The Ruggles Report™

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877.521.6256

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The Ruggles' Report is an ongoing, independently published report with insights, reflections and opinions from noted vehicle expert David Ruggles.

In Defense of Dealers

A few years back Michael Dell was quoted as saying he thought the auto industry should adopt elements of his "build to order" PC business model. He predicted that consumers would someday purchase new vehicles directly from the Manufacturer. Obviously, he didn't put much value on what the Dealer adds to the Consumer / Manufacturer equation.

But after making a pass at Asbury Group Mr. Dell is now a Dealer himself, having partnered with a former head of Sonic to buy dealerships. While we haven't heard much about that venture recently, we do recall Mr. Dell's comments about Dealers being an unnecessary and expensive link in the distribution chain. Not long after, Mr. J. D. Power made a similarly negative comment in an interview with the Wall Street Journal and was greeted with tremendous blowback. He was rumored to be a pariah at his company's own hospitality suite at that year's National Auto Dealer Association convention. It was not long thereafter J. D. Power and Associates came to be owned by the McGraw Hill Companies.

It seems it has become common for self appointed experts to lecture the industry on how to best retail and service new vehicles. We recall Ford Motor Company's ill-fated attempt at being a Retailer. Ford purchased all the Ford Dealerships in a number of markets, including Tulsa and Oklahoma City. This experiment took place under the Jacque Nassar regime and provided additional evidence that Manufacturers probably don't know how to retail new vehicles profitably. Ford couldn't make the venture work even as they owned all the Ford stores in the market! The Ford Auto Collection experiment, and the Saturn experiment at GM, didn't burnish the concept of "One Price Selling" either. After their short and costly experiment, Ford decided it was better to sell their Dealerships back to genuine Retailers.

8284 Club Meadows Dr
Dallas, Texas 75243
www.cybercalc.com

214.521.6256

People outside the business typically think the secret to success in auto sales is to keep cutting the price and make it up in volume. Real Dealers know they have to make gross profit wherever they can. During their time as Dealers, Ford focused on selling new vehicles. After all, Ford is a Manufacturer. A Dealer knows that selling new vehicles is likely to be a losing proposition at times, especially Detroit 3 Dealers. They structure their business accordingly. For that reason they learn to make up profit in their other departments. This allows them to sell new vehicles at a net loss when necessary, but still maintain overall profitability. Ford thought they could increase volume with "One Price" and regarded the pre-owned business as a necessary evil. The result? They actually achieved lower new vehicle sales at lower gross profits than before, and gave their pre-owned business away. It's no wonder they didn't make money!

Now the "authorities" in charge of the economy assert that GM and Chrysler would be better off with fewer Dealers, as if Dealers add significantly to a Manufacturer's costs. This is not to say there hasn't been significant "over-dealering", especially in metro markets. But "over-dealering" impacts Dealer's profitability, not the Manufacturer's.

The Other Side

Let's look at it from a Dealer's perspective. Dealers these days have typically been pressured by their Manufacturers into ever more expensive and expansive facilities, despite the fact that a consumer's Internet screen is now their "showroom" of choice. More and more consumers go to the "brick and mortar" Dealership to view inventory, acquire information, take a test drive, and perhaps get a price quote. The consumer then goes back to their PC to obtain price quotes on their desired vehicle. A Dealer's conventional sales staff is often competing against its own Internet department, as well as other Dealers, when it comes to price!

Moreover, new vehicles are pretty much a commodity these days. An excellent book on the subject is Dale Pollak's *Velocity*. He points out that the new vehicle business has been an "efficient market" for years. To economists, an "efficient market" is one where both buyers and sellers have equal information and neither has any significant advantage. According to Wikipedia, "The efficient-market hypothesis states that it is impossible to consistently outperform the market by using any information that the market already knows, except through luck." In other words, there is significant downward pressure on Dealers' new vehicle gross profits and they are often a loss leader. *Velocity* is primarily about the pre-owned market, but the principles of market efficiency have applied to new vehicles even longer than to pre-owned

The current discussion in Washington includes forcing GM and Chrysler to shed Dealers as a condition of receiving “tax payer backed” loans. For some reason, some members of Congress think getting rid of Dealers will save money for GM and Chrysler. They obviously don’t know that once established, there is very little, if any, cost to the Manufacturers for their Dealer networks. As a matter of fact, Dealers are the Manufacturer’s customers, not the buying public. The buying public is the customer of Dealers! Is it logical to try to increase sales by reducing customers?

In addition to selling new vehicles and parts to their Dealers, the Manufacturers also sell them special tools, equipment, furniture and numerous other expensive programs. The Manufacturers have transferred immense costs and risk to their Dealers. The risk of real estate, receivables, inventory and inventory financing is all born by Dealers, not by Manufacturers.

In fact, a recent study commissioned by NADA stated, “Far from being a burden to the Manufacturer it represents, the Automobile Dealer supports the Manufacturer’s efforts by providing a vast distribution channel that allows for efficient flow of the Manufacturer’s product to the public at virtually no cost to the Manufacturer. The independently owned and independently financed franchised Automobile Dealer network is a critical asset to the Auto Manufacturers. U.S. Auto Dealers have $233.5 billion invested in their businesses. This capital is supplied by 20,700 independent dealerships that employ and train over 1.1 million people.” According to Dr. Michael Smitka, Professor of Economics at Washington and Lee University and an auto industry expert, “Dealer profitability based on their $233 billion dollar investment and a reasonable 8% return should equate to an 18 billion dollar return for Dealers in aggregate. We’ve seen no evidence that target has been met over the years.”

Further, Dealers provide the resources to stock inventory. They take trade-ins. They arrange financing. They collect and pay billions of dollars per year in taxes. Combined, they represent 20% of all retail sales in the U.S. Unknown to the general public, Dealers collectively have more money invested in their business than their Manufacturers have invested in theirs!

Someone needs to explain to me how a Manufacturer can morally and/or legally push major investment and risk on their Dealers/Franchisees and then arbitrarily stop supplying them with product, outside of bankruptcy. GM killed Oldsmobile by first starving it for product. What was once GM’s most profitable division received “me too,” "badge engineered" vehicles to sell, at a higher price than the same vehicle from other GM divisions. At the same time they backed these less than wonderful vehicles with a marketing campaign that stated, "It's Not Your Father's Oldsmobile." This only further alienated their already aging customer base but failed to turn on younger buyers to their "me too" vehicles.

The money that should have been invested to bolster Oldsmobile was spent on a revolutionary new idea named Saturn. Saturn NEVER made money and Oldsmobile died a slow death. But at least Oldsmobile Dealers received a measure of compensation from GM. It is reported to have cost GM over a billion dollars to shed Oldsmobile, in yesterday's dollars.

The Upside to Saturn

The best thing to come out of Roger Smith's Saturn experiment is the Saturn Dealer network and their franchise agreement. This franchise agreement is unique in the U.S, but common in other some other countries, including Japan. It grants distribution rights for an area or region, rather than an individual market.

GM has refused to allow Saturn Dealers to dual with other makes. A Dealer friend once said, "When you can't pay the rent, you have to take in boarders!" But GM has denied this option to Saturn dealers despite the fact they haven't provided vehicles to Saturn Dealers that the market wants in enough volume to allow its Dealers to be viable.

From the beginning they were provided a line of mostly "tepid" vehicles to sell. While the recent Aura and Sky are great vehicles they haven't been enough to save Saturn! Besides, the Detroit 3 have never been able to consistently make money selling small vehicles. Consumers had some renewed interest in Saturn's offerings when fuel prices spiked but that quickly waned. Imagine the result if the Detroit 3 were to design and build only smaller fuel efficient vehicles, as mandated by Congress, and the price of fuel stays low.

Nevertheless, Saturn Dealers are a resourceful bunch and have learned to survive by being excellent operators, focusing on the pre-owned and service ends of the business. They "kill their customers with kindness!" Now they have officially been notified that they will be starved for new products and will soon be phased out. Let's hope their innovative franchise setup and professional Dealer body attracts a buyer that gives them the opportunity to represent a line of compelling vehicles, whether they be from China, India, Italy, or wherever. I wonder what might happen if Fiat decides they are better off buying Saturn instead of partnering with Chrysler? Saturn Dealers all have substantial investments in facilities that have little value if a successful automotive franchise isn't operating in them.

Beyond Suburbia

We should also have a special appreciation for "country" Dealers. These Dealers are also resourceful and have learned how to make money in the pre-owned and service business. This has been out of necessity as they typically have not had access to any real quantity of their Manufacturer's "hot merchandise" when their OEM produced a "winner." Many have become dependent on their Manufacturer's Certified Pre-Owned (CPO) offerings. Without a franchise that allows them to buy CPO caliber "program vehicles," their futures are in doubt.

What does an Auto Dealer do for a community? Aside from local employment, local service, safety recalls, warranty repairs, local charitable work, etc., Dealers collect Sales Tax! A portion of that Sales Tax goes to local government. If a Dealer goes out of business in a community and vehicle buyers are forced to drive out of the locale to make their purchase, the local tax revenue stays where the vehicle is purchased, depriving the previous municipality of its tax revenue. This is a major issue! There are many circumstances where local government has provided financing and other support to maintain a local Dealer and its associated tax base. Imagine a municipality guaranteeing a loan for a local Dealer and the Dealer's Manufacturer arbitrarily cancels or terminates the franchise agreement or stops supplying product. In this case the Manufacturer probably forced the Dealer to make substantial investments before shutting off product. I can hear the attorneys licking their chops.

What's Next for the GM & Chrysler?

GM and Chrysler are between a rock and a hard place! They are afraid of Chapter 11 (re-organizational) bankruptcy. They feel few consumers will buy a vehicle from a bankrupt Manufacturer with no real assurance of warranty or resale value. If they don't go Chapter 11, they are obligated to honor their contractual agreements, including their franchise agreements.

On a macro level, a Manufacturer bankruptcy would drop billions of dollars of pension and healthcare obligations on the federal government. The United Airlines bankruptcy dropped 6.6 billion dollars on the Pension Benefit Guaranty Corporation! (read that Federal Government.) Imagine GM, Chrysler, and a slew of suppliers hitting that system at the same time. The PBGC was already 23 billion dollars in deficit BEFORE the record UAL bankruptcy. It's no wonder the government is proving fairly easy to work with for two of the Detroit 3.

On the Bright Side

Fortunately Auto Dealers do have some "aces in the hole!" They have protection from state AND federal laws protecting Dealers and/or Franchisees from their suppliers. These laws are based on "fairness" and cannot be merely swept away by mandate from Congress, a Car Czar, or a committee. Auto Dealers have effective lobbying groups in the form of their state trade associations, Political Action Committees, and most importantly the National Auto Dealer Association.

Dealers are victims of many of the circumstances that led to the demise of their Manufacturers, but Dealers had nothing to do with the melt down of the U.S. financial system that dramatically impacted them. They had nothing to do with the sudden spike in fuel prices that rendered much of their inventory "sale proof" and decimated the value of their used vehicle inventories.

Dealers don't dictate to their Manufacturers what to design and build. Many are currently victimized by Manufacturer sales incentive programs that require the Dealer to order additional vehicles for inventory as a price of admission to the program. These programs may serve the Manufacturer's purpose but are catastrophic to a Dealer who is sitting on a 150 days (or greater) supply of inventory.

At the same time, the same Dealer is probably facing the prospect of having to "curtail" floor planned vehicles as a result of frequently arbitrary and frivolous mandates from lenders - often the Manufacturer's captive. This comes at a time when working capital is a most precious commodity. This practice often puts the dealer in the position of having to decline program participation and face the market with a serious cost penalty versus other Dealers selling the same brand. Many of these Dealers are already on "finance hold" due to too much inventory and/or deterioration of their balance sheet. So now they face having a serious cost penalty in selling the inventory they purchased in good faith from their Manufacturer months ago.

Many Manufacturer programs are frequently designed to give the OEM a "free float" on the Dealer's working capital while at the same time demanding immediate payment from the Dealer for the monthly parts statement.

In summary, Dealers are not only important, but absolutely necessary to a Manufacturer's survival and ongoing success. Shutting down an entire division may make economic sense to a Manufacturer, if they cannot afford to design and build vehicles to supply that Division's Dealers. But it will be quite expensive to do so. Merely thinning out Dealers as a method of increasing Manufacturer profitability is a totally flawed concept and strategies designed to force Dealers out of business should be dealt with sternly.

About Dave Ruggles

Dave Ruggles is a widely known, auto industry veteran with more than three decades' worth of experience. His self-titled Ruggles Report is a highly acclaimed industry insider brief detailing the latest hot-button topics in automotive sales, training, recruiting, finance and service.

Ruggles has sold cars, managed, owned and trained dealerships literally across the world. For the last sixteen years, he has spent a month each summer teaching sales desk training to the world's largest privately owned Toyota dealership group in Nagano, Japan.

He lives in Las Vegas, Nevada.

About CyberCalc.com

Based in Dallas, Texas and currently celebrating its 10th anniversary, CyberCalc provides a myriad of software services for the automotive finance industry. The company's namesake product is an internet-based lease comparison system used by franchised dealers, credit unions and independent leasing companies. Additional products include private-label derivitaves and custom designed commercial leasing, workflow and merchant services applications.

The company's latest effort is focused on a soon-to-be-released entry into the Consumer Market: BuyerBidsOnline.com. BuyerBids is set to revolutionize today's new and used car market by providing dealers with only the most serious buying leads. Whether you are a Buyer or a Dealer, BuyerBids will work for you to create an unequaled online car buying & selling experience.