Factory Facilities Programs: Phase 2

An NADA/CADA Research Project

By Glenn A. Mercer

February, 2013

Factory Facilities Programs: Phase 2
An NADA/CADA Research Project

By Glenn Mercer

Introduction

The purpose of this report is to build on the results of our project's Phase 1 report, released about one year ago. Both phases are focused on the challenge of trying to better understand the economics of investments in new-car dealership facilities, especially as requested by car company "image" programs. Phase 1 relied on a broad range of about 75 fairly short interviews with OEMs, dealers, and other industry experts, and focused on the impact on dealer economics (ROI) in the present day. Phase 2, in attempting to build on and improve upon the Phase 1 results, shifted methodology to a smaller sample of about 35 more in-depth interviews and visits with dealers and experts. Phase 2 also broadened its focus from the implications of facility investments on *today's* dealership, to the implications for *tomorrow's* dealership as well. (That is, even if an upgrade to a store makes sense in 2013, how can a dealer be sure that this upgrade will not have to be scrapped in a few years, as customer needs and market conditions shift.) The impetus for this second phase came once again from NADA, who, responsive to the ongoing concerns expressed by its members about factory image programs, decided to request these additional analyses and findings.

Besides the changes in methodology and focus, this Phase 2 report has an additional new element: the participation of Canadian dealerships. Factory facilities programs are of course not unique to the United States, and so, after Phase 1 concluded, the Canadian Automobile Dealers Association (CADA) asked for us to include a sample of its members in this Phase, and we have done so. Since the issues – and the way dealerships operate -- are similar on both sides of our mutual border, we have not generally in this report identified whether a particular store is Canadian or American, but we have inserted a separate section that discusses how our general findings may vary from one country to the other. We are very happy to have CADA's participation, as we believe this only makes our findings more robust, and thank them for their support of this project.

The contents of the rest of this report are as follows. After acknowledgements of those participants to whom we owe particular thanks, we will proceed to a summary of all our findings and recommendations. A recap of the Phase 1 findings follows, for the sake of completeness, but this can be skipped by readers familiar with the Phase 1 report (which is freely available on the NADA website). From there we go into the three main substantive topics of Phase 2: What has *changed* since Phase 1?, What have we *learned* further about facilities ROI?, and Where do we see the physical facilities of the dealership of the future heading? We close the second and third second sections with recommendations for action, and then wrap up with some appendix material.

Acknowledgements

As in Phase 1, to enable all participants to speak freely, we have followed a policy of absolute confidentiality: no names of any individuals, dealerships, or car companies disclosed without their explicit permission.[1]

However, several contacts *did* agree to disclosure, and we would like to take the opportunity here to offer thanks to several firms and individuals that were of particular help to us. These include

- Scott Watkins, Anderson Economic Group
- Joe Magyar and Greg Dougherty, Crowe Horwath LLP
- Jeremy Anwyl and Lacey Plache, Edmunds.com
- Alan Haig and Erin Corrigan, The Presidio Group LLC.
- Stephen Kay, Cushman & Wakefield
- Dealership design expert John J. Buono, Senior
- Architect Simon Yu
- Ralph Idems and Chester Nizol, of Design Science and OmniPlan

A special note of thanks must go to Charles Seguin and Patrice Maltais in Canada. Patrice was our invaluable CADA liaison; Chuck is President of Seguin Advisory Services. These two selected, arranged, and participated in all our interviews right across Canada. In particular, Chuck's relationships within the Canadian industry, and knowledge of the Canadian dealership landscape were extremely helpful. For questions about this report, please contact Glenn Mercer for USA-specific issues (gmercer2@gmail.com) and Chuck Seguin for specifically Canadian questions (cs@seguinadvisory.ca). Readers who are also dealers can of course get in touch with their respective NADA or CADA representatives for more information about this project and its report.

Note that none of the opinions expressed in this report should be attributed directly to any particular one of these people. Of course, any errors in this report are not theirs, but my own. Also, please contact Glenn Mercer if you'd like to be put in touch with any of these experts.

I would also like to thank all the good people at NADA who assisted me in this work, and especially thank them for their patience with and confidence in me, as various issues forced me to delay the production of this report by over a month. And also, it is important to remind all our readers that the opinions expressed in this report are my own, and do not necessarily reflect those of the National Automobile Dealers Association.

Finally, my heartfelt thanks go out to the many dealers, architects, designers, attorneys, accountants, OEM personnel, appraisers, and others who gave generously of their time and insights to us. Though they remain nameless here, they know who they are, and they have the sincere thanks of both myself as author, and of NADA and CADA as project sponsors.

[1] Some names appear in an indirect sense: for example, our discussions of Apple and Tesla are based on public records, and *not* on any direct communications with personnel at those firms.

Executive Summary

This Phase 2 report is split across three main sections, following a recap of Phase 1's findings.

In the **first** section we briefly examine whether the facility image program issue is still as painful for dealers as it was in 2010 and 2011, and conclude that indeed it is not, in part because business conditions have improved. However, there is still great room for improvement (which is one reason we are writing this report), as dealers overall still give facility image programs only lukewarm support.

In the **second** section we revisit the ROI issue from Phase 1, this time including a wide range of individual dealership case studies so that we are working with even more data. As a result, we essentially reconfirm our Phase 1 findings, that expansion of the facility can pay off well, that modernization is somewhat harder to justify, and standardization (as we define it, which is replication of features from store to store far above and beyond logos and signage) seems to be of no benefit at all. But we add more color and detail to the story, pointing out that some spending provides lucrative returns (typically through the refurbishment of a totally run-down store), and that some maintenance spending should not be expected to yield any significant return at all, as it represents the "table stakes" that dealers need to spend just to stay in the business. We, as before, add insights from other retailing industries, pointing out in particular that some of these have been pretty good at developing the solid, quantified business cases for facility upgrades that we find are lacking among some – but not all – automotive OEMs. As a result, we repeat our request to the OEMs that they redouble their efforts to provide dealers with better business cases in conjunction with their requests for facility investments – and especially, to ease off on standardization demands that seem to us very hard to justify.

In the **third** section we break newer ground, in looking at "the dealership of the future" (DOF). This topic came onto the radar screen when dealers began to ask, "Even if the investments I am making today pay off over the next few years, am I building a store that will be obsolete soon after that?" These concerns emerged as all of us noticed turmoil in other retail sectors, such as the closing of Border's stores and the downsizing of Best Buy "big box" outlets. We cast our research net wide here, taking into account the past evolution of our industry, previous predictions about where it was headed, insights from consumer research broadly, interviews of dealers and other experts, and more. Our conclusion is that the dealership of 2025 or so will be an evolution of today's store – the dealership system will stay fundamentally intact – but with the possibility for much greater efficiency of operations through the use of innovations from the moving offsite of support functions to the use of new approaches to grow service volumes, and more. But we are very worried that the present trend to ever more-expensive and more-brand-customized stores will lead to excessive and wasteful spending, as dealers repeatedly "raze and rebuild" their facilities, as OEMs constantly update their brand campaigns. And meanwhile customer needs and behaviors continue to shift. Therefore we urge that OEMs and dealers alike get more *creative* in addressing those changing needs and behaviors (especially in the crucial area of service work), and that OEMs become more *flexible* in approving low-cost ways to implement these ideas. In particular, we urge movement toward lower-cost ways of reconfiguring stores: for example, using reprogrammable graphic displays and projections to reflect changes in brand campaigns can be a lot cheaper and less disruptive than continually jackhammering up floor tile and knocking down walls. If we

head this way, the Dealership of the Future in North America will be less of an overbuilt and expensive "Garage Mahal," and more of a right-sized model of retailing efficiency.

As before, there is no one-size-fits-all solution in these pages, but we hope that the information and opinions contained herein will assist both dealers and OEMS to, on the one hand, understand each other's points of view better, and on the other, to negotiate on a more informed basis the most efficient (low cost) and effective (high growth) way to invest in dealership facilities, for today and for tomorrow.

Main Findings

I. Phase 1 Recap

This chapter can be skipped by readers who have gone through the Phase 1 report. Please see that report (available on the NADA website, www.nada.org) for more details about the condensed version presented below.

Genesis. Our original 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. However, when in response to such concerns, NADA first began investigating factory facility programs, they 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 to 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 Phase 1 of this project. It was 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.

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 agreed 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 phase dealt with those details, about which there was much less agreement. The details we 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* of customer satisfaction. The required 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.

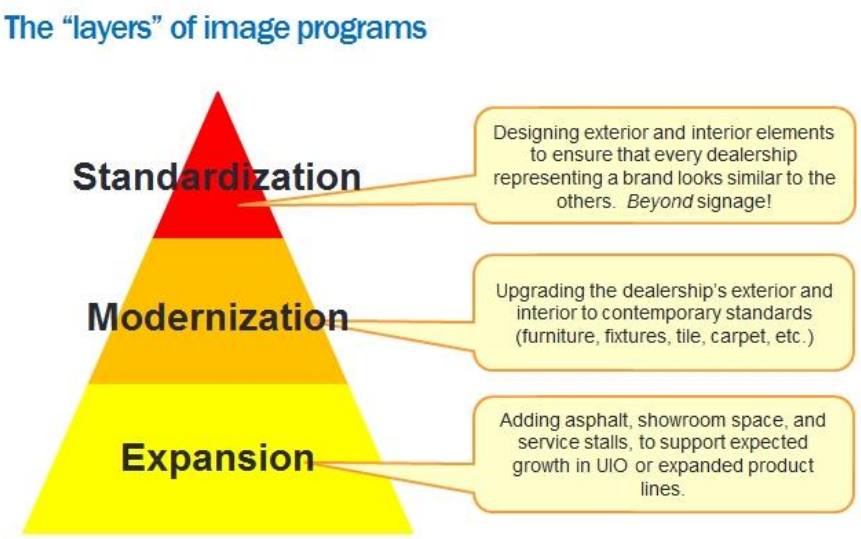
Caveat. It soon became clear that agreement on dealership facilities, virtually unanimous at a very high level, would be essentially impossible at the detailed level. There was no reasonable way for an industry-wide project to say that "The dealers want this…" or "The factories think this…" – there is 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 we did in our research uncover several areas where we thought there was real room for improvement, in program design and execution, that would benefit most participants in most situations.

Methodology. 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. In Phase 1, therefore, we 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 programs, including franchised restaurants and hotels. And, of course, we surveyed customers – car buyers – for their views. 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.

Overall Findings. We first identified 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. In summary, we found that 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 a three-layer analytical approach.

Findings by Layer: Definitions. 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 better 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 below.



Source: Phase 1 report

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:

- When an OEM and a dealer discuss adding things like 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.
- 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) or customer satisfaction.
- 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.[2] The goal of Standardization seems to be to somehow reinforce the 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.

Findings by Layer: Issues. The **Expansion** aspect of a facility program 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. But even though this was the least contentious of the three layers, there were four areas where it seemed that improvements could be made. In brief, we found OEM forecasts for expansion requirements first, were generally too high or too optimistic; and second, that they were too frequently changed to be useful planning guides; third, we saw that in planning expansion requirements OEMs often did not take into account capacity-boosting techniques such as 24/7 bay service bay operation; and fourth, when it came to *showroom* expansion we could not identify strong business cases as to how and why this would pay off.

The **Modernization** aspect of a facility program generated 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 led to the two areas where we see improvement can be made to the Modernization component of facility programs: 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; and 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.

Finally, we came to the **Standardization** layer of factory facility programs. This layer of spending generated 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

[2] 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.

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. The experts in particular were unenthusiastic: economists did not see how standardization made much sense in a car retailing environment; some marketing professionals were wary that standardization would make promises to consumers that could not be kept; and financial advisors saw spending on standardization as actually eroding dealership value. Perhaps the best summary of these negative views was, as one dealer put it: "Standardization costs are just the franchise tax I have to pay."

Cross-cutting Findings. 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 included:

- Timing: was now (2011/2012) 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?

For details of our findings in the first three of these areas, please see the Phase 1 report. The fourth area, renamed "Dealership of the Future," was considered to be important enough to revisit in real depth in the Phase 2 effort, and our findings about this topic are presented later on in this report.

Recommendations. We made several recommendations at the conclusion of Phase 1, with the three primary ones being these:

- 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.
- 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).
- All parties involved should move quickly to research and share their views of the dealership of the future, so as to avoid facility programs encouraging the building of stores that are quickly made obsolete, by evolution in consumer shopping and buying behavior. (This Phase 2 report represents an attempt – by NADA at least – to do its part in advancing this research.)

II. What Has Changed Since Phase 1 Completed?

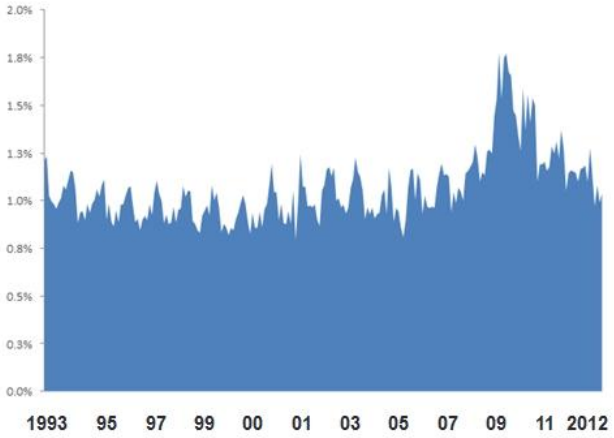
The importance of the factory facilities program issue for dealers is very significant, and accordingly, NADA has responded to their members' concerns about this issue with a variety of actions (including, for example lobbying meetings with OEMs, consultations with state dealer associations, etc. etc.). This report, in both its Phases 1 and 2, is another aspect of NADA's response. Additionally, NADA has recognized the importance of these issues by building them into the ongoing Dealer Attitude Survey

(DAS), which gathers dealer opinions on the industry's franchises, in order to help enhance dealer/manufacturer relationships. The first DAS to include questions on facility programs topics was run in mid-2012, and feedback from that has been provided to the appropriate dealerships and OEMs. In this section we will review briefly some of the relevant findings, although only at the industry level, since brand-specific results are only shared with the factories and dealers involved. Since this is the first DAS to contain these questions, we can't see *precisely* how dealer views about the image programs have changed since 2010 or so, but we can make some *genera*l observations based on our field work, combined with the DAS.

- First, and most surprising, we were impressed by the amount of confusion in the industry about factory image programs. For most franchises, dealers cannot figure out if an image program is currently active or not. That is, when we asked 100 dealers of Brand X if there was an active image program, 60 dealers might say "yes" and 30 might say "no," and 10 would be unsure. Obviously, there is an opportunity here for factory communications to improve.
- Second, and less of a surprise, we found that participation by dealers in programs varies widely: Asian and European brands saw roughly 75% of their stores in the process, one way or the other, in mid-2012; domestic American brands ran closer to 50%.
- Third, dealers seem mildly positive about the programs: on a 10-point approval scale all dealers averaged together came out at 6.5-7.0. This is not what one would call a sign of much enthusiasm, but it is broadly on the plus side of neutral. And in our opinion, this is a much more positive answer than we would have gotten if we had asked the question in 2010 or 2011.
- Fourth, there was a clear imbalance as regards dealer enthusiasm, and not just by brand: dealers who stated that they were participating in a program are slightly more positive about them (7.0-7.5), while dealers not participating are *much* more negative (4.0-5.0). In other words, those on board are only somewhat happy about it, and those not on board are *very* unhappy. The inference might be that dealers who were worried about a program before signing on are finding from actual experience that they are not as problematic as they might have feared.
- Fifth, a very short list of OEMs dominates the lower range of opinions. No OEM got a perfect score, but most did fairly well, with only a small number rated very unpopular.

Obviously, there is a great deal of room for improvement, but our "gut feel" is that dealer attitudes about image programs are somewhat more positive than they were in, say, late 2010. There are several reasons for this. First, steadily improving business conditions make the issue less painful: of course, it is easier to spend more money on the store if it is making more money. A proxy indicator for this is rent as a percent of sales, which is shown over time on the graph below.

RENT AND RENT EQUIVALENT AS % OF TOTAL SALES, 1993 to mid-2012



Source: NADA

While *absolute* dollars of rent per car (in part driven by image program investments) is higher than it has been – and we'll talk more about this later – the burden is *relatively* less than in 2009 to 2010, thanks to the recovery of sales. Other reasons for a slightly more positive attitude, we were told, include the simple fact of more and more dealers having gone through the programs. As more than a few dealers told us, their initial concerns receded as they actually went through the process: as one said "Let's face it, it was scarier when I did not know what would happen, and the reality was not so bad. Also, at some point, you just have to move on." And finally, some dealers told us that some OEMs were easing on a bit on their requirements, which is a positive step. However, other dealers told us of *tightening* requirements, as OEMs moved from a mode of "persuading everyone to join" to one of "picking off the stragglers." Therefore no one should assume the basic underlying issues of these programs have been resolved: there is still widespread dissatisfaction among the dealer base --which is one reason for this second phase of our work: the problem is not yet solved.

III. The Return on Investment in Dealership Facilities: New Findings

Since the problem was indeed not solved by our Phase 1 work, Phase 2 here revisits the issue. This time, as noted in the Introduction, we are focusing more on in-depth "bottom up" individual dealer case studies, rather than on Phase 1's broader but shallower "top down" process.

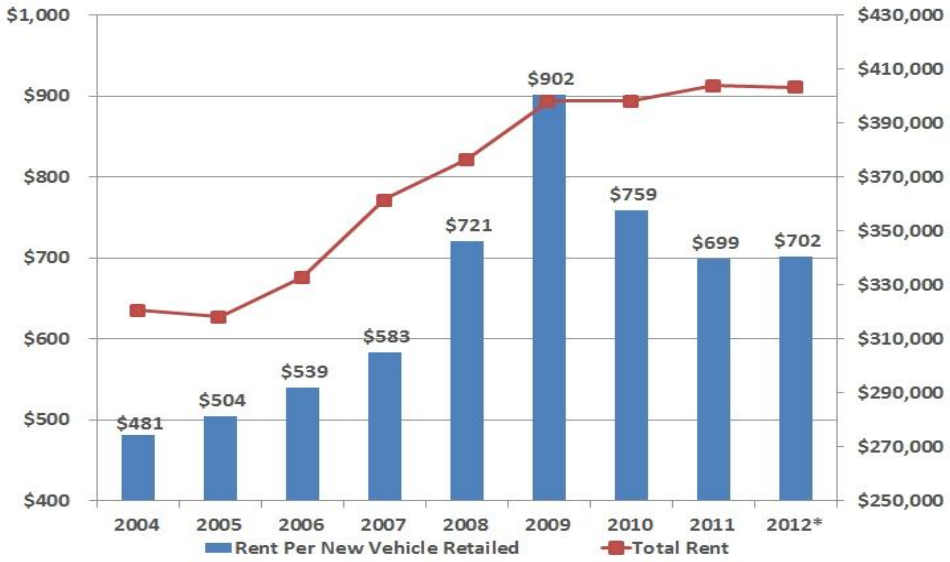
Before we get to the case studies, however, we'll add some new findings about the facilities investment challenge overall. First we'll look in more depth at the mechanics of the impact of facility upgrades on dealership economics, a topic raised in brief in Phase 1 and gone into in more depth here. Second, we will take another look at the impact on *customers* of facility improvements (also addressed, in a different way, in Phase 1). And finally, as we have done before, we'll try to see what we can learn from other retailing industries about appropriate levels of facility investments. With those three perspectives in mind, we'll summarize our case study findings and then go into detail on half a dozen of them,

followed by our summary of the ROI implications – and then recommendations for both OEMs and dealers alike as to what to do with these results.

How Big is the Problem? Dealer Perspective

While no one we know keeps good statistics on the actual amount of facility investments dealerships make in a given year, a review of dealers we sampled indicates the number is probably between $10 and $15 billion annually, between the USA and Canada. But the *total* amount is not as important as the impact of image program spending on the *individual* dealership. One way of estimating that impact is to look at average rent figures, as shown below:

AVERAGE RENT LEVELS FOR NADA DEALERS, 2004-2012



Source: NADA data analyzed by Erin Kerrigan, Presidio Group LLC

As we can see, both total rent (right scale) and rent per new vehicle retailed (left scale) grew throughout most of the last decade, as more and more OEMs executed more and more facility programs. (The spike upward in 2009 came not because facility investment rose, so much as because retail sales fell, raising the per-car rent burden, as we mentioned before .) In recent years the rent burden has leveled off, but it is still at historic highs. And given that new-car margins are at historic lows, the facility burden is still more painful than ever before. Furthermore, rent numbers don't tell the whole story: upgraded facilities almost always incur higher property taxes and higher insurance costs, and quite often trigger higher maintenance costs (e.g. when exotic exterior louvers replace plain walls) and sometimes even higher staff costs (e.g. if a second reception area is specified). In fact, rent per car sold today now probably matches or exceeds dealer advertising spend per car.

Another way to size the problem is to express the cost of facility investments in terms of the amount sales would have to grow to cover the capital outlay. The chart below shows how much annual revenue has to grow, by department, to just cover the cost of a $1,000,000 facility investment, assuming some typical gross margins and "cap rates" (which are effectively equivalent to the cost of borrowing to fund

the investment). One can immediately see why – as discussed in our first report – investment in service expansion causes so much less heartburn than showroom expansion, because service gross is so high. But a $1 million overhaul of a showroom requires an instant and constant "bump" in new-car sales of about 60 units annually (using $1.8 mm divided by a typical $30,000 retail price), an increase which all but a very few of our dealer case studies ever saw. And remember that these figures are the amounts needed just to *recover* the investment – not to earn any positive *return* on it. When a positive return on a showroom investment is looked for, almost all of our case studies failed to achieve this goal. In effect, while investment in service can pay off well (assuming the dealer can fill the new bays), investment in the new car department rarely does, leading most of our interviewees to call spending on the new-car showroom, as required by factory facility programs, a "franchise tax" – just spending required to be allowed to stay in business.

SALES GROWTH REQUIRED TO PAY OFF $1 MM INVESTMENT, BY DEPARTMENT

		New Car Department	Used Car Department	Service & Parts Department	All Departments
	Gross Margin	5%	13%	48%	15%
Cap Rates	8%	$1,600,000	$615,385	$166,667	$533,333
	9%	$1,800,000	$692,308	$187,500	$600,000
	10%	$2,000,000	$769,231	$208,333	$666,667

Source: Presidio Group LLC

How Big is the Problem? Customer Perspective

When it comes to investment in dealership facilities, in the long run the most important criterion is customer response. An upgraded store may be motivational for employees, it may please the local zoning commission, it can keep the factory happy, and it certainly can instill a feeling of pride in the dealer herself or himself. But if the investment doesn't change customer behavior – either by bringing in more customers, or by boosting close rates, or by improving customer willingness to pay more, or by improving service retention, etc. – all these other factors hardly matter.

And here is where there is a huge gap in the information available to dealers: we just do not know *in any reliable way* the linkage between a nice facility and customer shopping behavior. (Again, we must state that OEMs *may* know how to calculate this, but of the 12 we spoke to, only one provided hard data on the subject.) We cannot say, with any conviction, that a showroom that has gone 10 years since an

upgrade will draw fewer customers and sales than one that was redone 5 years ago, and if we think it does draw more customers, we cannot say how many.

In the face of this information vacuum, where dealers are asked to spend millions of dollars without really knowing how customers will respond, the industry turns to the only metric it has left: "customer satisfaction." There are several sources of satisfaction data, McGraw-Hill's J D Power division probably being the best known. Other sources include Foresight Research, Morpace, and more. These companies extensively survey customers , asking them everything from whether the service waiting area was comfortable to whether the salesperson made eye contact. And unfortunately, the conclusions they draw often diverge, in part because so much of a customer's response depends on how the question is asked.[3]

For example, a recent Foresight Research study we have seen shows "good dealership experience" as the 14th most important factor in selecting a car brand and model (with value, styling, brand reputation, mpg, etc. in the leading positions). Now, when it comes to selecting a particular dealership, *once the car brand and model is chosen*, then "comfortable dealership environment" rises to second place, behind "getting a good deal" and just ahead of "location." These findings would indicate that upgraded dealerships do very little to influence overall *brand* market share, but they do make a difference as to which *dealer* lands the final sale. But this means that spending on dealerships is essentially cannibalistic rather than conquesting: same-brand dealers stealing customers from each other rather than from rival-brand stores. And from what we have seen of this study, there is again no firm link between these ratings and actual behavior. That is, we can't connect "What the customer *said* she wanted" and "What the customer actually *did*."

As a second example, a Morpace report we have looked at, covering the same ground, shows that – once the brand and model are selected – customers are most influenced in choice of dealership by deal offering (a score of 40), positive prior experience with the store (20), referral by friends or family (10), inventory available (10), personal service offered (9), convenient location (5), and only then store environment (2). These findings are quite different from Foresight's, but even leaving that aside, again – as far as we have seen – there is no explicit connection between expressed customer *opinion* and actual *behavior*.

(For an example of how one industry does link store investment to actual customer behavior, see the section in this report on fast-food drive-through times.)

We remain deeply skeptical of customer satisfaction metrics as robust indicators of facility investment ROI. As one executive put it to me, bluntly and clearly:

"If customer satisfaction drove customer behavior, no airplane would ever take off."

---

[3] For example, we can all recall the raging debate about "no-haggle pricing" a few years back, in which lots of contradictory assertions flew around, in part for this very reason. Customers who were asked if they wanted to "Buy a car with no tedious arguing and haggling, in a no-pressure and transparent environment" would generally say *yes* to no-haggle pricing. But if asked if they wanted to "Buy a car with no ability to be sure of getting the best price, in a take-it-or-leave-it setting," they would generally say *no*. The result was mass confusion.

That is, airline passengers (in the USA at least) almost as a matter of faith complain endlessly and loudly about their dissatisfaction with the service they receive – and then continue to buy about 725 *million* tickets annually[4] . In this case, the link between satisfaction and behavior seems non-existent. We are not arguing that satisfaction is not crucial for success in the world of car retailing: annoy enough people often enough and eventually you will be out of business. But we repeat that we need a better argument for spending $1, $5, or $10 million dollars on a facility than "customer satisfaction will go up." We need to understand how an increase in satisfaction drives sales and margins – and why spending the extra $1 million on the store leads to a better result than spending the same amount on salesforce training, or website improvements, or advertising, or sales incentives, etc.

How Big is the Problem? Perspective from Other Retail Industries

Automotive retailing is not entirely like any other form of retailing, but it is similar to other retailing sectors in some ways. Furniture stores often offer financing; computer stores sell very complex products; supermarkets can require large facilities and extensive real estate; etc. etc. Given these partial similarities, can we learn from these other sectors as regards their levels of capital expenditures on facilities, furniture, fixtures, equipment, etc.? A well-known source for comparable financial data across industry types is the Risk Management Association, whose comparative financial statement studies compare the balance sheets and income statements of many thousands of small- and medium-sized businesses. We've selected seven types of retail stores to compare to dealerships, in each case looking at the scale of their annual depreciation and amortization (D&A) charges, in relation to their levels of total assets, net fixed assets, and gross profits. (We've used the results of the average store in each sector, averaged over the last five years.) Obviously the D&A charge doesn't precisely equal the amount of capital expenditures (capex) in any given year, but over time the two should approximately track each other. And in any case, there seems to be no reliable source of comparable capex spending amounts. Finally, the D&A line leaves out the cost of land, which is significant for dealerships (as well as for a few other retail types), but as land is not typically depreciated, there is no option to include it

Comparing D&A Spending by Retail Sector

D&A Metrics	Fast Food	Super-markets	Furniture	Electronics	Women's Clothing	Computers	Dept. Stores	Car Dealers*
D&A / Gross Margin	5%	4	2	2	3	2	3	2
D&A / Total Assets	9%	5	3	2	3	2	3	1
D&A / Net Fixed Assets	18%	15	14	16	17	16	13	11

* Adjusted by bringing inventory from 60% of total assets to 40%, a level more typical of other retailers
Source: Risk Management Association for raw data, plus author's calculations.

[4] FAA data

What can we learn from these comparisons? Given the enormous variety of the stores represented in this table, and significant differences in accounting treatments, it is dangerous to read too much into the figures. There are a few outliers one can comment on: for example, fast food restaurant D&A is high relative to total assets primarily because these stores carry almost no inventory at all, shrinking their asset base. (This is in stark distinction to car dealers, who lead all these retail sectors in terms of the massive size of their inventories, which – since they are financed by floorplan loans – we've adjusted to more typical levels for the sake of this comparative chart.) One observation we can make, however: it cannot be argued, based on these numbers at least, that the average car dealer is spending *more* on capital improvements than the average retailer. That doesn't mean that dealers *should* spend more – facilities investments should be driven by the needs of the particular retail environment – but it is hard to show that dealers are under a disproportionately heavier burden than their fellow retailers in other fields. And this comparison does give some ammunition to retailing experts we interviewed, who asserted that dealerships, historically at least, had tended to under-invest in their stores. Many OEMs would agree with this perspective as well, which may be why they are pushing so hard for upgrades and renovations today.

What are Actual Dealers' Experiences? The Case Studies

So, what we have learned so far (building on the findings from Phase 1), is that the burden of image-program-driven facility investments is significant for dealers; and that as far as we can tell the impact on actual customer behavior is minimal (beyond keeping the store clean, modern, and generally aligned with brand values). Because it is so difficult to calculate the ROI on these investments, in Phase 1 we turned first to the OEMs for their input, feeling that they would have the data points and the analytical horsepower to run the ROI numbers. As that effort to a large extent failed, we have turned the process around for Phase 2. Instead of starting top-down, from the OEMs to the dealers, we in this Phase went bottom-up, hoping by accumulating two dozen or so in-depth case studies, we could deduce some better answers.

The exhibit below lists our cases, which covered public and private stores, American and Canadian locations, single-points and large groups, high-line and volume brands, domestic and foreign brands, and rural and urban locations. We realize that we cannot extrapolate from these few cases to make conclusions for every dealer in Canada and the USA, but to the extent a dealer looking at these cases recognizes his or her own situation, there may be valuable insights to extract. Below the overall list we go into more depth with six individual cases, and then attempt to combine all this information into some guidelines about expected return on investment, by type of facility upgrade.

THE PHASE 2 CASE STUDIES

Dealer Case	Investment	Results	Comments
Rural European	$1,000,000	Gave up franchise to avoid the investment	Investment breakeven would require 15 years or more
Public chain	n/a	Modernizations fail our 9% ROI hurdle; service expansions generally clear it	Showroom expansions or upgrades pay only via factory bonus or allocation
Small-town Asian	$700,000	No improvement in sales or margins	Significant business disruption
Rural Domestic	$600,000	No improvement in sales or margins	"Entirely paid for by OEM, so why not?"
Dealer appraiser	n/a	Building <10 years old, recover 30% Building >10 years old, recover 75%	General estimates; value declines further if store highly brand-distinctive
Metro European	$2,800,000	Slight uptick in sales	Condition of buy/sell
Suburban Asian	"several million"	5% ROI w/o process changes; with, closer to 25%	Executed complete overhaul of all service processes, absorption >120%
Rural Domestic	$400,000	No change but not a major cost for us	Needed to retain the point
Urban Asian	$3,000,000	Sales almost doubled	"Increase due to process changes, not to facility upgrade"
Rural Domestic	"over a million"	No observable change…	… but "had to be done:" aging facility
Rural Domestic	$500,000	Sales up 5x, market share leapt up	"Store was completely run-down, a real dump, customers actively avoided it."
Suburban Domestic	$1,000,000	No visible impact but needed it	Elderly store
Suburban European	$10,000,000	Had to keep up with the competition, but my bottom line is unchanged.	"This is the last gigantic concrete box I will ever build!"
Urban Asian	$3,200,000	Complete overhaul, no impact….	… but it may be too soon to tell
Urban Asian	$2,500,000	No impact	"Now we're overbuilt, we have no idea when we will ever fill this store!"
Suburban Domestic	$1,000,000	Redid façade, for no gain	Had to do it to get sale approved
Suburban Domestic	$5,000,000	Revenues and margins soared	Elderly store in great location, big gains in sales and service now
Suburban Domestic	$3,500,000	Combined two stores: result is underperforming the prior two	Sales down but service up, CSI has improved. Overbuilt.
Rural European	$1,000,000	Complete deadweight loss	Huge expense just to increase showroom capacity by one car!
Suburban Asian	$2,500,000	No impact at all (very value-conscious buyers of this brand)	"My own fault, I let my ego dictate what to build. Looks great, no ROI!"
Urban Domestic	$1,200,000	No measurable impact yet	Done in anticipation of re-launch of this established name; fingers crossed
Private group	n/a	Modernizations show no impact on ROI; service expansions do	"Modernizations beyond our own regular upgrades do not pay off."
Rural Domestic	$1,300,000	No change, store needed it though	Did it to win new point approval
Suburban Asian	$3,000,000	No sales or margin impact	Growing brand, wanted to keep it
Metro Asian	"over $20,000,000"	No sales impact, service volumes up, rent tripled, bottom line unchanged	"We did this just as the brand cratered. It will never pay off."
Rural Domestic	$1,000,000	Minor margin improvement as replaced debt with cheaper debt	"Had to do it to stay in the game, OEM would have yanked the point."
Suburban European	$2,000,000	Gave up franchise to avoid the investment	Factory would not guarantee me I would not have to do it again in 3-5 years.

Six Cases in More Detail

Case Study 1: A Small Chain of Metro Stores

Three mid-range brands, both domestic and import, plus a European premium brand, make up this chain's portfolio. The dealer's experience with facility programs has not been positive. Taking each brand in turn, she told us:

- European premium brand: "I sold this store rather than go through another upgrade, primarily because the factory just could not commit to me how long it would be before I'd have to do it all over again. The first time through they covered about 2/3 of the cost of the 'Taj Mahal' they wanted me to build, and I went along with it. Now they want to do it again, for more money and less assistance, and with no assurance how long it will last. It's a good brand, but I am tired of changing from a round store to a square one and then back to round, from one color scheme to another and then back again. The customers don't even notice and my costs soar."
- Domestic mass-market brand: "I see the need for this overhaul, but the cost relative to my volume doesn't pencil out. I will drag my feet as long as possible, and bail if they push it."
- Import mass-market brand A: "I spent $2.5 million on this overhaul, and it did not budge my economics at all. Mostly wasted. But this one was my own fault: I got excited, got my ego involved, and overspent. The value-conscious buyers of this brand just do not care about facilities. I learned my lesson, but it was not the factory's fault."
- Import mass-market brand B: "This store is the poster child for the saying that 'Bricks and mortar do not sell cars." This old, tiny, and cramped store looks like a Buy-Here-Pay-Here used-car lot… and it is by far my most profitable. The buyers of this brand are sort of a cult following, I think they even *enjoy* how run-down the place is. The OEM will yank my deal if I don't put in about $3 million, and I will do it, but it hurts. Meanwhile, believe it or not, the local community board *likes* the old place, and is trying to block my modern rebuild!"

Key points:

- This dealer found facility return on investment to be very low… especially if an upgrade had to be torn out and redone soon after (causing her to actually exit one franchise to avoid this)
- Overbuilding can be the dealer's fault – often due to ego – as much as it can be the OEM's.

Case Study 2: A Large Chain of Stores

This particular large group of dealerships, representing multiple brands, has mixed but mostly negative experiences with facility programs. Taking programs by the three layers we've discussed, they see standardization as destroying value, modernization as usually not worth the spending, and expansions as typically generating a positive ROI: but only thanks to bonuses or allocations paid for by the OEM. In their view, standardization *hurts* the value of stores, by making the building less useful for any other use or brand: "A highly standardized facility, highly customized to a particular brand's image, is a store that we can usually not sell unless it is razed and rebuilt. Just too expensive to modify for another use or even another car brand." Modernizations are – in this group's view – only slightly better investments, in that "90% of them we would not do at all – the remaining 10% are justified because the store is just too old and run down." The reason for avoiding 90% of image upgrades?: "We have never seen an uptick in price, margin, volume, or CSI resulting from such an investment." Again, the only payback seen here is from the factory's allocation or cash bonus. Expansions are the most likely to pay off, though only in the service area (e.g. by adding bays). In fact, this group was negative about most investments in the showroom area. "I can't recall ever getting a negative comment from a customer about a showroom – but they certainly speak up about the service waiting area. I think investments in showrooms, especially as we move more and more of the sales process online, are not driven so much by economics

but by ego, either that of the dealer or of the factory: we need to spend more on the service area, and less in the sales area."

Key points:

- Negative ROI in standardization, modernizations a wash, expansions can pay out…
- …but positive results are due more to OEM payments rather than to underlying economics.
- Investment in service is more attractive than investment in sales

Case Study 3: Multi-Point Rural Dealer

This dealer has broadly positive experiences with two renovations, one mostly covered by OEM bonus payments, and one done without OEM help. In the first case, a domestic-brand store, the factory's bonus payments look set to cover 100% of his construction costs, so the dealer is quite pleased. As to the debate as to whether such payments are true incremental payments, or just front-end margin shuffled to the back end, his comment is "Look, the money is real, or at least as real as it gets. And back-end payments are more reliable than whatever I can keep of front-end margin." When pressed as to the true underlying economics of the program, this dealer figured it cost twice as much as what he would have spent on his own, but that he still would have done it (though maybe delayed it a year or two), as he has seen his local market share climb, and his fixed operations coverage rise as well. The implication thus is a positive underlying ROI, but probably at half the level that he might have achieved on his own.

His second store – also a domestic brand -- was renovated without factory help, and results here were even more positive, as the previous owner had not invested in the facilities for a couple of decades, and the building was in terrible shape. The situation was so dire that, when the overhaul was completed, a common comment from customers were "I didn't even realize this was a dealership before!" Sales have since soared, as the store moved from last place among local same-brand stores, to first place. The ROI was thus spectacularly positive. Even so, the dealer estimated that the project cost was twice what it should have been, in order to meet factory standards. As he put it, "In a rural area, the pace of life is a bit slower, and so I see much less return on things like quick-service lanes, waiting-area Wi-Fi, etc. But perhaps that will change."

Key points:

- There are potentially huge returns to overhauling a completed run-down or dilapidated store.
- Whether a program is needed or not, excessive OEM standards typically greatly increase costs.

Case Study 4: Single-Point Large Suburban Dealer

This large suburban import dealer does not argue with the basic thrust of image programs, in that dealerships must be kept up to modern standards, but sees their typical focus on how the store looks and feels as misguided. In his view, the basic processes underlying a dealership's operations are rapidly shifting, yet the building designs are not keeping up. "The ROI on image programs on their own, I have calculated, is perhaps 5%... you might as well put your money in a savings bond. It is only when you use the opportunity of a program or a relocation to make major improvements in your store's processes that you can see a real payoff. Given the changes I have made, and the added revenue and margin they have earned me, I would say a 25% return is very achievable." What are some of the changes this dealer

made? Years ago he moved the body shop off-site to free up space for more valuable uses (and subcontracted its operations to a specialist firm). Then he added quite a few service bays…. But at an off-site quick-service facility. His own research showed that his customers were most dissatisfied with waiting for service, so he laid out his quick-service processes and systems for ultra-high throughput. Fixed coverage is now well over 100%. The next step, he hopes, is to split all the remaining service area away from the sales area. "With more and more of our sales process online, we can use a much smaller showroom and move it to an expensive higher-traffic location. Maybe the original store just becomes a fulfillment center."

Key points:

- There is no significant payoff to just modernizing and standardizing the store…
- …but if a dealer takes the opportunity of the upgrade process to revise sales and services processes (and to redesign the physical facility to match), profits can really soar.

Case Study 5: Single-point Rural Dealer

This rural domestic-brand dealer emphasized a different aspect of compliance with OEM image programs. The actual impact of his renovations was pretty minimal but positive: "My customers already know me well, and were pleased but did not necessarily change their shopping patterns; let's face it, my 'frontage' is on the internet now… no one really needs to see my store to know what I have in stock or how I price it. Half my sales are from outside my area anyway: people only see the store when they come in to sign the deal. Employee morale is up, which is nice: they have stepped up and given more, with an improvement in their surroundings." More crucial in this dealer's view, than the modestly positive economics of the investment, was how he managed to fund them. The OEM kicked in perhaps 15% of the cost, but a very-low-rate 20-year SBA loan covered half of the rest, and a local bank's 'economic development' loan provided most of the remainder. As an added benefit, the raised cap on section 179 depreciation, and the special depreciation allowance acceleration on the rest of the spend slashed his tax liabilities. While these special provisions may not always be available, when they are, they can be major. The low current cost of debt is especially helpful to smaller dealers, who may just not have the liquidity necessary to make upgrade investments – even if their overall balance sheet is strong enough to support them.

Key points:

- Minimal measurable impact from the upgrade program, though both employees and customers were pleased… and the store was old enough that it needed to be done.
- But investment economics can turn from negative to neutral or positive if a dealer and his or her CFO can be very savvy about subsidized loans and local state and Federal tax incentives. "Don't just listen to your CPA: we found breaks even he didn't know about!"

Case Study 6: A Medium-Sized Private Chain of Stores

This dealer has a dozen or so stores, covering numerous brands, in a mid-sized city that is surrounded by a very rural market (dominated by farming). Taking into account all the various brands he deals with, his experience with image or upgrade programs is that they are a "franchise tax:" that is, the only ROI on these investments (above and beyond his own steady maintenance and modernization efforts) is that he

gets to stay in business. This is a positive number, but one he has never calculated. "There is no positive payoff, but there is a negative one if I do not act: the factory comes after me." Admittedly, his market is characterized by consumers with strong roots in the agricultural and natural resources industries, so that they may be less impressed by fancy showrooms than consumers in a different setting, such as the New York metro area. He also made the point to us that overhauls and improvements come with many hidden costs, or costs that many dealers and factories don't take into account sufficiently before investing. Above and beyond higher rent factors (or debt service), there is usual more tax to pay, usually more insurance coverage to order, often more maintenance if the façade is redone with some exotic material or with louvers, disruption of business during construction… and sometimes even more staff required.[5] "Dealers should take all this into account when deciding what to do: it is much more than looking at construction costs and the offsetting OEM payments."

Key points:

- If a dealer steadily maintains and renovates his or her own stores – on which only a minimal or zero short-run ROI should be expected -- factory image programs above and beyond this level do not seem to pay out. They are "Just a franchise fee, except I pay it to contractors rather than to the OEM."
- Any analysis of facility upgrade ROI must include hidden or secondary costs that many dealers and OEMs overlook when running their numbers.

Finding an Answer: the Financial Theory Perspective

The summary chart of dealer experiences with facility investments, and the selected detailed case studies, go a long way toward telling us what the apparent ROI of these investments is, and the simple answer so far is "not much." In the case of most of the examples we studied, dealers were unable to calculate any particular sales or service revenue or margin gains, with two major exceptions. The first exception was for completely run-down or dilapidated stores. Typically, these were situations where Dealer A purchased a store from Dealer B, who for many years had failed to invest sufficiently in the facility to keep it clean, modern, and comfortable. In these situations new investment by Dealer A could radically turn around results, leading to ROIs of 30% or even higher. The other exception was for service expansion, although it was by no means always the case that adding bays or stalls would pay off. But given the relatively low cost of adding a bay, and the very high margins on parts and labor, more often than not service expansion could generate good returns. (Although these returns were by no means guaranteed: dealers know "build it [a service bay] and they will come" does not hold true – effort has to be expended to drive the incremental service traffic, unless the service area is so backed up that appointment backlogs are enormous.)

Leaving aside these exceptions, we mostly see inadequate returns on investment in image programs[6].

---

[5] For example, splitting a showroom between two brands of the same OEM may require adding a second receptionist.

[6] Again, if such returns exist, we respectfully ask OEMs to show us the numerical evidence. Of the 12 we spoke with in Phase 1, only one factory provided hard, documented evidence of actual returns to dealers of their factory image programs.

This brings us to a real puzzle: if dealers do not see adequate returns on factory image programs, why do they participate? If the programs are truly voluntary, as the OEMs say they are, then a dealer can choose not to join in; if the programs are effectively compulsory, then a dealer can sell the store and exit the business – allowing her or him to invest the proceeds in some more attractive venture.

But dealers generally, on average, do go along with the programs, admittedly while trying to reduce their burden, by delaying expenditures, negotiating with OEMs for reduced spending, and even in some cases investigating legislative and judicial relief. Why would a dealer invest $500,000 or $5,000,000 for zero return? The usual answers to this question run along these lines:

- "I have to, if I want to remain a dealer."
- "It's just a cost of doing business."
- "I have to if I want to stay in the game, get cars, get bonuses."
- "If I don't do it the factory will come after me; I have to stay on their good side."
- "It's a franchise tax: I have to pay or get out."
- &tc.

What these all boil down to is an admission that there IS a return on investment to these programs, but it does not come in the form of growing *future* revenue or profits, but only in being allowed to continue generating *today's* sales and profits. How does one calculate that return? We talked to several accountants and finance professors about this, and the answer is pretty murky. A fictional example might help, though we'll make it an unrealistic case just to make the point clearly:

> Supposing a dealership is worth $5,000,000, cash. Suppose the OEM comes up with an image program that requires only a $10 investment, in a new potted plant for the showroom. If the dealer does not comply, she will lose the franchise. The decision is obvious: to protect the $5,000,000 investment, she will spend the $10. The return on the $10 spending is almost infinite – a true "no brainer." Now suppose that the program requires a $10,000,000 investment instead: a complete rebuilding of the store in the finest marble and granite. Again we have a "no brainer:" spending $10,000,000 to protect $5,000,000 is foolish, and the ROI massively negative.

The problem is, virtually every image program's requirements fall *between* these two (admittedly foolish) extremes. So what is the ROI of an investment that may have no return in itself (e.g. by boosting sales) but is does permit the dealer to keep earning a return on the dealership overall, by allowing him or her to stay in the game.

We talked to accountants and finance professors and professionals for their views on this puzzle, and they confirmed that an accurate answer was virtually impossible. There is a "sweet spot" between the $10 plant and the $10,000,000 "Taj Mahal," but there is no easy way to find it, especially a spot that will work for every dealer in every case.

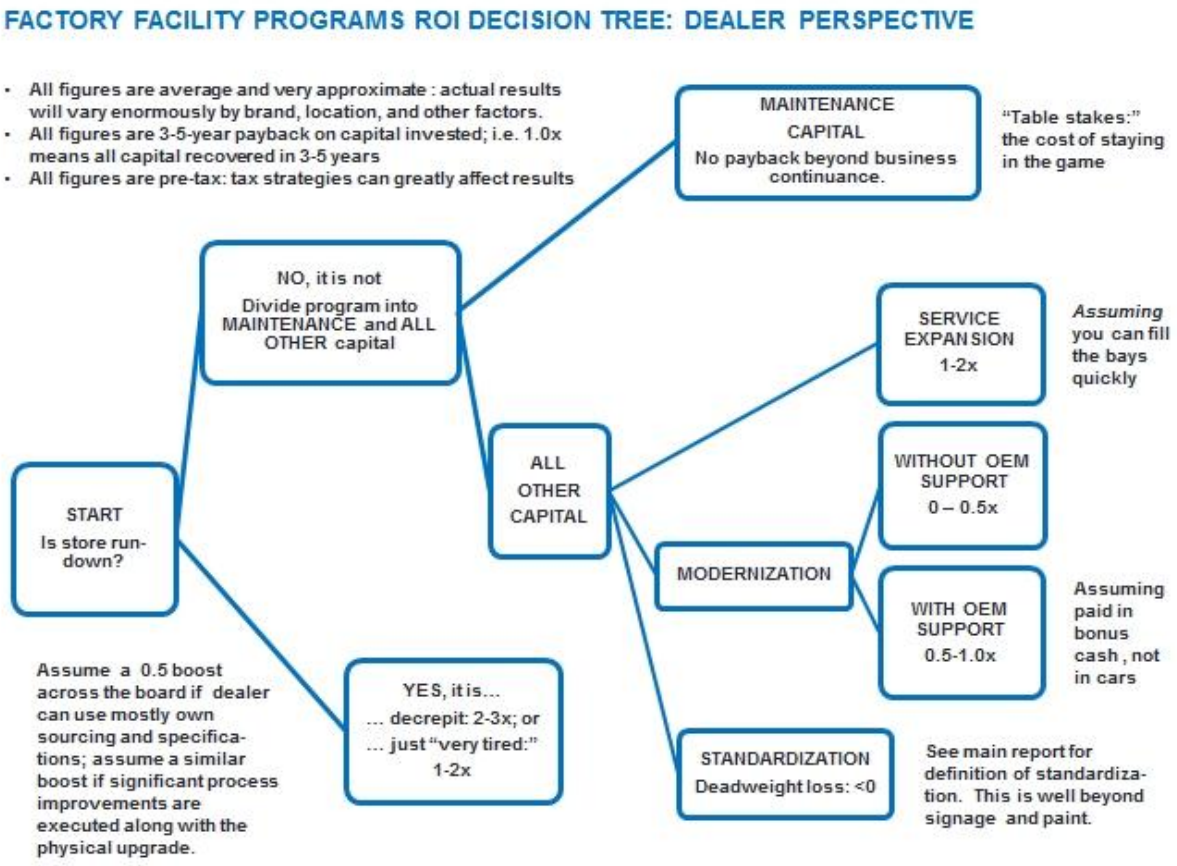
We suggest (as several dealers told us) the best – if very rough -- resolution is to divide requested program spending into maintenance capital and then everything else. Maintenance capital is the

investment a dealer estimates is necessary to stay in the game, to continue in business. This includes repairs to facilities, repainting scuffed walls, updating IT systems, replacing worn carpet and furniture, updating aging graphics, etc. On this capital virtually no return at all should be expected: these are table stakes. For all the other capital, the return to be expected depends on the nature of the investment, from high-payoff service expansion (assuming you can fill the bays) to zero-payoff standardization investments (replacing unworn floor tile that was approved by the factory three years ago, just because the OEM has proposed a new standard tile color for all its stores worldwide). The chart in the next section gives some guidelines for expected returns on these "above and beyond" investments, in terms of years required to pay them back.

A final comment. While a precise answer to this question in not known, what *is* known, according to the experts, is that if image programs continue to generate inadequate returns, investment will flow out of the industry. Dealers will make their investment decisions as they come up, and if as a result rent factors continue to rise while profits do not, dealership valuations will fall, and capital will exit the business, as dealer principals look elsewhere for attractive returns on their money. At some point dealers will be unable to afford image programs of any kind. This point was made to us in our field interviews, especially by premium-brand dealers, who are required ("requested") to spend the most money. More than a few of these business people warned that, especially as interest rates began their inevitable climb, premium dealership balance sheets, burdened by expensive facilities, would crumple under the strain, and owners sell and exit.

Summing It All Up

We've cast our net pretty wide, over a two-year period, trying to answer the question "What is the payoff to a dealer from investing in factory-requested image upgrade programs?" We've talked to over one hundred dealers of all sizes and shapes, to appraisers, lenders, accountants, buy/sell advisors, architects, designers, OEMs, academics, and all sorts of experts inside and outside our industry. In this particular report we've looked at the impact on dealership valuation (mixed, to say the least), the impact on customers (hard to discern), benchmarks from other retail industries (generally similar or higher levels of spend), financial theory, and of course, the multiple case studies. If we boil all this down, we do not, as we also stated at the very beginning of Phase 1, find a "magic bullet" formula that works for all dealers at all times. We'll probably never know how to figure out the payback of putting in just one more coffee machine in the service waiting area, or of bumping the showroom ceiling height five more feet. But we do have general guidelines, and these are shown in the summary chart below.



It's a complicated chart, but this is a complicated decision. Let's walk through it. Start at the far left: you've been asked by your OEM to invest $X million in the store.

1. Begin with an honest self-assessment: is the store very run-down? If you have been doing nothing more in the last two decades than slapping on a coat of paint every few years, the store will need major work – and the payoff on that work may be great. The biggest returns on investment in all our interviews (sometimes reaching 2 or 3 times your money back in just a few years) came when dealers told us they had taken a dilapidated store and totally transformed it: often in a buy-sell situation.
2. If the store is not run-down, if it is in basically sound shape, try to assess how much of the requested spending falls into the maintenance category. If your service waiting area is well-maintained but the TV is indeed six years old and only 32" in size – well, time to update. On these kinds of spending no significant return can be expected: these are the "table stakes" discussed in the Financial Theory section.
3. But what is left now is all the *other* spending, and this is where most of the contention and struggle lie. There are three sub-categories here:
    a. Is this spending for service **expansion**? If so, expect to get back all your money or more, in a few years – assuming the local market will absorb the capacity (which, more often

than not, it will), and assuming you have already persuaded the OEM to let you use cheaper expansion techniques, such as extending operating hours.

b. Is this spending for **modernization**? Again, we now mean above and beyond maintenance: this category might include – to stay with our TV example – replacing the perfectly fine LCD TV with an equally fine but more modern LED TV: it is an upgrade, but one customers would hardly notice. In this category we saw the most diverse results, mostly depending on how much assistance the OEM would offer. In some cases the cash payments equaled the investment, which means a full payback. Generally, however, assistance levels were lower and the payback less than full. Dealers should, in these cases, ask to see clearly quantified economics from their factories, that explain just how a particular change will help business. And the explanation should be as quantified as possible (see our fast-food waiting time example), not based on vagaries such as "the customer will love it!"

c. Is this spending **standardization**? To use the TV analogy one last time, are you being asked to switch from model year 2012 LED TV Brand Acme to model year 2012 LED TV Brand Apex, just because it is the standard for the car brand? In this case, as we discussed in Phase 1 and again in Phase 2, we have not been able to find *any* solid argument as to how this spending pays off, ever, for the dealer (above and beyond branding basics such as logos, signage, outside color of the store, etc.). This is where dealers should push back hardest, as if there is any benefit to this spending, it is all to the OEM rather than to the dealer.[7]

We note that payback can be improved significantly in all cases, if on the one hand OEM standards can be relaxed enough to enable cost savings (as many OEMs do in fact do) or if on the other, dealership processes can be changed at the same time as the upgrade investment, to improve operational results (e.g. using the expansion of a service facility as a chance to add a high-speed express lane, if the local market demands it).

Boiling it all down to one sentence: "Renovating a dilapidated store pays off, and while one should not expect much of a return from maintenance spending, service expansion can pay off well, whereas modernization investments tend to depend on how much assistance the OEM offers, and standardization spending is almost always a pure deadweight loss." And as we have said before, if our conclusions about these returns are incorrect, we would welcome OEMs to show dealers clear and quantified numbers that show otherwise. To date, only one OEM has provided us such evidence.

[7] And as we have argued before, it is not even clear what benefit there is to the OEM, to standardize stores in Moscow to look the same as they do in Mumbai or Minneapolis. We repeatedly asked OEM executives the question: "When you propose investing $1 billion in global dealership format standardization, how do you calculate the return on this spending?" – and we never received a good answer. Answers ranged from "It cannot be calculated" to "We never tried to calculate it" to "We just know it is right." Given that OEMs can keep track of spending on things like warranty reimbursement or lease subvention down to the last Euro cent, yen, or penny, we remain deeply unconvinced that there is a sound economic argument for making all dealerships look alike, but that this is rather a matter of corporate ego or a tool for eliminating dealer personal identities from the equation.

Are the Answers Different in Canada?

Readers will notice that in this report we have not identified Canadian as opposed to American dealership case studies (in fact, two of the six cases discussed in detail are Canadian). This is because, in our joint work with NADA and CADA, it became clear that all the issues that dealers and factories face as regards facility upgrades are similar on both sides of the border. However, based on discussions with CADA personnel, we thought it was important to point out three general and one particular difference between the two countries, as regards how the dealership systems are set up and run. The three *general* differences are legal, contractual, and procedural.

1. In terms of legal differences, most Canadian provinces (as opposed to American states, with their automotive-specific franchise laws) do not have a large body of local franchise regulation, though the local (provincial franchise laws) do exist in five provinces. These franchise laws while focusing primarily on the disclosure obligations between a franchisor and franchisee also contain other obligations such as a duty of good faith and fair dealing which can be of assistance to dealers. There are provincial-level Motor Vehicle Dealers Acts, which address matters of licensing and consumer protection, for example. As well, most provinces also have independent consumer protection and sales of goods legislation. Perhaps most striking to readers in the USA is the fact that in Canada direct ownership of a dealership by an OEM is significantly easier and more common on the north side of the border than on the south. Whereas in the USA factory ownership tends to be very rare and in many cases temporary, in Canada, while by no means widespread, it is not uncommon and tends to be more permanent. Another interesting difference between Canada and the United States is that dualling is practically non-existent in Canada compared to its prevalence in the United States.
2. As for contractual differences, these are fairly modest, in that American and Canadian dealer/factory agreements tend to be similar – but generally, there are fewer constraints on the OEMs in Canada.
3. Speaking of procedures, most OEMs and dealers in Canada (though not all) are signatories to the National Automobile Dealer Arbitration Program (NADAP), a private mediation and arbitration program, which is where most disputes between dealers and OEMs are settled. It is safe to say that, because NADAP exists, in Canada there is less resort to traditional public court litigation – by both dealers and factories – than in the USA, whether over facility or other matters.

In summary, it is safe to say that in Canada dealers are less protected from factory initiatives than in the USA – but also that the atmosphere is significantly less adversarial, as well. And indeed, our survey of Canadian dealers indicated a different tone to factory relations: a dealer in Canada faced with an onerous image program seemed to us more likely to sell the store in question, whereas in the USA there was more of a tendency to "stand and fight."[8]

[8] We are not taking a position that either the Canadian or American approach is superior or inferior, only noting the differences. Also, as the author of this report is not a licensed attorney, I am making comments on legal matters only as an observer, not as an expert.

The *particular* difference between the two countries is that OEMs are certainly at liberty to offer different image program terms in each nation. We were struck by how different program terms were – in some cases – between the two countries, even though their automotive market environments were broadly similar.

Do Other Retail Industries Better Understand Facility ROI?

In carrying out this project, we interviewed experts in other retail industries, in order to determine how they evaluated investments in facilities and stores. While it is true that no other retailing industry is quite like automotive, there is still a lot to be learned. In particular, we were impressed by how much scientific rigor some other industries bring to the investment decision – and we would encourage similar rigor to be applied in the world of car retailing. The fast-food industry in particular is very much driven by hard data and performance metrics. For example, the industry has an intense focus on drive-through waiting times, since a given restaurant's profitability is often completely dependent on take-out business, and take-out customers are extremely sensitive to waiting times in the drive-through lane. In fact, "There is an industry maxim that for every seven-second reduction in total service time, sales will increase by 1% over time."[9] The table below shows how precisely this industry measures wait times… no rounding to the nearest second! These times are seconds elapsed between entering the drive-through lane and receipt of one's order.

2011 Drive-Thru Study: Historical Speed of Service

The benchmark group includes the top six performers over the life of the study—Burger King, Chick-fil-A, Krystal, McDonald's, Taco Bell, and Wendy's—plus a regional chain that has also performed well historically. This year that chain is Del Taco, although *QSR* and Insula will rotate that selection in future years. Below are the historical performances of the benchmark group.

Chain	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Burger King	178.45	171.33	178.2	162.22	173.37	160.52	173.19	166.1	166	179.9	153.06	166.65
Chick-fil-A	219.39	198.81	194.8	167.21	150.57	146.38	163.74	168.6	191.9	194.3	175.01	167.59
Del Taco	192.42	173.79	201.41	191.56	185.32	208.88	213.31	209.3	232.6	200.4	188.7	150.3
Krystal	215.08	232.45	200.45	202.04	170.78	149.57	171.92	199.2	185.9	208.4	193.77	190.02
McDonald's	177.59	167.02	169.88	170.85	162.72	156.92	152.52	167.9	163.9	167.1	158.77	174.22
Taco Bell	184.22	181.96	192.69	179.43	167.15	159.12	148.16	153.4	156.2	163.1	154.88	163.17
Wendy's	171.3	150.29	141.73	134.67	127.21	116.22	124.69	135.7	135.1	138.5	131.08	134.09

Source: *QSR* (Quick-Service Restaurant) magazine

And indeed, published research[10] shows that the industry maxim is spot on: taking just 7 seconds (!) out of drive-through wait time will increase a restaurant's local market share by anywhere from 1 to 3 percentage points. (That is *absolute* share points, not *percentage* change: taking 7 seconds off the wait

[9] Matt Jennings, President of Data Management at consultancy Restaurant Technologies.

[10] "How Much Is a Reduction of Your Customers' Wait Worth? An Empirical Study of the Fast-Food Drive-Thru Industry Based on Structural Estimation Methods," by Allon, Federgruen, and Pierson, 2011.

time of a McDonald's that has a 30% local market share, will likely increase that share to 33%.) Armed with this kind of data, it is very easy for a fast-food franchisee to see exactly what the ROI could be for adding (e.g.) a second drive-through lane. And, crucially, the industry can calculate the *sources* of changes in sales and share, whether it is from **conquesting** customers from one chain to another (always a gain), **cannibalizing** one's one sit-down sales by switching customers to drive-through (which can be a net gain or loss), cannibalizing sales from a rival store of the same brand, or **attracting** entirely new customers who would not have bought fast food at all. We have never seen data from any car OEM showing this kind of detail, though it may exist somewhere: that is, even if factory X knows that upgrading one of its dealerships generates $Y more in sales, it does not know if these sales are conquested from brand Y, or cannibalized from other X-brand stores down the road.

Of course, every industry is different. And a person can argue that, in this case for example, when one has millions of daily customers, it is easier to measure how facilities affect customer behavior. That being said, we believe the auto industry has the analytical horsepower to attack the problem. Throughout our work we were struck by the "disconnect" between *assertions* about facilities, and *facts* about customer behavior. That is, there are more than a few industry surveys which show how a particular facility feature (e.g. a modern and comfortable service-are waiting lounge) affects customer satisfaction, but none we could find that then linked that satisfaction to actual behavior. When a fast-food restaurant puts in a second drive-through window, sales go up. When a dealer puts in a nice waiting lounge, customer satisfaction goes up – but does service retention go up? Does the average RO increase? Does fixed coverage improve? *Of course* a customer will prefer a comfortable to an uncomfortable lounge – but does a more comfortable lounge change his or her shopping behavior? The answers to this kind of question seems to be lacking in the automotive retailing industry.

IV. The Dealership of the Future

Introduction

Various interviewees in Phase 1 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 obsolete by 2025. 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. While we touched on some of these concerns in the Phase 1 report, NADA felt the issue should be addressed in real depth in Phase 2, and the findings from this work follow.

What Can We Learn from Past Predictions of the Future?

Before launching into our predictions for the dealership of the future, we should step back and adjust expectations about the accuracy of our crystal ball – because many *past* efforts to foretell the future have fallen short. The list of developments that different people believed in at different times, that have not come to pass, includes:

- Multibranding: repeatedly industry insiders and outsiders alike have predicted the rise of dealerships powerful enough to force OEMs to allow them to stock and sell brands from different companies under one roof. No less a personage than David Power said, in *Automotive News* in 1989, "We will be seeing larger car supermarket facilities, with multifranchised operations…." Not only has this practice not come to pass, but one can argue we are heading in the reverse direction, as more and more dealerships become exclusive to a single brand.
- Build-to-Order (BTO): this topic was especially hot in the 1990s, when Dell's computer BTO model was seen as feasible for cars as well (at least by several leading OEMs). A survey in *Automotive News* in 1993 found a majority of experts consulted, including dealers, predicting that "instead of carrying large inventories ready for instant sale, dealers will custom-order what customers want, to be built and delivered directly to the buyer within a week." The barriers to true BTO (ranging from customer impatience to factory production realities and beyond) have turned out to be significant enough that some manufacturers have told us that in fact they have seen a *decline* in the percentage of their sales that are BTO. Indeed, inventory levels at car dealerships remain in the 30-90 day range, whereas in a true BTO environment a store in theory would need to carry only a handful of demonstrator cars.
- Public ownership: certainly in the 1990s, when many of the current public chains first came into existence, there was near-panic among many private dealerships that these large chains would "sweep the board" -- and pronouncements by management back then supported this fear, as the benefits of their economies of scale and scope were widely touted. Again, a variety of barriers emerged, from OEM resistance, to difficulties of capturing the expected scale economies, to customer indifference to retail chain branding in cars, that have kept the combined market share of these major public companies at well below 10% for many years now.
- Internet disintermediation: another challenge to the dealership system that threatened in the 1990s to become a trend was the disintermediation, or cutting out of, the dealer in the process that moved cars from OEMs to customers. Autobytel and other online firms seemed likely to claim the customer for their own, reducing the dealership to just a delivery point: indeed, after its IPO in 1999 Autobytel stock moved up from its initial pricing of $23 per share to over $70 by 2004. But the traditional system absorbed the online challenge and in fact adopted its techniques, so that internet sites (for now at least) remain vital for shopping for cars, but have not managed to actually cut dealers out of the loop. And as of this writing, Autobytel stock is trading at about $4.
- OEM forward integration: While various factories at various times have attempted to get into the car sales business over the years (and indeed, if we go back to the 1920s or so, this method was quite prevalent), in recent years only two serious attempts have been made to do so: the Ford Retail Network experiment of 1997-2001 and the parallel GM Enterprises concept that was cancelled before it could be launched. The failure of the FRN – in which the OEM would take a controlling ownership stake in dealerships – had many causes, but suffice it to say that the primary lesson learned was that in the US environment at least, factory ownership of dealerships is impractical and costly. (We must note that in Canada, as mentioned before, direct

OEM ownership of stores is more feasible, though hardly widespread, and is not seen as the entering wedge of a general OEM buyout of dealerships.)

Given that these five sweeping predictions of the last two decades or so have failed to come true (at least to date), the lesson learned is that the North American dealership system is extremely resilient, and thus predictions of rapid change are very risky to make. Despite the constant drumbeat of complaint in the press about the system being "broken," customers seem happier than ever with their dealership experience, and no rival system has been shown to be able to better execute its tasks (which include not just the sale of new cars, of course, but the sale of used cars, warranty service, customer-pay service, collision repair, the provision of finance and insurance products, and the support of in-field vehicle recalls). And as readers will see, our own forecast for the physical "dealership of the future" lays out only relatively modest changes for the year 2025 or so.

However, just because several large past predictions have missed the mark, that does not mean we should not attempt once again to take a shot. For one thing, to build a store which may last 25 years or so, without some view of what those 25 years will bring in terms of customer demands, regulatory changes, product evolution, and other factors, is just simply irresponsible. But also, some things *have* come to pass in the auto industry that most observers did miss.

The prime example of missing a key automotive development, in our view, is CarMax. Founded in 1993, this company's imminent demise has been predicted virtually every year since then. The supposedly fatal flaws attributed to CarMax over time included: "they can't buy inventory as smart as real dealers can," "they don't have access to the closed auctions," "they can't survive without a giant captive finance arm behind them," "a dealer can always undercut their prices," "they'll be caught out with the wrong inventory when the price of gas spikes up," "buying cars off the street will never work for them," etc. etc. Yet here they are in 2013, not only surviving, but thriving. In fact, CarMax's market capitalization is about $8 billion, generated essentially by used car sales only, at only 110 locations; whereas the market cap of the largest full-service dealership chain, AutoNation, which has about 215 dealerships, is just under $5 billion. The lesson learned is that we should not be complacent: some forecasts of major change *do* come to pass.

Evolution of Dealerships Over the Past Half Century

One way to forecast the future evolution of dealerships is to ignore expert predictions and just look at the actual historical facts. If we can see how dealerships have changed since 1950, we might be able to extrapolate that change trajectory to 2050. So let's step back from the future for now, and see how far we have come. We'll choose as an arbitrary start date for this journey the mid-1950s.

How can we characterize the physical dealership of the 1950s, using for now just the US case? We will take several major categories in turn.

- Number: in 1955 there were some 41,000 new-car stores in the USA…
- Size: selling about 150 new retail units annually, from an inventory of about 40 days of sales…
- Consolidation: under the control of some 35,000+ owners (basically one per store)…
- Brands: handling usually one major OEM (e.g. Ford) but filling in with a few secondary brands…

- Service: with fixed operations contributing about a third of annual profits…
- Location: and the whole thing usually sited on a major downtown street…
- Integration: with new, used, parts, service, and F&I typically all on site…
- Balance of Power: and with the OEM pretty much in charge of the show.[11]

The actual physical format of the store varied all over the map. This was in part because dealerships were at this time rapidly evolving: the store of the 1930s tended to be an existing retail space adapted for car sales, but by 1950 purpose-built dealerships were being constructed. Also, prior to 1950 OEMs hadn't bothered to exert much influence over format: the 1948 General Motors publication "Planning Automobile Dealer Properties" was one of the very first of the architectural planning guides than OEMs would eventually come to issue in the hundreds.[12] Taking this manual as an example, we can see that the OEM was overwhelmingly concerned (in terms of the sales showroom) with its location, its visibility to passing traffic, its signage, and the size and number of its windows – there was nary a mention of floor tile! This emphasis was in large part because the customer was evolving from a two-lane downtown walk-in to a four-lane suburban drive-by, and the look of the store had to communicate very quickly that a) this is indeed a car store and b) this is the brand being sold. This need to make a big bold statement quickly also led to a shedding of detailed architectural features that ornamented stores in the 1920s and 1930s, in favor of big blocky stores with big windows and bigger signs, easily glimpsed from the highway. Dealers did everything they could to boost visibility, choosing ever larger and taller signs, adding neon to some and mechanical rotation to others, and festooning lots with banners and flags.

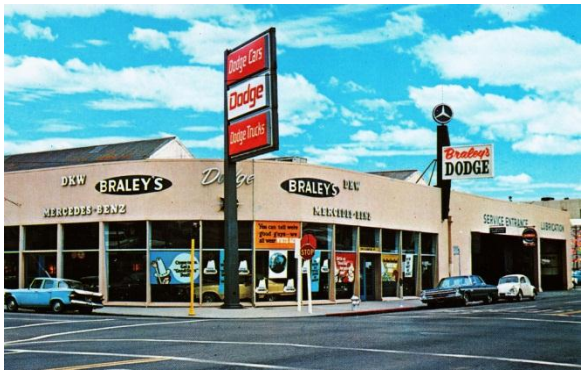
A key point to keep in mind is that at this time dealerships were highly "fungible" – easily switched from brand to brand. With few factory standards and an emphasis primarily on location, visibility, signage, and windows, a store that might have been a Ford outlet on Friday could be a Plymouth outlet by Monday, with just a change of signage (sometimes as simple as painting over the brand's name).

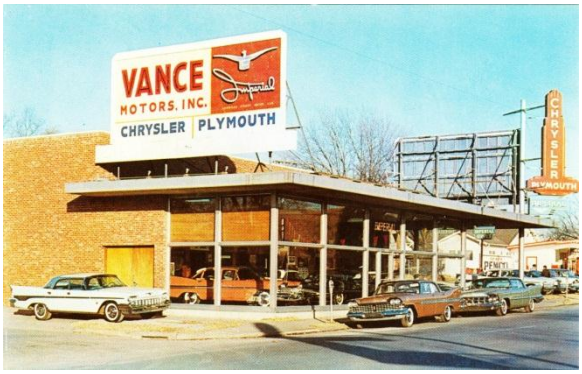
It was also a time of some pretty grim-looking stores. With demand for cars strong (often from returning GI's) and little guidance from OEMs, dealers were free to do pretty much what they liked – in terms of the physical store – and that meant there was wide variation in looks. Some were spectacularly gorgeous… others were spectacularly ugly.

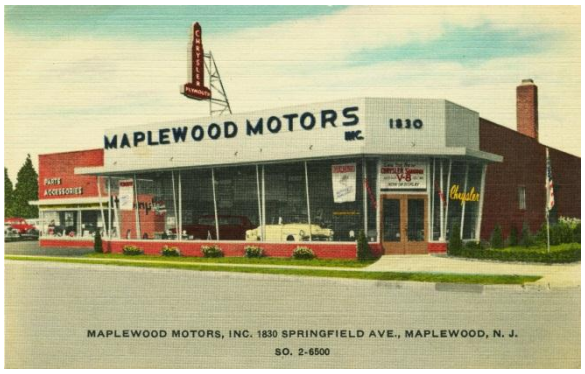
The photos on the next page illustrate many of these key points about 1950s stores.

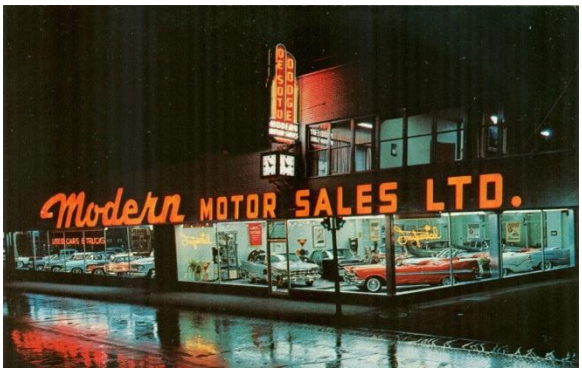
[11] Numerical data are from various Automotive News annual data editions; comments are the author's.
[12] A PDF copy of this guide is available upon email request to the author.

DEALERSHIPS OF THE 1950s AND 1960s









Photos courtesy of Alden Jewell, from his collection at www.flickr.com/autohistorian

Now let's fast-forward to about 2010 or so, about half a century later. What has happened to physical dealerships in the USA?

- Number: from 41,000 we have shrunken down to about 18,000 dealerships
- Size: but with growth in total sales the average store now sells some 650 new units annually; but with the proliferation of models the average days of inventory have risen from 40 to 60…
- Consolidation: and there has been significant shrinkage in the ownership base, with the typical dealer principal owning several stores in a local region (but on the other hand the national chains have not swept the board)…
- Brands: while dualling has been dramatically reduced, as OEMs move to mostly exclusive-to-one-factory stores…
- Service: and fixed operations are contributing even more: about half of annual profits…
- Location: while most stores have moved out from downtown to the suburbs….
- Integration: and some dis-integration has occurred, with only 1 in 5 stores now having an on-site bodyshop, and administrative and other functions are moving off-site as well…
- Balance of Power: while, thanks to the efforts of dealers, state associations, and NADA, the balance of power between OEMs and dealers has become much more even (while consumers, thanks to the rise of the internet, are gaining more power relative to both dealers and factories).

As far as the physical format goes, dealerships by now are almost wholly purpose-built (as opposed to being converted from some other retail space), and appearances are much more standardized, as OEMs started rolling out image programs in earnest in the 1990s. Now, for better or worse, factories attempt to specify much more than just windows and signs, and issue planning guides that go right down to the level of furniture design, floor tile and carpet specification, and even the look of stationery, landscaping, and bathroom fixtures. Along with this higher level of store customization comes the inevitable reduction in fungibility. Dealerships since the 1950s have always tended to be single-purpose facilities, useful only as dealerships, whereas general retail stores can be switched from yogurt shop to bookstore to clothing boutique without much trouble. But the increasing customization of dealerships means these stores are so expensive to remodel that not only would they have be torn down and rebuilt to repurpose for another use, but even switching to a different brand would require "raze and rebuild." This kind of customization may *improve* the value of the dealership to the OEM, but *reduces* the value of the dealership to the owner.

Before we extrapolate these trajectories to the dealership of the future, let's look to a few other sources of insight, to add to the mix. Since pundits often tell us that automotive retailing is about ten years behind general retailing, perhaps we can learn from today's trends in the world of food, clothing, and other retailing sectors, about what might be about to happen to our own industry.

Looking Forward: General Retail Trends

We did not find a lot of good solid work on the topic of the future evolution of the physical dealership . Not many experts, either architects, academics, or consultants, spend much time trying to predict the physical dealer of the future – it seems that all their energy is wrapped up in looking at changes to the online side of the store, from email to CRM to social media to SEO (search engine optimization) and

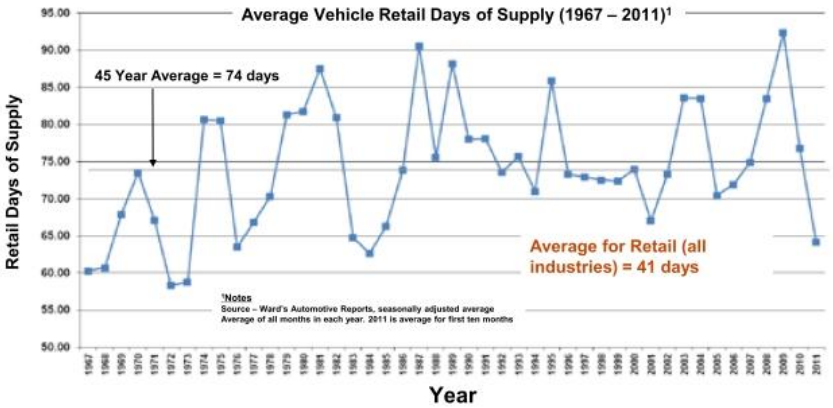
more. And dealers themselves are pretty quiet on the topic: while worried that their store may not be the right format for the next generation to inherit, few of them have spent a lot of time thinking 5 or 10 years ahead, which is understandable given how complex a task just running today's store is.

So, with little to draw on here, we widened our scope and sought out experts on overall retailing trends generally: primarily academics and consultants who spend their time thinking about the retail store of the future, since in the end dealerships are retail stores, and therefore any trend shaping retail generally should have some impact on dealerships as well. We spoke to numerous people, but in particular several professors attached to the Jay H. Baker Retailing Center at the Wharton School of the University of Pennsylvania in Philadelphia. After completing our interviews, we boiled down the numerous trends they highlighted to the following seven. Some of these may seem obvious, but just because an observation is obvious that does not make it unhelpful. In each case we tried to link these trends to implications for the DOF, to take into account in our own forecasts.

Seven Trends Shaping North American Retail Over the Next Decade

1. CONSTANTLY RISING CUSTOMER EXPECTATIONS: Customers benchmark all retailing against their best experiences, from any store. If Nordstrom's comes up with an innovation, customers will soon expect it at the Gap. IMPLICATION: First, dealers and OEMs should not be afraid to adapt best store format ideas from anywhere. Second, store design should be flexible enough to be able to reconfigure the dealership quickly and at low cost, to keep up with rising expectations.
2. PERSONALIZATION OF SHOPPING EXPERIENCE: The best merchants everywhere segment the buying *process* as well as the *product* (for example, restaurants can deliver to your home, let you dine in, offer take-out, and even drive-through). Car dealers have tended to segment the *product* (e.g. minivan, sedan, SUV) but not the *process*: impatient informed younger online buyers might have to run the same hurdles as a retired and less-informed "off line" senior citizen. IMPLICATION: It may be time to accelerate segmentation of dealership sales processes and facilities. Is there an automotive equivalent of the "express checkout lane?"
3. CUSTOMERS SEEKING AN EVER EASIER EXPERIENCE: "Easier" can be defined in many ways: faster, simpler, closer to home, less confusing, etc. This trend has never changed, only how it is implemented has evolved: thus Sears introduced the mail order catalog in 1888 and the internet introduced online ordering a century later, but both were responses to the same "Make this more convenient!" trend. IMPLICATION: Dealers and OEMs must stay flexible and creative to improve convenience. Taken to its extreme, for example, 100% home delivery of cars might mean "no" store at all.
4. TECHNOLOGY (OFTEN) DISPLACING PHYSICAL ASSETS: When we looked at past predictions for dealerships they often included whiz-bang technologies such as holographic displays. Much of this evolution has not yet come about, but sooner or later interactive displays, high-speed automated dealer inventory swaps, seamless online/offline shopping integration, mobile shopping apps, and even true BTO may become widespread. IMPLICATION: Many of these technologies will serve to allow reduction in inventory levels: note that car dealers have consistently for decades run inventories that are much higher than regular retail levels. (See

chart below, from JDA: dealers have averaged about 75 days of inventory for about half a century, while the average for all retail industries combined hovers at about 40 days) Lower inventories should permit smaller stores and lots. Other technology changes can enhance the buying experience, but their rapid rate of change again argues for flexibility in store design: for example, more than one dealership has run miles of Ethernet cables, only to see them made obsolete two years later by Wi-Fi.



5. THE INTERNET ALLOWING MANUFACTURERS TO REACH THROUGH RETAILERS TO CUSTOMERS: For many decades now retailers have been gaining power relative to manufacturers, thanks to their closer contact with customers: thus a store like Best Buy can "own" the customer and therefore demand deep discounts from Panasonic, Samsung, et al. But the internet allows manufacturers to start clawing back the customer, through very inexpensive direct contacts. For example, when a customer can scan a product's bar code with her smartphone at any retail store, to find a better price, the manufacturer's brand gains importance relative to the store's. IMPLICATION: Dealers will have to move "up the sales funnel," to get access to customers before manufacturers (or third parties, typically online services) grab them. Much of this will take place online, but dealers can still broaden their reach by physically getting in front of customers wherever they may be – the idea of Tesla boutiques in shopping malls may not be entirely crazy (and indeed, dealers themselves have experimented with offsite "demonstrator" outlets).
6. CUSTOMERS INCREASINGLY DRIVEN BY THE TOTAL OWNERSHIP EXPERIENCE RATHER THAN THE SINGLE TRANSACTION: When products are highly differentiated the customer wants to get the best deal possible on the best product he can afford. When products become commoditized, other factors come into play: service, brand, advertising, atmosphere, store environment. Merchants evolve into dealers and then into retailers, escorting the customer throughout the relationship. IMPLICATION: As cars commoditize[13] not only does the experience in the

[13] As evidence of commoditization, look at this simple fact: in 1960 the slowest car *Road & Track* tested took 27 seconds to reach 60 mph, while the fastest took 10 seconds. By 1995 the slowest 0-60 time the magazine clocked was 11 seconds, and the fastest 5. The gap between a "fast" car and a "slow" car had shrunk from 17 seconds to 6. The extra cash spent on a Porsche 911 versus a Subaru WRX, for example, delivered less of a speed boost today than previously. In terms of everyday driving, most cars today are effectively the same, for the average driver.

dealership become more important, but there may be a shift of influence from sales to service: the dealer has many more degrees of freedom to delight the customer in the service area (through dozens of visits over the years), but really only one shot to do so in the sales process (the transaction). Dealers and OEMs may want to divert more of facility spending from sales to service.

7. CHANGE ACCELERATING GENERALLY: This obvious trend covers all the above trends and more: not only are customer expectations and enabling technologies changing ever faster, but competitors are moving more quickly: obsolescence comes blindingly fast. IMPLICATION: Again, dealers and OEMs alike should strive to build stores that are easily reconfigured at low cost. Dealerships in the 1960s could shift from Brand A to B over the weekend, by changing a sign or two: today the store often has to be torn down to the ground and rebuilt. Can dealerships become as easy to update and redo as the typical retailer "box" store in a shopping mall?

We'll keep these trends in mind as we begin to develop our DOF forecasts. Meanwhile it might make sense to look at one *non*-automotive retailer who is seen as a leader in keeping on top of these trends, Apple.

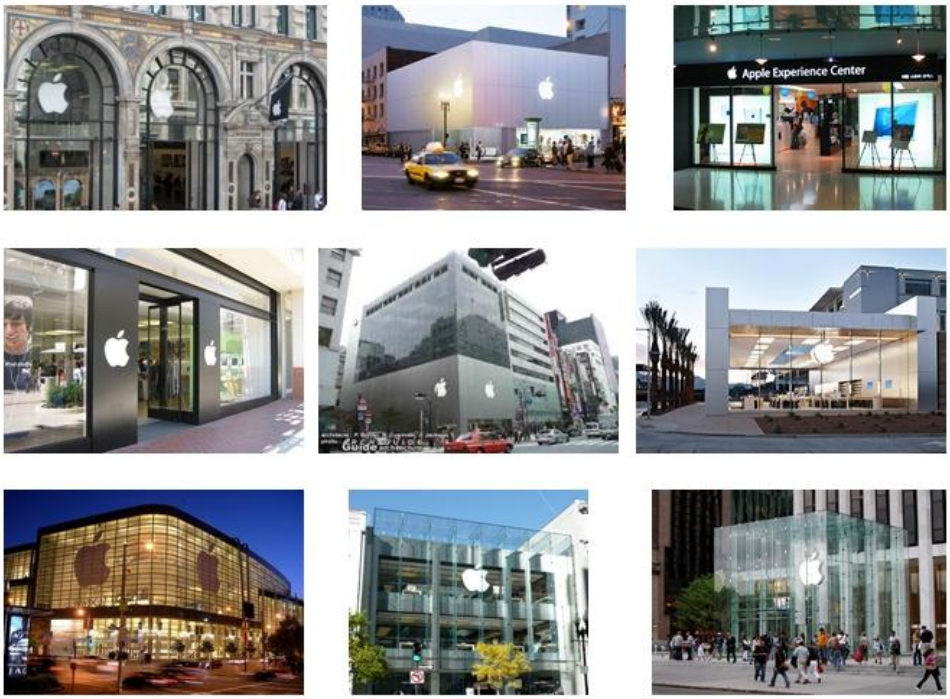
Looking Forward: What Can We Learn from Apple Stores?

Throughout the course of this project more than a few OEM executives brought up the example of Apple as a company to emulate in the area of retail facilities.[14] Generally executives praised the stores' reinforcement of the Apple brand image, and held them up as an example of how a "consistent" or "standardized" facility format could really add value. However, while agreeing entirely that Apple stores support the company's fantastically strong brand image, we'd draw different lessons from how these stores are laid out. First, they are not, in our view, very standardized, as the photographs of Apple stores from around the world, shown below, demonstrate.

Manufacturers and dealers have to turn to other means to differentiate the product, including enhancing the total ownership experience.

[14] It is hard to argue with Apple's success, but the automotive industry's current fascination with this company reminds me of a similar fascination with Dell years ago (in the area of BTO, or Build-To-Order), though no one seems to mention this example any more, perhaps given the very slow pace of progress toward BTO in American car retailing, or perhaps given the significant decline in Dell's share price since the late 1990s.

NINE APPLE STORES AROUND THE WORLD



Source: Internet searches

Other than the prominent logo and – when possible – the use of a lot of glass, we cannot see how these stores are standardized, at least as far as their *exteriors* are concerned.

Secondly, while it is true that Apple *interiors* are more standardized, in that they tend to use lots of wood, simple display cases, and bright lighting, the lessons we take away from Apple interiors are two others: low cost and high flexibility. Apple stores' interiors are just not very expensive: simple unadorned boxes, some moveable plain display cases, ordinary lighting, some wall displays and graphics. They are also very flexible: no element is very hard to change or move – an Apple store that on Friday looked modernistic could by next Monday look positively Victorian, by laying down a few rugs, putting up some old posters, and replacing the display cabinets. This is not the case in the world of car dealers, where OEMs seem to insist on built-in, expensive, literally "cast in stone" brand elements, such as expensive colored floor tiles, large fixed-in-place reception desks, immovable interior walls, and architectural elements such as portals and mezzanines that cannot be revised if necessary, but only torn down and rebuilt. See this photo of an Apple store interior (taken after hours), in support of our point

Thirdly, one consistent feature of Apple stores worldwide is that they are crowded, thanks to the massive popularity of their products. Automotive OEMs, conversely, seem determined to specify showrooms that resemble large and echoing empty caves. Compare and contrast, for example, an Apple store and a typical upscale automotive showroom, below:

As more than one dealer said to us, an empty or almost-empty showroom is both intimidating to the customer, and a signal that the brand is not popular. Our suspicion is that factories insist on very large showrooms not because they are focused on appealing to the *customer*, but because they are focused on showing off their *products* to the best advantage. To the extent a car showroom resembles a museum, it hardly seems an inviting place to actual shop in.

Finally, it should be obvious, but we believe Apple's success is much less linked to its retail formats and much more to its products (e.g. iPods, iPads, etc.), its processes (e.g. the Genius Bar tech support system), and its people (highly-enthusiastic if low-paid sales associates). The same applies in the world of cars.

Key points:

- Contrary to what some would assert, Apple store exteriors are *not* highly standardized
- Apple store interiors are both low in cost and high in flexibility, which is not often the case for car dealers, where much of the brand image is "cast in stone" (or, at least in tile)
- Apple stores tend to be very crowded, to no detriment to the brand, whereas automotive factory showroom square footage requirements can counter-productively lead to an absence of crowding, which can intimidate or turn off customers

- The Apple case reminds us that it is almost always the case that products, processes, and people are more crucial to market success than facility design and expense.

Looking Forward: Are Tesla Stores a Peek into Our Future?

DISCLAIMER: We realize that there is a great deal of debate in the industry about the viability of Tesla's business model and the legalities of its distribution arrangements. In this report we are leaving aside all these complex and contentious issues, especially the legal issues surrounding the stores, from the point of view of state-level statutes affecting dealer licensing, factory ownership, provision of adequate service facilities, etc. We are purely focusing on *the physical layout* of the stores, to see what ideas we can glean from them. This report in no way serves as an endorsement or as a refutation of any Tesla strategy or business process.

As the writer William Gibson is famous for saying, "The future is already here — it's just not very evenly distributed." His meaning is that some aspects of any given future trend are already present in our time, so predicting the future is just a matter of finding those cutting-edge instances. Do these exist in dealership design? Some observers would point to the new Tesla stores as the wave of the future. Just as Tesla is selling a relatively new kind of car (high-end EVs), so the company has decided to sell these cars in a relatively new kind of facility, a small showroom placed on high-traffic (and therefore high per-square-foot cost) urban real estate, with service facilities typically situated at an off-site location.[15] Is this format the future of dealer showrooms generally?

There are reasons to *not* directly compare Tesla showrooms to existing car dealerships: for one thing, the Tesla line-up is so limited at present (essentially one car) that it would be hard to imagine stuffing a typical 15-model OEM lineup in one of these small storefronts. But if we set aside concerns like this for now, what can we learn from the Tesla design?

Some aspects of these stores' layouts are extremely familiar to present-day dealers, and so do not represent a step forward: demo cars are on display, test drives can be arranged, large video screens (often touch-enabled) demonstrate key vehicle features, and there are wall-mounted displays of vehicle color choices and accessories and options. But there are at least two distinctive features, both of which support our own view of how dealerships might evolve.

First, as noted, Tesla splits sales from service. To reach its urban and suburban target customers most efficiently, it places showrooms in high-traffic shopping areas, which leads to very high real estate costs. But it splits service off into separate service centers located elsewhere, on cheaper real estate. This splitting of sales and service has been identified to us by numerous mainstream dealers and OEMs as a trend that is already occurring and that is likely to accelerate. It just makes sense to tailor the location of dealership functions to their optimal positions: put the showrooms where people shop, put

[15] This experiment is also interesting since the leader of Tesla's retailing effort, George Blankenship, is an Apple alumnus bringing Apple store design ideas to car retailing: see the prior section on Apple.

administrative people in a low-cost central office, and put service where it works best (if you're doing car pickup, on the cheapest real estate you can find, and if you're not, on land closer to where customers live – which may *not* be where they shop). And dealers who own multiple brands and stores can leverage this "unbundling" even further: we met with two different dealer groups, each of whom had half-a-dozen brands, who had moved *all* collision repair, *all* vehicle prep, *all* customer shuttle services, and *all* administrative personnel to central shared locations. The savings were striking.

Second, Tesla stores are very easily and inexpensively reconfigurable (see photos) – just like the Apple stores we discussed separately. Generic cabinets hold necessary supplies, simple white walls support electronic screens and easily-rearranged component and graphic displays. Essentially, the brand image heavy lifting is done by the cars themselves, by some signage, and by flexible graphics. Very little of the store's identity is (literally) cast in stone: no curtain walls of glass or textured concrete bunkers, no stylish mezzanine balconies, no massive exotic-wood greeting desks. As the car lineup evolves, the store is quickly and easily upgradeable, without the painful necessity that so often afflicts typical dealerships, of having to jackhammer up tiles or knock down walls. We heartily endorse this low-cost approach: if vehicle OEMs are going to continuously fine-tune and update their brand messages, enabling dealerships to do this at the lowest possible cost makes great sense. Dealerships should have more of their brand image based in easily reprogrammable "software" (digital displays, wall graphics, the cars themselves, etc.) than in expensive and fixed-in-place "hardware" (expensive building fascias, exotic floor tiling, costly architectural features, etc.)

LOW-COST RECONFIGURATION? TWO TESLA SHOWROOMS

In this regard, especially for dealerships pursuing "new urban" customers (see separate section), Tesla may be on the right track. This format will not work for everyone (especially rural dealers), but the broader point is that this format is tailored to a particular type of customer demographic. For a century we have segmenting customers with *product* (e.g. selling families minivans, farmers pickup trucks, outdoor enthusiasts SUVS, etc.): it is time now to segment customers by *process*, too (e.g. traditional dealerships in rural areas, Tesla-type showrooms in urban areas). But under current dealership design philosophy, OEMs try to make "one size fit all," in trying to shoehorn a given standard floorplan into all possible situations, regardless of how they vary. And the way this format is laid out, a mistake in design is easy to correct: a Tesla showroom in an upscale shopping strip can easily be sold to a clothing retailer,

whereas an orphaned mainstream dealership has so little alternative-use value that it often must be torn down before the land can be reused.

Tesla stores in particular may not be the wave of the future, but their unbundling of sales and service, and their ability to be updated at low cost, are probably strategies that dealers and OEMs should closely study.

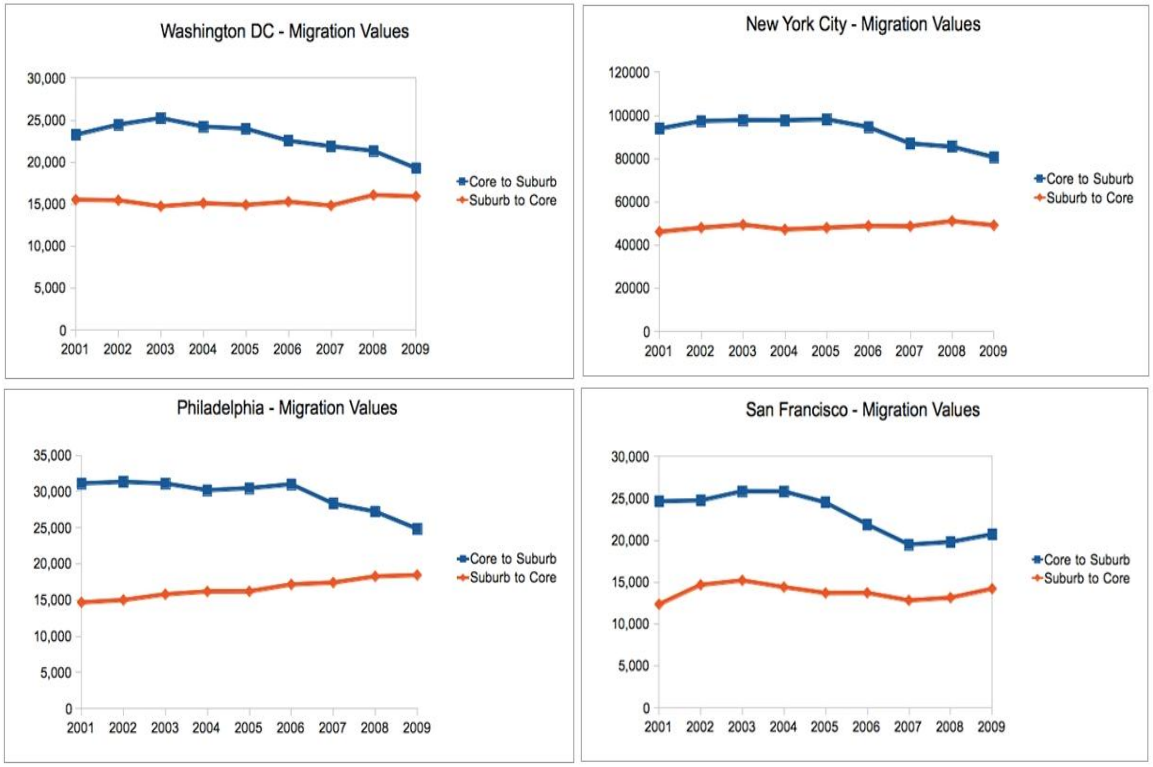
Looking Forward: Will the "New Urbanism" Require the Revival of Downtown Stores?

It is beyond the scope of this report to discuss optimal locations for dealerships, either today or in the future: there are too many variables involved, and numerous much more expert firms and people who can crunch demographic and traffic numbers and then find the right site. But future dealership design is within our scope, and as location affects design, we should comment on any trends we see in store location overall. The trend most often brought up to us during this project was what is sometimes called "new urbanism:" the movement of the American population back into city centers, after decades of migration outward, into the suburbs. As the suburban exodus went on, dealers followed, moving from urban Main Streets to suburban Auto Miles. With this migration came a change in facility layout, as inexpensive suburban real estate and high-traffic suburban roads encouraged the building of very large stores with very extensive frontages. Floor traffic was no longer walk-in, but drive-by.

Now, however, we are starting to see some movement of Americans back into cities, or at least a dramatic slowing in the suburban outbound migration. Various factors drive this movement, from high gas prices inducing people to shorten commutes, to ultra-low urban real estate prices making downtown living more of a bargain.[16] Whatever the reason, if this trend persists (see charts showing the shift in migration for four major metro areas), the implication is that we may need to design a "new urban" dealership.

[16] See, for example, a July 20, 2012 article in the *Huffington Post*, identifying ten cities (not only in the Midwest but also in foreclosure-wracked Florida), where the price of an average house was less than the price of a typical new car sold in that city! "10 Cities Where Homes Cost Less Than A Car," by Rusty Weston.

MIGRATION TRENDS INTO AND OUT OF FOUR CITIES



Source: Aaron Renn (www.theurbanophile.com) analysis of US Census data

This is because there is no way to shoehorn a large-scale suburban store and lot into a downtown setting, for reasons of cost, zoning, and simple land availability. Architects, designers, OEMs, and dealers alike are experimenting with solutions to the challenge, from multi-story stores, to stores with significant amounts of service bays and vehicle inventory held off-site. The implication is that facility programs that were designed around the traditional large-format suburban store may be irrelevant to the "new urban" store. Thus the dealerships of the future may be a more diverse collection of store types, from suburban megastore, to rural old-style store, to new urban innovative designs. Once again, it seems that more flexibility by OEMs, as regards store design, is warranted: certainly it is a rare urban environment, for example, that would tolerate a typical large conical or cylindrical dealership "portal." There is even an opportunity, we believe, for an innovative OEM to seize the lead among new urban customers, by being the first to innovative with new downtown store design.

The Ford temporary "pop-up" stores recently demonstrated in California (see photos below), may be an early shot across the bows in this direction, as what was a temporary experiment could mutate into a permanent innovation.

FORD CALIFORNIA "POP UP" SHOWROOMS: ADVERTISEMENT AND INTERIOR VIEW

Factors that Will Slow Change

Now that we've looked at forces and trends and examples that indicate that the DOF will be significantly different from today's store, it's time to step back and look at the forces and factors that will tend to slow or inhibit change. The problem with many forecasts about the future is that they might end up being right, but late. For example, antilock brakes first appeared on American cars in 1969 (as an option on the Ford Thunderbird), but it took a quarter of a century before they were installed on more than 50% of new cars. Issues of cost, engineering, consumer acceptance, and OEM marketing all combined to retard their progress. Change happens, but getting the timing right is everything. So what forces are out there that would serve to *slow* the rate of change of the physical dealership in the USA? We would nominate three: regulation, complexity, and risk aversion.

REGULATION: Not only is purchasing a car massively important to customers (who rarely spend as much money on anything else), but also to governments, at the local, state, and federal level. Whether this is because dealerships…

- employ so many people (who then must be protected via agencies such as OSHA),
- or because they take up so much land in a community (and as such are of great interest to zoning boards),
- or because their owners are politically influential (as business people who are major campaign contributors and whose city-, state-, province- and federal-level dealer associations are energetic advocates for dealers),
- or because they generate so much tax revenue (typically at least 25% of a given community's sales tax inflow, for example),
- or all the above and more,

… this industry is very highly regulated. Much of this regulation focuses on topics which directly or indirectly influence the physical layout of the store, even if that was not the original intent. For example, regulations that intend to protect consumers by requiring service facilities to be bundled with

sales locations can make it hard to set up satellite service locations – even if both dealers and customers might prefer this. Or, as some interviewees told us, community restrictions on tall, large, or illuminated signs can actually drive OEMs to demand more expensive store facades, since now the store has to carry the brand image in the way that the sign used to.

Further, many of these regulations vary from state to state, and even from community to community, making it difficult for someone who has come up with a new idea to roll it out quickly and broadly across the country.

And finally, for many of these regulations there is no organized constituency interested in change. For one thing, customers buy cars at such long intervals that they tend to accept regulatory impositions, as they might not see them for another five or six years. Thus, for example, consumers may be VERY aware that Amazon (to date at least) does not generally charge sales tax, since they are reminded of this fact every time they click on a book or DVD to purchase. But the intricacies of inter-state regulations on sales of cars come to their attention so infrequently that it is hard to build up a groundswell of complaint about them. The situation is similar to that of the electoral college: no one really likes it, but since the topic comes up only every 4 years or so, there is little momentum for change.

Thus we can imagine that regulatory barriers – for better or worse – will continue to have a dampening effect on the rate of change in the auto retailing industry.

COMPLEXITY: As a dealership is several businesses integrated into one location (new, used, parts, service, finance...), the complexity of its operations make it harder to experiment with change. A dealership is a system, not just a single function. And customers have come to expect this, as they should: there is great convenience in being able to buy, sell, maintain, finance, repair, and sometimes even rent a new or used car all at a single "one-stop shop." Dealers also see benefits to the integrated system: a full-service dealership can sell you a used car if no new one on the lot seems right, and can offer you a trade-in price on your car while it is in the service lane. In summary, a lot of the current dealership physical layout is driven by this need to bundle all these different offerings in one place. This kind of complexity is seen in no other business, as far as we know: a furniture store, for example, might sell you a new sofa and also finance it, but it typically won't repair a worn couch or take it in trade!

(It is interesting to note that some of the most successful innovations in automotive-related retail formats have realized this and avoided trying to challenge the whole system, instead focusing on peeling off one profitable bit at a time. Thus the founders of CarMax scarcely considered going all-in with new car dealerships, instead perfecting the used-cars-only superstore model.[17] Thus the creators of quick-lube chains avoided handling the full range of repair services dealerships offered, focusing instead on light maintenance work such as oil changes and filter and fluid replacements – none of which required highly-skilled techs or time-consuming diagnostic work.)

[17] Although the company does retain a few new-car stores, new vehicle sales for CarMax in fiscal 2012 represented only about 2% of total revenues.

RISK AVERSITY: Cars are so costly and owners keep them for so long, that many customers tend to be – understandably – somewhat conservative when it comes to tinkering with the process they go through to getting the transaction done. Stated *demand* for change (e.g. "I just want to be able a car online and get it delivered to my house!") often reverts to unchanged *behavior* when it comes time to write the check (e.g. "Maybe I need to see what the car's color looks like in person, before I click the Buy button…"). We've seen this behavior with the products as well: look at how many mid-sized sedans that car enthusiasts call boring or bland are nonetheless snapped up by the millions, because they are a "safe bet," whether in terms of repair costs or resale value. Easy changes get made rapidly, of course: virtually every customer looks up car prices and features online, but this activity entails minimal cost and no risk. But when it comes time to messing with risky elements of the process, change comes more slowly. For example, one advantage small garages have traditionally had over large dealerships is the ability of the customer to develop a personal relationship with the garage owner or even the individual technician. For some customers this relationship acts to reduce their risk of being fleeced on a repair order, and no amount of innovation by a dealer (e.g. late service hours, pickup and dropoff, etc.) will offset this sense of confidence.

Ideas from Our Interviewees

The final ingredient going into our dealership of the future forecast is, of course, input from our interviewees, ranging from all sorts of dealers to industry architects, marketing and retailing professors, interior designers, and many more. We won't attempt here to summarize the rich depth and breadth of the opinions expressed, but have attached as Appendix A a sample of some of the more fascinating comments. Our thanks again, to everyone who provided input.

Our Predictions for the Dealership of the Future

It is time to polish up the crystal ball and make our own predictions now. In doing so we'll keep in mind everything we have learned so far, discussed in detail above:

- From past predictions: be wary of forecasting the onset of multibranding, widespread BTO, dominance of public chains, internet disintermediation, or OEM forward integration… or of rapid change generally
- From the last half-century of dealership evolution: be aware that the number of stores has fallen dramatically while the average size has soared, that consolidation has proceeded but not as fast as many expected, and that formats have changed from urban flexible and dealer-personalized to suburban inflexible and OEM-standardized
- From general retail trends: we should know that customer expectations are continuing to (rapidly) rise, notably for more personalized, convenient, and tech-enabled experiences
- From Apple and Tesla: that physical standardization of stores need be neither extensive nor expensive: flexible low-cost fixtures are more important than inflexible high-cost architecture
- From demographics: we should be on the lookout for a chance to serve "new urban" customers with small-format urban stores reminiscent of the dealerships of the 1950s
- From the main forces that shape the industry (regulation, complexity, risk adversity): that the rate of change may be slower than many pundits might expect or hope for.

- From our interviewees: we learned a wide range of things, but if we had to focus on one, it would be the imperative to address the various challenges facing service operations.

Taking all this into account, here's our forecast for the dealership of the future, perhaps in the year 2020 or 2025. We'll show this in two ways, first as a thumbnail sketch of what *one* of these stores might look like, and then from the point of view of the *overall* industry.

A dealership of the future. The store is part of a small local privately-owned group, perhaps five points carrying seven brands, with very little inter-OEM dualling, if any. This store, located a few miles out of town, in particular has three branches: a small demonstrator outlet downtown, and a satellite service facility in the outer suburbs… which it shares with another brand owned by the same group. The store moves 1,500 new and 1,000 used units annually, but is no larger in acreage or square footage than it was in 2010, as it is turning inventory very rapidly. This is because, even though its true BTO share of sales is not even 20%, swaps with other dealers -- and in one case with an OEM inventory pool -- total some 40% more. Additionally, it has a low-cost off-site vehicle storage and PDI facility nearby, also shared with other stores in the group. Service absorption is about 120%, thanks to the satellite facility (which is AMM[18]), an express-service lane onsite, available pickup and dropoff service, extended shop hours, a lavish waiting area, and even limited driveway service calls. The showroom (finally) has a full-sized holographic display system, so that not every model has to be physically parked in the showroom. The showroom is a generic box with both physical and projected graphics (indoors and out) used to vary imagery and display at low cost. This allows frequent brand-image updating, while allowing the physical facility to go well over a decade without significant physical modifications. There are *no* administrative personnel, collision-repair, PDI, or other such functions onsite, freeing up space for sales and service. These functions reside in one low-real-estate-cost facility shared by all the stores in the group.

A caveat: obviously not every, nor even most, dealerships will look like this in 2025. There will always be a need for small single-point stores in remote rural areas, lavish flagship stores in high-prestige cities and suburbs, suburban "old school" ultra-high-volume spots, stripped-down bare-bones stores for value brands, etc. But our snapshot represents the general direction we expect the typical store to go.

The dealership industry of the future. Now let's step back and look at what this forecast means for the industry across the continent. The exhibit below sums it up, for the US version. The symbol ► indicates where we are showing a *recommendation*, rather than a *forecast*.

[18] "All Makes and Models"

THE EVOLVING AUTO DEALERSHIP: KEY FEATURES

Characteristic	Past (1955)	Present	Future (2025)
Main Physical Features			
Number of dealers*	41,000	18,000	about the same
Size (annual NVR)	150	650	1,000
Consolidation	None	Nat'l low, local medium	Region mid, local high
Showroom/sales	Glassed-in storefront Inventory ~40 units Salesmen, brochures	Highly brand-customized Inventory ~60 Salespeople, internet	►Flexible "box" Inventory ~40 "Virtual reality"
Service	1/3 of profits On-site Generic	1/2 of profits Express service emerges Comfortable lounges	??? Satellite, pickup, shuttle, etc. Advanced technology
All other functions	On-site	Body shop (BS) offsite	BS, all admin offsite
Dominant location	Main Street	Suburban auto mile	Diverse locations
Format flexibility	High (change the sign)	Low (raze and rebuild)	►High (low-cost customization)
Life of format	Indefinite/long	10-15 years (remodel)	≤ 10 years
Other Features			
Brands	From many to one	Store one, group several	Store one, group many
Consolidation	None	Several national chains Many regional groups Numerous local groups Many single-points	National chains – unchanged Regional groups – unchanged Local groups – multiply, absorb many of the single-points
Function of store	Dealer (margin)	Retailer (back end money)	"Company store?"[19]
Role of dealer	Vital	Major	???

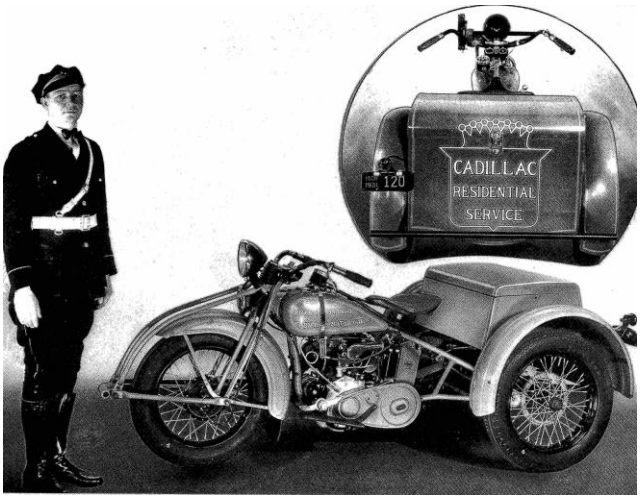
* Figures here are for the USA, but we see the same trends for Canada: for example, the dealership count there dropped from about 4,000 in 1990 to about 3,000 now. NB: Our view on national chains applies only to the USA, since such chains are generally absent in Canada.

The **number** of dealers we see as constant, with the sharp decline in counts now mostly completed. Some OEMs will keep dropping stores, but others will add points, for a net change of roughly zero. Holding the number constant and applying consensus forecasts as to the growth in annual sales over the next decade or so, we see the average **size** of a store rising to 1,000 new units annually. While we cannot see the economic logic of the national chains getting much larger, there seem to be clear economies of scale for local groups to continue to advance their **consolidation**, typically a half-dozen or

[19] Meaning not a store owned by the OEM, but one owned by the dealer yet controlled in most aspects of operations by the OEM – thus closer to a fast-food franchise's than to a fully independent business.

so stores in a minor metro area: concentrated enough to be manageable, and big enough to be able to share facilities and staff to bring down costs. While volumes per store will grow, we see advanced **inventory** management techniques (e.g. dealer swaps, inventory-management software) as enabling turns to accelerate, so that acreage need not increase. The **showroom** itself should (finally) be enabled by very-high-resolution virtual reality displays, allowing dealers to not have to have every model physically inside at all times, thus shrinking footage. And we *strongly recommend* that OEMs follow our suggestion to allow brand customization in the sales area through static (graphics and photos) and dynamic (imaging, projections, lighting) displays, which can be changed frequently and at low cost, rather than continuing on the current path of ripping up and redoing tiles, carpets, fixtures, furniture, and architecture (walls, balconies, facades, entries, portals) to update brand support, which is both extremely disruptive to business and needlessly expensive. As for the **service** area, we have no one specific forecast, but rather a range of options that dealers can tailor to their local clientele, in order to capture or recapture service volume that otherwise will be lost. We see these options including satellite service (customer-facing or not), pickup and dropoff services, increased hours up to 24/7, centralized shuttle runs, on-lot touchscreen displays for unattended service dropoff, service facilities shared with other brands, driveway service (both own-brand and AMM), etc., etc.[20] The point is we need much greater *flexibility* in meeting the needs of the service market, beyond building ever-larger onsite service facilities on very expensive land. If the average dealer cannot in this way claw back service volume, there is no way to financially support the investments in the brand that OEMs are seeking from dealers, as we cannot expect any help from (ever-shrinking) new-car sales margins. All **other functions** move offsite, as the typical body shop already has: it is a matter of matching a function's economic value to the appropriate real estate cost, and modern technology allows the unbundling of these functions. In terms of location, changing consumer needs and wants, and the revival of city centers, as well as retail innovations generally, imply a greater diversity of dealer locations than the past default template of "follow 'em to the suburbs." All of this adds up to a forecast of greater creativity in physical format design and layout, offering greater flexibility to meet customer and commercial needs. And in turn we

[20] Perhaps proving the saying that there is nothing truly new under the sun, see this photo of the Harley-Davidson Servi-Car, sold in the 1930s to enable garages and dealers to provide service in, or even retrieve cars from, their customers' driveways. (Photo source: The American Car Dealership, by Robert Genat, Motorbooks Classic, 2004).



strongly recommend that OEMs move off the path of ever-greater standardization to one of their own greater flexibility in encouraging these new ideas. Otherwise we are afraid that OEMs will impose needlessly costly uniformity just as markets are moving in the other direction, to low-cost creativity and diversity.

Beyond our forecast for the physical aspects of the dealership industry of the future, the exhibit shows a few other predictions. We do not see multi-branding (i.e. cars from different OEMs) taking hold in the USA in this timeframe. Nor do we see the national chains gaining much more market share – but we do see that local groups' share of the market may very well soar.

More fundamentally, however, we are worried about the role of the dealer him- or herself in this future. In the 1950s the dealer was truly a "dealer:" making money by buying low at wholesale and selling high at retail, living and dying by the margin on the car. Fifty years later the dealer is now really a "retailer:" living and dying not on margin, but on the numerous bonuses, allocations, spiffs, incentives, holdbacks, subventions, and supplementary payments awarded by the factory, for compliance with dozens of metrics, from CSI scores to sales targets to image compliance to tech training and IT implementation. The degrees of freedom open to the dealer – who may not even be allowed now to have the family name on the store – have been and are shrinking. If dealers cannot demonstrate to OEMs their value in customizing people, processes, and *store formats* to local market needs, by 2025 the dealer may be a company store in all but name: funded by the family's capital, but operated entirely according to an OEM's rulebook, much in the same way that a fast-food franchisee can hardly take a step without consulting the corporate three-ring binder. Dealers will still exist in this future, protected by years of tradition, customer loyalty, and regulatory and legislative defenses – but they may not like this future very much, as they become less like entrepreneurs and more like corporate managers.

Dealership of the Future: Conclusions and Recommendations

This concludes our forecast as to the evolution of the North American car dealership. It contains input from a wide variety of informed sources, but we'd always like to have more input, so we ask our readers to chip in with their own views. If we were to summarize briefly everything we've said so far, and then draw some recommendations for action from them, we could lay it out in three categories: what might not change, what might change, and what should change.

What Might Not Change. As we've pointed out, past predictions about the dealership of the future have not been very accurate, which should make us cautious about forecasting massive future changes ourselves. We all recall past years when, in turn, people projected that publicly-traded chains of dealerships would sweep away privately-held stores; or that internet services would cut out the dealer; or that the car companies would forward-integrate into owning much of the retail network themselves. None of those things came to pass in any significant way in North America. Therefore we realized we had to be cautious about predicting radical changes for the dealership of the future, despite endless chatter in the press and the blogosphere about how the current system was "broken" or "dysfunctional. Most importantly, we found NO evidence that the basic dealership system, as it is currently set up, would be going away any time soon. It is here to stay.

In trying to determine ***What Might Change***, we looked at the history of actual change in our own industry, as well as at trends in the broader world of retailing generally. We concluded that the dealership of 2025 is likely to be – relative to today's store – larger in sales volume, but not in size, due to greater efficiency in turning inventory; more often part of a local or regional chain of stores; more creative in addressing the challenge of growing service volume and profits; and more disaggregated in that more and more support functions will be moved offsite to cheaper real estate.

And that takes us to ***What Should Change***. The various developments we have discussed can come about in a costly and painful way, or we can all, dealers and factories, work together to make the transition cost-effective and low-stress. Two things are necessary for this: Creativity and Flexibility.

By ***Creativity*** we mean that the auto retailing industry is full of ideas as to how to best meet the challenges of the future, but often dealers are overly cautious in proposing them, and then OEMs excessively conservative in blocking them. Let's just take one example, what can be called the service challenge. We have about 19,000 dealers out there in North America, serving a fleet of over one quarter of a billion vehicles. Well, the independent aftermarket outnumbers us by ten to one or better, with another 250,000 locations, or more. And yet customers tell us repeatedly that the single biggest barrier to their doing more service business with us is that our locations are not convenient – that it is too far to drive. And it's only going to get worse, as by 2025 there may be 300,000,000 vehicles on the road… and still just 19,000 of us. We think dealers and OEMs need to work together to solve this challenge. There are lots of great experiments out there, from satellite service (both customer-facing and not), shared service facilities, pick-up and drop-off shuttles, driveway retrieval, and more. But too often we find these creative solutions blocked by any number of fears, including those involving territory encroachment, management challenges, worries about liability in driving customer cars around, etc., etc. We encourage both dealers and OEMs to be more creative in both coming up with solutions here, and in approving their implementation.

If Creativity relates to *what* we do, ***Flexibility*** relates to *how* we do it, or put another way, how much it costs. We understand the OEM's preference for rigid facility standards: for one thing, they are easier to apply than case-by-case judgment calls. But costs have gone out of control, and a big part of the problem is that we seem to be designing facilities as if we wanted them to be ridiculously inflexible. Look at a regular retail store, handling clothing or computers. Typically it is generic box filled with some low-cost fixtures. On Friday it might close as a "nature theme" shop, and by changing some display cases, lighting, and a few wall graphics, open on Monday as "industrial chic." But for us, for the typical dealership, such a change usually means tearing down a wall, ripping out a massive reception desk, and jackhammering out the floor tile. If OEMs want to keep up with changing customer tastes by regularly updating the brand's look, we have to find less expensive ways to do this. Fifty years ago a dealership could change its identity by swapping out a sign and putting on some paint: now it is "raze and rebuild," tearing the store down and starting again. This practice generates enormous cost for no clear customer benefit that we've been able to detect. Other retailers are embracing flexibility: your local Starbuck's manager probably picked out the furniture herself, and Apple store facades vary enormously from place

to place. We think it is time for automotive OEMs to catch up with the times, and work with us to build stores that are modern, attractive, and supportive of brand image – without breaking the bank. [21]

In summary, dealers and OEMs together can come up with the creative facility solutions needed to both keep up with changing customer needs and evolving OEM strategies; and OEMs can demonstrate greater flexibility in helping dealers implement those strategies efficiently and at low cost. Otherwise we may find the North American auto retailing industry landscape littered with more and more empty, overbuilt, and unsustainable buildings, reminiscent of the half-empty shopping malls that now litter our landscape. This will be to the benefit of no one: neither the OEMs, the dealers, or the customers.

V. Conclusion

We've covered a lot of ground in this report. We learned that the issue of facility investment is still a painful one for most North American car dealers, though the level of contention has probably eased somewhat over the past year. We tried a second time to estimate the return on investment in facilities (as encouraged by factory image programs), and both reconfirmed our Phase 1 findings (e.g. that expansion tended to pay off, that modernization only sometimes did, and that standardization never did), and built on them with more detail and insight. And finally, we tried to project what the physical dealership facility of 2025 might look like, so that we built *today* stores that would still be valuable *tomorrow* – and urged dealers to be creative in coming up with new facility concepts, and OEMs to be flexible in allowing such concepts to be tried, so that we could avoid building costly and short-lived "white elephants," to no one's benefit.

It has been a fascinating set of topics to cover, and while investigating them we were thrilled to meet and speak with so many industry participants, from architects to appraisers and of course to the dealers themselves, who are what makes the whole North American car distribution system actually work. We didn't find a magic formula or a silver bullet, but we hope we did shed some light on the complex problems these entrepreneurial men and women face, in order to help them spend their hard-earned investment dollars on their stores in the most efficient and effective way possible.

[21] And indeed automotive firms *are* starting to experiment with flexible but compelling and innovative brand communications: see Appendix B for photos of what can be done with exterior video projections, just as one example.

Appendix A: Dealership of the Future Interview Extracts

Organized by forecast category; note that some comments could fit under more than one heading.

Number of Stores

"We see a decline in dealer numbers, in the thousands, overwhelmingly small rural dealers. This is because these stores won't or can't afford to add the technologies that will be needed. Who will provide service in remote rural areas? Dealer groups that specialize in rural areas will take are of this: some exist already. E.g. a dealer in Fargo buys out dealers in small surrounding towns and converts them to service-only points."

Size of Stores

"With less flexibility to vary margin, one cannot survive on selling a few cars, a few of which will generate high profits: we have to make a small amount on every one of a high volume. This trend is further enhanced by pressure (e.g. from state AGs[22]) on F&I profits. As a result, dealers will be fewer and larger, within limits. But larger in terms of pushing more volume through the same size of store, not in terms of building larger facilities. Technology helps by offloading a lot of the sale to online."

"A very key challenge is what to do with small rural stores. These carry less brand weight, tend to have captive markets, tend to have little competition, tend to be solid Detroit 3 markets, and tend to have customers who do not demand major-market bells and whistles (e.g. Wi-Fi). Forcing them out of business via demands to meet higher metro standards may represent OEMs' shooting their feet off. There needs to be a workable small rural format solution."

Consolidation

"As for the projected trend of smaller stores with minimal inventory, this is difficult. Best if one owner owns all the small stores in an area, for fluid access to all of their inventory (instead of having to swap for or buy inventory from other principals). And customers still on balance prefer more choices at their fingertips. CarMax seems to make it work."

"The future is for branded local groups like ours. A national chain of dealerships doesn't do much for the consumer, since the consumer shops for cars locally. But in a local geographic region I can get both demand efficiencies (by marketing, e.g. my group overall) and supply efficiencies (e.g. shared service bays, back office, shuttle service… we have one used-car manager for the whole group)."

"As cars get better they commoditize and that means brand loyalty ebbs and that means customers will want multi-branded dealers or dealer groups."

Location[23]

"It is 'The Revenge of Geography' in the Internet age! Originally people would not travel far for a car because they could not see prices or inventories at dealers far afield. Then the Internet arrived and they

[22] Attorneys General

[23] Note that location strategy was not a major focus of our work: we looked mostly at changing store formats, not on changing locations. But location has a big impact on format (expensive real estate = smaller store, everything else being equal), and so some location comments are included.

COULD see prices and inventories. So you would think they would travel further, but what happened instead is the Internet narrowed all the price bands. So now there is no gain to travelling, and we revert to local shopping again. Thus groups like ours differentiate now on something other than price. People just like they used to buy where they live and work."

The Front End: Sales (both showroom and inventory)

"The store NEVER goes away (in favor of online purchase): too much regulation, customer desire (the furniture store analogy), deal complexity… and with electronic gizmos we do more training than ever before…."

"OEMs may need to develop regional inventory depots to quickly ship cars to small stores, giving them virtual inventories as deep as the bigger urban and suburban stores."

"We'll see more open plan generally: showroom waiting room and service area all blend together. And no one really wants to spend time here, so make the waiting area comfortable and efficient but no more than that. Will we just become delivery centers in the future? Maybe. I sure hope so, I could get rid of large numbers of staff!"

"I see dispersed sales points, lower inventory levels, service off in low-rent locations, etc. It may take a Chinese or Indian new entrant to start the ball really rolling. Body shops have already moved out, we can do it again (they have to be big to turn a good profit, so you can have good division of labor, but you can't afford to give them the square feet they need on an expensive lot positioned for car sales). The same will happen with service bays."

"Think through showroom expansions: I LIKE a crowded showroom, it gets people's pulses going, and makes them more eager to buy. A big empty showroom can be intimidating, and also suggest that the brand is not popular."

"The big trend in showroom design is for more media, video, interactive displays. At some point allowing customer to visualize the desired car thoroughly, and then order it. This should allow reduced on-lot inventory. Eventually. It has been predicted for years, has not come about. Yet."

"I think all dealers must get ready for a more BTO environment, even if they cannot force the pace. This means touch screens and media devices allowing for exploring configurations, etc."

"Sure, I hear about this interactive display stuff, but I've got several touchscreen kiosks in my store, and I don't think even a CSI forensics team could find a single fingerprint on any of them!"

"We can't move 100% online due to liability issues, regulations, the need for a properly instructional delivery process, etc. All back office operations can move offsite or to some other spot on the campus."

"As for the projected trend of smaller stores with minimal inventory, this is difficult. Best if one owner owns all the small stores in an area, for fluid access to all of their inventory (instead of having to swap for or buy inventory from other principals). And customers still on balance prefer more choices at their fingertips. CarMax seems to make it work."

“Showroom size should be more driven by local weather than anything else.”

"Ten percent of our customers (and we have older people who are not necessarily adept with technology) essentially close the deal before they come in. But they still test drive, play with the knobs, show us their trade, etc. PURE online purchasing is many years away, but if everything goes smoothly, we can do it all in 45 minutes."

“Large expensive stores will become stranded assets as internet shopping reduces dealerships to "fulfillment centers." This is a misallocation of capital. Only service and used cars really need physical facilities; new cars and much back office do not.”

The Back End: Service

“If we can't split service from sales, can we split sales from service? As customers see and like more "pop up" or flexible shopping experiences… food trucks… pop-up shops… online… store-in-store… can dealers have more of these remote little selling (or marketing) spots?”

“The showroom becomes less important as activity shifts online. Might even have home delivery of new car. Yet service offers more customer contact points and more room for differentiation. Service becomes more important. Prepaid/free maintenance may be necessary for all. Split sales and service, and allow small sales outposts. Satellite service for light work and central service facility (shared) for heavy stuff. Pickup/dropoff you may have to do, but the liability is huge!”

“Quick Lane or any satellite service facility will only work when all processes are reoriented to support it, otherwise there will be management issues, rivalry between main store and satellite, etc.”

"Skip the putting greens and the dog play area, which make the wait more pleasant: reduce the wait!"

“There is a shift of focus also from the front/sales end of the store to the back/service end, which makes sense because we are at diminishing returns in the showroom -- but not yet in service. Also there are more degrees of freedom in the service area, as well as more money. “

“There is lots of buzz and interest as regards satellite service; the big challenge so far is managing them: dealers are already stretched to manage the one store.”

“You say it is hard to manage satellite service? Try getting cars in and out of a 70-bay single operation!”

"We'll need more satellite service sooner or later: customers just won't drive that far, and if we don't go to them they will go to the independents."

“Service and sales will split apart, whenever real estate prices force it.”

"With quality improving warranty plummets and so we must get customer pay. We'll throw in more free service, just to build loyalty: tires, oil. People and processes will keep them, once we snag 'em."

“We’re in a 3-stage evolution as far as service areas go: we went from unpleasant to wait in (before 1990 or so), to very pleasant to wait in (by 2000 or so), to no waiting at all (pickup and dropoff, loaners,

etc.), today. To increase service volumes we don't need satellite service: we can do it with pickup/dropoff, loaners, shuttle vans. Note that there is a difference between customer-facing service facilities and non-customer-facing ones: if we can't do one we can do the other."

"How about an EZ-Pass for service? Customer drives in and *bingo* she and her car are logged in."

"Our area is mature and growth is in other parts of town: we'd love to do a satellite service point there, but OEMs don't like mixed-brand ones (even if their customers ask for it), and I can't afford a single-brand place. Also, OEMs like sales and service bundled because they *always* want the chance to sell a new car, even to a service customer. And other dealers could or would object."

The Back End: Other Functions

"I've already centralized all back office in one location. Minimal staff elsewhere. The future is giving a whole town to one operator, a la Saturn, who can get scale economies by sharing back office, ditto by sharing inventory, and because he is the only game in town no one will protest his satellites. In the past OEMs did not like this because they worried the dealer would trade volume for margin: but nowadays no one gets margin anyway!"

"In service computers replace manual libraries and record file cabinets. Parts department shrinks with frequent deliveries. And high-density parts storage. Go vertical in dealers to save real estate costs; rooftop parking. Offsite service and more, such as collision repair, administration."

"If pickup and delivery of customers (new/used cars, service calls) climbs, we can have smaller waiting areas, etc."

"We're ultra-centralized: there is a head office which has ALL the accountants and general office staff, freeing up space in the stores and reducing their footprint. F&I remains in each store. We have a central used-car recon center for all the stores. We run a centralized shuttle service. As service work declines, we pulled back subbed-out detailing and undercoating, etc., and do it in the freed-up stalls."

"Move more off-site, only sell cars on the costly (and limited) real estate we can get. My body shop is centralized, my prep shop also, my car storage area ditto. All these areas serve all my stores, letting each of them be smaller. We WILL need a showroom: pure online unlikely, with such an expensive purchase, at least for some majority of customers (a minority may go this way): books could be 100% online since they do not vary in features, color, size… but cars are more like clothes, where not 100% of people are happy with online – and of course returning an item is easier if it is clothes… All administration is offsite. Easiest to do this with a group you own, but why could not several dealers cooperate to do this? Most OEMs support this kind of offsite move. Satellite service they are less happy with: harder to maintain quality control, objections from other dealers, no chance to see a new car."

Flexibility

"There is no consensus as to the future best design, which tells me we need flexible formats that can handle anything. This includes sizing better: build small with easy expansion options, rather than build too large and not fill the store."

“There are more and more electronics in a store, more wiring, more IT, more iPads, more screens and displays, more high-tech wiring: dealers should make sure this stuff is all flexible so they can reconfigure easily, up the wattage, etc. Also note that the panels we use for walls now are infinitely easier to reconfigure and move, versus traditional cinder block.”

"We have built our last gigantic concrete box . We cannot afford to tie so much money up in fixed assets. We have to make this capital more flexible: reconfigurable at low cost, more productive (in service at least) via added shifts, etc."

“Always build a generic simple box, that supports process flows, then add the OEM’s bells and whistles. Avoid building the OEM’s desires into inflexible and expensive-to-change concrete, etc. (It is also easier to plumb and re-plumb and wire and re-wire a box.)”

"My view is the best blend is a standardized exterior and a locally-variable interior."

"I am afraid we will see more raze-and-rebuild, as OEMs more rapidly update images. We need some way to flexibly update the store, instead of tearing it down all the time."

“The variable side is a tollbooth; the fixed side is a destination… architecture must flex to meet both needs. In variable ops, the showroom, we are not sure what the customer wants; in fixed ops we know what he wants, but we are not sure we can afford it. Lavish waiting areas, pickup and dropoff, etc.”

"We've moved from generic stores that are totally unresponsive to local needs and preferences, and to OEM brand image as well… to stores that are highly responsive to OEM brand needs but are still unresponsive to local requirements…. now it is time to respond to local requirements, or the municipalities will do it for us!"

“If in the future the dealership image will have to be updated more frequently, as retailers of other goods do, why not make it cheap and easy to do by using easily-updated digital displays and static graphics and reprogrammable lighting, etc.? "The building can become the ad," especially if one can project a large advertisement right on the side wall. With new technology this will work in daylight as well as at night. Build a simpler box and dress it up with displays.”

Miscellaneous

"It will take a long time, but sooner or later, the paper moves 100% to a pad or a screen."

"Part of the reason for the upgrading is that customers have higher expectations now, too. Enough exposure to HGTV and *Architectural Digest* and innovative retail store design, and customers come to expect that from dealers, too."

“Many people think mobile will have a huge impact – but no one knows what it will be!”

“Big schism: DEALERS want facilities to support PROCESSES; OEMs want facilities to support BRANDS.”

“As to social media and all communication channels: mostly now this is all about reputation management. The underlying sales process does not change, the matching of people to cars, the

searching of inventory, the negotiation of price, etc. But the way the customer hears about me shifts constantly, from newspapers and billboards and radio and TV to internet and Yelp and Twitter and Facebook. Dealers have to manage all these things but I am not sure they are "game changers." People have a herd mentality where they all go the same way at once (e.g. "Gotta be on Facebook"): dealers need to keep pace, but you do not need to reformulate your business model in pursuit of this stuff. "

"Facilities will become more important and thus more expensive. Upgrades occurring more frequently. But I also see new margins shrinking and service volume falling, so something has to give. But what?"

"The future is indeed a store that is run as a company store and funded as a local franchise. We will all become Wendy's."

Appendix B: Exterior Visual Projections as One Type of Flexible Brand Imaging

Source: Google image search