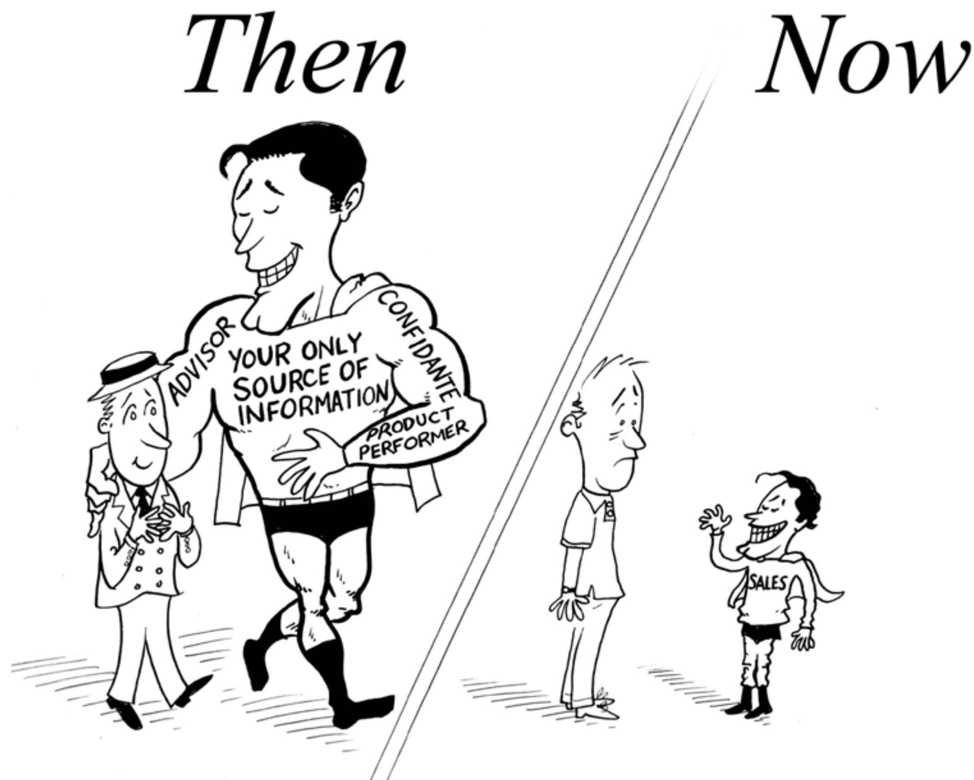
Whitepaper 02

Long Live New-Car Profitability

How to Thrive in a Net Margin-Compressed World



Executive Summary

Auto dealerships today operate under intense market pressures. The new-car purchase process has changed permanently, due in part to a complex interplay of factors – not least of which is the effect of a sea change in consumer behavior. Consumers now start their search on the Internet and fully expect transparency from that process. Such transformations challenge the sales model, cost structure and commission system of the traditional auto retail operation. How a given dealer responds to these challenges will determine whether the operation survives – and thrives – in the business of marketing and selling what has become a commodity. Dealers who resist evolving their operations to serve this more empowered consumer are placing their businesses at risk.

Net margins are shrinking, and have been for some time. According to NADA, new cars were mostly a break-even operation throughout the '90s; profits rose '01-'04, but saw a big decline in '05.[1] Profitability isn't the only thing being squeezed; sales themselves are off. U.S. dealers sold 16.1 million new cars in 2007, per NADA estimates, but that figure is dropping 3 percent per year on average.[2] As a general rule, the only way to grow market share in a declining market is to master sales. That may be why it sometimes appears that the entire $675 billion retail automotive industry is driven by a single motivator: net margin preservation. Although the franchise model remains protected by regulatory controls, new-car profits on a per-sale basis have been eroded over the decades – from a high of 40 percent per transaction in the 1930s to an industry average of below breakeven today.[3]

New-car net margins may be an endangered species, but it's a myth that they're dead. The status quo among dealers is to stave off net margin compression by optimizing profit per-transaction – pricing vehicles high on the front end and marshaling various less than customer-centric sales tactics to make the sticker price stick. While these tactics "work" short-term, longer-term, they're a recipe for self-destruction because they devalue both the customer experience and the imperative to operate more efficiently. Instead, increasing net margins over the long term involves "just" two things, both non-trivial: (a) embracing upfront pricing and (b) changing the organization's cost structure accordingly – thereby reducing expenses – to compete in this new environment.

Countering net margin pressure aggressively in such a sustainable way is more than just a good idea: there's an urgency to doing so. Geographic exclusivity is a thing of the past, creating a more competitive marketplace and placing even more pressure on price competition. A buyer's first stop in the shopping process is now online – as a general rule, consumers no longer walk into the dealership to get a brochure. Technology has forever changed the way buyers and dealers find each other. Now that consumers enjoy anonymous access to robust vehicle product information online, the way they choose a dealer is increasingly decided by one factor: price. Dealers who offer a good, informed price upfront will earn the trust – and the business – of these newly empowered consumers. Upfront pricing (and the dynamic that it sets in motion) can be an important strategy to significantly decrease dealer costs.

Upfront pricing is the new automotive retailing paradigm. It's the tonic – the profound change – that simultaneously increases volume and decreases per-car sales expense. Without upfront pricing, dealers are far less likely to be found by consumers seeking an informational advantage online — thereby risking irrelevance and, ultimately, extinction. With informed, competitive upfront pricing, however, dealers are not only able to potentially boost volume, they are able to change their cost structure and preserve their net margins by operating with greater efficiency. At this critical juncture in the industry's evolution, dealers who embrace the next wave of change will be this era's winners. Reorganizing the automotive retail business around this guiding principle has become mandatory.

1. National Automobile Dealers Association Industry Analysis Division, NADA Data, "*Dealership Financial Trends*," NADA's *AutoExec*, May 2008.

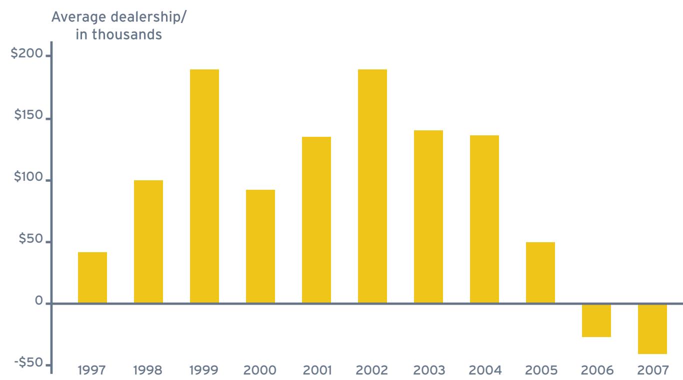
2. National Automobile Dealers Association Industry Analysis Division, NADA Data, "Economic Impact of America's New Car and New-Truck Dealers," *www.nada.org*, 2008.

3. National Automobile Dealers Association Industry Analysis Division, NADA Data, "*Dealership Financial Trends*," NADA's *AutoExec*, May 2008.

What Is Happening to New-Car Margins?

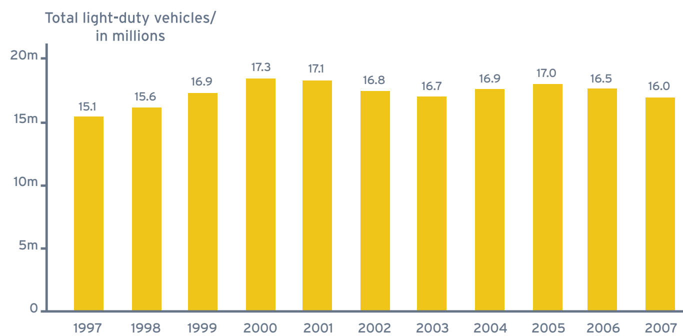
The one-two punch of pricing compression and rising costs at the dealership have combined to put enormous pressure on a dealer's new car net margins, which now hover below the breakeven point. Several developments have converged to contribute to pricing compression and eroding profits on new car sales: (a) the commoditization of the car; (b) the primacy of technology and the Internet as a way of distributing comprehensive, unbiased information; and (c) the ensuing change in consumer shopping behavior, triggered by the ability to go online anonymously for that informational advantage—which, in turn, has forced dealers to alter how and where they market to these newly empowered consumers. Let's consider each of these.

Net Profit of New Vehicle Departments[4]



According to the NADA, new vehicle department net profit has been on a constant decline since 2002, with recent years actually showing a net loss.

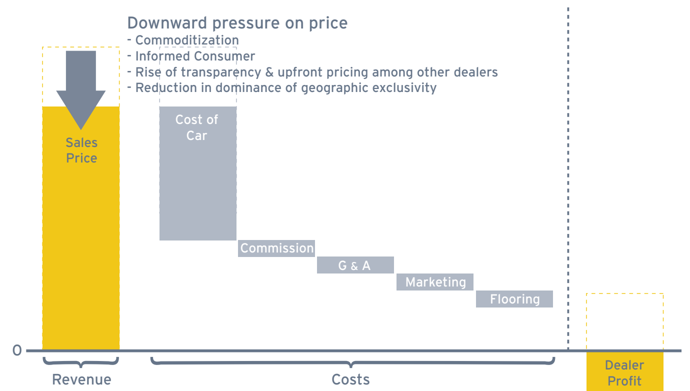
New Vehicle Unit Sales[4]



There has been a well known and highly publicized steady and significant decline in the sales of new vehicles since 2000.

Pricing Compression Is Real

Compression of Dealer Margins[5]



Several factors are compressing sales prices on cars and ultimately irradicating dealer profit.

The Car as a Commodity

New car buyers today are confident in the quality and consistency of the cars they shop for. Given the same make, model, trim and option package from the factory, variations in quality and reliability simply do not exist—the industry has achieved complete product ubiquity. As a result, based on what the factory is delivering, there is no greater value in patronizing one dealer over another, other than the convenience factor. The BMW-5 series the consumer buys in Beverly Hills will be exactly the same as the one he or she buys in Baltimore.

Consumers recognize and accept this as a reality - that there is no greater value between Dealer A and Dealer B in terms of where to buy. Even so, the "commoditization" of the car doesn't mean that brands and individual vehicles can't be accessorized in such a way as to make them personal and unique—but the real world problem is that two different customers can go to the same dealership on the same day and buy the same product from the same salesperson, and pay a dramatically different price.

The upshot is that the default business model for dealerships has become one of "price optimization per customer" as a way to maintain net margins. And the only way to maintain net margins under a price optimization model is to introduce a salesperson into the process, thereby increasing costs even further — overhead that actually exacerbates pricing compression and contributes to a costly disconnect between dealers and today's increasingly informed consumers.

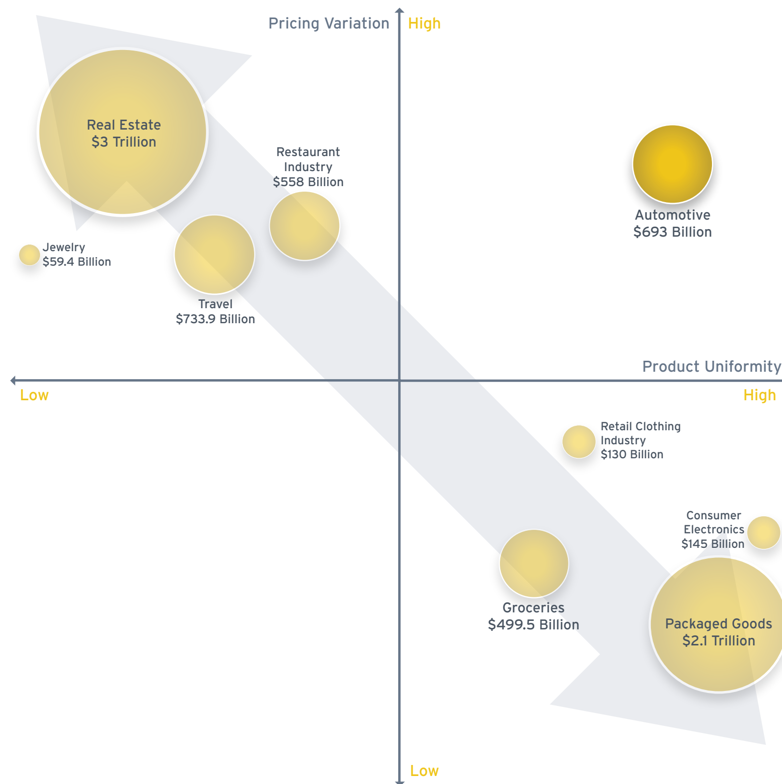
4. National Automobile Dealers Association Industry Analysis Division, NADA Data, "*Dealership Financial Trends*," NADA's *AutoExec*, May 2008.

5. Zag Data, 2008

Upfront pricing -- and the dynamic it sets in motion -- can be an important strategy to significantly decrease dealer costs.

Optimizing profit per-transaction is today's status quo on both the front and back end of the auto purchase transaction. On the front end, one strategy is to "price high and close hard" (i.e., dealers pricing vehicles as high as possible and leveraging aggressive sales tactics to close the deal). On the back end, dealers are loading vehicles with accessories, or "up-selling." These tactics work—as does an increased reliance on profits from used-car, service and parts departments. Indeed, total used-car profits increased in 2005 and 2006, and accounted for 27 percent of the average dealership's total operating profits in 2007. Similarly, service and parts department profits accounted for 81 percent of total dealership operating profits.[7]

Commoditization[6]



Commodities are defined by high product uniformity and low pricing variation. That is to say that the same product on the same day will not have a high variation in price. Clearly several industries are not commoditized industries, such as real estate, jewelry, and travel, due mostly to their low product uniformity. The automotive category is remarkable as a category with near perfect product uniformity within models, yet high pricing variation.

These tactics and approaches are in some cases understandable responses—but they're not long-term solutions. They're band-aids. The only way to sustain these tactics is to introduce a salesperson to the process to size up informational advantages and disadvantages per customer, per transaction. This requires that a significant cost structure be added to the business; embracing upfront pricing does not. In addition, this added cost structure does nothing to improve the overall customer experience; indeed, it has precisely the opposite effect. The salesforce needed to optimize profit per transaction is more likely to disenfranchise consumers from dealerships they can no longer trust. What the industry needs instead is an overarching strategic and systemic solution — versus multiple reactive, tactical ones — that truly addresses the underlying problem. In this sense, net margin-compression is a symptom, not a cause, of what ails auto retailing.

The Informed Consumer

Add to this mix the fact that consumers have evolved from having to completely rely on the dealer for all product and pricing information prior to the 1960s, to gaining access to some rudimentary pricing data, and then independent research through resources like *Consumer Reports*, up through the '90s, to today—the Internet. Anyone who has researched a new car purchase on the Internet over the past decade has experienced firsthand the power of anonymous online access to robust product information.

Today's consumer is much more informed about cars themselves, which alters the dynamics of the negotiation (indeed, consumers often know more about the cars than the salesperson, with questions having evolved from, "What can you tell me about this car?" to "Does this one come with Option Package 13B?"). More information – often in the form of anonymous, online access to that information – and more dealers from which to choose, results in a far more empowered consumer.

6. "Jewelry Report, 2006 Update: The Who, What, Where, Why and How Much of Jewelry Shopping," *Research and Markets*, June 2006. National Association of Realtors, *NAR Data*, 2008. National Automobile Dealers Association Industry Analysis Division, NADA Data, "Total Dealership Sales Dollars," NADA's *AutoExec*, May 2008. Mary Holz-Clause and Malinda Geisler, "Grocery Industry," AGMRC, September 2007. Suzanne Duffree, "CEA forecasts $155B in Consumer Electronics revenue," *Electronic News*, January 8, 2007. "Travel, Airline, Hotel, and Tourism Industry Trends," *Plunkett Research*, LTD., 2007. "Clothing Stores, Industry Profile," First Research, April 2008. "2008 Restaurant Industry Forecast," *National Restaurant Association*, www.restaurant.org, 2007. Grocery Manufacturers Association, Inc. and PricewaterhouseCoopers LLP., "*Insights into the Food, Beverage, and Consumer Products Industry: GMA Overview of Industry Economic Impact, Financial Performance, and Trends*," 2006.

7. National Automobile Dealers Association Industry Analysis Division, NADA Data, "*Dealership Financial Trends*," NADA's *AutoExec*, May 2008.

Thanks to this easy access to information—via dealers and manufacturers online, car shopping sites, third-party information sources (infomediaries like Autobytel, Edmunds and KBB.com)—consumers can now more readily find a dealer. Once these informed consumers have settled on a make/model, they are now willing to engage with more dealers across a wide geographic area, effectively stripping away the inherent protections (that is, geographic exclusivity) of the automotive retail franchise system. The Web has effectively nullified the dealer's territorial expectations.

Part of the urgency for dealers to reinvent their operational model is borne out by the data: the number of new-car dealerships in the U.S. is shrinking. During the last 20 years, the pace of decline has accelerated, with nearly 4,000 dealerships closing their doors during this period.[8] As 2008 began, there were 20,700 new car dealerships with nearly double that in franchise operations nationwide.[9] This trend toward attrition and consolidation is projected to continue, with greater competition among dealers not only regionally but from state to state.

The Web has effectively nullified the dealer's territorial expectations.

The Net and the Rise of Transparency

Knowing consumers have their pick, dealers recognize that pricing becomes the key competitive advantage. As a result, some dealers—especially publicly owned volume dealerships operating in urban markets—are offering upfront pricing, re-setting the bar for the new maximum price in markets where competition is greater. Put simply, those dealers who recognize the reality of easy access to information via the Internet, who provide pricing transparency, and who place a premium on providing the customer with a better experience, will grab market share from those adhering to the old paradigm. (For a more detailed discussion, see Zag's white paper, "The Case for Upfront Pricing.")

Controlling Costs is the Only Answer

As suggested a bit earlier, what the industry needs instead is a systemic solution — versus multiple reactive, tactical ones — that truly treats the underlying problem and resolves the fundamental challenges that dealers now face in terms of controlling costs.

Retail car dealerships work overtime to control a combination of both fixed and variable costs in an effort to maintain net margins. The typical dealer has four cost centers: marketing costs, salesperson costs in the form of commissions, general and administrative overhead costs, and inventory maintenance (including flooring and carry costs, i.e., vehicle depreciation from factory delivery to sale). Although a generalization across all brands and all dealerships (and thus worthy of a caveat here), most dealers will spend $2,000 to sell a single car. Here's a closer look at how these elements and their respective roles are driving costs higher over time:

Marketing

Of the $13.17 billion that the retail auto industry spent on advertising in 2007, $2.35 billion was spent online—and that ratio is expected to increase dramatically over the next few years.[10] The Web was originally thought to be a more efficient way to deliver customers ready to buy, since it's targeted, measurable and open to personalization. Instead, it has created a new set of challenges, with its own cost implications. While dealers have mastered the Internet as a source of mining inexpensive leads, for example, the incremental value of those leads continues to fall as dealers are forced to harvest them in increasing volumes to attract true, in-market prospects.

With the vast majority of U.S. dealers committed to some level of online presence—and most committed to the prevailing lead generation model—it's questionable how much longer dealerships can continue to pour dollars into marketing efforts that fundamentally don't generate quality ROI. Put simply, the marketing spend today isn't paying off; the shift in dollars from offline (print, broadcast, etc.) to online has yet to deliver on its promise in terms of cost-per-lead for dealers. Dollars are spent chasing leads, not sales. (For a more detailed discussion of lead generation, see Zag's white paper, "Lead Generation is Broken for Dealers and Customers.")

Commissions

Commissioned salespeople logically work to achieve higher net margins by focusing on (read: haggling over) five final sale figure determinants, some of which are infinitely negotiable: invoice, MSRP, trade-in value, buyer credit score and monthly payment threshold. But in a commodity market, constant haggling over price with every potential buyer can be costly. Haggling takes time away from additional sales (in other words, impeding higher volume)—especially when trying to separate tire-kickers from legitimate, ready-to-buy shoppers. Over the decades,

8. National Automobile Dealers Association Industry Analysis Division, NADA Data, "*New-Car Dealerships*," NADA's *AutoExec*, May 2008.

9. National Automobile Dealers Association Industry Analysis Division, NADA Data, "Economic Impact of America's New Car and New-Truck Dealers," *www.nada.org*, 2008.

10. eMarketer, *Automotive Marketing Online, Negotiating the Curves*, June 2008.

dealers have learned to factor these haggling inefficiencies into their cost of sales.

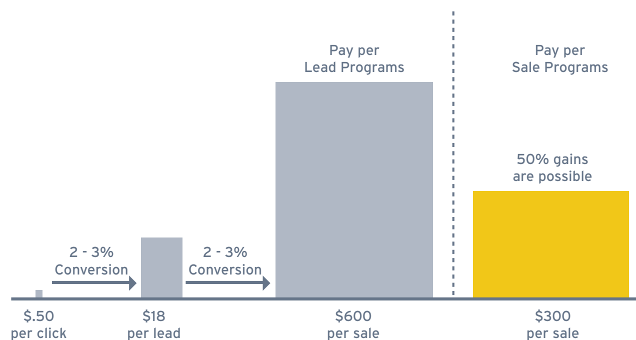
Compounding this is the surprising discovery that consumers believe dealerships are entitled to more profit than they're now receiving. According to a recent Zag/Synovate survey that asked 1,000 consumers what they thought a fair net margin would be for the sale of a $40,000 car—with all marketing and overhead costs considered—72 percent were willing to give dealers more money than the dealers were actually netting.[11]

The reality is that dealerships average less than $1,000 in net margin per new car sold. The take-away is commissions are spent on salespeople haggling to maintain net margins below that which consumers would grant in the first place—a colossally inefficient use of resources, and an expense that dealerships do not need to bear.

General & Administrative

It's no surprise that displaying new cars for sale requires large showrooms with good lighting, ample real estate and perhaps a cappuccino machine or two. Yet sales, general and administrative cost centers only continue to grow under the traditional auto retail paradigm, because dealerships now must spend *more* to drive increasingly diminished traffic to showroom displays—due, in no small part, to the fact that the Web and consumers' online search for pricing, model and features information have trumped any given dealership's territorial advantage.

Controlling Marketing Costs[12]



Generally, we know that the effective per sale cost on leads averages out to about $600 per sale. Reductions of 50% are possible through pay per sale programs.

While dealers have mastered the art of maximizing profit per transaction, they must now also boost sales volume and reduce costs.

Inventory

As any dealer can attest, it is impossible to "floor" or display every car or truck in inventory. What's most critical is increasing sales velocity and selling more vehicles more quickly. Yet it is often just as impossible to fulfill every buyer's ideal choice of car from available inventory. This translates into inventory that fails to turn over. What's more, cars that aren't being floored are depreciating by the day and must be financed—resulting in additional "carry costs" for the dealer. Consequently, the velocity of inventory and corresponding cost centers are hugely important to dealerships.

As a result, dealers must move the inventory they have, while informing consumers about what's on hand. Displaying complete inventory on the Internet, and managing that catalog dynamically, enables dealers to rotate inventory more quickly, targeting specific buyers at specific vehicles, and ultimately reduce carry costs—but even this solution bears significant ongoing costs in the form of IT, hosting and development expense.

Containing (and Mitigating) Dealer Costs

Controlling costs at the dealership isn't a matter of scrimping and saving—nickels and dimes won't fill the treasury. Instead, reversing net margin compression begins with a fundamental change in mindset—one that acknowledges that staying in business means doing business in a very different way.

Reduce Marketing Costs

Marketing represents the largest cost center in automotive retailing, which is why dealers must do all they can to hold their marketing dollars accountable and drive ROI. Dealers pay an average of $600 in advertising costs per car sold[13],a cost that dealers have sought to mitigate through online lead generation, with decidedly mixed results. In fact, dealers' advertising expenses per new car sold have actually moved upward since the Internet has taken over as a primary marketing channel—going from $314 in 1996 to $590 in 2006.[14]

11. Zag data, survey of 1,000 consumers conducted by Synovate eNation, April 2008.

12. Zag Data, 2008.

13. National Automobile Dealers Association Industry Analysis Division, NADA Data, *Advertising and the Dealership*, NADA's *AutoExec*, May 2008.

14. National Automobile Dealers Association and AutoExec, *Automotive eCommerce: Best Practices, Technologies and Strategies to Master Online Success*.

Dealers have learned to factor haggling inefficiencies into sales costs–if the haggle can be cut, time and staff can be used more effectively.

The upshot is that marketing expenses focused on buying leads that no longer drive sales effectively, can be cut in favor of partnerships that enable dealers to essentially become the "preferred" merchant for large groups of buyers who don't require any selling – but who instead drive sales efficiencies via in-market members. In a practical sense, when the partner or "affinity" group is doing the "selling" (delivering in-market buyers with little heavy lifting), the dealership can reduce marketing, personnel and commission expenses accordingly.

Upfront pricing itself can help dealers expand their territories and drive down marketing expenses by enabling them to reach more buyers online — buyers they may not have reached otherwise — and by offering online shoppers exactly what they want: an informed, upfront price.

Cut Commissions

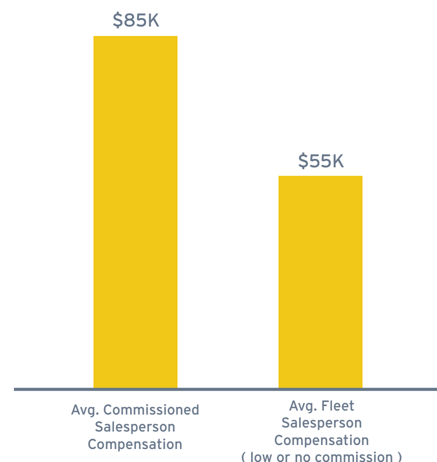
Embracing upfront pricing without dramatically re-envisioning today's commissioned salesforce is tantamount to doing only half the job. Various major auto groups have recognized this and have implemented upfront pricing, including United Auto Group, Carmax, AutoNation and other dealerships that operate fleet departments. One major dealer group that has implemented upfront pricing, Lithia's L2 operation, also completely eliminated its commissioned salesforce. Lithia's experience is instructive and the implications can't be overstated: (a) the commissioned salesforce will need to be disbanded; (b) delivery and service specialists, sans commission, will need to act as the dealership's front-line to the consumer; and (c) perhaps most critically, the overall mindset will need to shift to "our job is serving the consumer."

If the haggle can be eliminated, time and staff can be used more efficiently—a scenario proven time and again when dealers offer aggressive, transparent upfront pricing. Indeed, dealers can virtually eliminate commissions in the upfront pricing scenario. There is ample room, in other words, for commission and salesforce costs to come down—especially when those costs arise from activities that don't deliver a better customer experience. Upfront pricing does not, of course, eliminate the other factors of the sale, including financing, insurance, trade-ins, etc., but it can fundamentally change the economics of the dealership nonetheless.

Reduce Selling, General & Administrative Costs

Given that the Internet has changed how dealers find and market to customers, it's critical that dealers match their sales velocity plans with their marketing channels. Dealers need to have a sufficient pool of in-market customers to whom they can quickly sell cars, so those cars are not depreciating on their lots. This is done via access to volume marketing channels that in turn have access to the dealer's informed, upfront pricing. The throttle to making this happen is marketing—reaching consumers where they are: online.

Controlling Commissions[15]



A key method for reducing commission costs is to stop paying commissions on sales that have been closed before the customer enters the dealership through the use of upfront pricing. Such sales can be handled with low commission, or no-commission representatives similar to fleet managers for significant reductions in personnel expenses.

A tipping point exists at which it is better to reduce per-vehicle price to realize volume gains. Selling more units for a little less certainly enables dealers to achieve overall higher profits across their operations. These gains are solidified by the fact that moving inventory also reduces carry costs and earns higher factory allocations from manufacturers.

15. Zag estimate

Dealerships' sales process automation likewise reduces expenses and promotes efficiencies—reducing G&A, better managing inventory, saving flooring costs and the like. In addition, dealers who embrace upfront pricing and agree to allow access to some sales data can save marketing expenses by participating in pay-per-sale programs (in which they are charged a flat fee only when a car sells, rather than paying for every lead). Over the next five years, sales automation will represent one of the most significant areas in which dealers can reduce their operating costs and gain measurable efficiencies.

In the past, the consumer would engage in a shopping process, a negotiating process, an administrative process and a closing process. True sales automation collapses these transactional steps (and associated costs) by integrating each further upstream in the sales cycle. Dealer websites that offer financing, the full inventory online, and affinity buying group partnerships, light the way toward achieving such efficiencies by identifying and engaging in-market consumers into the sales channel earlier—and with far greater rates of success.

Put simply: when traditional cost reduction tactics are married to upfront pricing and partnerships through an online platform, sales efficiencies and expense reductions become even more dramatic.

A buying program must be able to pull together all these various elements. The task is a formidable one. It requires sophisticated technology that can track a transaction from start to finish, analyze industry pricing to ensure the buyers are getting good deals, and provide an online interface that makes the transaction easy for the customer—while reducing costs and increasing sales volume for dealers seeking to thrive, not just survive, in an increasingly net margin-compressed world.

Conclusion

Auto retailing has reached a critical juncture for the traditional new-car sales paradigm, which is today defined by relentlessly shrinking new-car net margins that have reached an historic low. This dramatic and prolonged dive in new-car profitability has been driven by a mix of factors that include—but certainly aren't limited to—lower prices, savvy shoppers empowered through the Web, increased dealership competition and costs, and a lead generation paradigm that sells names (but not cars).

In this environment, dealers are working hard to optimize per-sale profitability, increase sales volume, decrease costs and build promising new profit centers such as used-car, service and repair departments. While these are admirable, even essential steps to take—**new car net margins are not dead.**

Dealers that embrace this emerging model can operate more efficiently, decrease per-car sales expenses and boost profits while simultaneously delivering a better customer experience. Delivering a better customer experience will become an increasingly key differentiator in today's exacting marketplace — one that has economic value for dealerships that recognize it as perhaps the most effective way to counter that seemingly irreversible downward pressure on net margins.

Dealers can realize greater profit by embracing upfront pricing—which simultaneously cuts costs and drives incremental volume. This is good news for beleaguered dealerships, because lower costs and upfront pricing generates more consumer trust, which in turn drives sales and generates higher profits—a bold but necessary stroke that will free an industry constricted by the Gordian knot of shrinking net margins and empowered consumers.

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