

The Struggle for Survival

Helping automotive dealers in enhancing business profitability through effective operational practices



Content

Abstract	1
1. Introduction	2
2. How the Crisis Impacted on Dealerships	4
3. Working on the Network: How to Improve Poor Operational Practices	6
4. Build Effective Recovery Plan	7
5. Conclusions	9

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Abstract

Over the last six years the European automotive industry has faced an unprecedented downturn that dramatically impacted sales volumes and profit margins both at OEMs (Original Equipment Manufacturers) and automotive retailers' level. Despite analysts forecasting a rebound in 2014, sales volumes are not expected to be back at the pre-crisis level in the years to come.

Until now OEMs and their NSCs (National Sales Companies) have reacted to the crisis by undertaking short-term tactical actions while waiting year after year for a market recovery that has never come about, instead of investing in more structural measures such as the rethinking of the distribution model and the restructuring of their retail network.

In the meanwhile, car dealers have been struggling to survive not only due to their competence gaps in envisioning the future, but also in the understanding of their weaknesses and identifying the recovery actions needed to bounce back to profitability.

Car retailers' profitability erosion and connected business continuity issues represent a high-priority risk for OEMs in terms of maintaining market share and upholding brand reputation towards customers and possible new investors.

While awaiting new structural measures to be adopted by OEMs, NSCs must face this critical crossroad in the mid-term: whether to leave underperforming dealers to act without any external support and run the risk of bankruptcy, or plan and launch contingency plans to support them in implementing operational best practices, enhance their economic and financial performances and lay the foundation for long term business sustainability.

1. Introduction

The global automotive market outlook highlights an increase in total light vehicle sales, with global demand equal to 82 million units at the end of 2013. The compound annual growth rate of the global light vehicle market is expected to reach 4.3%, depicting a scenario of about 97 million units sold in 2017¹.

Within this positive mid-term global outlook, different markets are coexisting, each with its own story and numbers: the Triad (Japan, US and Western Europe), the BRICs (Brazil, Russia, India and China) and the Rest of the World (see Figure 1).

According to IHS Global Insight forecasts, the light vehicles demand in emerging markets is expected to double its global market share in a decade, rising from about 15 million units sold in 2007 up to 40 million forecasted in 2017.

This upswing will be driven by rapid economic growth, low and manageable debt levels, and the rising demand from millions of new customers.

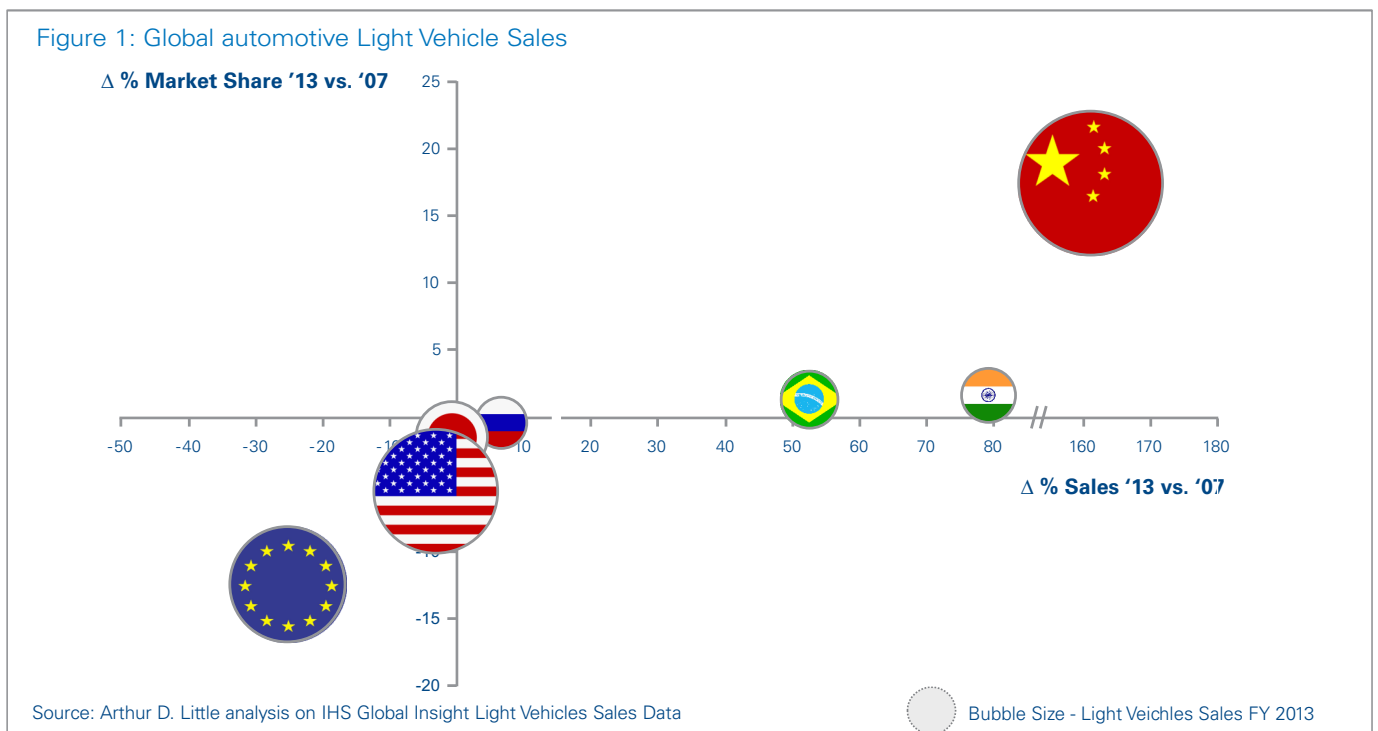
On the other hand, slow economic recovery, high levels of debt and growing unemployment rates (Eurozone) cause stagnation in Triad markets.

In such regions, light vehicles sales demand, which in 2007 summed up to 38.2 million units, is expected to slowly rise again from the 33.6 million reached at the end of the 2013 up to 36.0 million in 2017.

Among Triad markets, Western Europe registers the worst performance, showing a drop in year-over-year sales of approx. 330K units in 2013 and falling by about 24% since the peak of 16.9 million units registered in 2007.

The beginning of light vehicle sales decline in the Eurozone corresponded with the 2008 collapse of Lehman Brothers and the following slowing down of the European economy.

The financial crisis has rapidly morphed into a full economic recession, via the mechanism of collapsing consumer



1 IHS Global Insight 2014

confidence, falling consumption, sharply decreasing investment spending and workforce layoffs.

Government-funded car incentives helped in some countries during 2009 and 2010, but such measures were unable to reverse the downward trend of the automotive market.

There is not a European wide analysis describing how the concern about the European banks liquidity position affected the credit availability for vehicle loans, however is well known that credit institutions have been tightening their lending criteria all over the region.

The fiscal austerity also has to be analyzed deeply: nowadays there is a high density of negative news, higher taxation including VAT on cars, crackdown on income tax evasion and lower Government spending, while in the near future there will be events of higher income tax rates, later retirement dates, less job security and advantageous conditions of company cars being questioned.

Western Europe is also affected by new consumer trends and behaviors that are making the consumers drift away from car purchases, such as car sharing and long term rental, increasing numbers of people in crowded cities choosing not to own a vehicle, as well as the decline of cars as a status symbol.

There is also a demographic issue, since the combination of an aging population² and a smaller pool of new drivers³ will result in a de-motorization process in Western Europe.

Furthermore, customers moving away from car purchase are mainly young people, which are the class mostly affected by the crisis due to unemployment (23% unemployment rate of 15 to 24-year-olds in the Eurozone in 2012, with peaks of over 50% in Greece and Spain)⁴.

Market analysts at IHS Automotive predict a steady recovery for Western Europe starting in 2014, with sales rising from 13.1 million this year to 15.2 million by 2020, which is still about 1.6 million units below the 2007 peak.

Car demand seems therefore to have "reached a ceiling", but most of the current problems affecting the automotive market are structural in Government, society and culture and could not be solved in months or even years.

On account of this, the return to normal speed of the market demand can be assumed to be slow and susceptible to numerous roadblocks.

2 A 2012 Morgan Stanley report projected that Europe's aging population alone could depress sales by 400,000 cars a year in the next 5 years

3 From 2015 driving age population will grow at 0.5 million/year rate, compared to the 1.3 million/year observed in 2005-2010 (source: IHS)

4 Eurostat Data 2013

2. How the Crisis Impacted on Dealerships

The current automotive crisis has put the automotive distribution model in Western Europe under great pressure. On average, market volumes contracted by about 24% compared to 2007, with the large majority of top fifteen automotive brands in Europe (EU27+EFTA) registering a double digit decrease in sales between 2007 and 2013 (see Figure 2).

The sales drop reflected in a more than proportional revenues reduction, due to the combined effect of sales volume decrease and the downshift from higher to lower vehicle segments.

According to IHS analysis, the quota of smaller and less profitable segments has been constantly increasing since 2007, whereas the more profitable quota of upper-medium and luxury segment has been registering a downward trend. These market dynamics highly affected the profitability of

European automotive dealers, whose cost structure is highly inelastic, considering that approximately 67% of their operating expenses are represented by fixed costs⁵.

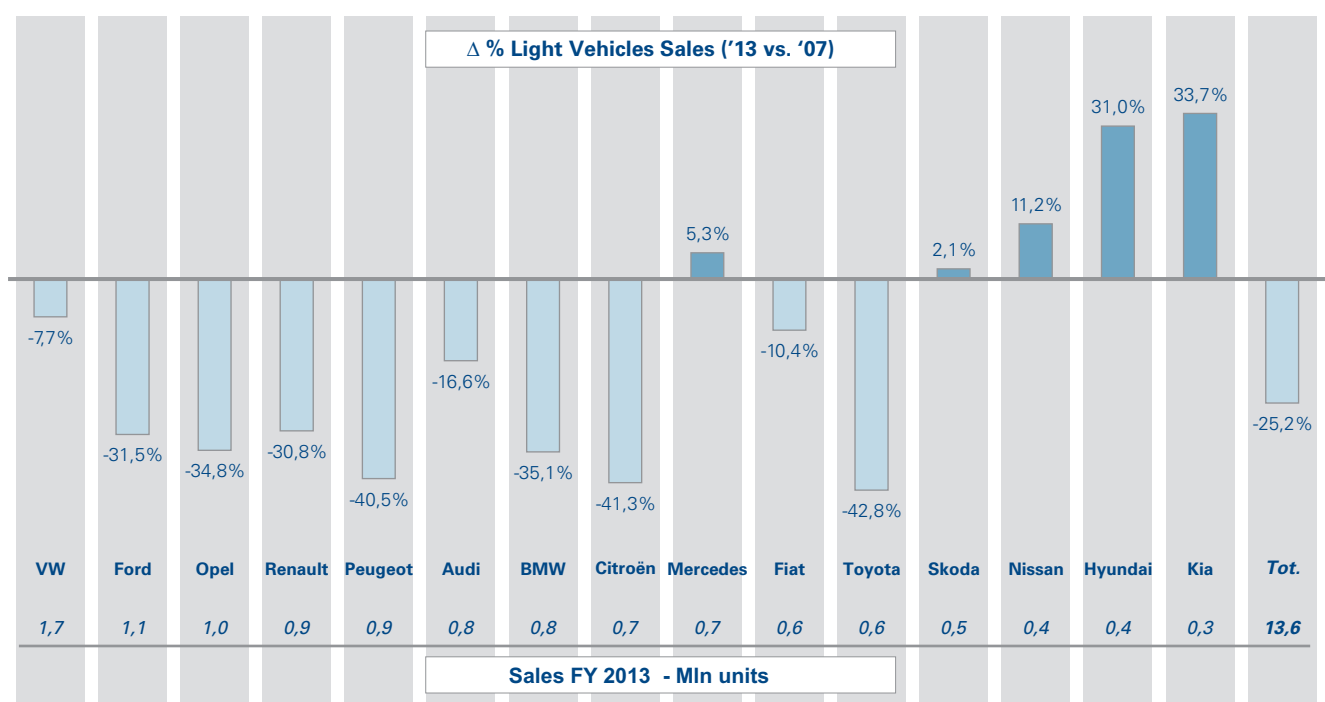
As shown in Figure 3, the average dealer profitability in the Eurozone further decreased in 2013, reaching an overall value of 0.8% in terms of net profit as percentage of turnover, with the quota of dealers in loss increasing from 39% up to 43% in a six month timespan⁶.

Concurrently, US dealers' profitability showed an upward trend driven by increasing sales volumes.

Profit erosion led to a progressive decline in franchised dealer network across all major European Markets, with the sole exception of UK.

Italy represents one of the European countries most affected by the automotive crisis, summing up to 42 consecutive months of negative trends (up to Nov '13).

Figure 2: Top 15 European Brand Light Vehicles Sales

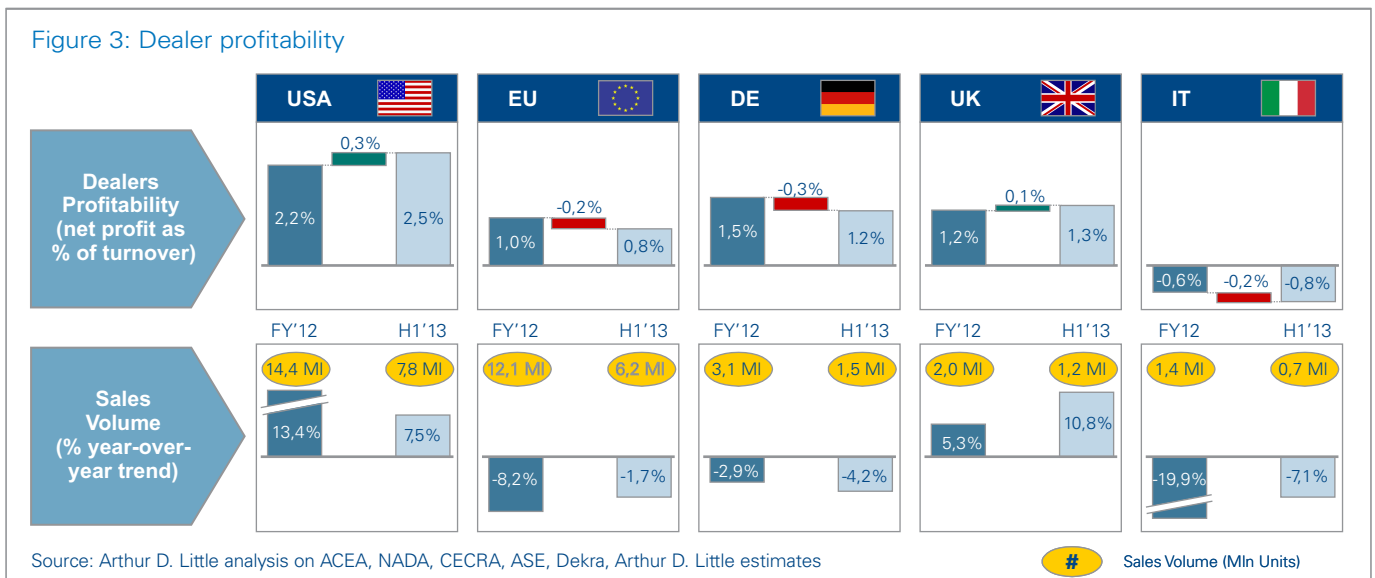


Source: Arthur D. Little analysis on IHS Global Insight Light Vehicles Sales Data

⁵ Arthur D. Little analysis on a multi-brand panel consisting of 300+ Dealers located in the major 5 EU countries

⁶ Source: ASE plc.

Figure 3: Dealer profitability



Italian light vehicle sales have decreased by 48.4% since 2007, the number of franchise contracts has dropped from 3,850 to 3,292 (-14.5%) and it is likely to further decrease in the years to come, reaching 2,800 in 2017⁷.

Contrary to what has happened in US over the last three years, in Italy, and generally speaking in the whole Eurozone, the reduction of franchised dealers has not exerted a positive impact on profit margins.

This is because the yearly unit sales per outlet have substantially remained the same over time.

In other words, the number of franchise points of sale has decreased at a very low ratio as National Sales Companies of major OEMs have tried to preserve their market share and territorial coverage by consolidating franchise contracts on bigger and healthier dealers (see Figure 4).

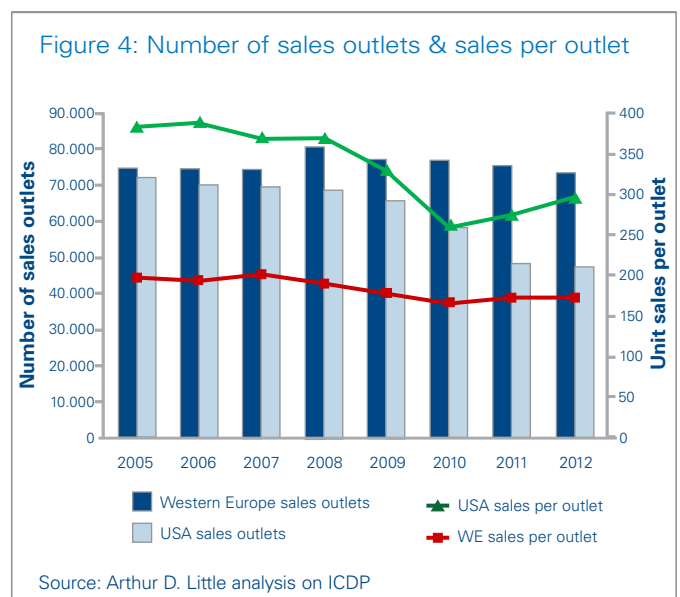
Up to now, the number of bankruptcies has mainly involved smaller automotive dealers, but even larger resellers have recently started to suffer profit erosion, due to difficulties in covering wider market areas and their inability to meet financial obligations at sustainable costs.

To enhance the profitability and the business continuity of European car dealers, OEMs need to rethink the distribution model and consolidate their retail networks, not only in terms

of franchise contracts, but also in terms of points of sale.

Such structural measures, together with the expected progressive recovery of the automotive market, require time to generate tangible results on a large-scale basis. However, in the short run automotive dealers can no longer wait for a "hand from heaven" and have to undertake structural changes to survive the crisis.

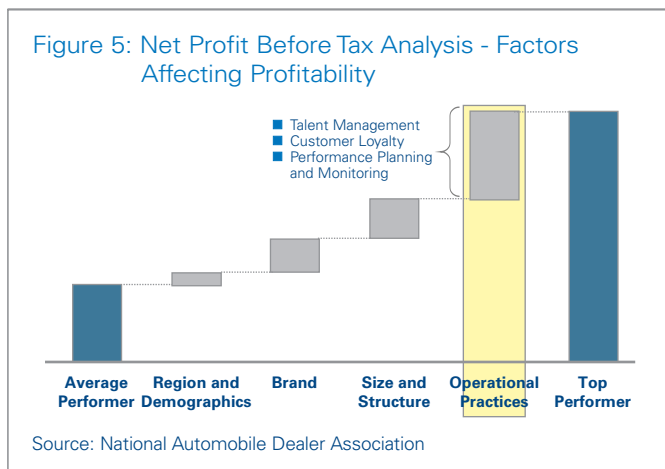
Figure 4: Number of sales outlets & sales per outlet



7 Source: Quintegia

3. Working on the Network: How to Improve Poor Operational Practices

On the basis of Arthur D. Little experience, automotive retailers' profitability is highly correlated with the effectiveness of the operational practices implemented. This means that underperforming dealers can substantially improve their profitability through the implementation of efficient operational practices such as performance planning and monitoring, talent management and customer loyalty enhancement. This is also confirmed by a study conducted by the National Automobile Dealers Association (NADA) on a panel of US dealers, finding that approximately 50% of the difference observed in profitability between top performers and average ones is due to the operational practices implemented (see Figure 5).



Operational excellence still represents an open issue for automotive retailers. On one hand, they lack managerial skills in financial management and performance monitoring, given that the “golden past” of the automotive market led them to mainly focus on sales and marketing expertise. On the other hand, car dealers cannot rely on fully-featured Dealer Management Systems (DMS) which are unable to provide an exhaustive set of information to monitor business health and promptly identify critical issues to be tackled. To analyze the state-of-the-art of automotive retailers operational practices, four areas of analysis have to be deeply investigated:

1. Organization and Governance: this area of analysis concerns the evaluation of the company's macro and micro organizational structure, its governance model and operational mechanisms that interconnect business units, as well as the soft factors which contribute to the

organizational health such as the leadership style and the working climate.

- 2. Top line performances:** the aim of this area of analysis is to look into reasons behind quantitative and qualitative performances of all business lines. More in detail, this area includes all factors exerting a direct or indirect impact on revenues as the go-to-market model, sales strategy, business processes, sales team steering and, last but not least, the quality of service provided to the customer.
- 3. Bottom line efficiency:** this area refers to the identification of cost areas that show an addressable saving potential and the definition of viable saving initiatives to enhance short term profitability. Indeed, retailers are concerned about costs, but they mainly focus on headcount cutting rather than addressing relevant saving potentials among directorate costs, rental and leasing costs, cost of debt, utilities expenses and fees for professional services.
- 4. Finance and capital structure:** this area represents by far the most relevant one in the light of current market dynamics. The focus of the analysis is not only represented by the deep understanding of current financial health, but also concerns internal processes, tools and policies to monitor the future development of coverage ratio and optimize debt and capital structure accordingly.

With regard to these areas of analysis, Arthur D. Little's “field” experience highlights a series of recurrent criticalities that must be tackled to enhance profitability and business continuity. These critical issues have been ranked in the following table on the basis of their frequency (see Figure 6).

Figure 6: Most recurring critical issues at the dealership

Organization and Governance	Top Line Performances	Bottom line Efficiency	Finance and Capital Structure
<ul style="list-style-type: none"> Ineffective governance processes, rules, tools and policies 	<ul style="list-style-type: none"> Peppered territorial coverage and improvable customer reach 	<ul style="list-style-type: none"> Overpriced rental costs 	<ul style="list-style-type: none"> Unbalanced debt structure (excessive incidence of short-term sources)
<ul style="list-style-type: none"> Lack of managerial skills and financial know-how 	<ul style="list-style-type: none"> Lack of adequate CRM processes and tools 	<ul style="list-style-type: none"> High incidence of directorate costs 	<ul style="list-style-type: none"> Inadequate financial monitoring processes and tools
<ul style="list-style-type: none"> Inadequate rewarding systems for sales and service staff (if any) 	<ul style="list-style-type: none"> Unexploited cross-selling opportunities (e.g. BUs cross fertilization) 	<ul style="list-style-type: none"> Ineffective tools and policies to monitor staff productivity and efficiency rates 	<ul style="list-style-type: none"> Inadequate debt/equity ratio
<ul style="list-style-type: none"> Oversized organizational structures (with particular regard to indirect labor staff) 	<ul style="list-style-type: none"> Inadequate management of used car business 	<ul style="list-style-type: none"> Out of control general expenses and variable costs 	<ul style="list-style-type: none"> Volumes and ageing of stock not aligned with business requirements

4. Build Effective Recovery Plan

To support dealers in enhancing profitability and business continuity, OEMs and their NSCs should plan and launch structured retail coaching programs focusing on the eight intervention areas shown in Figure 7.

1. *Market Area Coverage*: this area of intervention aims at increasing dealers' market share in their areas of influence through market coverage optimization and customer reach enhancement.

To achieve these goals, automotive dealers need primarily to assess possible gaps between the sales potential expressed by each district of their market areas and the respective market penetration rate, and then to review their go-to-market model, sales organization and marketing initiatives accordingly.

2. *Retail Sales Boost*: dealers should better leverage their data archive to increase sales conversion rate, customer retention rate and cross-selling opportunities.
On one hand, sales force effectiveness could be enhanced by deeply analyzing the sales funnel ratios and understanding the main reasons behind lost sales; on the other hand, customer data needs to be gathered from

Sales and After Sales archives and analyzed to launch targeted CRM actions to promote re-purchase behaviors or win-back actions.

3. *Incentive Scheme Review*: sales force and sales manager rewarding systems are often inadequate to align company goals with the individual ones and to ensure an effective and motivating risk sharing model.

Dealers need to overcome their cultural hurdles, go over their existing bonus schemes and switch to new performance-based models focused on sales margins (not only volumes!) and involving the after sales personnel as well.

4. *Used Car Excellence*: although the used car business represents a key factor for dealer economic and financial performances⁸, this business line is still considered by most of car resellers more as a "necessary evil" rather than an opportunity to be exploited.

The Used Car Business lacks a well-structured governance model (e.g. business KPIs, targets, monitoring processes, reporting tools) and adequate practices for both trade-in and stock management processes.

Figure 7: Intervention areas to enhance operational excellence

Pillars	Intervention Areas	Scope and Objectives
Sales Excellence	1 <i>Market Area Coverage</i>	Optimize territorial coverage and enhance market penetration index within Dealer's area of influence
	2 <i>Retail Sales Boost</i>	Enhance Dealer's sales effectiveness and conquest rate through CRM and direct marketing campaigns
	3 <i>Incentive Scheme Review</i>	Review the structure and «rules of the game» of the incentive scheme for sales team and service staff
	4 <i>Used Car Excellence</i>	Enhance sales processes for the Used Car Business and define short-term initiatives to optimize Net Working Capital structure
Operational Excellence	5 <i>Cost Efficiency</i>	Identify viable saving potentials and define Cost Reduction Plans to enhance Dealer's profitability and business continuity
	6 <i>Organizational Right-Sizing</i>	Review Dealer's organizational structure both from a functional and a dimensional point of view
Brand Enhancement	7 <i>Customer Satisfaction Enhancement</i>	Enhance retail processes and «customer oriented» behavior of Dealer's staff to increase customer satisfaction performances
	8 <i>Customer Loyalty Enhancement</i>	Define a methodology to measure Customer Loyalty performances and enhance customer retention

8 The Used Car Business represents the second revenue stream for dealers, accounting for the 28% of total revenues in the Top 5 EU countries in 2012 and showing an increasing incidence in terms of margin contribution (Source ICDP; Top 5 EU countries: UK, Germany, France, Italy, Spain).

Therefore, dealers need to review their operations to increase business margins, reduce financial costs and optimize the net working capital structure.

5. *Cost Efficiency*: this intervention area aims at defining viable action plans to enhance short term cost-efficiency initiatives and improve overall profitability.

Many dealers have undertaken cost-cutting actions over the last few years to mitigate the impact of sales reductions on the net profit but, as previously mentioned, saving initiatives have been mainly focused on labor costs rather than addressing other relevant areas such as financial costs, general expenses, management fees, etc. The implementation of exhaustive cost cutting plans can generate an average increase in terms of Dealer profitability equal to 0.7% of net profit as percentage of turnover, without compromising sales effectiveness, quality of service and compliance with corporate standards (e.g. organizational standards, visual identity, etc.).

6. *Organizational Right-Sizing*: the very large majority of dealer organizations show room for improvement both from a functional and a dimensional point of view, but dealer management still shows difficulty in identifying adequate rationales to assess the as-is situation and define the most suitable corrective actions.

As a consequence of this, right-sizing plans are often based on rough sizing criteria (especially when it comes to re-sizing the after sales and the administrative staff) and are designed without taking into account the evolution of business performance in the mid-long term.

7. *Customer Satisfaction Enhancement*: the delivery of a unique brand experience is most definitely a strategic issue for all automakers, but still represents a challenge for authorized resellers, with negative impact on both customer retention and business profitability (as a consequence of the qualitative bonus achievement).

Most dealers can hardly identify reasons behind dissatisfaction and need to be provided with tailored quick wins to make the customer "delighted" and optimize the effort-to-result ratio at the same time.

8. *Customer Loyalty Enhancement*: this intervention area aims to support dealers in analyzing the loyalty index of their customer base and defining tactical actions to increase customer retention rate. To date, two main factors have limited the true understanding of loyalty-building issues:

- 1) the large majority of OEMs have not yet defined accurate metrics and common rules to measure customer retention rate across the entire product life cycle;
- 2) the current DMSs (Dealer Management Systems) are more than often unable to provide fresh and accurate figures about customer behaviors and loyalty performances and their enhancement requires significant time and effort.

Therefore, dealers need to be provided with proven methodologies and specific tools (gap fillers) in order to plan and implement an effective loyalty strategy.

5. Conclusions

Facts and figures about the automotive market along with our long-lasting project expertise, lead us to draw the following conclusions about the evolution of the automotive retail business in Western Europe.

1. **The golden past will not come back again** – Most of the current problems affecting the automotive market are structural and cannot be solved in the short run. Despite analysts forecasting a steady recovery in mature European markets, car sales are not expected to be back at pre-crisis level in the near future.
2. **Automotive retailers struggle to keep going** – Revenue drop, triggered by the combined effects of sales decrease and downshift to lower vehicle segments, together with the highly inelastic cost structure of automotive retailers and their inability to cope with the crisis, resulted in a progressive increase of bankruptcies.
3. **Car manufacturers beat about the bush** – To preserve market share and territorial coverage, OEMs started consolidating franchise contracts of pre-bankruptcy dealers on to bigger and healthier ones, with the number of outlets and sales-per-outlet being substantially flat over time and profitability issues still remaining unaddressed.
4. **Sustainable future requires strategic thinking** – To make the car retailing business really sustainable and appealing for new investors, OEMs need to identify innovative sales approaches and new formats⁹ to enhance the customer experience at sustainable costs for dealers. These strategic changes cannot be avoided, yet require time.
5. **Operational Excellence is key for survival** – Automotive retailers cannot wait any longer and need to promptly adapt to the “new normal”. To bounce back to profitability in the short-term they have to efficiently plan and manage their operations and achieve business continuity without compromising the quality of service provided to the customer. Dealers will face a tough road ahead and OEMs and their NSCs have to plan and launch contingency plans to support them.

The battle for long-term sustainability in the automotive retail business has begun. Arthur D. Little can support OEMs in driving the change by both implementing Operational Excellence Programs to enhance dealer profitability in the short-term and reshaping the car distribution model for the years to come.

⁹ These topics were covered in a recent ADL study “Spinning the Wheel Online” available at www.adlittle.com



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Arthur D. Little

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