Factory Image Programs
An NADA Research Project

By Glenn A. Mercer
Factory Image Programs:  
An NADA Research Project

By Glenn Mercer

Summary

This report, or "white paper," summarizes the findings of the NADA Factory Image Programs research project. We begin with some history around the project, the context in which it was carried out, and the methodology we employed to obtain a wide range of honest and candid input. There are some areas we just could not delve into (e.g. state-level regulatory details), and we lay those out below.

Our findings begin with an overview of the very differing perspectives on image programs held by dealers, car companies, experts, and customers alike, and then go deeper into the details, via a "three-layer" model of these programs, which divides their objectives into Expansion, Modernization, and Standardization modes of activity and investment.

Our detailed findings are in the pages following, but boiled down to their core, they include our belief that the economic value of these programs remains only weakly demonstrated, our worry that program cost is excessively high, and our concern that such programs may not be best preparing automotive retailers for the future evolution of our industry.

We close with recommendations in each of these three areas. However, we believe that even if our recommendations are only partly implemented, the very process of reviewing and discussing our findings may help dealers and OEMs alike to better understand and empathize with each other's views, which may in turn lead to less industry contention about facility programs. Such contention and strife are generally a waste of everyone's time, effort, and money.

Finally, our thanks go out to the very many – necessarily nameless – individuals and firms who participated in the study by sharing their views and sometimes their data. Without their assistance none of this would have been possible.

I. Genesis

This project was launched by NADA in August of 2011, in response to numerous communications from NADA members expressing concerns and frustrations about how factory facility programs were both designed and executed. NADA members were very aware that investment in their facilities can run to billions of dollars annually, and that such investment has a significant impact on their finances. In many cases the financial burden was severely straining dealer resources, and in some cases it was even persuading dealers to leave the business.
However, when in response to such concerns, NADA first began investigating factory facility programs, we were surprised to find that little hard evidence exists as to the return on investment (ROI) in facilities, either to the OEM or to the dealer (not to mention the customer!). As a result, the facility investment decision is often based on subjective factors such as opinions, assertions, and anecdotes, which is no way to guide such massive spending.

Accordingly, NADA undertook this project. It is intended to be an objective, unbiased study of the various factors that drive the economics of facility programs, both positively and negatively, in order to move the facility investment decision onto a more rational, informed and fact-driven footing. It concludes with a few recommendations which we believe, if adopted, can help the industry address facilities issues more productively. What this study cannot do is provide a "silver bullet" solution that can work equally well for the over 15,000 dealers and two dozen OEMs that are every day working through facilities issues in a wide variety of particular cases. However, if it helps all industry participants (dealers, OEMs, attorneys, accountants, brokers, and more...) to more productively and positively discuss and resolve the issues that surround these programs, then we will consider the effort to have been worthwhile.

II. Context

At a very high level, this project was over the very day it started. That is, if we speak in the most general terms, virtually everyone in the American auto industry agrees that dealers, OEMs, and consumers alike are justified in expecting that new cars be sold from clean and modern facilities that are supportive of the car brand a given dealer is carrying. However, "the devil is in the details," and this project deals with those details, about which there is much less agreement.

The details we have focused on are those involved with car company facility programs. These go by various names, but in every case they involve the Original Equipment Manufacturer (OEM, aka "the factory"), such as Ford or Fiat, requesting that its dealers expand, modernize, or standardize their facilities (aka "stores") in order to meet a projected quantity of sales and service demand, and with the appropriate quality level of customer satisfaction. Typically such programs involve both complex numerical planning guidelines (specifying, e.g., the square footage of the store's service department) and more qualitative facility standards (specifying, e.g., the type of floor tile for the showroom, or the color of the building's exterior fascia). Further, many – but not all – OEMs choose to incentivize dealers to participate in the program. These incentives may include "carrots" such as financial assistance with the cost of participating (which includes the costs of facility construction and of purchasing furniture, fixtures, equipment, and more); and also "sticks" such as site control mechanisms that may limit the ability of a dealer who is non-compliant with the program to sell her or his store to another entrepreneur. The specified expenditures can be very significant: it is hard to imagine a program whose cost is under $100,000, and it is common to see outlays exceeding $5,000,000.

It is in the realm of detailed program specifications, and their financial implications, that tensions arise between dealers and factories. Unfortunately, for at least two reasons, these tensions – and therefore their complete resolution – are in some part unavoidable.
First, some tension is built into the franchisor/franchisee relationship that governs OEM/dealer relations. As soon as an OEM chooses to use independent dealers to market its products, it has brought into the equation entrepreneurs whose goals may not exactly match its own, and then conflict, to a greater or lesser extent, arises. And our interviews in franchised industries outside automotive (hotels and restaurants) confirmed this is pretty much inevitable: franchisees (dealers) will never see completely eye-to-eye with franchisors (factories) about any number of things, from sales targets, to business processes, to ... appropriate facility investments. As one interviewee put it for us: "In a perfect OEM world, the dealers would renovate every store every year. In a perfect dealer world, the OEMs would update every car model every year. Neither world is realistic, so we thrash out compromises in the middle."

But there is another reason these tensions are inescapable, and that is because the American dealer body is incredibly diverse, as was brought home to us in our interviews. To highlight just a few of the dimensions on which we saw how dealers can differ in their views of facility programs:

- Publicly-traded dealer chains, with high ambitions for growth, may be more accepting of factory programs, as they will need factory approval to buy more stores; private dealers who are happy with their one or two existing facilities may be less eager to "keep the factory happy."
- Dealers of luxury cars may be more willing to invest in facilities (as their customers may expect posh surroundings); whereas dealers in mass-market cars may believe that their value-conscious customers can be turned off by expensive stores, which they see as hikes on the price of the car.
- Older dealers, who are looking to retire from the business, may resent having to spend large sums on store upgrades just as they are getting ready to sell the franchise. On the other hand, younger dealers may be eager to expand and grow the store they just inherited from a parent.
- Dealers with a very strong used-car business or a very strong service business (warranty-paid and customer-paid repair parts and labor) may be resistant to spending on the new-car showroom in their facility, since new-car sales may not represent much profit for them. Conversely, for the factory, new-car sales are usually the primary focus.
- The first dealer of a given brand in a given metropolitan area to execute a facility program may be resented by his same-brand rivals, for "raising the bar" for them unnecessarily. On the other hand, the last dealer in that area to do an upgrade may be resented by his fellow dealers for "free riding" for so long on their investment in the brand.
- Finally, and more fundamentally, dealers can just have different views of the value of facilities. At one extreme the view is "dealership as tollbooth:" customers just want to get in and get out, with a good deal on a good car, and investing in the store is therefore a low priority. At the other extreme is "dealership as destination:" customers enjoy the dealership environment.

1 For a simple example, imagine a dealer who for personal reasons prefers to stay open 5 days a week, and sell 10 cars a week at an average price of $25,000 each, for a gross profit of $2,000 each and a weekly total of $20,000. The factory, which sells cars to the dealer at $23,000 each, might prefer the dealer to stay open for 7 days a week, and price the cars at $24,350, resulting in 15 sales weekly. Since in the second situation (in this simplified illustration) the dealer makes scarcely more money ($20,250) by doing so, he might refuse to add the 2 selling days, costing him almost nothing, but trimming the OEM's potential sales by a third. Thus conflict arises.
(there may be a children's play area, free snacks, a big-screen TV, etc.), and so investing in the store makes very good sense.  

With so many divergent views, it became clear to us that agreement on dealership facilities, virtually unanimous at a very high level, would be essentially impossible at the detailed level. There is no reasonable way for an industry-wide project to say that "The dealers want this..." or "The factories think this..." – there is too much divergence of circumstances, experiences, values, and beliefs. In the absence of a one-size-fits-all solution, therefore, we adopted a more modest goal: if we can't eliminate tensions with a universal solution, then at least we can reduce tensions by bringing as many opinions, issues, and perspectives as possible out into the open, from a variety of industry participants. And it is not just a matter of reducing tensions so that we all feel better: industry strife costs time and money in the short run, and possibly some freedom in the long run. As one interviewee put it, "If we can't work out compromise solutions between reasonable parties, we'll end up letting the courts and the legislatures figure this out for us, and last time I looked, the last thing this industry needed was more regulation. We have to take a deep breath, step back, and be careful what we wish for."

* * *

Despite our conclusion that there is no one right answer for all factories and all dealers in all facility discussions, we did in our research uncover several areas where we think there is real room for improvement, in program design and execution, that will benefit most participants in most situations. Those recommendations were included in brief form in the Summary section (above) and are discussed in more detail in the Recommendations section (below).

III. Methodology

Since, as hinted above, our initial review of both the general business press and academic economics literature uncovered no "textbook" answer to the facility investment question, we had to go out and uncover our own answers. Our process for finding these answers was straightforward: we would try to carry out in-depth interviews with everyone and anyone who might have insight into the topic. We therefore spoke to dozens of dealers (public and private, large and small, highline and mass-market), OEMs (twelve in all), and experts in various aspects of automotive retailing (dealership-focused attorneys, CPAs, buy/sell brokers, facility appraisers, architects, designers, lenders, economists, vendors, and more). We also sought insights from other retailing industries with experience in facility upgrade

---

2 There is another dimension of dealer divergence, and that is on basic attitudes towards the OEMs. Some dealers are more than happy with their factories, and move almost in lockstep with them; others are deeply distrustful of OEM intent, and see factory initiatives as by definition suspect. No amount of argument will move either extreme from their positions. As one anti-OEM dealer said, his pro-OEM colleagues are "delusional: they've drunk the Kool-Aid." As one pro-OEM dealer said, the anti-OEM dealers "Could get a check from the factory and they'd complain about the color of the paper it was written on." We hope this report can nudge those with extreme views on both sides more towards a middle position, but we do have to be realistic and acknowledge that dealers are strong-willed entrepreneurs who are not easily swayed, so we will in this report steer clear of both ends of this spectrum.

3 And we haven't even discussed yet how OEM views of their programs diverge: see more detail on this later in the report.
programs, including franchised restaurants and hotels. And, of course, we surveyed customers – car buyers – for their views. See Exhibit 1 for more detail (all Exhibits can be found after the text portion of this report).

We then supplemented these interviews (numbering about 75, both in-person and via phone) with desk research covering automotive industry periodicals, economic journals, facility program manuals, and various other sources.

From the very first day of the project it was clear that interviewees were quite concerned about "blowback" from other industry participants, if they spoke on the record. For example, some dealers were worried about adverse reactions from their OEMs if they spoke candidly about their facility programs. Conversely, some OEMs were concerned about the negative impact on their reputations if sound bites from their interviews were leaked out of context. Accordingly, we adopted a "double blind" confidentiality policy for every interviewee. Not only is no quote in this report attributed to any individual or firm, but there will be, further, no disclosure as to which individuals or companies even participated in the work. (And all interview notes provided to NADA have been scrubbed of all information that could identify any interviewee.)

The upside of this policy is that interviewees felt secure enough to speak candidly and at length, which was vital to us. The downside is that we cannot, here or elsewhere, thank the interviewees by name for their help, which was in virtually every case given readily and extensively. All we can do is express our sincere gratitude to each and every person involved.⁴

IV. Exclusions

There are three topics which have bearing on the issues raised in this report, but which are excluded from it, primarily in order to keep a steadier focus on the main topic of the economics and commercial impact of facilities programs.

First, there is the whole body of legal, regulatory, and legislative activity which affects and in some cases governs exactly how and what a factory facility program can or cannot ask for from a dealer. NADA Legal and Regulatory staff did provide background briefings on the issues involved, and updates on key state-level actions related to facility programs (e.g. as in Virginia). And the staff also reviewed this report to ensure that its findings and recommendations conformed to the legal and regulatory facts on the ground. But early on in the project it became clear that the diversity and complexity of all this activity was too great to encompass in this report, and was best left in the hands of experts such as state regulators, OEM legal staffs, dealer attorneys, and of course the people at the state and metro dealer associations (also known as the Automotive Trade Association Executives, or ATAEs). If there is a remaining direct link between this report and state-level legal and regulatory activity, it is in the hope that open and fair discussion of the issues raised in these pages can lead to their more often being

---

⁴ I would like to add my own personal thanks, above and beyond the collective thanks of NADA as an organization. There was not one "clunker" of an interview among the many dozens I carried out: I learned something new in every one of them, up to and including the very last one.
resolved in negotiations between business people, rather than being decided in the courts and legislatures.

Secondly, this report does not directly address issues of exclusivity of stores, whether that topic comes up when dealerships are bought or sold, or via factory incentives to convert a "dual" dealership to an exclusive store, or in site-control language in franchise or related agreements. Obviously exclusivity has an impact on facilities (most clearly if a dealer needs to build an entirely new showroom for a given brand), and in this regard it was discussed in many of the interviews. But to some extent, as one expert said to us: "That ship has already sailed," in that factories and dealers have generally sorted out many of the rules of the game in exclusivity requirements. This is not to say this is not still a contentious and important issue in individual cases, but that on an industry-wide basis, the argument about facilities is a hotter topic than is the argument about exclusivity. And further, facility programs are difficult enough to analyze for one brand at a time, without adding to the mix the additional complication of exclusivity actions. So in this report exclusivity requirements will not be directly addressed.

Finally, at no point in this report will we be naming, comparing, contrasting, or evaluating specific factory programs. This is in part because we were only able to enlist open and candid OEM participation in the project by assuring them that their input would not be turned against them in some sort of facility program "beauty contest." We will, however, in this report, make overall recommendations as to how any facility program might be improved. Secondly, we felt that program positives and negatives might vary dramatically by individual dealer situation, such that we should not be in the business of telling dealers which program was or was not right for them. And finally, the very nature of NADA as an industry association imposes legal constraints (related to anti-trust issues) which bar us from officially weighing in as to which OEM or OEM program is better or worse than any other.

V. Findings: The Big Picture

As a first step in assessing the question of the value of factory facility programs, we'll summarize here the overall views of four key constituencies, or groups of industry participants with a stake in the answer: dealers, OEMs, supporting players (experts such as CPAs, lenders, attorneys, dealership brokers, etc.), and consumers. The following are overall perspectives only: later on in this report we'll get into the details.

Dealer Views

Dealers' views of factory facility programs we would summarize as "Supportive of the concept but skeptical of the economics." Of the dealers we spoke with (which we'd call a roughly representative sample\(^5\)) a very large majority agreed that clean, modern, and brand-supportive facilities were necessary.

---

\(^5\) Because the facilities question is so complex and nuanced, we took the approach of carrying out a smaller number of in-depth interviews rather than executing a larger number of quick-hit "check the box" questionnaires. To ensure that the sample we talked to was somewhat representative, we aimed for a mix of small and large stores, domestics and imports, high-line and mass market, and public and private stores. We also attempted to include in the sample any dealer who reached out to us and asked to be included, although about half of this group
for business success, and a smaller majority understood the need for factory programs to help bring facilities up to snuff. However, as we will see in more detail later, only a minority thought that there was a solid economic business case to be made for program participation. The majority view was that a dealer would go along not because he or she could see a clear economic upside, or sales or service gain, but rather participate to avoid a sales decline; or to capture factory incentives; or to keep in good graces with the OEM; or to stay competitive with participating dealers; or to show commitment to the brand; or to earn factory clearance for a dealership sale. Further, dealers were often concerned with the costs of facility programs, which they saw as too high, due to excessively demanding specifications, or to limited choice of vendors, or for other reasons also discussed later. Exhibit 2 shows a small sample of illustrative dealer quotes as regards facility programs in general.

**OEM Views**

OEMs were, as might be expected, strong supporters of their programs, and typically backed up their commitment with a mixture of incentives to induce dealers to comply with them. We would summarize their views of programs as "Highly supportive of the concept, but highly diverse in their implementation." This is because the OEMs we spoke with covered quite a spectrum when it came to program parameters such as cadence (e.g. from "every ten years" to "as the need arises"), stringency of specifications (e.g. from "this is your one choice of tile" to "select what you want, within reason"), and use of incentives (e.g. from "you're on your own" to "our payments might cover 100% of your costs"). Regardless of these variations, OEMs were unified in their view that their programs were absolutely necessary to support both volume growth and the brand values — although they expressed this in different ways, as Exhibit 3 shows.

**Expert Views**

Experts whom we consulted included attorneys, accountants, buy/sell brokers, economists, research firms, vendors to the industry, and more. We felt it important to seek their input not only because they were generally very well-informed, but because they typically had worked with dozens if not hundreds of dealers over the years. In this way they effectively expanded our interview sample, by reporting not only their own opinions, but those of the dealers and OEMs they had worked with. Despite being a very diverse group, their opinions we can summarize fairly accurately as "Supportive but skeptical," much like dealers themselves. While Exhibit 4 shows a sampling of their various views, a constant theme across them was that of facility program participation as "table stakes:" if a dealer is signed up with a given

---

6 Typical "carrots" (incentives encouraging dealer participation) OEMs might employ included lump sum cash payments (often a percentage of total facility upgrade expenditures by the dealer), Increased or improved allocation of vehicles (either temporarily or permanently), addition of "back end" margin bonuses or per-car payments (typically paid quarterly), and favorable treatment on various issues (e.g. site control, access to open points). Typical "sticks" (disincentives against opting out) included removal of the margin or per-car bonuses (possibly making the non-compliant store less competitive or profitable) and unfavorable treatment on the issues cited. There are pro's and con's around each incentive type: again, no "one size fits all."
brand, and has faith in the brand, then periodic renovations just go with the territory, regardless of whether a particular investment will ever pay off its cost.

**Consumer Views**

Finally, of course, we come to the consumer. A more studied, surveyed, and analyzed group of people probably does not exist in the USA than car buyers, given that in any particular year they may spend $400 billion on new cars alone. Therefore, there was no way for a small project like ours to come up with precise dissections of consumer views of dealership facilities, that would rival the OEMs’ own surveys, focus groups, and market research, or even dealers’ own read of consumer views, based on millions of interactions over the years. But we did want to get at least a general sense of what American car buyers thought, and we did this via a short survey of a few hundred in-market consumers. The results were that, as regards dealership facilities, consumers are "Indifferent and unimpressed." As Exhibits 5 and 6 show, this indifference extends to both the car choice and to the dealer choice: the situation of the dealership facility had little influence on either choice of vehicle brand or on choice of dealer, once the vehicle brand was selected. Now, it is very true that what consumers *say* and what consumers *do* are often two very different things, but the survey results make it clear that if dealership facilities do mean much to consumers, then consumers are hiding this opinion very well!

In summary, dealers are supportive of the concept of facility programs, but wary of their economics. Expert observers tend to echo this view. The OEMs are understandably enthusiastic about the programs, but approach them in very different ways. And consumers, if what they are telling us reflects their actual behavior, are mostly indifferent. But we cannot draw too many conclusions from these views, or make recommendations as to how to align programs with them, because as noted at the outset, the devil is in the details when it comes to these programs. We needed some way to tackle those details, and came up with the three-layer analytical approach laid out in the next section.

Before we go on, however, there is one more constituency that came onto our radar screen as our project progressed: dealership employees. While we did not interview employees directly, more than a few dealers expressed pleasant surprise that, after they completed a store upgrade, it became much easier to attract, retain, and motivate good staff. One multi-point dealer even told us that "I modernize as much to attract good staff as to impress the customers." Another pointed out that with improved employee morale came improved CSI scores, which makes sense. The impact seemed especially powerful in the service area: as one interviewee put it: "A dropped ceiling in the service bays will do wonders in attracting and retaining good technicians, who are pretty used otherwise to being ignored." We saw during the project no particular effort to quantify this effect, but it might make sense for OEMs to circulate surveys of the opinions of employees who can provide before-and-after views of morale when a renovation is carried out.

A closing comment for this section: dealers and experts alike, after sharing with us their own views, were eager to speculate as to the "real" reasons OEMs initiated facility programs. We of course have recorded in this report only what factory representatives told us, as we have with all our interviewees, because we have taken all comments in good faith. However, in part because the *business* case for
facility programs seems so weak or so unclear, industry participants spent a lot of time theorizing about other OEM motivations for launching programs. It may be informative for all parties to review a list of the various theories we heard different interviewees put forth (see OEM Sidebar).

**OEM Sidebar: The Story Behind the Story: What Motivates the OEMs?**

In part because many dealers and experts are skeptical of the underlying economics of facility programs, these groups indulge in quite a bit of theorizing as to what are the OEMs' "true" motivations in promulgating these programs. Listed below are some of the theories we heard during the course of this project. We present them without comment or endorsement (though we suspect that each of these is at least a little correct), but hope that in reviewing them all parties will better understand each other's thought processes.

**The Higher Purpose theory:** This reasoning asserts that the OEMs know that if they don't enforce higher standards on dealers, the dealers themselves will not do so. This is likely to be true if there is a large "free rider" problem in automotive retailing. That is, if all dealers (and the OEM) together benefit from dealership upgrades (and thus better brand strength), then it will be a good thing for all dealers as a group to do. However, any one dealer can decline to upgrade, and "free ride" on the investments all the others make. Thus the factory has to intervene and persuade all (or most) dealers to participate.

**The Longer View theory:** Under this reasoning, since only the OEM knows well what products it will be bringing to market in the future, and how attractive they will be, then dealers (less certain about the future) will not on their own invest enough ahead of time to be ready for these products. Dealers will thus tend to not invest until they see the product, whereas factories will want them to invest in advance – and so start facility programs.

**The Cars as Commodities theory:** If you adhere to this theory, you believe that distinctions among cars are eroding, so that the battle for the customer is shifting to the customer experience. In this case, the state of the store facility is becoming more critical to market success, and so factories are stepping up their upgrade programs.

**The Hands are Tied theory:** Given years (even decades) of successful regulatory, legal, and legislative action, mostly at the state level, dealerships have erected strong defensive barriers against OEM control of their business decisions. The result is – this theory states – that OEMs find they cannot easily bring into line underperforming dealers, and so they resort to one of the few levers they have left: facilities programs (and site control agreements that often require facility compliance in buy/sell deals).

**The Few Bad Apples theory:** Under this reasoning, OEMs know the vast majority of dealers will invest in facilities appropriately on their own – but to bring in the 5% who would on their own refuse to do so, facility programs are required. Some OEMs told us that a further reason for doing this is their concern that if they do not "treat every dealer identically," they could be open to legal action.

**The Share the Burden theory:** This view asserts that, if OEMs are spending billions on new car development and advertising (etc.), then it is only fair for dealers to spend on facilities, as well. The universal rebuttal to this theory is along these lines: "$1 billion (of shareholder’s money) to an OEM executive is nothing much, but $500,000 of (my personal wealth) is everything to me."

**The Domestic Catch-up theory:** Many industry participants feel that the recent difficulty of the domestic OEMs might have been in part due to aging or deteriorated dealership facilities. If one adheres to this view, then the argument goes that now is the time for these dealers (and their OEMs) to accelerate investments, and "catch up."

**The Because They Can theory:** Less a theory, really, than a belief, this view asserts that OEMs roll out programs not because they are valuable, but because they have the power to impose them on dealerships (even though every program is designed to be "voluntary" in some way). It is difficult to analyze this theory one way or the other, as it is usually based on deep personal convictions.
VI. Findings Beyond the Big Picture: Program "Layers"

Almost from the day this project kicked off it became clear that the phrases "facilities programs" or "image programs" meant very different things to different people. Some interviewees wanted to talk about signage requirements, others about service bay or stall additions, others about floor tile upgrades. A more precise yet still comprehensive definition of what we were investigating was necessary. What we came up with, which was then confirmed and fine-tuned in numerous later interviews, is the pyramid model shown in Exhibit 7. Basically, the pyramid recognizes that there are at least three "layers" to facility programs: Expansion, Modernization, and Standardization. The issues around each layer tend to be different (even though all three might be bundled together in any particular program), and so in our research we needed to address them separately. We defined each layer as follows:

Expansion Defined

When an OEM and a dealer discuss adding parking space (for customers or for vehicle inventory), service stalls, and interior space (such as showroom or service waiting area square footage), they are discussing Expansion. Typically the Expansion discussion starts because a brand's UIO (units in operation) has grown rapidly (necessitating adding service bays to repair the larger fleet), or because an OEM is adding new models (necessitating a larger showroom), or forecasting higher future sales or market share (requiring expansion of the entire store). Tension here tends to arise when the factory asks for more expansion than the dealer thinks is necessary, e.g. due to inflated volume forecasts.

Modernization Defined

Assuming the dealership facility is sized correctly, the next layer at issue is Modernization: bringing the store up to contemporary standards both inside and out, for example with new building fascia or windows outside, or with upgraded furniture, fixtures, and equipment (e.g. free Wi-Fi) inside. The goal of Modernization is of course both to attract more customers and then to better satisfy them, by surrounding them with a pleasant and up-to-date environment. Tensions can arise both on the cost and benefit side of the equation: one dealer might see the value in the upgrade, but believe that the factory's approved materials vendors are too costly; another might not have a problem with the cost of the specified fixtures, but not see any value in the project, in terms of either increased sales (in cars or service work) or customer satisfaction.

Standardization Defined

If the store is now the right size and is sufficiently up-to-date, the next layer facility programs often tackle is Standardization: ensuring that the updated facility looks as much as possible like those of other dealers carrying the same brand, via the use of similar or identical materials, floorplan templates, and commonized furniture and fixtures.\(^7\) The goal of Standardization seems to be to somehow reinforce the

---

\(^7\) We did not focus on signage when we discussed Standardization issues, as the great majority of our interviewees, whether OEMs, dealers, or others, acknowledged the reasonableness of the OEM's requirement for tight control over, and standardization of, brand logos, images, signs and even exterior building color generally.
power of the brand by providing a similar look, feel, and experience for a customer of a given brand – whichever store she or he happens to visit. Tensions arise here in part over the cost of Standardization, but especially over its worth: as will be discussed later, many interviewees had trouble seeing why Standardization – as defined by some but not by all OEMs – might be valued by a customer.

Once we had this three-layer definition of “facility programs” in place, our interviews became more productive, as we could disentangle which opinions applied to which layer.8 (Of course, different programs involve different mixes of the layers: an over-dealered OEM might ask for no spending on Expansion at all, whereas an OEM with surging sales volumes might focus entirely on Expansion.) The next section covers the facility issues we uncovered that were specific to each layer. After that discussion, we will cover issues that cut across all three layers.

VII. Issues by Layer

Expansion Issues

The Expansion aspect of a facility program is defined as when a dealership expands its land, parking, showroom, office, waiting area, or service space, to support existing or expected growth in UIO, sales volumes or product line scope. We could discover no hard numbers as to "pure" Expansion spending (since, as noted, often Modernization or Standardization come along with Expansion), but our interviewees guesstimated it represents some 40% of total program spending.

While this is a large category of facility spending, it generated the least argument and OEM/dealer tension among our interviewees, partly because it is the only layer where hard numbers are very often available. For example, a dealer can calculate the cost of a new service bay and also calculate the return on that cost, based on utilization percentages, technician billing rates, and parts markups. UIO can be measured and projections made (which of course can turn out to be wrong). The return on showroom expansion is of course more problematic.

Furthermore, there is both a large "carrot" and a large "stick" inducing dealers to participate in Expansion programs. On the "carrot" side, much of the benefit of Expansion spending flows directly to the individual dealership, often via increased parts, service, and sometimes CPO (Certified Pre-Owned) margins. This is different than spending on (e.g.) Standardization, as we will see later, where if there is benefit it flows as much to other dealers and to the OEM as to the investing dealer. On the "stick" side, virtually every service and sales agreement between an OEM and a dealer does require a dealer to be

8 For example, a dealer who might be asked about a program generically ("What do you think about OEM Facility Program X?") might answer with a vague response ("It's okay but way more than I need.") If we split our question into the three layers, the answers became more helpful ("My store did need modernization, so that was fine with me, but as far as expansion they asked for way too many additional bays, not realizing I run service till 2 AM, so my capacity per stall is much greater than they calculated.")
sufficiently capacitized to sell and maintain expected unit volumes – which does mean the factory has some standing to cancel a franchise that does not keep up with expansion requirements.⁹

But even though this was the least problematic of the three layers, there were four areas where it seemed that improvements could be made, two related to OEM expansion forecasts, one to capacity formulas, and one to overall business cases.

1. Forecasting (1)
Dealers depend on their OEMs’ forecasts of sales volume and UIO to make their own Expansion decisions. While no one expects these forecasts to be unerringly accurate, many interviewees pointed out that they were perennially biased in one direction, and that was to the upside. As one expert put it, "When I look at all the factories' market share forecasts, they always add up to 120%!" Unreasonably high future volume forecasts lead to costly overbuilding by dealers (not to mention OEMs), and as events in the last decade have demonstrated, we have all seen to what bad results that can lead. Further, expansion and contraction are not "symmetrical:" it is easier to add a bit more capacity (e.g. by knocking out a showroom wall), and spend the incremental money, than it is to shrink capacity (e.g. one can hardly sell off a couple of excess service bays) and recover the money spent. One OEM we spoke with noted that they had an explicit policy to slightly under-build, and we can endorse this policy. In general, however, we would request OEMs to consider more conservative forecasting methodologies.

2. Forecasting (2)
Our interviewees were almost unanimous in their view that OEM sales volume or UIO forecasts tended to change too frequently, bouncing up and down from year to year, or even more frequently than that. Excessively frequent changes to forecasts can cause costly waste (e.g. by overbuilding or, conversely, by having to rip up and enlarge underbuilt facilities). As one expert put it, this is a matter of matching maturities: “It makes no sense to change every six months the square footage I will need in my service area in a year or two, when I’ve got 3 years left on my franchise agreement, will be paying for this with a 7-year loan, and you are telling me the tile I will be laying down has a 20-year life!” One dealer showed us actual factory forecast figures gyrating both up and down by 20% or more from year to year, over the course of several years. While of course allowances must be made for unexpected events (e.g. tsunami’s, unexpected recall campaigns, OEM bankruptcies), it seemed to us within the power of OEMs to try to smooth their forecasts, reducing uncertainty and risk for all involved.

3. Capacity Formulas
Almost all of our non-OEM interviewees brought up the issue of formulas for service-area capacity calculations as being outdated. For example, a formula might require one stall for every 1,000 UIO. Thus if UIO in a dealer market area in the year 2000 was 20,000, twenty stalls would be required. But by 2010, the dealer might have introduced extended service hours (e.g. to 1 AM), as well as night-time drop-off, and service loaners. These actions may have increased stall capacity by 50%. If UIO in 2010 was now 30,000, the factory might be asking for thirty stalls even as the dealer believed that twenty was still adequate. We did not evaluate individual OEM calculation algorithms, so we are sure that different

⁹ An OEM would have less recourse as regards (e.g.) Standardization requirements, as these are not directly linked to issues of capacity.
OEMs have updated them at different rates. But the general point remains, that we would encourage frequent revisiting of capacity formulas, so that expensive overbuilding is avoided.

4. Business Cases
As we will repeat in both the Modernization and the Standardization sections, dealers, experts, and even some OEMs acknowledged the need for better business cases to be made for Expansion. As noted, service-bay expansions tended not to be problematic, but acreage and showroom or office expansions are still argued as much on "soft" factors such as faith, assertions, or anecdotes, as on "hard," quantified business cases based on the experiences of dealers who have made such investments. Again, the availability of business case or ROI calculations varies immensely by OEM, but we would encourage all OEMs to devote more of their vast analytical horsepower to improving the cases they present to dealers whom they are encouraging to expand.

Doing so would not only reduce tensions between dealers and OEMs (by presenting more persuasive arguments for Expansion), but would even possibly make financing Expansions easier. We were quite surprised to find no commercial lender who was willing to evaluate or size a facility Expansion loan based in part on the store’s expected sales and margin gains. Instead, lenders would ignore such forecasted gains, and extend finance only against past and current cash flow, or against current levels of collateral, or against simple square footage rules of thumb. This is in part due to understandable conservatism (especially justified after the recent financial crisis), but also due to skepticism about the payoff of dealership Expansions. Stronger business cases might therefore encourage lenders to improve loan terms, or even increase loan-to-appraisal ratios.

Modernization Issues
The Modernization aspect of a facility program we defined as when a dealership upgrades its facility, both inside and out, to contemporary standards. In some cases major components of the structure may be rebuilt, or architectural elements added (e.g. entry portals), but in almost every case building fascia and windows are redone, and interior furniture, fixtures, floor tile, carpets, graphics and more are overhauled or replaced. Expenditures typically run from the low six figures into seven or even eight digits, for high-line (luxury) dealerships. As with Expansion, we could discover no hard numbers as to pure Modernization spending (since often Modernization or Standardization come along with Expansion), but our interviewees guesstimated it represents some 40% of total program spending.

This layer of spending generates a great deal of controversy, because while the costs are painfully clear, the benefits are at worst minimal (the view of the most skeptical dealers and experts) and at best unquantified (although one or two OEMs did share with us some very useful numbers, as discussed below). Furthermore, even those who see the benefits of Modernization often feel that its cost, as driven by the factory's requirements and procedures, is too high. These two problems lead to the two areas where we see improvement can be made to the Modernization component of facility programs.
1. Clarifying the Value of Modernization
First and foremost, we believe it is incumbent upon OEMs to apply their enormous analytical resources to making renewed efforts to demonstrate the value of Modernization at the dealership level, whether to themselves, to dealers, or to customers. Exhibit 8 shows in summary form what we heard from OEMs as to what this quantification might show, or even if it is possible. As one can see, OEM views range from defeatism (quantification is just not possible), to subjectivity (anecdotally we think it pays off), to partial objectivity (we have looked at a sample of dealers and it more or less supports the case for investment).

We tend to reject this overall half-hearted attempt by OEMs at making a business case, for two reasons. First, we just do not understand why this work cannot be done. Automotive engineers can calculate the weight of a car's glove box door to the nearest half a gram, marketers can slice and dice advertising views down to the zip code, and the average dealer can figure a monthly lease payment almost in his or her head – and yet when it comes to asking for hundreds of thousands or even millions of dollars from dealers in facility investments, the most common rationale seems to be "Well, it supports the brand." This does not seem reasonable to us – excepting of course the small number of OEMs who showed us convincing and detailed data. We also note that in the fast-food restaurant industry, and in other retailing industries, such quantified business cases are more common. We do understand that a dealership is not like a restaurant, but we do not think that that is an excuse to not know the numbers.

The second problem with asking for investments without (in most cases) showing a clear quantified rationale for doing so, is that this practice triggers suspicion and even paranoia among dealers, which is just not good for an industry that depends for its success on close collaboration between factory and store. We heard more times than we would care to count assertions such as:

- "They don't show us the numbers because they know they won't be able to make the case."
- "They don't share a business case with us because it's not their money, so why bother?"
- "OEMs make us comply not because it pays off, but because they can. They hold the power."
- "Every dollar of profit I make my factory considers stolen from them, anyway."

There will always be trust issues in automotive retailing in the USA: and as we said at the start, such tensions are inherent in a franchised system. But these tensions, if left unaddressed, lead to any number of counterproductive and wasteful actions, such as lawsuits, legislative battles, endless negotiations, and more. We do believe that redoubled efforts to make the case for dealers will pay off in a reduction in such activity.

2. Reducing the Cost of Modernization
Secondly, even for those dealers who are convinced of the need for and benefits of Modernization (by our estimate probably three-quarters of the dealers we spoke with), there is a strong sense that the cost of renovating a store according to an OEM facility program is needlessly high, relative to what it would have cost the dealer on her or his own. The average estimate of this cost overrun was 20-30%, which of course varied dramatically by OEM program. Exhibit 9 shows a few factors that interviewees (dealers...
and experts) believed combined to generate this cost penalty. We can only urge OEMs to continue to be vigilant on the cost front, and to address both the perception as well as the reality of any program cost issues. We also, however, urge dealers to assist OEMs in identifying legitimate, validated cost savings. Too often we heard dealer assertions such as "I could do this for half the cost if they only let me!" – without any specifics or good evidence for how this could be done. It is only fair that if dealers ask for better cost justification from OEMs, that dealers on their side provide equally solid guidance for potential cost savings they identify.

**Standardization Issues**

Finally, we come to the Standardization layer of factory facility programs. This layer is defined as the collective requirements, within a program, to ensure that each dealership carrying the brand looks as much as possible like every other store carrying the brand. Standardization efforts always emphasize the exterior look of a dealership (since this is what every potential customer driving by sees), and often (but not always) focus on interior looks as well. To be clear, Standardization is not Modernization: Modernization may require every dealer to put in new floor tile, whereas Standardization may require every dealer to use the same tile supplier, the same tile size, and the same tile color. As with Expansion and Modernization, we could discover no hard numbers as to "pure" Standardization spending (since often Standardization comes along with Modernization and Expansion), but our interviewees guesstimated it represents the final 20% of total program spending. (Again, we are excluding signage from this discussion: see footnote 7.)

This layer of spending generates the most controversy, because Standardization's benefits are very unclear. Some interviewees thought there were benefits, but that they were minimal. Others thought there were benefits, but that they flowed all to the OEM, and not to the dealer (although in the long run the interests of the two must to some extent converge). Others thought Standardization had no positive value at all, and actually was a drag on dealership and brand performance. We will highlight some of these concerns in more detail below:

1. **The Economists' View: Standardization May Not Make Sense in Automotive Retailing**

   We spoke with several economists with special expertise in franchise economics. In their view, there are two valid reasons for store standardization, but neither applies in automotive retailing:

   **Local quality control.** If a local franchisee can have a big impact on product quality (e.g. the cook flipping the burgers leaves them on the grill too long), then a standardized building is a signal to the customer that the national franchisor is on the job and will enforce quality processes at this location. But in cars, the product’s quality level is set at the factory, with little local dealer ability to influence it.

   **Transient customers.** If a franchise's customers tend to move around as they shop and purchase, then the standardized building signals that “Here you can find the same products as you did back near your home” (e.g. on the family vacation Dad can look for a favorite restaurant, which he knows his children prefer). But in cars, customers tend to buy from a very limited and local set of dealers, rather than by roaming far afield.
2. A Marketer’s View: Be Careful of the Promise Standardization Makes

Standardizing the store promises the customer that his or her experience will be the same, whatever dealer he or she visits. But we know that customer experience is not standardized across all the dealers of a brand (in fact, it is more likely to be standardized across the different brands owned by a single dealer principal). Are OEMs therefore setting up customers for disappointment, by promising a consistent experience that they cannot deliver on? And to the extent that standardized facilities look more like company stores than locally-owned dealerships, won’t the customer increasingly blame the brand, not the dealer, for disappointment? And if customers come to believe that "All the dealers of Brand X are the same," then if a customer has a bad experience at one of them, won't she or he extrapolate that to the entire brand? As one marketing expert put it: "Be careful what you wish for, when you standardize."

Marketing experts also pointed out that in other retailing fields there have been signs of a rejection of standardization, as customers grow weary of "cookie cutter" stores. Thus Starbuck’s has given local store managers leeway to decorate interiors with "artifacts of local relevance" and community bulletin boards; thus Best Buy has opened small-format Best Buy Mobile units, for insertion into shopping malls; and McDonald’s is moving to a "portfolio" of interior look options, while also allowing for exterior treatments that can vary among stone, stucco, brick, and other materials. Is the automotive industry moving in precisely the opposite direction to these retailers, by seeking more standardization?

3. The Financial View: Standardization Can Erode Dealership Value

One of the most striking findings from our work was the strongly negative view of facility Standardization from sophisticated dealer financial advisors and brokers. While acknowledging that a dealer may have no choice but to follow Standardization guidelines, especially if she or he wanted factory approval of a buy/sell transaction, those who had thought at all about Standardization were unanimously negative about its impact on dealer finances. As one summed it up: "Expansion adds value, modernization can maintain it, and standardization impairs it." There were a few reasons for this view:

- First, to the extent Standardization adds fixed cost to a dealership, it reduces the value of a store to a buyer: "Each additional dollar of annual fixed cost takes the resale value of the store down by $3, $5, or even more."  

---

11 This concern applies of course to unjustified Modernization expenses as well.
12 While on the subject of fixed costs, we should point out that any business case or ROI analysis arguing for facility investments (Expansion, Modernization, or Standardization) must of course take these into account. That is, the ROI of a facility program is not simply the additional margins we hope to gain from the program, divided by the capital cost of new buildings, furniture, floors, etc., required to generate those margins. Additional costs are also incurred during a renovation, and they must be taken into account as well. These include a) higher real estate taxes on the improved facility; b) higher insurance costs on the improved facility; and c) increased maintenance costs (driven by added square footage but also in some cases by extra maintenance required by new features: e.g. glass curtain walls replacing brick walls require frequent cleaning). Furthermore, some dealers told us that the biggest ongoing cost they faced, after increased rent factor, was that of customers lost during messy renovation projects – some of which customers they expected to never win back later, once they had switched dealerships. All these costs need to be built into any worthwhile business case.
• Second, to the extent Standardization generates any value at all, presumably it is to the OEM rather than to the dealer (since we saw no convincing business cases for dealers) but the dealer, in general, pays for it.

• Third, to the extent Standardization makes the dealership less "fungible" (inter-changeable across brands), it reduces the value of the store. As one interviewee put it: "In the 60s the store was a box with a sign. Close a Ford store on Friday and open it as a Chevy store on Monday, just swap signs. Today, with portals and towers and hangars and entries and all the rest, some literally carved in stone, an Alpha store I want to convert to a Beta store I will probably have to rip up and rebuild." Store buyers know this, and will reduce their offer to the seller accordingly, since they know the store only has value as an Alpha point.

• Finally, there is a "specification trap." If an OEM standardizes, it will set standards as needed in the most demanding market it faces (e.g. an upscale part of the Los Angeles metro area). Now the standard is well beyond what would be needed in a more downscale market (e.g. a Midwestern rural location). The average store will thus be overbuilt.

A cynical observer might read these points and say "So what? The dealer exists to support the brand, not to sell off his store, or possibly convert it to a rival brand." This is a valid viewpoint, but other analysts would refute it as short-sighted: to the extent the dealer feels that his or her store is growing in value, he or she should be more willing to invest in it. If the OEM asks for investments that actually reduce its value, by making the store less attractive to buyers, the dealer's willingness to do so must of course be less. If OEMs hope to continue to attract strong operators, they should be very interested in ensuring those operators see a clear path to growing personal wealth.

4. The OEMs' View: Divergent, Uncertain Arguments

While we found near-total unanimity among OEMs as regards Expansion and Modernization, around Standardization there was more divergence of views as to how it should be done and what its value was. The range of opinions was striking. For example:

• One more pragmatic OEM thought that standardization beyond exterior colors and one key architectural element would just raise cost, for no benefit.

• Another said it was retreating from extreme standardization, as the rationale for it was weak.

• One mass-market factory thought that standardization was valid for volume brands ("We're like Fairfield Inn, we build our brand with a consistent look and feel") while believing it invalid for luxury brands ("They're like Ritz-Carlton, the brand is already strong enough, so customers seek some variety and innovation above and beyond that.").

• Another felt that it was absolutely crucial to vary the dealership's look according to local market needs, e.g.: "If you're in San Diego you had better have a Spanish tile roof and adobe-look exterior – but I sure would not try that in Vermont!"

• One luxury brand asserted that standardization of the facility was in part necessary in order to standardize the process (for example, one cannot offer customers warm and dry service drop-off without an enclosed marquee in the service drive).
Another made the comment that the dealer's view of what supported the brand was often different from the OEM's view of what supported the brand, and that this had to be corrected (although why this had to be done was not made entirely clear).

Several OEMs believed that as the car was standard across stores, the stores now had the freedom to vary some elements to match local market values.

And finally, one mass-market OEM was very proud of how much individual innovation its dealers had executed, especially in interior designs, which ranged in looks from "ski lodge" to "Western ranch" to "chrome and glass" to "indoor forest" and beyond.

This diversity of views does serve to reinforce the opinion of some dealers and experts that OEMs themselves cannot identify a consistently compelling rationale for high levels of store standardization.

In summary as regarding Standardization: the economists are dubious, the marketers concerned, the financial advisors negative, and the OEMs themselves somewhat unsure. As for dealer opinions, please see earlier comments: if dealers were generally appreciative of the benefits of Expansion, but somewhat doubtful of benefits from Modernization, they saw little if any upside to Standardization. As one dealer put it: "Standardization costs are just the franchise tax I have to pay."

Accordingly, we would recommend that OEMs who do insist on high Standardization levels revisit their motivations for attaining these levels (and their costs). We suggest this even while realizing that most if not all OEMs assert that they offer some flexibility when it comes to Standardization, thus reducing its negative impacts. However, except for a few OEMs, the flexibility seems to lie more in the realm of adjusting square footage guidelines than in allowing diverse materials and equipment options, which therefore does not solve the problem. We believe a more "clean sheet" review of the costs and benefits of dealership Standardization is still called for.

VIII. Cross-Cutting Issues

In addition to the concerns raised in our layer-by-layer review of facility programs, we came across four sets of issues that cut across all three of these layers. These include:

- Timing: is now a good time to invest in a facility program?
- Size bias: do OEM facility programs disproportionately burden smaller dealerships?
- Incentives: are there better ways to design the incentives factories sometimes offer to dealers?
- Store evolution: are we building today dealership formats that will be obsolete tomorrow?

We address each of these four issue areas in turn below.

1. Timing

When, in both 2010 and 2011, NADA members communicated their concerns about factory facility programs to NADA staff, they often mentioned that "Now is an especially bad time for factories to be asking for program upgrades," citing the weak economy as the reason for their position. Accordingly, during our interviews in the Fall of 2011 we asked respondents for their views on the timing issue.
Exhibit 10 shows the results. In general, our estimate of the consensus among dealers and experts is that now *is* a good time to make facility investments (assuming one thinks such investments are a good idea at all). Concerns remain, as shown in the Exhibit, but as these are generally macro-economic in nature (related to the American economy as a whole), we offer no recommendations as to what OEMs or dealers should do differently. Of course, if a given dealership is in a loss-making position, for *that* dealership "now" may be a very bad time indeed, and we expect that OEMs will take this into account in rolling out their programs.

A pair of additional timing issues was raised by various interviewees: those of 1) pace or cadence of factory programs, and those of 2) overlap of successive programs.

The **pace** issue is the concern that OEMs try to update facilities too frequently, before this is justified (by either wear and tear, or changing customer expectations). As context, retailing experts we spoke to considered 5-7 years a good interval for renovation of stores carrying apparel and other fast-moving products; hotel operators generally stuck to a minor refresh every five years and a major overhaul every ten. Restaurants seemed to be on an even slower cycle. Most automotive OEMs we spoke to were of the opinion that there should be no pre-set interval ("We'll ask for it when the circumstances call for it"), but if pressed for a number, opted for "ten years or so," with one OEM a bit faster and one a bit slower. We are also aware that state legislative efforts to control pace seem to be gravitating to ten-year intervals as well. In our view there is not enough data available to evaluate whether this pace is too fast or too slow, but we do point out the problem of maturity matching: if a factory expects dealers to do major overhauls every decade (for example), it may not make sense to specify materials all with 20-year service lives (or better). At a minimum, OEMs may want to consider taking a page from the lodging industry playbook, where uncertainty about timing of renovation expense is reduced by annually and steadily setting aside funds reserved for future facility overhauls (see Hotel sidebar).

### Hotel Sidebar: Another Way to Plan for Upgrades?

The automotive industry tends to address facility Modernization on an *ad hoc* basis, with factories launching image programs whenever they see the need for them, and dealers doing their own upgrades as they see fit. The lodging industry relies on a more structured process, involving annual capital reserves, which might be useful for automotive to consider.

Most lodging chain franchisors (and lenders!) require franchisees (hotel property operators) to annually reserve some percentage of revenue for Modernization expenditures, typically 4-12% depending on the property type. This reserve is variously called a capital or an FF&E (furniture, fixtures, and equipment) reserve, depending on whether it is targeted to minor property upgrades or significant structural alterations. These funds are spent on both franchisee initiatives (e.g. adding an executive lounge because nearby rivals have them) or franchisor “brand programs” (e.g. Westin’s Heavenly Bed upgrade, which in part inspired Sheraton’s Sweet Sleeper response). Some hotels also reserve for longer-term major capital improvements (aka “property improvement programs”), often triggered at time of hotel sale.

While there are certainly tensions between franchisor and franchisee in the hotel and motel business, they are reduced significantly because of the presence of the reserve requirement: all parties involved know from "Day One" that they will have to set aside funds for eventual facility overhauls. It is true that in hotels "the facility is the
product” (whereas in auto retailing the facility is just the place where the product is sold and serviced), so the analogy is not exact. But there is something to be said for setting expectations for refurbishment investment from the start, if only because then the argument will be about how to spend the funds, rather than whether they need to be spent at all.

The overlap issue was more contentious, and blurred into the broader issue of “excessive changes in direction.” One OEM in particular was criticized for launching two waves of programs too close together in time. OEMs in general defended themselves by pointing out that, if it took a year or two to design a program, a year or two to roll out, and two or three years for dealers to implement them, then at any given point in time there will always be one program ramping up and another ramping down, causing the appearance of overlap. This issue was hard for us to evaluate, centered as it was on one particular OEM, but obviously it is common sense to not have consecutive programs running into each other.

More broadly problematic was concern about changes in direction in a program during the time it was running. This is another difficult issue where it is hard to see one clearly correct path: if an OEM holds standards absolutely steady over a decade, it runs the risk of not responding to competitive moves by other OEMs; if it frequently updates standards and specifications, it runs the risk of abusing dealers' time, resources, and patience. Further, much of the argument in this area was in the nature of accusations and counter-accusations at the local zone or dealer level, in an unproductive cycle of "he said/she said." We were at a loss to suggest how to resolve these disputes systematically, other than by encouraging all involved to keep careful records of written communications between factory and dealer, and perhaps rely less on sometimes-faulty recollections of who-said-what on the phone.

2. The Size Bias in Facility Programs

A consistent theme in our research was that facility programs were "biased" against smaller dealerships, for the most part because they do not scale in a linear fashion, especially when it comes to Modernization and Standardization investments. (The Expansion component of course tends to scale fairly well, since every OEM lays out facility guidelines that are in proportion to planning volumes or UIO.) As one interviewee put it, if a large dealership selling 100 units a month needs a new entry portal that costs $150,000, a small dealership selling 10 units a month won't be able to get away with a $15,000 portal: the costs are relatively higher for smaller stores. Factories try to adjust for this with tiered levels of requirements, but generally dealers and experts thought that these did not fully remedy the imbalance. This leads to real problems for the industry, as Exhibit 11’s quotes reveal, with all parties involved accusing each other of bad faith, or hidden motives, or inflexibility. In our view, taking everything we heard into account, we do think OEMs could go further in flexing programs for smaller stores. This goes beyond just scaling square footage to sales and service volumes, but further into loosening or even removing some requirements for the smallest stores. Some OEMs do this now.

(Note: Part of the anguish surrounding the facility program small-dealer problem is the related "two-tier pricing problem." That is, to the extent an OEM uses a per-car payment incentive to induce program compliance by dealers, and to the extent that some dealers sign up and some do not, then some industry participants would assert that dealers would now be paying two different prices for the same
car, which opens up a whole range of important legal issues. While we are aware of this issue and discussed it with various interviewees, to the extent this is a legal matter it falls outside the scope of this report, as noted in the Exclusions section. But see more on the contention incentives cause generally, in the next section.)

3. Incentives and Their Impact

Closely tied to the size-bias issue is the issue of the incentives OEMs sometimes offer to dealers to persuade them to participate in programs (see footnote 6 for a brief list of incentive types). This is because such incentives are sometimes tied to a store's sales performance – and even if the incentive is a fixed per-car-sold amount, a store selling fewer cars will obviously earn a smaller total amount of cash than a larger one – even if its building upgrade cost may be similar.

But the incentives issue is broader than just this large/small problem. Frankly, it is ironic – but true – that the incentives the OEMs have put into place, to help dealers execute programs, are often a huge source of stress in our industry. They also further highlight the incredible diversity among dealers and OEMs. To explain why, some history may help.

Years ago, facility programs were modest at best: a dealer would be asked to put up some standard signs, make sure the showroom was large enough to hold a reasonable sample of cars, and prominently display factory-provided product brochures. If a specific dealership looked really run-down to an OEM, factory field staff would approach the dealer principal and work something out informally. The dealer might expand his or her store (or not), and the factory might offer a larger allocation of cars, and even a cash grant or loan to "get the deal done."

Now we fast-forward to the present day. For a variety of reasons,\(^\text{13}\) OEM facility programs are much more aggressive than ever before. This already creates stress on the dealer body (which is one of the main points of this report). At the same time, OEMs have launched a wide array of incentives to motivate dealers to participate in these programs. While it is hard to argue with the motivation for offering incentive programs (helping dealers to pay for facility investments), their implementation has created a whole new set of questions for dealers. These include:

- **Program Duration**: how long will my increased allocation run, or for how many years will my per-car bonus continue? Will my OEM end the program if it comes under financial stress?

\(^{13}\) To recap some of these reasons, some touched upon in the OEM sidebar, an OEM might ask for more facility work today because it believes that: a) cars are becoming commoditized, so that the in-store experience is now a bigger part of the customer decision process than before; b) innovative (and expensive) store designs such as Apple's retail outlets can help sell more cars; c) dealership franchise statutes and regulations are now so strict and all-encompassing that facility design is one of the few areas where an OEM can influence a dealer (given that it is now quite hard to terminate, encroach, or buy out a specific dealership); d) only by establishing strict store guidelines for all dealers can the "few bad apples" be brought into line, since most franchise rules require an OEM to treat every dealer equally; e) consumers have experienced store innovations and upgrades in other consumer goods (e.g. Ikea stores, Starbuck's shops, "Nike Towns," etc.) and so are expecting them now in car dealerships; and f) in the case of the Detroit OEMs specifically, that their dealership networks have been allowed to decline for far too long, and must be pushed to catch up to the modernity of the import stores.
• Pricing Confusion: per-car incentives tend to open up the Pandora's Box of the "two-tier pricing" problem (whether such "tiering" was in fact intended or not).
• Incentive Consistency: if an incentive is linked to sales volume, as many are, it is encouraging a different behavior (selling more cars) than it was originally intended for (improving or expanding a facility). Many interviewees argue that incentives and behaviors should be better aligned.
• Program Funding: If an OEM pays for incentives by rebalancing the allocation of the MSRP-wholesale price margin (e.g. "moving it from front-end to back-end margin"), is it truly putting new money in play, or just shuffling funds?
• Etc.

Many of the dealers we spoke with were very troubled by these questions, and we can see why. On the other hand, we can see the OEM's point of view as well, since OEMs offering incentives can point out to dealers that some money is better than no money at all, and that various OEMs offer no construction incentives, period. But it is true that dealers now must not only deal with the question of "What do I have to do?" (e.g. expand, modernize, standardize) but also with the question of "How do I get paid?" (e.g. up-front or over time, via cash or cars, in a single sum or per-car, etc.).

There is probably no perfect resolution to this incentives dilemma (again, no one size fits all), but that doesn’t mean we can’t look for better answers. We would encourage OEMs, as they design and redesign facility programs, to take these issues as much into account as much as possible, and see if there are ways to ensure that the incentives they employ dodge pitfalls such as those outlined above.

Finally, we have to make the more general point that the use of incentives of any kind, however well intentioned, tends to introduce friction and anxiety into OEM/dealer relations, and even dealer/dealer relations. (As one OEM said to us, "We try to steer clear of incentives at all, as they are so divisive of the dealer body.").) However, while the best incentive for dealers to invest in facilities is for OEMs to provide them a steady stream of excellent products at attractive prices, it is just competitive reality that not every OEM can do this all the time. Therefore the need for incentives arises: we are probably just stuck with this challenge.¹⁴

4. The Internet and "The Dealer of the Future"

Various interviewees raised the concern that factory facility programs were incentivizing the building of "monuments" (or worse, "mausoleums"): dealerships that were well-suited to the shopping and buying practices of the past, but which would be somewhat obsolete by 2020. Some of this concern is no doubt driven by the very visible collapse of bookstore chain Borders (which many attribute to the rise of online book sales and e-readers), but also by public announcements of store format size reductions by Best Buy, Walmart, and others. Other interviewees were fairly convinced that the internet would strip away the functions of the brick-and-mortar store, leading to a radically downsized format. Some of the ideas about this are presented in Exhibit 12.

¹⁴ See again the Hotel sidebar: regular investment reserving might ease this incentives-tension problem somewhat.
However, it was clear from our interviews that concern about this issue is modest at best: most industry participants expect no significant changes in most dealership formats any time soon. And except for the most vocal enthusiasts for change (mostly providers of internet-enabled services), most interviewees were very aware that state-level regulations would probably keep the pace of change slow for quite some time (e.g. states tend to require on-site service facilities at any car sales point, thus blocking wholesale unbundling of sales and service). Interestingly, several OEMs took a very conservative stance regarding changes to the basic dealership format (even though they are very aggressive in pushing the envelope of change in car technology, from Bluetooth ports to collision-avoidance systems).

Representative quotations from OEMs included:

- "There is just too d**n much paperwork, security checking, and deal-specific particulars to move all of the process online any time soon. Also, customers still seem to want a human touch."
- "I can see a somewhat smaller footprint: we just cannot keep expanding showrooms as we add more models. But no big changes otherwise."
- "We can trim the store a bit (e.g. use of tablet computers cuts down on service-writer desks), but basically the dealer of tomorrow looks like the dealer of today."
- "A new format for the future? We can barely get the existing format adopted!"
- "The future dealer will be more internet-enabled, but as 60% of the footprint is in the service area, and as laws won't allow splitting that off, we're only talking about downsizing the remaining 40%. Assume that drops by a quarter in a decade, we're only down 10% in footprint."
- "Maybe we could alter store size if our BTO rate went up – but it stays stubbornly low."

On the other hand, some dealers and OEMs did express the worry that the pace of change in retailing was accelerating, and that dealers and factories who could act on this change would gain an advantage. In particular, some interviewees felt that smart dealers and OEMs would be diverting more and more facility spending into the service area. Various reasons were cited for this rebalancing:

- As relatively low new-car sales meet an ever-older car fleet (the average age of the US fleet is at a historic high of almost 11 years), more and more of a dealer's business is in service, rather than in new sales.
- There is more opportunity to influence consumers in service than in sales, given that a customer might visit a service area a dozen times in three or four years... and the new-car showroom only once over the same period.
- There is also more opportunity to innovate in the service area than in the showroom. Once the showroom is attractive and comfortable, there is not much more to do. But in the service area one can add ever more customer amenities (snacks, sodas, coffee, Wi-Fi, child care, entertainment, etc.), or even set up separate satellite service units, as some dealers do now.

15 Build To Order: the percent of cars purchased that were built to specific customer order. In theory (and only in theory!), internet-enabled car configuration was supposed to lead to high BTO rates, and thus reduction of the dealership to a vehicle delivery point, with minimal inventory held in stock locally. This has not happened.
Given these results, we suggest that dealers and OEMs, either separately or together (perhaps in an industry-wide effort) take a good hard look at market and consumer trends, and see if it makes sense to adjust facility programs accordingly. Retail experts told us more than once that automotive retailing tends to lag other retailing industries (e.g. apparel, food service, etc.) by a decade or more: the time may have come to close this gap, before any more future "mausoleums" are built.

IX. Recommendations

Now that we have shared all that we have learned, from all our interviews and analyses, what are our recommendations for improvements in the facility programs arena? Our recommendations emerge from the various issues analyzed above, grouped into three key topic headings: Value, Cost, and the Future.

Before we get into the details, however, a caveat. As we pointed out earlier in the report (pages 1-4), the incredible diversity among dealers and OEMs makes it impossible to provide a single “silver bullet” solution for all dealers and OEMs, and thus none of our recommendations discusses a single, uniform, or common approach, either for dealers or OEMs. We do, however, hope that each dealer and OEM will consider the general findings, analyses, and recommendations of this report in reviewing and perhaps improving their own individual facilities and facility programs.

1. Recommendation One: Better Demonstration of the VALUE of Investment in Facilities.

In brief: OEMs need to show better demonstration and quantification of the VALUE of investment in facilities. This is needed not so much in Expansions, but certainly in Modernizations, and especially in Standardizations, where the value is completely unclear.

In detail: it should be clear from every page we have written that we firmly believe that it is incumbent upon OEMs to provide dealers with more persuasive business cases for investment in facilities. Expansion arguments need the least support. In the case of Modernization spending, however, all OEMs should follow the lead of a few of the more progressive factories, in moving beyond anecdotes and examples to full-blown analyses of just how and when investments in store upgrades can drive unit volumes, profits, and customer satisfaction. Ideally, such analyses would also show when sales gains are the result of cannibalization from other same-brand stores, and when they are via conquest from rival brands. And finally, when it comes to Standardization, it was clear to us that the arguments for this spending were very unclear. We think every dealer would appreciate harder evidence as to why more-identical stores make sense, even as other retail industries seem to be moving away from a "cookie cutter" approach.

We believe the burden of proof here falls primarily on the shoulders of the OEMs, and so this recommendation is addressed to them specifically.

If OEMs wanted to go a step further, and where regulation and legislation permit it, they could consider putting more "skin in the game" as regards facility upgrade value, as sometimes occurs in the restaurant industry. Probably nothing would better reassure dealers that the factory had faith in an upgrade business case, than for the factory to take a financial stake in that upgrade, as the Restaurant sidebar
lays out. However, on the other hand, dealers may not wish to allow OEMs further into their business dealings, as this kind of procedure would permit.\textsuperscript{16}

**Restaurant Sidebar: Aligning Incentives To Facility Upgrades**

Given that OEMs are often highly confident of their UIO or planning volume forecasts, the question arises as to whether they would consider funding dealer Expansion projects, earning a return on their investment through higher sales. We realize that some OEMs already do this in various ways (sometimes through their captive finance arms), but it might be interesting to also see how one fast-food franchise has approached this over the years.

On a case-by-case basis, this franchisor (call it “HQ”) will advance to the franchisee (effectively, the “dealer”) a portion of the cost of a store remodel, based on HQ’s forecast of resulting sales growth. If sales growth materializes as expected, HQ gets its money back (and often more) via higher “rent” payments. If sales growth does not materialize as expected, HQ absorbs the loss (writing off its loan over some period of time).

This works especially easily in restaurants, since the franchisor makes its money not on selling products to the operator/dealer (as in automotive), but via “rent” fees charged as a percentage of revenue (e.g. 8-12%). In the automotive world it might occur by crediting some dollar/car amount of OEM profits to the loan.

It should be noted that this is not a standard policy, but a case-by-case tool for getting renovations or even relocations done. A typical case in which this might be used would be for a franchisee who has recently levered up to acquire a new store or two, and though HQ would like to see a remodel, the franchisee has too much debt already. In this case HQ might advance the funds. Typically they will only be a portion of the total cost, in order to share the risk with the franchisee.

2. Recommendation Two: More Aggressive Control of the COST of Facilities Investments.

In brief: OEMs and dealers need to work together to demonstrate how programs can be executed at lower COST, both by more flexibility as regards designed-in cost (e.g. material specifications, vendor approval lists) and by better implementation of program execution cost (e.g. fewer shifting deadlines, fewer squabbles over exceptions sought or granted, less confusion caused by “outsourcing” decisions to third-parties such as design firms). As regards the “small store cost penalty” specifically: “tiering” a program to offset these disproportionate costs might make sense (beyond just scaling square footage).

In detail: Even for those dealers who are quite convinced of the value of store Expansion, Modernization, and Standardization, or some combination of the three, there is equal conviction that the cost of executing these programs is needlessly high. The typical estimate of how much more costly it is to execute one of these programs, versus doing it oneself, is about 20%-30%, with the public dealers at the higher end of the range. We think these cost overruns are driven by two factors: the building-in

\textsuperscript{16} We are aware, of course, that OEM captive finance arms effectively do something like this now, when they make facility loans to dealers. However, we found no lender who went so far as to actually participate in financial gains or losses if sales increases linked to facility upgrades materialized... or failed to. One OEM does on occasion directly advance funds to dealers for partial financing of upgrades, getting paid back (or not) by crediting against the loan OEM margins from increases (or lack thereof) in car sales. This seems like a process worth a closer look.
of higher costs from the planning stage onward, and the generation of waste along the way in the process. Accordingly, we have two cost-related recommendations:

First, in terms of designed-in costs, it was clear to us that excessively high specifications by some OEMs (for materials, fixtures, and more) are leading to higher costs, especially in areas where impact on the consumer is minimal. Further, the practice of some OEMs to very narrowly limit sourcing options (e.g. numbers of approved vendors) can only encourage vendors to price up, and limit individual dealers' ability to negotiate down. Costs are also increased by over-optimistic sales and fleet forecasts, which lead to over-building; and then constantly-fluctuating forecasts create uncertainty in investment planning, which can lead to expensive errors as well. Outdated capacity formulas (e.g. for service stalls) can also lead to excess capacity. Finally, while most programs do try to take into account the relatively higher cost burden they place on smaller dealers, we would encourage a rethink here for the smallest most rural stores, who on the one hand are least able to afford these investments, and who on the other are least likely to use a lower cost position to poach sales from larger, program-compliant dealerships.

While these six cost levers rest mostly in the hands of the OEMs, we recommend that they could best be revised (and costs thus reduced) by OEMs and dealers working jointly together, with dealers providing very specific suggestions for cost savings (e.g. sharing cost data relating to facilities improvements and vendor recommendations).

Secondly, regardless of what costs are built into facility programs, we came across in our interviews many anecdotes about needless waste (and thus needless costs) due to problems in the whole program process, as it moves through various stages such as planning, designing, permitting, construction, etc. Every OEM with a program indeed had a clear process for the program: the problem was in the execution of this process. Some wounds here were self-inflicted: if an OEM has a checklist of 100 key compliance items for a dealer to execute, it is almost certain that there will be a lot more work to do regarding shortfalls and exceptions than if the list instead had just 25 crucial items on it. And we do realize that factories do not have infinite resources to send into the field to ensure smooth sailing, but it does seem that present staffing levels may be inadequate, as tales of missed communications, rip-up-and-redo fiascos, and collisions between local community regulations and program rules made clear. On the

---

17 A word on community regulations, such as zoning rules, signage limits, and commercial appearance guidelines. It became clear during the project that yet another constituency involved in this arena is the local community in which the dealer operates. These have enormous influence over the degrees of freedom of an OEM program. For example, if in Southern California a town requires Spanish roof tiles for local businesses, then an OEM has little recourse but to adapt program architectural guidelines to allow this. But more broadly, municipalities are shaping these programs at the strategic level as well. One OEM told us that more-stringent community laws against large and visible dealership signs, starting in the 1990s or so, induced OEMs to go for a more branded look for the store exterior as a whole, as the exterior would now have to carry the brand message that the sign once did. Further, as communities tend not to like "cookie cutter" stores of any kind (beyond just auto dealerships), they can hem in the standardization efforts OEMs are making. As one dealer said to us: "The community board used to be my biggest enemy; now it's my best friend, as it sides with me against some OEM requirements." Finally, a major source of waste in implementing image programs arises when dealers end up as intermediaries between factories (who have
other hand, it was not always clear to us that dealers were innocent of triggering communication snafus themselves. Further, we did hear more than a few stories about dealers "gaming" programs, turning to legal remedies first and negotiation second (as one disapproving dealer put it, "fire, ready, aim!"), and making accusations about factories (e.g. "They all take kickbacks from the vendors") that seemed guaranteed to create an antagonistic – and therefore expensive and strung-out – program environment.

►►► A step that might support both recommendations One and Two, and reduce some of the unproductive contention and rhetoric that surrounds these issues, might be, for those OEMs who have not already done so, to establish Facility Committees (similar in rigor and requirements to Product Committees) within their Dealer Council structures. These Facility Committees could discuss – and head off in advance – facility issues such as program value, program cost, facility design and format, program incentive design, and field execution issues before they literally are “cast in concrete.”

►►► Given these observations, a further "soft" recommendation here is for dealers and OEMs alike to step back, recognize their mutual interests and dependency, revisit how many resources they need to devote to the process (e.g. OEM field staff, dealer principal attention), and – most crucially – turn down the heat as regards rhetoric, complaints, and accusations. The level of contention benefits no one and costs everyone time and money.


In brief: All parties involved should move quickly to research and share their views of the dealership of the future, so as to avoid facility programs incentivizing the building of stores that are quickly made obsolete, by evolution in consumer shopping and buying behavior and needs.

In detail: Our first two recommendations deal with the here and now, with the costs and benefits of current facility programs. However, we would recommend to both OEMs and dealers alike to jointly tackle the issue of whether the dealerships we are building today are going to be the successful dealerships of tomorrow. By no means do we expect the American dealership system to go away – but we do worry, as do some dealers, some experts, and some OEMs, that the current store format may do so. Square footage requirements may shrink, total inventories may decline even as model counts go up, customers may demand new conveniences, and maybe the number of satellite service facilities will climb. It would be better to analyze these trends now, rather than later, to avoid a future full of white elephant stores. One has only to look at recent changes in computer retailing, book retailing, restaurants, and even suburban shopping malls in general, to realize that format evolution does occur, and can have negative impact on those merchants who do not anticipate and move with the change.

no interest in developing relations with local zoning boards) and communities (who often have no interest in understanding why an OEM is asking for a given fascia, or insisting on a given completion date). This three-way negotiation process frequently leads to miscommunications, delays, and even cost over-runs.

18 For example, few fast-food operators would have forecast, twenty years ago, that by this year a typical outlet would see as much as a full 75% of its sales volume coming from the drive-through lanes. Formats set up for inside dining have ended up being under-built relative to drive-through demand.
X. Conclusions

Factory facility programs, which scarcely existed a few decades back, are now part of daily reality of for virtually every new-car dealer in the USA. While almost everyone involved in automotive retailing in America agrees with the underlying principles of such programs (bringing to the customer clean, modern, and brand-supportive facilities), there is significant disagreement about the details of their design and implementation, at the Expansion, Modernization, and Standardization layers, and across these layers as well. Boiled down to their core, these issues relate to uncertainty about the benefits of the programs, and worries about their excessively high costs – as well as some concern about whether they are best preparing automotive retailers for the future evolution of our industry.

It was the goal of this NADA research project to flush all these various details and perspectives out into the open, by speaking with a wide range of industry participants in a confidential setting intended to generate honest and candid discussion. We've then made, based on those discussions and on our analysis, a few recommendations as to how OEMs and dealers, working together, might reduce some of the tensions among them over these issues. Throughout, we have tried to be as objective and neutral as possible, which was no easy task when so many opinions are held so fervently and deeply – and when no one perspective can ever hope to cover the differing situations of thousands of dealers and dozens of factories. Regardless as to whether our recommendations are accepted, if this report helps, in even a small way, all industry participants (dealers, OEMs, attorneys, accountants, brokers, et al.) to more productively and positively discuss and resolve the issues that surround these programs, then we will consider the effort to have been worthwhile.
Exhibit 1: Methodology: ~75 Interviews in Total

- Lenders: one captive, three independents
- Private dealers: two dozen, representing small single-point domestic stores, single-point import stores, and multi-point operators with domestic and import lines; mass-market and luxury brands both represented; surveys of dealers also consulted
- Public dealership chains: six
- Dealer-specialized accounting firms: five
- Economic research firms with a specialization in dealerships: two
- Economists with some expertise in automotive retailing: three
- Dealership design or architectural firms: three
- Law firms with dealership expertise: six
- Vendor of fixtures and equipment: two
- Dealership broker (buy/sell advisory) firm: two
- OEMs: twelve
- Online automotive information provider: one
- Provider of dealership software and services: one
- Restaurants: one franchisee (dozens of stores); one franchisor (~1,000 stores)
- Hotels: one multi-unit franchisee; one hotel industry association executive
- Retailing consultant/expert: one
- State automotive associations: two
- Several miscellaneous other contacts

Exhibit 2: Dealers’ Views of Facility Programs Overall

- “We accept the need for facility standards, in principle. But the programs are onerous, unrealistic, and the OEMs intransigent.”
- “It’s a facilitates’ arms race which leads to needless spending.”
- “The programs make sense, but they cost too much and allow for little adaptation to local conditions.”
- “The condition of the store is important, but my people and processes have a greater impact on sales success.”
- “My investment will probably never pay off, but you have to do it to stay in the game. I can only justify it not in a sales increase but in an avoided sales decrease.”
- “Here’s the problem: if a bad dealer lets his store fall apart, the factory is right to make him clean it up, and he screams about the high cost. But that’s because he hasn’t been spending all along to keep it shipshape. And then his sales rise, so he can do it. Meanwhile, a good dealer has been investing all along, so an upgrade costs him less... but his sales don’t climb much, as he’s already in shape.”
- “I’m a believer in the programs: this has to be done. Some OEMs have been too lax in making us toe the line.”
- “Of course we support the concept of nice, modern facilities. Expansion and modernization have to be done. Not sure what all the standardization does for us. And a modern store helps us attract and retain quality personnel.”
- “I think we need to do this, but the uncertainty kills me: will the factory be providing me with good, attractive products when I am finished making my store better, and more attractive? I am spending now, and hoping for payback later...”
- “Bricks and mortar sell more cars, yes. But only a few.”
- “I think the programs make sense, but cost too much because of all the specs and the limited sourcing options.”
- “It doesn’t pencil in the short run, but it does in the long run. And if I ever want to sell, I’d better be compliant!”
- “We embrace these programs: we do most of it on our own anyway. We do it in part to stay in the good graces of the OEM, in part for the incentives, and in part because modern stores attract shoppers! But the programs do cost more than they should.”
- “We domestic dealers have to do this, if only to catch up to the imports.”
- “We’re a poster child for this. Our store needs the work, the incentives are generous, construction labor is cheap, and loan rates are low. What the OEM asks for is very reasonable.”
- “Sure, I support the need for good clean modern facilities, but when I hear of a new OEM program, first I ask ‘How much will it cost me?’. Then ‘How long can I put off doing it?’”
- “I see a sales lift if the store is pretty run down. So we invest to stay in the game and not see sales drop. But then again when we do it the rent factor climbs, so we often are making less money on more volume.”
- “We do expansion in joint consultation with the factory. Modernizing the store we’d do on our own, but not as frequently or as lavishly as the OEMs request. The issue here is cost: doing it our way would cost about 25% less. As far as all the imaging stuff goes, however, what a gigantic waste of money: we do it because we have no choice.”
Exhibit 3: OEMs’ Views of Facility Programs Overall

- “We are doing this because our dealers feel the facilities are old and outmoded, and we will not be fully competitive with some dealers until we bring our network up to snuff.”
- “We truly believe implementation of our program leads to higher grosses, greater ease in attracting good personnel to work at dealerships, and better support of brand value—which leads to greater profits for both us and dealers alike.”
- “We have been dramatically increasing our product line breadth. With that comes greater sales volumes and new customers our dealers have not seen before. The first change meant we had to ask dealers to expand their facilities; the second meant we had to ask them to upgrade their facilities to meet higher customer expectations.”
- “Most of what we have asked dealers to do is as regards expansion, as our volumes have been steadily growing. We do ask them to modernize and standardize as they go, but expansion has been the main driver of our program.”
- “We are a smaller, lower-tier brand. Thus we can’t advertise as heavily as the bigger OEMs. Our stores therefore have to pick up the burden of promoting the brand to consumers as they drive by. So we really focus on getting a distinctive exterior look. Dealers have a very, very hard line as regards the interior. And we don’t insist too much on standardization. It only adds a lot of cost burden to the dealer, for not much benefit we can see.”
- “We are very sure that customers over time migrate to better-looking stores. We’re over-capacitated right now, so we aren’t asking dealers to expand, we need to modernize stores that, relative to other brands, are old or tired.”
- “Much of what we have asked dealers to do has been for expansion; we are growing rapidly. But we do insist on upgrading stores because we sell high-end cars. And we believe stores should be highly standardized because we believe our customers expect that. But we do try to make sure the dealer is profitable before we ask too much, and so we provide good incentive payments.”
- “Cars are our product, so they carry the brand message. Accordingly, we are not demanding about modernization, and as far as standarization does, we require that there be just a few design elements. We do upgrade, namely transforming slower incremental change. We try to be flexible, the dealer needs his or her own individual identity. But because our cars are great, and because we try hard not to over-produce or to over-dealer, our dealers are strong and profitable, so we do not need to incentivize them to upgrade. Besides, as soon as you introduce incentives, you create dissension among your dealers, and that we want to avoid.”
- “We’ve been moving the brand upscale, and so we ask our dealers to move their stores upscale as well. We kick in some incentives, but the best way to persuade dealers to invest is to give them more and better product!”
- “We think we have the best cars, so we expect our dealers to build the best facilities. We don’t provide cash or margin incentives, but we can show dealers that compliant stores deliver more profit than non-compliant plans.”
- “Our network is elderly and outdated and there is no choice but to insist dealers modernize. We’ll help out, but frankly at least half of our dealers doing upgrades instigated the idea themselves.”

Exhibit 4: Experts’ Views of Facility Programs Overall

- “Expansion makes sense, but I can’t see how changing the look of the dealership does anything for the R&M.”
- “We advise dealers to go along just to keep the factory happy and to keep the factory money coming in, if there is any.”
- “I do think remodels increase sales, on average, but probably by stealing sales from same-brand stores who did not remodel.”
- “Most of our clients have been less than successful, and although there is plenty of grumbling along the way, we’d say 95% of them succeed, in terms of sales goals, CSI goals, etc. The domestic stores are sold off, the sales team is probably less experienced, the standards are lower, the standards are lower, the standards are lower.”
- “It’s a cost benefit analysis of these things. If dealers and customers wanted expansions and upgrades, dealers would do so. To the extent dealers are pushed to do them, it is probably because the factory knows they do not pay off.”
- “I really hate to say this, since dealers are my clients, but we aren’t sure 65% of the benefit paid out to the OEM. Not all the cost is paid; the sales team is probably less experienced, the standards are lower, the standards are lower, the standards are lower, the standards are lower.”
- “I’d tell your question around: what dealer can afford NOT to comply? But more seriously, for the average domestic dealer, you had better do it; these changes are way behind import rivals. Trouble is, dealer pays for 75% of the cost, but I bet 75% of the benefit goes to the OEM. Not that the OEM is wrong in asking for renovations; you can’t have 95% of your dealer’s complaints, having paid millions to do this, and then let the remaining 10% free ride on everyone else’s investment in the brand.”
- “Service spending tends to go up. But in the new-car side (e.g., the showroom)? Tricky. Dealers say ‘We invest there, new car margins are shrinking.’ But if you never sell another new car you won’t get the service work, or a shot at the trade-in.”
- “Let’s be honest: a lot of complaints about the program are really complaints about other dealers. You don’t like the first guy in a market who does it, since they raise the bar, and you don’t like the last guy in a market if they up to the bar, as he is a freeloader.”
- “I support the program. The challenge is, the benefits flow more to the OEM and all the dealers in a given market… not just to the dealer. For two reasons together, it makes sense, but one of them will always want the pot and not invest.”
- “Most of my clients are pretty accepting of these programs, and see the value. But they are too costly.”
- “I want to see a modern store as much as anyone. But these investments raise dealer’s fixed costs, and as a broker I have to say that every $1 in added annual fixed costs is going to knock the sale value of the dealership down by maybe $5. But you may have to do it to not lose customers. Expansion adds value, modernization can maintain it, standardization impacts it.”
Exhibit 5: Consumers’ Views of Facilities (1)  

Question: What matters most to you when it comes to selecting a new vehicle?

Percent selecting top three factors

Vehicle size, features, etc.  
Price  
Quality (of the product)  
Reputation (of the brand)  
Purchase process  
Financing terms  
Selection, inventory  
Dealership facility  
Advertising

Exhibit 6: Consumers’ Views of Facilities (2)  

Question: What matters most when it comes to selecting a dealer (once you’ve picked out a car)?

Percent selecting top three factors

I use online research sites  
I shop 2-3 nearby stores  
I read online dealer reviews  
I ask friends and family  
I scan newspaper ads  
I return to the same store  
I go to the nearest store  
I pick the nicest facility
Exhibit 7: The Three “Layers” of Facility Programs

- Designing exterior and interior elements to ensure that every dealership representing a brand looks similar to the others.
- Upgrading the dealership’s exterior and interior to contemporary standards (furniture, fixtures, tile, carpet, paint, etc.).
- Adding asphalt, showroom space, and service stalls, to support expected growth in UIO or expanded product lines.

Exhibit 8: OEMs on the Business Case for Modernization

- “We need to do a better job of this, but we can demonstrate some positive effect. We took a sample of compliant and non-compliant dealers and showed that there is a sales, margin, and CSI gain of more or less 10%. But we don’t know if this is at the expense of our other dealers, or if it versus our rivals’ dealers.”
- “Our dealers know what is needed, but there is just no way to quantify the impact. We do have anecdotal evidence in that all stores who have executed the program dealers, employees, and customers all comment favorably.”
- “We show no business case because we cannot calculate it.”
- “We’ve done an analysis of a sample of stores and we think there is a clear sales gain. We don’t know if this is just cannibalizing from our own own-brand dealers, or generating conquest sales.”
- “We can’t show an ROI case because how could we ever get two dealerships on an apples-to-apples basis, for a fair with/out comparison? We do see that our standards-compliant dealers have stronger profits than those who are not compliant, but I don’t know which way the causality flows: do stronger dealers decide to invest in the program, or do those who invest in the program get stronger? We think it is the latter.”
- “We are growing fast so all our projects are for expansion. But when the dealer expands, we ask him to modernize too. Because both things occur at once, we cannot calculate the ‘lift’ of modernization. Yet we know it is there.”
- “For many years we have provided our dealers with products that allow them to grow and prosper. So they are willing to invest. And our requirements on the modernization side are modest and inexpensive. As a result we got very little pushback and as a result have never really had to show a business case. We all know what we have to do.”
- “Actually, we do rough out a business case, working with the dealer. We have no magic formula but look at past upgrades, the local market, the dealer’s condition, and come up with a mutually agreed-on sales forecast, which includes the gain from the modernization. We don’t offer a lot of incentives but we will not in some percent of his cost as a loan, and if sales do not materialize as we jointly predicted, and if it is not his fault, then we will just get paid back.”
- “We DO show very quantified business cases. We can show a dealer how modernization is almost certain to lead to greater profits for the dealer. Because with modernization the rent factor goes up, profits as a percent of sales do not grow, but because sales volume goes up (both in new cars and in service), total profit dollars climb, substantially, and that is what matters. And when we survey our dealers, they are overwhelmingly supportive of this program.”
- “We do see better CSI in imaged stores; a sales gain is harder to see. But we are a 2nd-tier brand so we must up-grade stores, as they carry the brand image that our ads cannot, because we can’t match the big boys’ ad spend.”
- “We can show a sales gain for participating dealers. But the sales gains take a while to kick in, as customers slowly realize how improved the store is. While the rent factor hits immediately, so profits may be down for a while.”
Exhibit 9: Cited Drivers of Excessive Cost of Programs

- Excessively high or rigid **STANDARDS**: e.g. use of more expensive materials when cheaper ones would look as good, insistence on a particular shade of tile when a close substitute would do as well, requirements to position an architectural element with costly precision (e.g. triggering removal of a wall).

- Lack of consideration of **LOCAL MARKET CONDITIONS**: e.g. insistence on materials that will not stand up to harsh winters (requiring frequent replacement), ignorance of variation in local sourcing costs, resistance to local community needs.

- Dismissal of **DEALER PURCHASING POWER** (typically for large private or public dealer chains): OEM deals cut with suppliers ignore the potential for large chains to be able to negotiate even lower prices.

- Use of a **“NARROW” SUPPLIER BASE**: limiting the number of eligible vendors of equipment and materials always tends to drive up costs.

- **LACK OF AGGRESSIVE MANAGEMENT OF SUPPLIERS**: “If the OEMs went after the vendors they tell us to use as aggressively as they go after the companies that supply them with parts for the cars they build, we’d be a lot better off. But since it is not their money, they do not, and we pay the price. I won’t go so far as to say there are kickbacks being paid, but there does seem to be a cozy relationship among OEMs, vendors, and design firms.”

►►► Average estimate of excess cost resulting from the above factors: 20-30%

Exhibit 10: Cross-Cutting Issue 1: Timing

**Overall** it seems that now is a good time to invest, though not for every dealer.

**Is now the time to make store investments?** Interview consensus (80%) is yes...

**YES**: Dealer profitability is up strongly, such that we can afford such investments

 "Despite anemic new-vehicle sales, the average dealership's net pretax profit margin hit a 24-year high in 2010 ... according to the National Automobile Dealers Association.” (July 2011)

**YES**: Interest rates are at historic lows (lowest since ~1980), so we can afford to borrow

**YES**: Real estate prices are weak (down ~40% since 2007 peak), enabling low-cost expansion

**YES**: Construction firms are eager for business, and thus discounting prices

**YES**: The economy is in (slow and unsteady) recovery, so the volume outlook is positive

**YES**: (for domestics only): It is long past time for the Detroit Three to overhaul networks

... but there are issues and concerns (20%):

**NO**: The recovery will falter and a “double dip” recession ensue

**NO**: Even if the average dealer is doing well, many are still barely scraping by

**MAYBE**: Interest rates are low but loan terms (e.g. % of cost advanced) are still tight

**MAYBE**: Yes, let’s do it now, but reassure me I won’t have to do it again in a few years

**MAYBE**: Dealers may be profitable but still “feeling poor,” as the real estate collapse cuts both ways (many dealers have seen the value of their own real estate fall sharply)

**MAYBE**: Be very careful about basing your P&L on current debt payments: rates can only go up, and an over-leveraged dealer may be in very hot water in the next few years
Exhibit 11: Cross-Cutting Issue 2: The Smaller Store Bias Problem

- "The biggest losers in this are the smallest stores, which cannot afford the programs as easily. Yes, OEMs try to ‘flex’ programs so the burden is lighter on the small dealers, but there is no getting around the fact that they don’t scale well. The $100K sign outside the 50 cars/month dealer won’t cost just $20K for the 10 cars/month store." (Lender)
- "The programs do favor larger stores. I am not sure if it is intentional, but that fact does mean these programs tend to encourage smaller stores to quit the business, which is probably something domestic OEMs don’t mind seeing." (CPA)
- "Are the OEMs doing this to speed consolidation, by flushing out smaller, weaker stores? Definitely!" (Public dealer)
- "Sure, the programs are costly for smaller stores, but it’s just arithmetic, not a plot. A single most common view
- "Domestic OEMs be careful these smaller stores are where some of the most loyal customers shop." (Lender)
- "The programs do hurt small guys, but it’s not just a matter of cost. If you’re a small retailer, you know everyone in town anyway. So an upgrade has no impact. For you, the cost is high and the benefit low a double whammy." (CPA)
- "We’ve heard the complaints. We have several ‘fears’ of program now, and we’re going to launch another one." (OEM)
- "Yes, the math means smaller stores are burdened. So we review every dealer’s finances and adjust our specs accordingly. We don’t stress about the smaller stores; the big metro stores get the brand image anyway." (OEM)
- "Image programs have persuaded a few of my smaller clients to throw in the towel." (CPA)
- "The smaller guys are in a bind too because they have less negotiating power if they have five other stores the OEM might go easier on me, as I can shift my focus to these. If I am a single-store guy, I have nowhere else to go." (Attorney)
- "We reject the charge that we’re using image programs to conscript dealers. We’ve done decades without insisting on modernization, and that helped put us into the situation we were in a while back. We can’t just let our loyalty network continue as is. And we devised a very generous program, so that a dealer of any size can make the grade!" (CPA)
- "I’m not sure there is a bias against the small guy. If you’re in a remote area you’ve got loyal customers and little competition, you can opt out of the program, since you don’t even need the incentives to survival." (Public dealer)
- "Some small dealers cry foul, but the program costs too much since for years they’ve been putting income out of the store, not keeping it up. You can’t survive the store for years and then be shot at the upgrade cost!" (OEM)
- "It’s often a game of cat and mouse. Small guys are largely dependent on used car sales and fixed ops. So why spend on the new-car side? But the OEM needs the new-car side in order to grow and survive!" (OEM)
- "Some small guys are really worried, but others are playing the game, you’ll see a bias and two-tier pricing, bank as many incentive bucks as you can, and see what happens. For them it’s a negotiating stance, not a real problem." (Lender)
- "It’s no one’s fault. The small domestic store has suffered for years, and it didn’t give the cash to make upgrades. Now Detroit is on the mend, it’s time to upgrade and it will be costly, given the growth in the past years. And this dealer is just not used to spending on the store!" (Dealer)
- "So tell me how we do this? Cut the little guy a break, allow him to get a low cost base and can take low-ball price ads into a market where all the others have compiled. What do I tell them, who spent as I asked?" (OEM)

Exhibit 12: Cross-Cutting Issue 4: Dealership of the Future

There is a risk that, just as customers are moving to new shopping behaviors, we are building stores dedicated to the old behaviors – stores that may soon be obsolete.

From: Old realities of store design?

He who has the most inventory wins = Build a very large lot.

Road frontage is valuable advertising = Build on high-traffic street.

We can close on 1/3 of all in-store shoppers, so we need to maximize foot traffic = Opt for a large, roomy showroom.

There is a lot of detailed administrative work to be done to close the deal = Provide for numerous F&I ‘cubes.’

Customers need to see service bays to reassure them we can fix the car = Build large onsite service facility.

Weekly parts deliveries = Large warehouse

To: New realities of store design?

The customer selects a model online, rather than picking off the lot = Shrink lot size.

Customers can find us in many different ways now = Choose less costly street.

Customers come in sold or not already, foot traffic is falling = Build smaller showroom.

We can handle much of the admin stuff online = Trim the ‘cube farm.’

Customers assume few quality issues and great service, no need to see 30 bays = Move more service to satellite locations.

Daily parts deliveries = Downsized parts dept.

Note: For the sake of this discussion, we are ignoring regulatory constraints (e.g., regarding on-site service.)