franchise networks that made varying demands on franchisees. These include Fiat, Hummer, Infiniti, Lexus, MINI, Saturn, Smart, Fisker, Scion and Coda. Franchises were awarded to experienced dealers as well as newcomers to the business with franchises awarded solely by the automaker. Each of these brands and/or manufacturers set its own criteria for how it wanted its vehicles displayed, marketed, and serviced. The ability of these brands and manufacturers to establish their own facility, customer experience, and other standards belies the concerns that a dealer-based distribution system is inconsistent with the introduction of new technologies or products:

- Lexus required separate stores under a common design theme and required dealers to provide exceptional and personalized customer service (sales and maintenance) as a hallmark of the brand. Toyota selected Lexus dealers from among its best performing Toyota dealers who committed to the facility investment and, at the time, unique high touch customer service mandates.
- Scion, a new brand also from Toyota, allowed Toyota dealers to sell and service these vehicles only if they created separate showroom areas and agreed to a one-price philosophy.
- Hummer dealers agreed to build elaborate “Quonset hut” facilities to showcase the ruggedness of the vehicles but were relieved of that obligation as sales fell and GM terminated the brand.
- Saturn was the most widely heralded vehicle experiment of the last three decades that was based upon collaboration among management, labor, and dealers to provide a superior product and ownership experience. The Saturn tagline, enshrined early on through a very effective advertising campaign, was “A Different Kind of Company, A Different Kind of Car.” Adherence to strict and specific standards enabled every Saturn store to offer the same customer touch points from the moment the shopper entered the store through photographs with the sales staff on delivery of the new car and later in service.

The first Saturn vehicle was assembled in 1990, but several years earlier the division named its dealers. Each franchisee built a free-standing facility under a common scheme and layout. To compensate for the substantial capital investment, GM allocated large and exclusive market areas to Saturn dealers so they had sufficient volume to earn a profit. The sales staff was paid a salary rather than commissions which attracted people without auto retail experience. Mandatory “uniforms” conveyed a casual atmosphere reinforced by the popcorn and coffee served to waiting customers.

The fact that Saturn was able to sell nearly 300,000 units in 1995 was more a testimony to the commitment of its dealers than to the limited product line they had to sell. By 1996, Saturn tied with Lexus for first place in the J.D. Power Customer Satisfaction survey which ranked the dealership experience.

- Fisker awarded franchises to existing dealers of highline brands and mandated that Fisker would have its own showroom and service facility. (The company's failure had nothing to do with its dealers but rather its premature release of a vehicle that experienced several widely publicized fires and lacked any discernible performance advantage despite its lofty price tag (in excess of \$100,000). Fisker was unable to meet Department of Energy company performance benchmarks and failed to qualify for additional government loan funding.)
- Coda sought out established multi-line dealers as franchisees in urban markets who were "pro green" and believed in the future of electric vehicles. At the same time, Coda was going to establish "experience centers" in high traffic retail locations to educate customers about its electric vehicle and schedule test drives but would not perform sales. However, it offered an outdated vehicle, priced at nearly \$40,000, with a limited range of 88 miles per charge. The vehicle only received two stars from NHTSA for its frontal crash rating. Coda was underfunded and was not granted a DOE ATVM loan; it simply ran out of money. The company was never viable so it is amazing that it was able to attract anyone who wanted to represent it.

Dealers Make Considerable Investments in their Stores and, as a Result, the Majority of Customers are Satisfied with the Dealer Experience

Although precise numbers are not available, voluntary investment by dealers in their facilities along with compliance with factory mandated image programs has easily exceeded ten billion dollars since 2003. A conservative estimate would put annual investment by dealers at more than \$1.5 billion. Modern dealerships reflect exterior and interior design aesthetics of their brand, with special emphasis placed on providing a comfortable lounge for service customers and high tech service bays. Competition among dealers exists today in their ability to deliver a pleasant sale and service experience in comfortable surroundings. Most car owners prefer not to have to deliver their car to a remote service location or wait for a service team to arrive at their home. Franchised dealers operate clean, state of the art facilities and provide their customers with an array of conveniences aimed at ensuring that they can maintain their work and family obligations while their car is in for service.

Furthermore, the frequently repeated adage that customers hate buying a car or having it serviced is incorrect. Cars.com, a major automotive website listing new and used car inventories, asks visitors to voluntarily comment on their dealer experiences. Cars.com analysis indicates that all dealers and especially franchised dealerships get high marks from in these reviews:

- Total dealer reviews on Cars.com: 281,771
 - *Franchised Dealer Reviews: 210,020*
 - *Independent Dealer Reviews 71,751*

- Average dealer review rating:
 - Overall 4.5
 - 80% are 4 star or above

- Average dealer review rating Service/Sales breakout:
 - Service: 4.5
 - Sales: 4.5

- Average dealer review rating Franchised Dealers
 - Service: 4.6
 - Sales: 4.5

- Average dealer review rating Independent Dealers:
 - Service: 4.5
 - Sales: 4.3

- % of reviews with responses (dealers can reply to the consumer on the Cars.com platform)
 - 25% of reviews have dealer responses. Of that:
 - Franchised response: 57,066
 - Independent response: 15,353

- Review distribution (average reviews per dealer)
 - Overall: 3
 - Franchise: 12
 - Independent: 2

Source: Cars.com

The data speaks for itself – consumers generally view their dealer experience as a positive. Journalists and others will likely continue to ignore data that show that overall dealers are providing a high level of satisfactory service for their customers. Like the Boston Globe writer referenced earlier in this analysis, they will go on wondering why they can't buy a car at department store!

IV. Misconceptions about Dealers and the Franchise System

Fifteen years ago the media and scholarly publications were filled with speculation that the Internet would disintermediate the dealer in favor of factory direct ordering. This was supposed to enable automakers to capture the hypothetical savings projected by consulting firms analyzing post-factory distribution costs.

The Internet has dramatically changed the car buying experience, but not the role of the dealer. Unfortunately, the unfounded assertion that the franchised dealer adds unnecessary expense persists in the media and elsewhere today despite the enormous body of evidence proving otherwise.

Throughout the past two decades the franchise system has frequently come under attack as the retailing equivalent of a caveman. At the dawn of the Internet age, academic researchers, investment analysts, and even automakers proclaimed that we would soon buy our cars online and built-to-order. Photos and clicks would replace dealerships and their huge facility investments, advertising and personnel expenses, and massive inventories of new and used cars and parts. The franchised dealer was viewed as an unnecessary middleman who added costs to vehicle distribution. Automakers were going to move from a “push” to a “pull” production model that all but eliminated high customer acquisition costs and inventory on the ground. The press dutifully reported this speculation and the hyperbole still lives on to influence contemporary opinions and publications on the subject even though few if any of the academic or investment analyst reports had any validity when written and are now simply reminders of how off track intelligent people can get when caught up in a frenzy.

Franchised dealers have embraced the Internet in nearly every aspect of their business. Even with the maturation of the Internet, it is the nature of the car and the purchase process that necessitates franchised dealers, not the existence of state franchise laws. The failure of previous experiments to remove the dealer in whole or in part from the vehicle sales and service process validates the consumer benefits that dealers provide as well as their importance to the automakers they represent.

Stanford Business School Case Study Predicts Demise of Franchised Dealers

In February 2000, at the height of Internet mania, Stanford University’s Graduate School of Business published a case study titled “Disintermediation of the US Auto Industry.” We cite this case study, issued at the apex of the Internet bubble, because it has lived on to become source material for journalists and other authors on the subject. This analysis relied extensively on business media and investment analyst reports of that period and recalls the frenzy in which nearly everyone was caught then. The case study provided many, but not particularly relevant, statistics related to production and retail sales of new vehicles in the U.S. It cited the “research” that claimed that 30% of the costs of car were related to vehicle distribution and represented a prime opportunity for cost reduction through Internet channels. The report listed all of the emerging alternatives from online brokers, online lead

generators, and listing services as well as direct sales by AutoNation and a venture, Greenlight.com, set up by Asbury Automotive and a well-known Silicon Valley venture capital firm.

The range of alternative models that attracted capital, including from large franchised dealers, was unprecedented and little of it survived after quickly burning through initial venture capital funding. That fact, by itself, should make modern day writers question the validity of the report's assumptions about the value and functionality of alternatives to traditional dealers.

The notion of savings in a direct-to-consumer retail model was also popularized in a Goldman Sachs' analyst report in 2000 extolling the potential in such a distribution model. This report, which added dollar values of potential savings, followed up on a previous report from Booz Allen. The Booz Allen management consultants created a model of the expenses associated with distribution and areas of savings in a direct retail model (Changing Channels In The Automotive Industry: The Future of Automotive Marketing and Distribution by Evan R. Hirsh, Louis F. Rodewig, Peter Soliman and Steven B. Wheeler published in January 1999). Together, the two reports which claimed potential savings merely represented a math exercise that assumed that such expenses would vanish in a direct distribution model. However, had the authors understood the needs of real car buyers they would have come to a different conclusion. As detailed previously, GM's six year experiment selling its Celta online revealed that there were no cost savings realized, and the manufacturer thereafter reverted to traditional dealer sales in 2006.

The Flawed Department of Justice Report Should be Ignored

Presumed savings from a direct-to-consumer sales model is also the foundation of Gerald Bodisch's DOJ report published in 2009. Using the data from the Goldman Sachs report as evidence of savings from a direct sales model, he goes on to praise the success GM had with direct sales of the Celta in Brazil. In particular, he states that "GM initiated a build to order sales model in Brazil for its Chevrolet Celta economy car over eight years ago. In 2008, the Celta was among the sales leaders in Brazil." He goes on to cite a December 2000 article in CNET News that included the comment that build-to-order could result in "spectacular improvements in the company's competitiveness and profitability." The Celta was among the sales leaders in 2008 because it was a good car and it was sold through GM dealers all over Brazil.

But as we noted in detail before, GM terminated online sales of the Celta in 2006 and, in a direct response to us, noted the importance that the high cost of maintaining an online infrastructure and distribution centers played in its decision. This was nearly three years before the publication of Mr. Bodisch's report. So, instead of proving that there were savings from a direct sales channel, the Celta experiment proved the opposite. Distribution costs shifted from the dealer to GM but the costs still remained!

Mr. Bodisch's report relied on out-of-date material, with 23 of his 26 source documents dated 2003 or earlier, so his portrait of dealers and customer attitudes towards dealer is not accurate. He failed to discuss the enormous impact the Internet has had in providing car buyers with price and incentive information, inventory data, and access to third party sites that act as lead generators for dealers. Dealers themselves often staff business development centers with staff ready to provide prices and facilitate transactions according to each customer's needs. None of this made it into his report which, as a consequence, is factually and historically inaccurate.

Even though the Department of Justice disclaimer indicates that the report is that of one person and not the opinion of the Department, the fact that it was published by the DOJ gives it additional credibility, and it is frequently sourced by journalists, academics, and even in testimony today related to the franchise system.

For example, in 2010, a lengthy article, "State Franchise Laws, Dealer Terminations, and the Auto Crisis" by Francine LaFontaine and Fiona Scott Morton (Professor of Business Economics and Public Policy, University of Michigan and Professor of Economics, Yale University, respectively) was published in the *Journal of Economic Perspectives* [Volume 24, Number 3 – Summer 2010]. A portion of the article discusses the supposed virtues of build-to-order and again references the Chevrolet Celta and the Bodisch study. The authors even went as far as suggesting that a venture promoted in 2001 that would build cars to order (using components from other auto manufacturers) would lead to savings for consumers through its direct model. The authors somehow believe that it would be possible to build a car to order using parts sourced elsewhere, then sell direct to consumers – and save the magical 30%. Of course, this start-up venture, called BTO.com, failed to attract funding as investors recognized the ridiculousness of the proposition. The facts that (1) the Celta online experiment was terminated due to high costs four year earlier by GM and (2) BTO.com never attracted investors nine years prior to the publication of their article should have caused the authors to question their premise.

Unfortunately, the discourse surrounding the franchise system has been contaminated by faulty research where later authors perpetuate the mistakes of earlier ones. What is clear is that no viable alternative exists to replace the franchise system's responsibilities to serve both automakers and customers. Supposed savings from transferring some portion of the car buying process online or removing the dealer does not eliminate the need for retail stores which provide on-site inventory supported by skilled employees to facilitate trade-in, arrange financing, handle the delivery process (with customer education of new technology), service vehicles, provide warranty and recall support for the factory, and provide advocacy on behalf of the customer with the factory. Happily, the independent dealer franchise system does all of this quite efficiently, so the need to find a viable alternative simply does not exist.