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Future of Automotive Retail

Alternative *distribution models* to enhance sales effectiveness, profitability and customer experience

FOREWORD

The profitability of OEMs has shrunk over the last two years, mainly driven by increased investments in e-powertrains and autonomous driving technology. Looking forward, the rise in shared mobility, combined with the impact of the pandemic, will affect top-line growth and put additional pressure on OEMs' margins.

M&A and partnerships have surged in the automotive industry with the aim of achieving cost optimization synergies and ultimately enhancing profit margins. Beyond inorganic moves, most OEMs recently undertook global cost transformation programs, whose focus was primarily in the operations space.

This transformation journey had a marginal impact on the retail model, which has been kept substantially unchanged over the last decades.

The current three-tier distribution – focused on a separation of duties between the OEMs' headquarters, National Sales Companies (NSCs) and the franchised network of dealers – has proved many limitations. The brick-and-mortar retail model required copious capital expenditures, yet the returns for the dealerships in the last few years have been negligible. Low earnings translated into limited investment capabilities to drive digital innovation and deliver the experience that customers expect.

In such a troublesome scenario, the automotive retail model should not be exempted from a complete rethink. The Covid-19 pandemic has further sharpened the need for a change of business model in the automotive downstream as lockdown measures have accelerated the transition of consumers towards digital channels.

In this Viewpoint, we explore the retail innovation journey that car manufacturers should undertake to optimize the cost-to-serve as well as providing customers with a seamless and compelling omnichannel experience.

The evolution path of the automotive distribution model we envisaged from the current state to 2030 will be shaped around three main dimensions:

- *the consolidation of the dealership network*;
- *the progressive switch towards the agency model*, with dealers operating as agents for the trade of new vehicles and no longer holding inventory risk;
- *the adoption of a direct-to-customer business model* for OEMs, with dealerships acting as service providers to complement the on-line customer journey.

There is no "one-size-fits-all" approach across Europe. OEMs need to find the right mix and magnitude of these dimensions based on the specific context of each market.

According to our estimates, **the profitability level of the automotive downstream value chain could more than double in the next decade** with this paradigm change, leveraging greater economies of scale as well as higher commercial effectiveness.

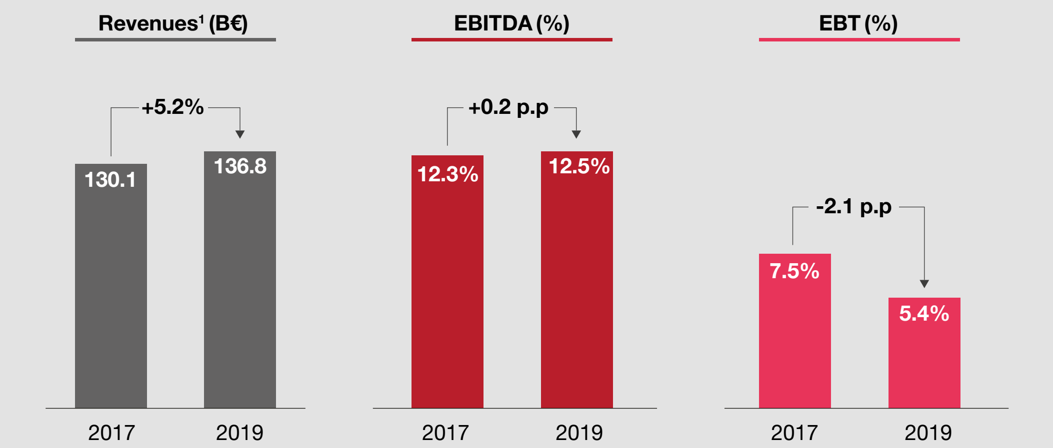
AUTOMOTIVE MARKET CONTEXT AND OUTLOOK

The profitability of OEMs has shrunk over the last two years mainly driven by increased investments in e-powertrains and autonomous driving technology

The aftermaths of recent crises, and the typical competitive dynamics of mature industries, have hampered the ability of Automotive OEMs (Original Equipment Manufacturers) to generate interesting rate of returns for their investors. This profit erosion has been further exacerbated by the considerable investments in e-powertrain and autonomous driving technology required to comply with strict CO_2 emissions standards and increased market demand. The impact of the technological disruption affecting the Automotive industry is clear when analyzing the financial statements of the major global OEMs.

> **Between 2017 and 2019, Earnings Before Taxes (EBT) of major industry players decreased mainly as a consequence of the higher Depreciation & Amortization (D&A), increasing from 5.7% to 7.4% due to the growth of Research & Development investments (Exhibit 1).**

EXHIBIT 1
Major OEMs financials



1) generated from core operations only
Sample: Average value for BMW, Daimler, FCA, Ford, General Motors, Honda, Nissan, Peugeot, Renault, Toyota, Volkswagen
Source: Company financial statements; Strategy& analysis

The rise in shared mobility and COVID-19 outbreak will further reduce top-line growth in the future, putting additional pressure on OEMs' margins

The vehicle parc has constantly expanded in the past years, providing relief to the financial statements of Automotive OEMs. This expansion will soon come to an end due to the rise in shared mobility. According to our forecasts, the total number of vehicles in use in Europe will peak at 308 million of units in 2025 and drop to 294 million units by 2030[1].

The COVID-19 pandemic has posed an additional shorter-term threat to this negative outlook on sales volumes, with vehicle registrations in Europe not expected to recover to pre-crisis levels before 2023 according to our estimates.

Increased investment requirements, combined with a poor outlook in terms of top-line sales, are urging Automotive OEMs to optimize their cost structure and ultimately enhance profit margins.

1 | Digital Auto Report - PwC Strategy& 2020

THE RESPONSE OF OEMS: COST-TO-SERVE A NEW FRONTIER?

M&A and partnerships have surged in the Automotive industry with the aim of spreading investments across a higher sales base

In recent years, mergers, acquisitions and partnerships in the automotive sector have increased with the intent to seek further economies of scale and scope, sharing investments over a larger-scale production. Automotive M&A deal value has surged by 70% from 2017 to 2019[2], with almost all top 10 transactions focused on enhancing Research & Development capabilities in the race for electric and autonomous mobility or in driving economies of scale.

Automotive players underwent all types of combination models, ranging from mergers, co-investments to joint ventures. The most recent example is the merger of FCA and PSA to create an OEM player better equipped to respond to the investments and efficiency challenges of this era. Joint ventures have also flourished in order to respond to specific investment needs. For instance, BMW, Daimler, Ford and Volkswagen have joined forces to create *IONITY*, a network of ultra-fast charging stations to encourage Electric Vehicle adoption.

OEMs are reducing costs heavily along the value chain and Sales & Marketing should be no exception

Beyond inorganic moves, OEMs have put a strong emphasis on optimizing costs to render sustainable mobility economically viable. Daimler, General Motors, Jaguar Land Rover, Renault and Volkswagen have recently announced pervasive cost transformation programs aimed at reducing costs in the range of €2 to €4 billion each. These cost saving initiatives are mainly focused on operations, with the intent of reducing engineering complexity, improving manufacturing efficiency as well as rationalizing sourcing.

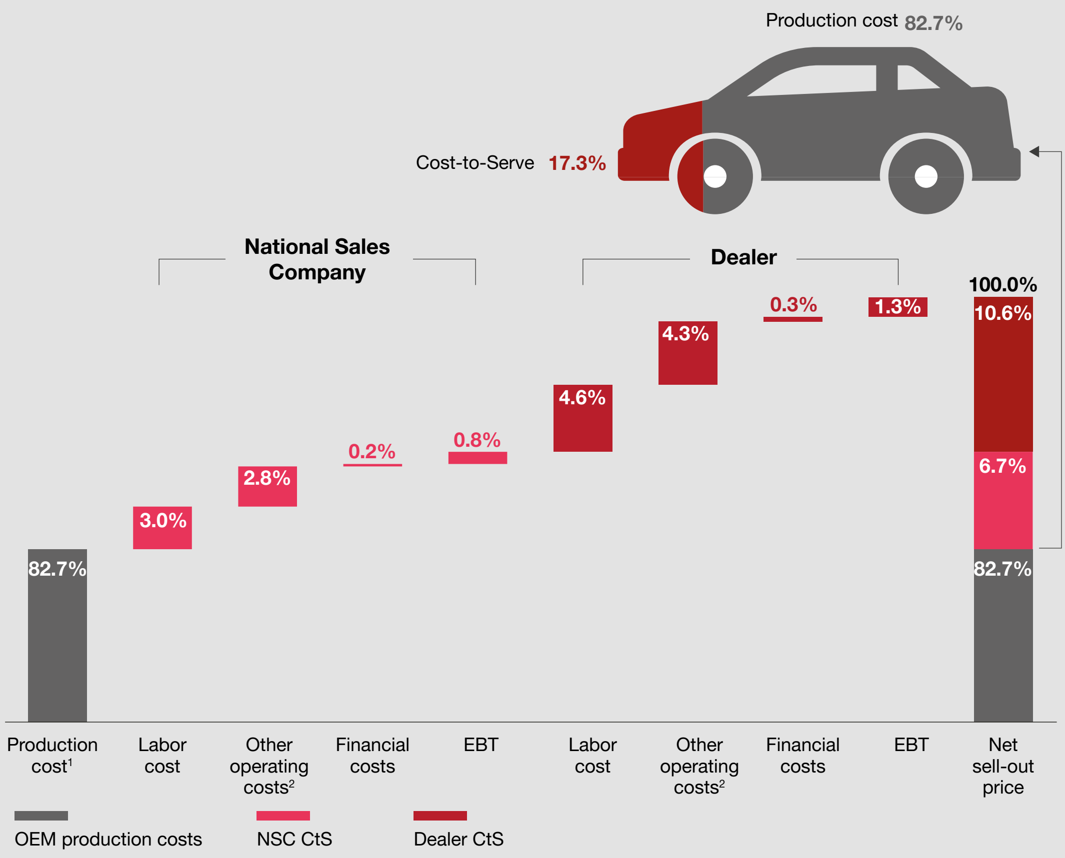
According to our analysis, the Cost-to-Serve (CtS) in the European Region accounts for approximately 17% of the final vehicle net price, of which approximately 11% is referred to dealerships-related operations (Exhibit 2).

The Automotive distribution model, which has experienced very limited change in the last decades, urges a paradigm change to optimize Cost-to-Serve and fulfil changing customer needs.

> **Sales & Marketing could further contribute to achieve cost saving objectives.**

2 | Automotive Deals Insights - PwC

EXHIBIT 2
Cost-to-Serve (CtS) breakdown (2019, 100% = net sell-out price)



1) manufacturing costs, shipping costs, SG&A and other OEM-related costs; 2) Sales & Marketing-related costs (including advertising, commercial bonuses, promotions), rent and leasing costs, Depreciation & Amortization, utilities and services (including legal, accounting)
Sample: 36 National Sales Companies, 2.023 dealerships from Germany, Italy, Spain, France and the UK

Source: Company financial statements; Strategy& analysis

LIMITATIONS OF THE CURRENT DISTRIBUTION MODEL

The brick-and-mortar retail model required copious capital expenditures, yet the returns for the dealerships in the last few years have been negligible

In the current distribution model, OEMs have consistently required dealerships to perform major investments in real estate and corporate identity to promote brand values and ultimately enhance the brand experience. Our analysis on a representative sample of more than 2,000 financial statements of dealerships located in the five major European markets shows that dealers have invested consistently since 2010, expanding fixed assets by 2-3% on a yearly basis.

Over the last decade, high capital expenditures have not translated into an improved RoS (Return on Sales) for the European dealerships, whose average EBT margin ranged from 1.0% and 1.5% in the past five years.

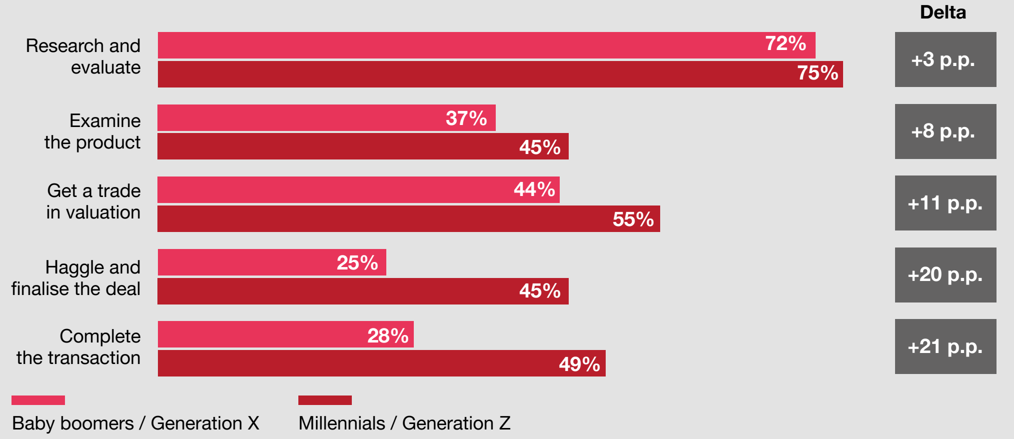
Dealers and National Sales Company are in a difficult position to respond to customers who are asking for innovative customer journeys and digital retail experience

The preference of customers for digital channels has strongly increased over the last few years. Car buying journeys are manifold with several transitions across digital and physical channels and customers increasingly demand a seamless integration between the diverse touchpoints with a consistent and efficient information flow. A seamless omnichannel experience will gain additional traction in the near future. Younger generations – Millennials and Generation Z – are more inclined to remotely interact with sales personnel and ultimately buy online (Exhibit 3). Such generations will represent the majority of buyers by 2025.

> **Poor profitability resided also in the high fragmentation of the dealership network, that exacerbated intra-brand competition and over-relied on small, family-owned dealers which struggled to innovate.**

EXHIBIT 3

Online channel preference by sales process phase and age



Source: ICDP 2019; Strategy& analysis

> **The COVID-19 outbreak and consequent social distancing measures have deeply influenced customer behavior, accelerating the digitalization trend. Since the beginning of the lockdown, the interest of consumer has shifted towards digital channels for the search of information and purchases compared to before the pandemic[3].**

The increasing demand for a digital and contactless car buying experience has not yet been fulfilled by the dealerships since investments in customer journey innovation have been drained by flat earnings. On the other hand, the OEMs' National Sales Companies (NSCs) could be in a privileged position to act as orchestrators of innovative omnichannel customer journeys, although an excessively fragmented dealership network prevents them from fulfilling this role. Disputes over customer data ownership between dealers and NSCs, as well as the heterogeneity of the dealerships' ICT landscape (e.g. Dealer Management System, CRM), undermine the integration needed to provide a seamless omnichannel experience to end customers.

3 | The Impact of COVID-19 on the European Automotive Market - PwC Strategy& 2020

RETAIL DISTRIBUTION MODEL INNOVATION JOURNEY

Automotive OEMs should adopt a digitally enabled direct sales model to enhance downstream profit margin and deliver the experience that customers expect

Establishing a *direct-to-consumer* business model would allow automotive OEMs to address the limitations of the current distribution paradigm by reinventing their business relationship with the dealership network. This is a major step forward that OEMs should properly assess market by market based on their competitive positioning, the maturity level of customer demand as well as their bargain power with the local dealership network.

This new retail paradigm will entail several benefits:

- lower **cost-to-serve**, as a consequence of labor and operating costs optimization at the level of both dealerships and National Sales Companies;
- enhanced **commercial effectiveness**, resulting from centralized pricing policies, front-office staff professionalization and full exploitation of customer insights into market intelligence activities;
- improved **customer experience**, ensuring a truly omnichannel and compelling approach – taking advantage of new digital technologies – increasingly in line with consumer expectations.

In our view, the evolution path of the automotive distribution from the current state to 2030 should to be shaped around three main dimensions:

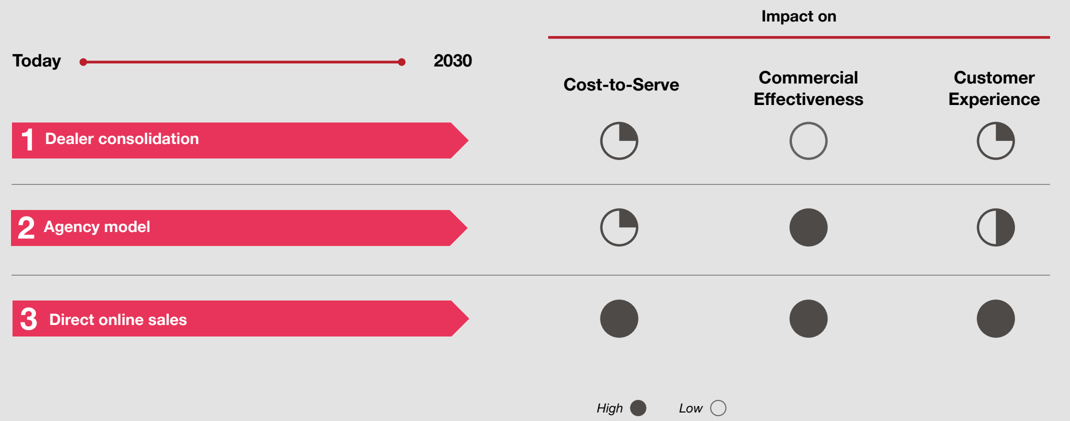
1. **Dealer consolidation**. A more consolidated network will reduce cost-to-serve leveraging economies of scale, at the same time paving the way for a smoother path to innovation as bigger dealerships are financially stronger and generally more professionalized. The ongoing COVID-19 crisis will further accelerate the consolidation within the dealership network.

2. **Agency model**. Promoting a different business relationship with the dealerships – having them act as agents rather than franchisees – will represent a win-win solution to address their high-risk and low-reward conundrum, as well as to enhance commercial effectiveness and customer experience with full control over the marketing mix and direct relationships with the customer base.

3. **Direct online sales**. OEMs will need to complete the transition by establishing a *direct-to-customer* business model. In this setting, dealerships will become service providers for all the required physical touchpoints (e.g. product presentation, test drive), yet the full sales process will be performed online through the OEM platform. This direct sales model will ensure full potential in terms of cost-to-serve and customer experience.

There is no “one-size-fits-all” approach across Europe. The OEMs need to drive the change based on the specific context of each market and find the right mix and magnitude of these dimensions.

EXHIBIT 4
Building blocks of future retail distribution model



Source: Strategy&

Dealer consolidation

Past crises have provided a stimulus towards distribution network consolidation in the quest of efficiency. The fast-deteriorating liquidity position of several family-owned and smaller dealers, caused by the downturn in registrations, presented buyout opportunities for prominent operators looking to better absorb fixed costs and mitigate profitability reduction trends. Between 2007 and 2013 main dealer outlets decreased by approximately 14%[4] in the five major European Automotive markets, due to collapsing sales triggered by the financial and Eurozone crises. From then to the end of 2019 the dealerships consolidation process across Europe continued, yet at a slower pace than expected.

The COVID-19 outbreak provides OEMs with a new opportunity to further drive the dealerships consolidation process and ultimately reduce the cost-to-serve of the automotive downstream value chain[5]. The abrupt stop in sales caused by the pandemic has accrued financial distress situations and provided M&A opportunities to best-in-class and large-sized dealer groups.

Based on our estimates, a dealer consolidation will enhance pre-tax profit margin of the value chain in the range of 0.4 to 0.6 p.p. (Exhibit 5).

The main component of EBT optimization from dealer consolidation is represented by the higher ability to absorb fixed costs from higher-scale dealers. This effect is also demonstrated by our analysis on the financial statements for FY 2019 of more than 2,000 dealers in Europe, showing a direct link between dealer profitability and business volumes, with a differential of 0.4 p.p. on EBT (1.0% vs 1.4%) between small-sized (yearly turnover below €20 million) and large-size dealers (yearly turnover above €100 million).

A more consolidated network provides another opportunity to reduce cost-to-serve – to a lower extent – by streamlining the National Sales Companies' field force, since the number of counterparts to deal with will progressively decrease.

> **The dealership network consolidation will reduce the cost-to-serve leveraging economies of scale and pave the way for a smoother path to innovation, as bigger dealerships are financially stronger and generally more professionalized.**

4 | The Impact of Covid-19 on the European Automotive Market - PwC Strategy& 2020
5 | Including both National Sales Company and dealerships cost-to-serve

Agency model

Beside dealer consolidation, OEMs should review their distribution paradigm, with the ultimate goal of increasing sales effectiveness. This can be achieved by establishing a direct relationship with end customers and gaining greater control over commercial policies.

The agency model, in which dealerships operate as agents and no longer hold inventory risk, is one of the most important levers that OEMs can take advantage of to evolve their retail paradigm.

In such distribution model, the role of dealerships is not eliminated but it is rather transformed. The dealership will act as an agent of the OEM and will be remunerated through an activity-based model, rewarding services such as test drive execution, consultation or delivery of the vehicle.

In our estimates, we forecast an overall positive effect from the agency model on the automotive downstream operating margin in the range of 0.6 to 1.0 p.p. (Exhibit 5), due to the balance of:

- **price realization**, as a result of end-customer discount policy directly managed by the OEM, ensuring dynamic adjustment as well as consistency across the network, and thus avoiding intra-brand competition;

- **optimization of financial costs** to fuel working capital and investments in corporate identity as well as **lower indirect labor costs** (i.e. customer service, sales administration staff, etc.) due to scale effect when shifting responsibility from the dealership network to the National Sales Company;

- **increased IT spending** to centrally manage customers relations, dynamic pricing, offers, invoicing and integration of dealer systems (e.g. DMS, CRM).

The agency model will also provide OEMs with a wealth of data to enhance customer insights and inform marketing initiatives aiming at increasing brand loyalty, cross and up-selling.

> **"The agency provides an interesting alternative business model to the dealerships since the slim retained profit achieved on new vehicles sale frequently no longer justifies the risk taken in respect to the stock and the uncertainty related to the dependency on volume bonuses.**

Direct online sales

Customers attitude towards online sales is progressively gaining traction, providing OEMs with the opportunity to render the direct sale model a viable case for change. In this scenario, OEMs will control all touchpoints with buyers, whose customer journey will alternate between visits to the OEM site and physical visits to dealerships' outlets.

The OEM web site will be at the core of this new model and will need to be enhanced to provide customers with the opportunity to perform all sales process steps online. For example, the OEM web site will need to offer virtual product walkarounds, online quotations and enable contracts to be concluded with a digital signature. For all these activities, the OEM should provide customers with the ability to virtually interact with sales personnel to obtain consultancy, in true virtual showroom fashion.

Retail formats will also need to be updated accordingly. Dealerships will operate with a hub-and-spoke model where *brand experience centers or temporary pop-up stores* will ensure product awareness and showcase the latest launches in strategic urban areas, whereas *mega stores* located in urban outskirts will provide the full range of services and back office functions. This model will entail lower investments in real estate positively impacting the cost-to-serve.

Dealerships will still remain at the forefront of the automotive distribution of the future, fulfilling a primary role in the aftersales and pre-owned business, and guaranteeing the territory coverage needed to offer all the physical touchpoints required by clients even in the envisioned direct sales model.

Our estimates show that the full transition to direct sales could entail an additional 0.8 to 1.2 p.p. in the downstream operating margin (Exhibit 5). This positive effect is mainly explained by a lower cost-to-serve resulting from the combination of:

- **reduced investments in real estate**, as a consequence of a rise in digital sales, combined with the optimization attributable to the scale effect of shifting part of the investment responsibility from the dealership network to the National Sales Company;
- **streamlining of direct labor** costs related to the sales of new vehicles, as a significant portion of these activities will be managed through the online platform;
- **rationalization of the OEM's field force**, since ground activities at dealership level will be reduced and simplified;
- **increased investment in ICT capabilities** to manage all steps of the sales process online (e.g. virtual showroom, online test drive reservation, digital contract signing).

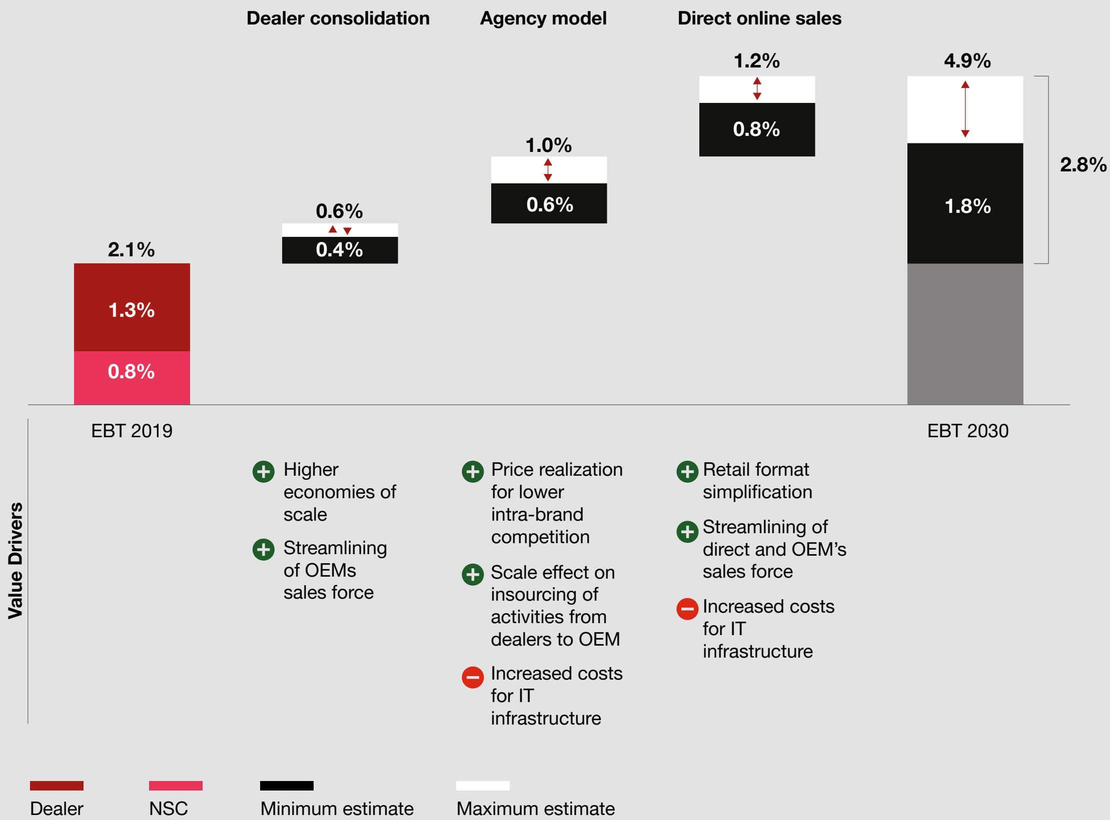
> **The direct online sales model will provide full potential in terms of cost-to-serve and customer experience.**

> **The envisaged paradigm shift of the retail distribution could more than double the pre-tax profit margin of the downstream automotive value chain by 2030.**

The new model will tackle the cost-to-serve imperative, enhance commercial effectiveness in addition to providing more traction to deliver the omnichannel Customer Experience requested by consumers (Exhibit 5).

EXHIBIT 5

Innovation journey value drivers and EBT impact analysis



Source: Strategy&

This evolution path will entail major implications, both for OEMs and their dealership network, that need to be taken into consideration.

- **Resistance to change**: OEMs will first need to address the resistance to change of internals and dealerships, which will require guarantees towards a win-win agreement.
- **Legal constraints**: the contractual framework regulating the current distribution model will need to be renegotiated, although existing agreements have a multiyear duration with expiration dates not synchronized across markets, requiring complex consultations with dealership councils across Europe. The negotiated provisions will need to be in line with the Vertical Block Exemption Regulation (VBER), governing the agreements for European distribution. The European Commission has launched a review of the VBER and has already committed to provide additional clarity over rules defining agency agreements. The new regulation will be defined before May 31st 2022.
- **Customer readiness**: while demand for a more digital and omnichannel sales experience is clearly gaining ground, a significant portion of the customer base will keep on looking for the traditional approach in which physical touch with sales personnel still plays a pivotal role.
- **Investment requirements**: the new distribution model will require OEMs to allocate large investments to fund new (on-line) own-retail formats, new digital platforms and vehicle stock given the shift of responsibilities with the dealerships.

Why now?

The envisioned paradigm change of the automotive distribution will allow OEMs to tackle the margin erosion challenge and drive profitability growth in the years to come.

As is often the case, crises provide opportunities: Covid-19 sales disruption, with the financial strain placed on the retail network, has created the right case for change to trigger the consolidation of dealerships and progressively introduce the agency model, starting with those retailers that are now in financial distress.

The introduction of Battery Electric Vehicles (BEV) is another opportunity that OEMs can take advantage of to experiment with the agency model. Some first steps in this direction have already been made. The latest example is provided by the Volkswagen group, which has recently signed an agency agreement with all its retail partners in Germany for the sale of its BEV ID family.

Technology is another lever that OEMs can now use to their advantage in this transition. Virtual and augmented reality can be exploited to showcase vehicle variants to clients, reducing the stock of vehicles exposed in the showroom. This will drive down real estate requirements and provide a positive business case for the dealerships.

The increased penetration of Long-Term Rental (LTR) agreements, and, more in general, the spreading of flat rate solutions, is also contributing to setting the right environment for direct online sales since this form of payment is more suitable to the channel.

Finally, new entrants in the automotive arena – the likes of Tesla Motors or the Chinese players such as Nio, Byton, Aiways – who do not have a legacy dealership network are planning to scale up using a direct sales approach, posing an additional threat to incumbent OEMs and urging them to respond.

The direct sales model has long been on the agenda of OEMs to address the limitations of the current distribution, yet few steps have been made towards this direction so far.

> **Tackling the cost-to-serve imperative and innovating the customer experience is a top priority for the future sustainability of the business of car manufacturers and their dealerships. Now is the right time to in depth analyze possible benefits and investment requirements to bring the automotive distribution to the next level.**

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About the authors

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