A report to NADA

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The 2020 NADA Show

DOT II: USA CAR DEALERS PREPARE FOR CHANGE

PART 1: INSIDE THE STORE

BACKGROUND

The original Dealership of Tomorrow (DOT) report was commissioned by NADA in order to provide its dealer members perspectives on the changing automotive retailing environment, as input to their planning processes. The report was intended to act as a "thought starter" to assist dealers to engage in such planning, looking ahead to roughly 2025.

In early 2019 NADA asked for an update on the report, as the environment was continuing to shift. The present report represents the findings of the updating process as of November 2019 – readers are advised that some of its conclusions may shift as the updating work continues.

As about 2.5 years have passed since the original DOT, focused on 2025, was issued, this update looks somewhat further out, to the late 2020s.

BELIEFS ABOUT THE CUSTOMER

No primary customer research was done for this report. This is because there is an abundance of pre-existing good research on customers already available. Our report draws on this research to assume that the retail customer of the future has these characteristics, *on average*:

- A bit *older* than today (median age up by a year by 2030, to 39)
- Somewhat *richer* than today (GDP grows at 2%, population at 1%)
- Even more *comfortable online*, but as offline experience improves…
- … seeking equilibrium: from "bricks *vs.* clicks" to "bricks *and* clicks" (the distinction may be meaningless by 2030)
- Probably more open to different ownership *models* (uncertain)
- Ever more likely to default to *used rather than new*
- Consistently insistent on more and more *convenience*
- …

"INSIDE" CONTENTS

In this section we set aside discussion of ACES*, which will be addressed in the "outside" section. This section assumes non-disruptive technological evolution, in order to generate a forecast baseline, with ACES impact to be added later. Topics addressed in this section include:

- New car sales outlook
- The nature of the store
- Structure of the store network
- Changes in dealer economics, shop by shop and in total
- Also: subscriptions, stairsteps, OTA updates, AI, etc.

*ACES = autonomous vehicles (AV), connected cars (CC), electric vehicles (EV), (shared) mobility services (MS)

SUMMARY

Our research convinces us – again – of a positive outlook for the American franchised new-car dealership system.

We foresee much change to the dealership over the next decade, and probably some compression of profitability, but no revolutionary change or disruption.

It is clear, however, that we are moving from a Recession Recovery Era (in which rising sales lifted all boats) to the Age of the Operator, where better-managed stores are likely to open a clear lead.

What has changed in our view since 2016/17 is an inversion of the relative threat from "inside" vs. "outside" trends. There had been worry that outside threats (e.g. EV, AV) would overwhelm the industry – while current operations stayed strong. Now that the hype around these outside issues has cooled, they're seen as less worrisome – but conversely, we are *more* concerned about inside issues, such as: near-term financial performance slightly erodes, as growth plateaus; and as a recession (eventually) arrives.

"INSIDE" CONTENTS

- New car sales: stable volumes, rising prices
- The nature of the store: physical/digital (smaller?) hybrid
- Structure of the store network: rooftop count flat, ownership (slowly) consolidates; mostly private
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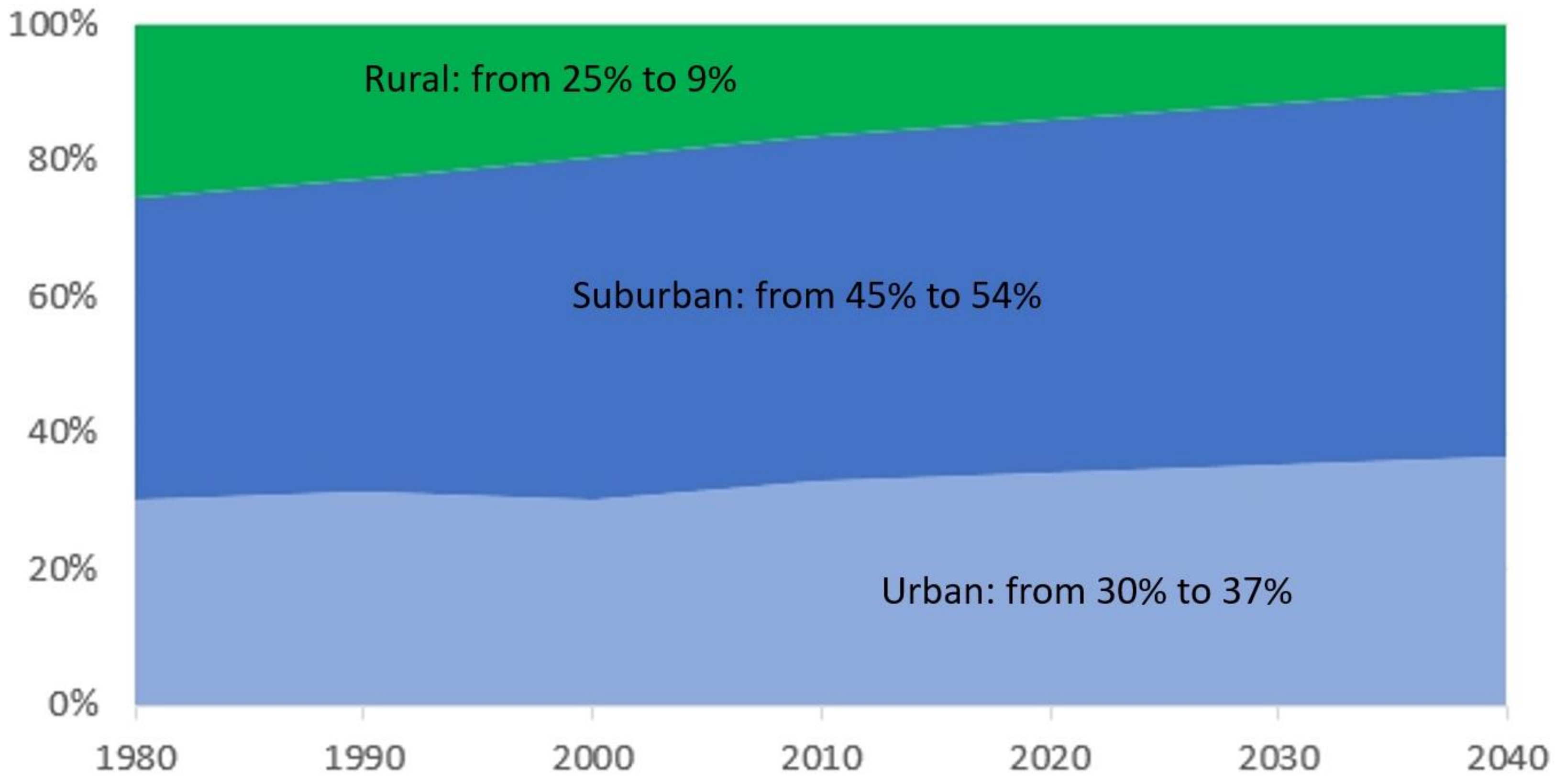
A DRIVER OF DEMAND: THE SUBURBS STILL GROW

AMERICAN POPULATION BY PLACE OF RESIDENCE

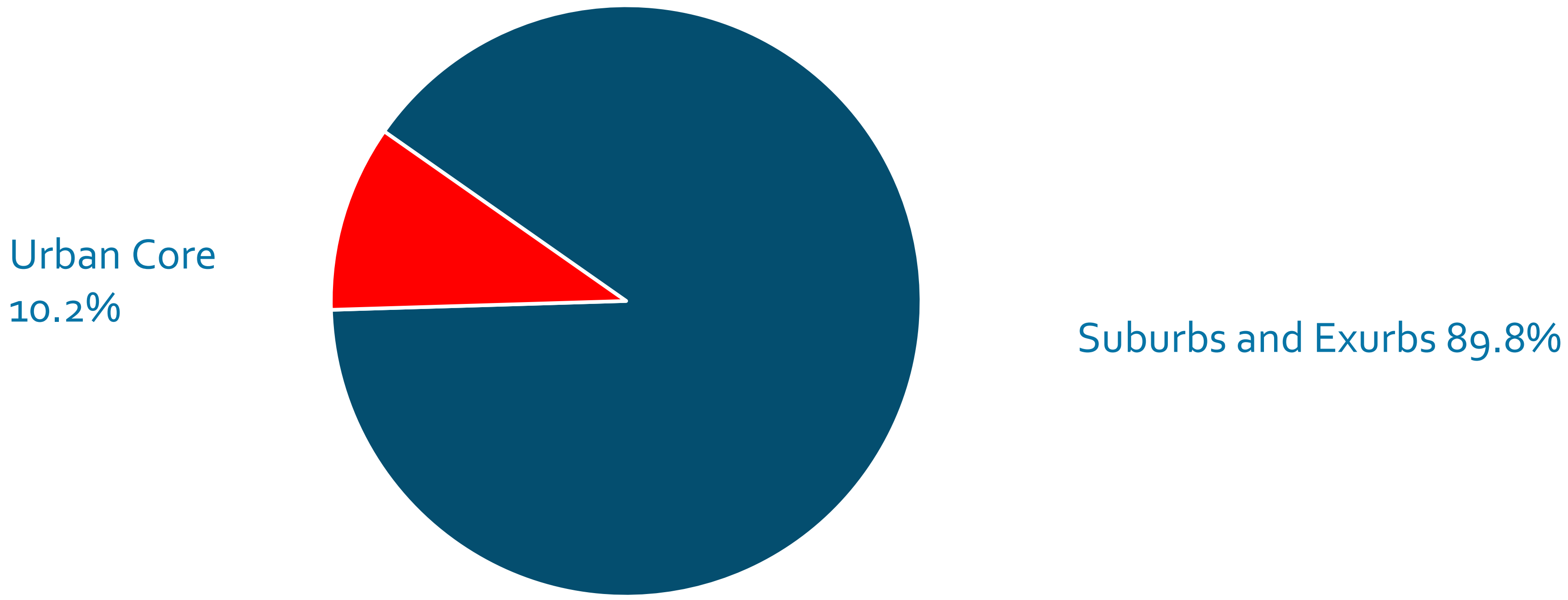


Source: Department of Transportation, from Census Bureau projections; cars/hh in rural areas 2.4, suburbs 2.4, urban 1.0; author's calculations

INCREASED SPRAWL: SUBURBS REIGN…

Despite news stories to the contrary, American city centers (where the personal car is less useful) have been and are projected to grow more slowly than the suburbs (where the personal car is a requisite).

2010-2017 POPULATION GROWTH IN URBAN VS. SUBURBAN AREAS:

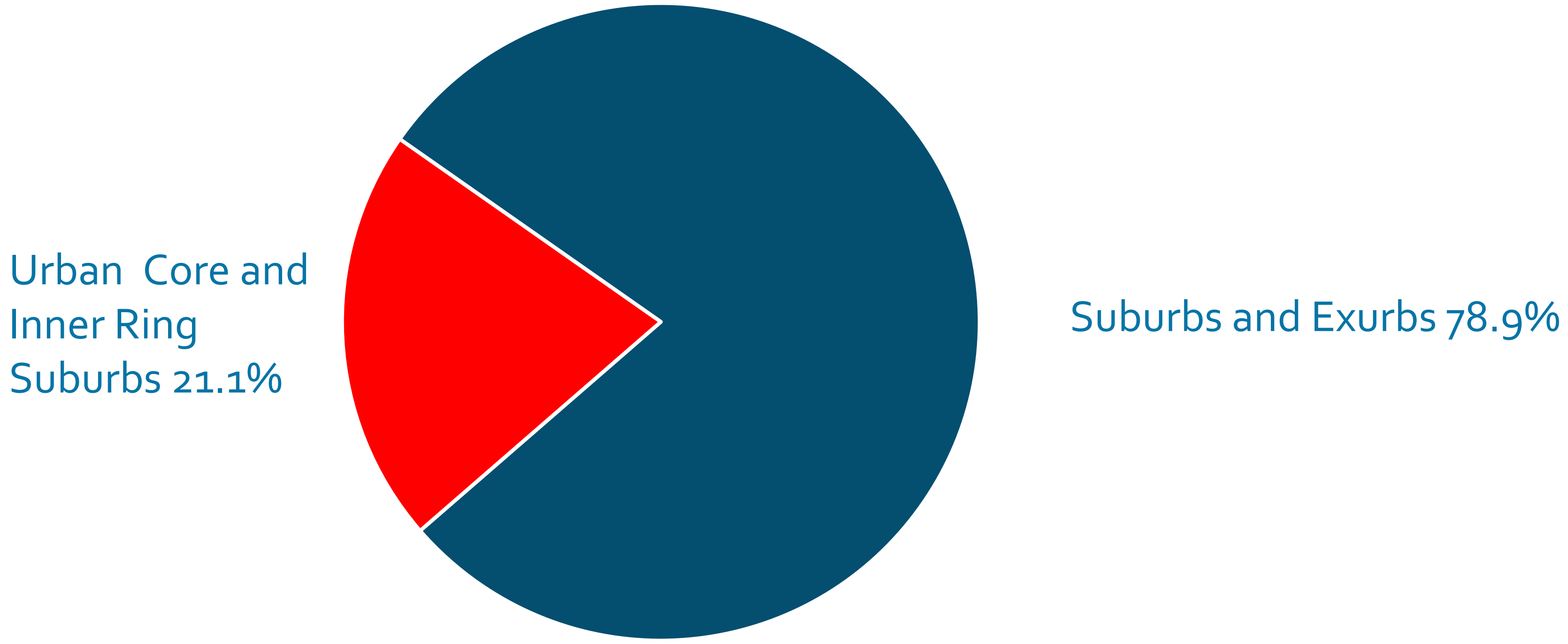


Source: Wendell Cox, from American Community Survey Data

WAIT, MILLENNIALS *LOVE* CITIES, RIGHT?

Again despite news stories to the contrary, American millennials (defined here as aged 25 to 34) increased in number by about 2 million between 2010 and the present – but most of them chose to live in the suburbs and beyond.

2010-2017 MILLENNIAL POPULATION GROWTH IN 53 LARGEST U.S. METROS:

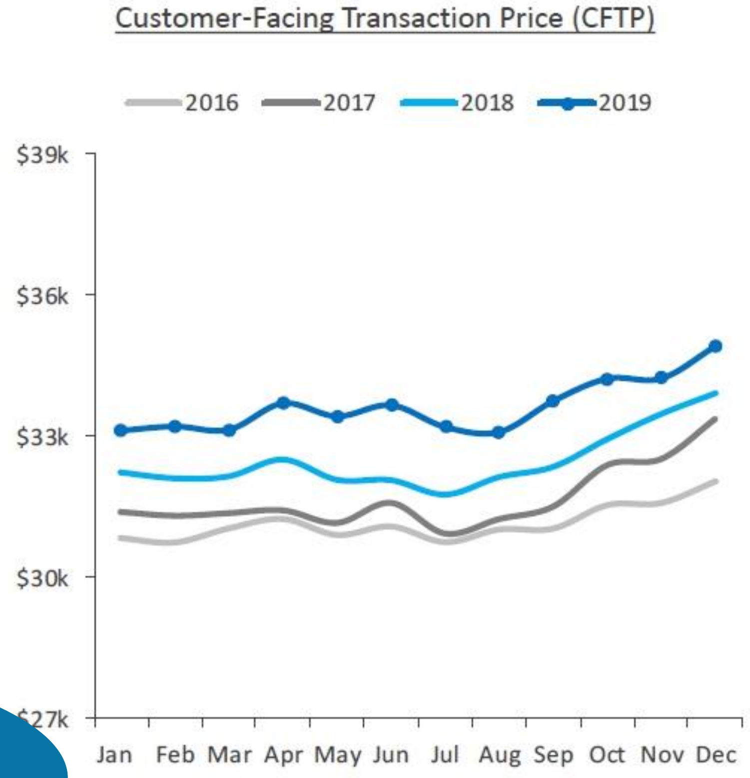


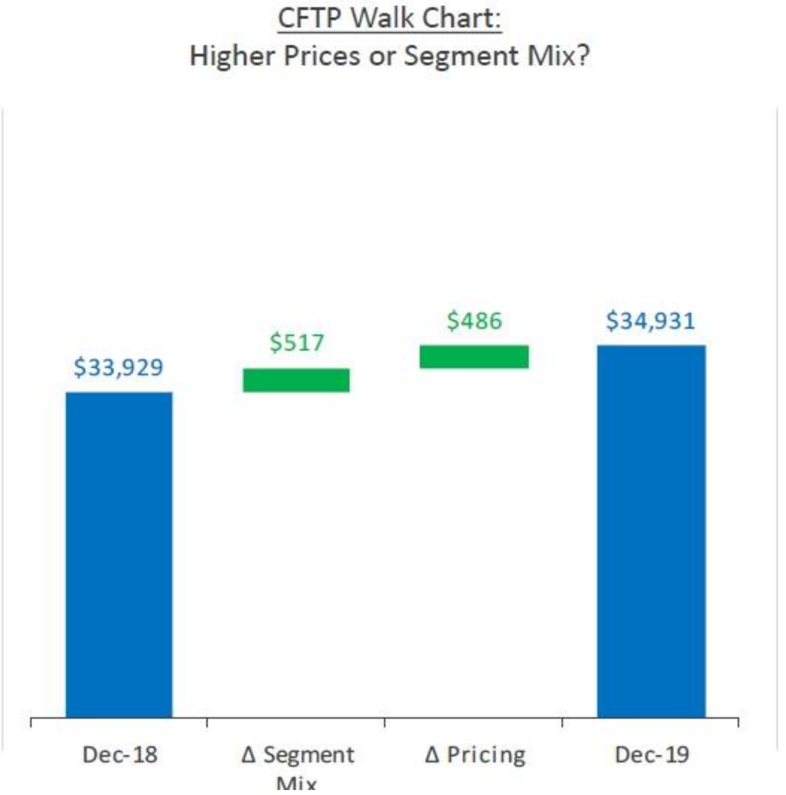
Source: Wendell Cox, from American Community Survey Data

CONSUMER-FACING TRANSACTION PRICES (NET OF ALL INCENTIVES)

NEW CAR PRICES DRIFT UPWARDS AS BUYERS BECOME MORE AFFLUENT

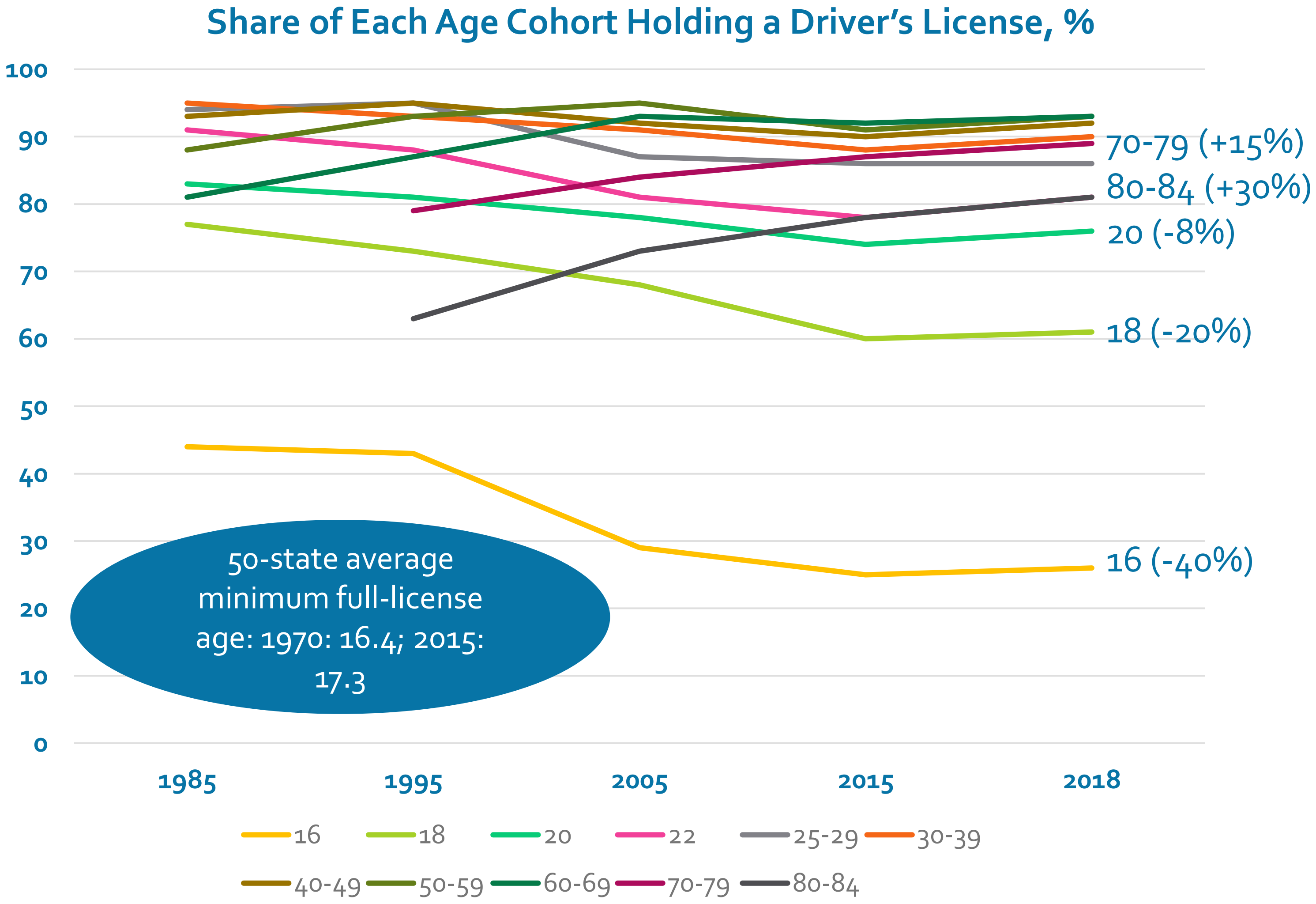
Average income of new-car buyer household: ~$100,000 (various sources)





Source: J D Power Information Network

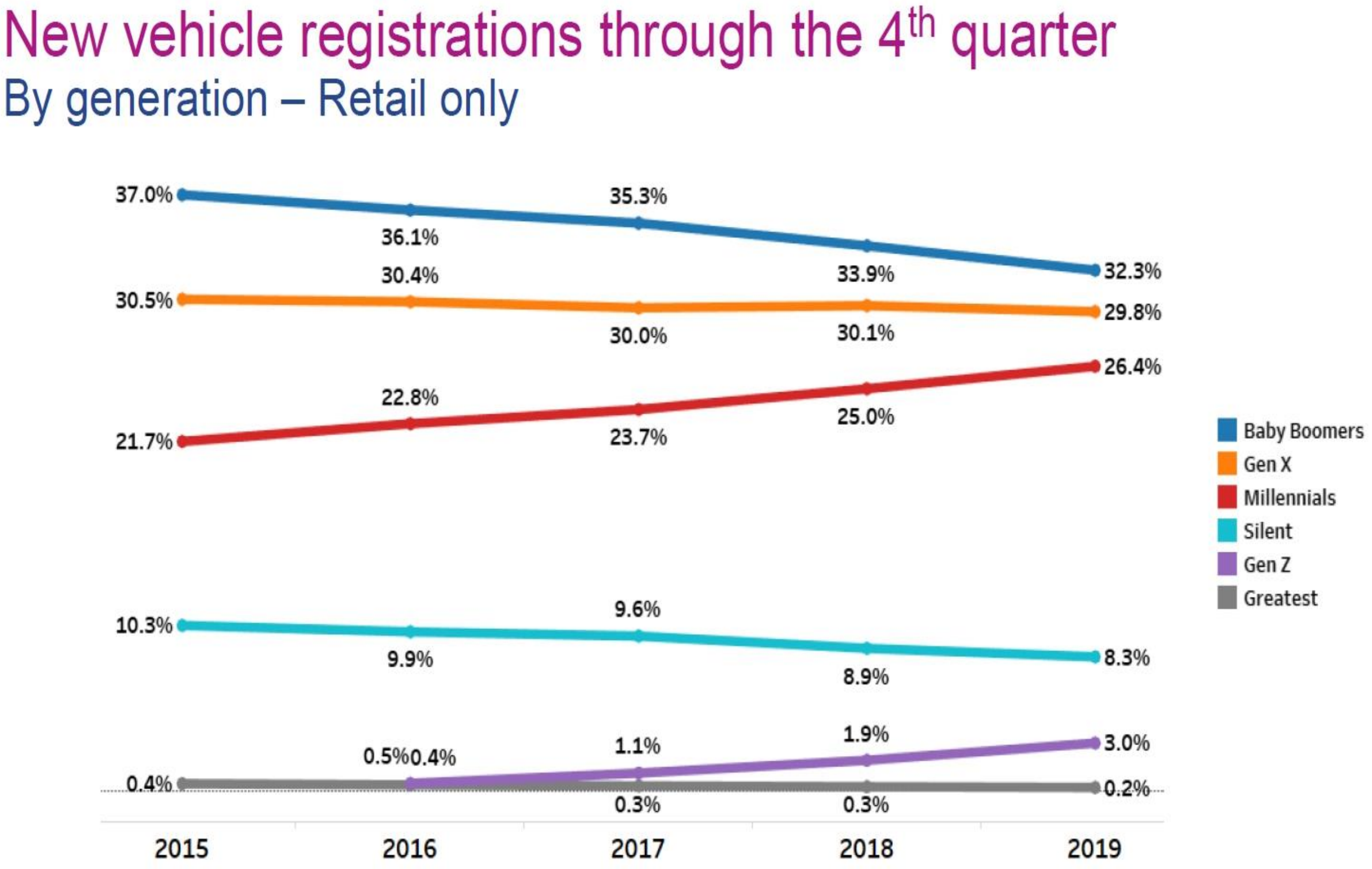
YOUNGEST AGES ARE DEFERRING DRIVING, MIDDLE ARE HOLDING STEADY, OLDEST ARE DRIVING LONGER



Source: FHWA

REGARDLESS OF LICENSE RATE, MILLEN-NIALS HAVE BECOME CAR BUYERS IN FORCE.

NEW-CAR SALES BY CUSTOMER GENERATION (EXPERIAN)



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THE STORE REMAINS, BUT ITS FORM EVOLVES (SMALLER, MORE VARIED?)

- Concerns that the physical store would be replaced by purely online sales have not in any way materialized… but there are signs of movement towards less lavish physical facilities, as retailing shifts to a mixed online/offline approach (aka "omnichannel")

- Interviews with OEMs consistently reveal an *intent* to back away from the overbuilt "garage mahals" of the recent past, but actual *behavior* is not necessarily consistent with such stated intent.

- OEMs are watching carefully "digital native" retailers such as Casper (mattresses), Bonobos (clothing), Warby Parker (eyewear), et al., all of which started life online, but now are building physical presences (almost 500 across just these three). These tend to be small, simple, and low-cost facilities.

- Geely/Volvo's Polestar sub-brand represents this concept, with its intent to use dealers; but require only "small, modest" stores (called "guide shops") of 2-2,500 square feet in size and ~$750,000 in cost; take most orders online; and hold minimal or no inventory on site.

(All this being said, it is unclear that Americans, beyond a high-income time-constrained niche segment, are willing to move to a BTO (build-to-order) from BTS (buy-from-stock); or that factories designed to run flat-out will be willing to accept the volume fluctuations BTO generates.)

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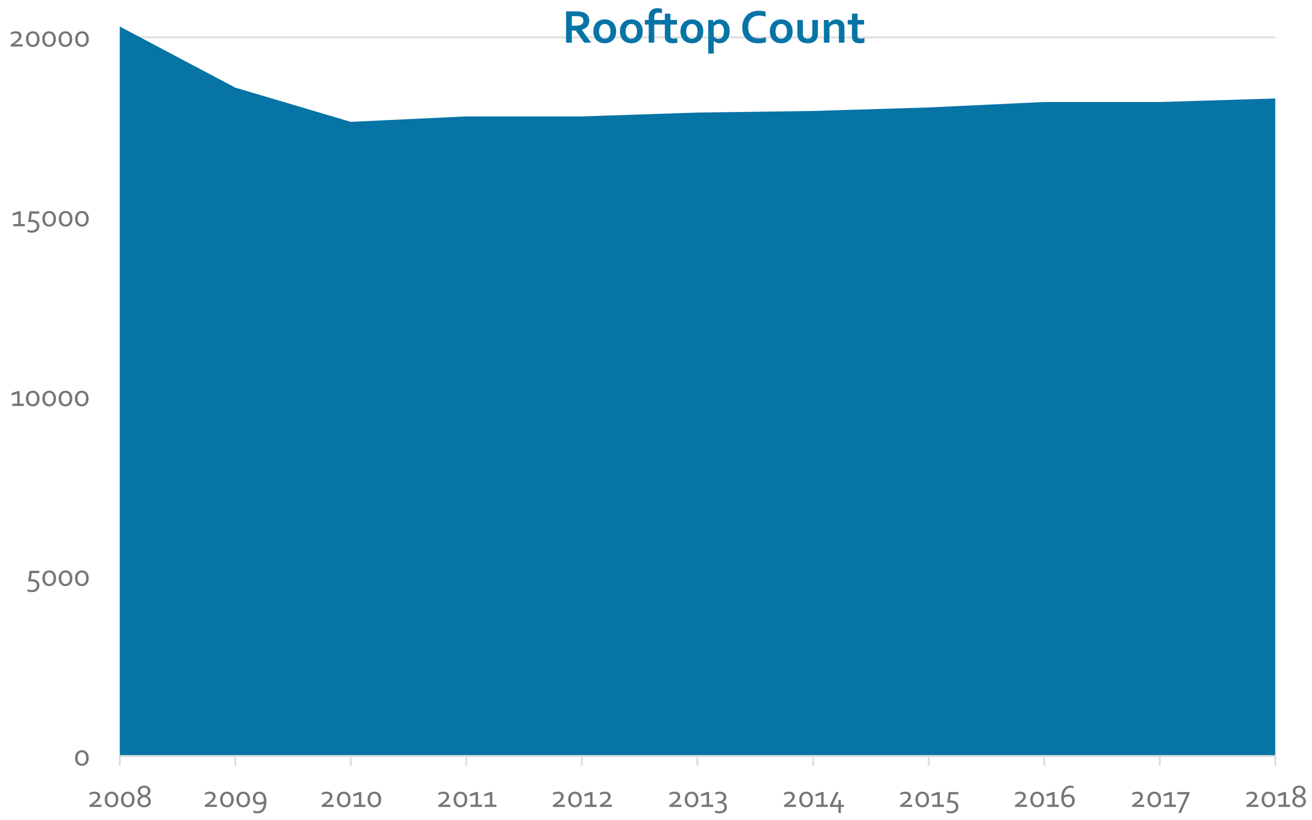
STORE COUNT FLAT…

Since the "brooming" of (mostly GM and FCA) stores during the bankruptcies of the Great Recession, store count has inched up, to the surprise of many.



Source: Urban Science; note that US, *Automotive News*, and NADA censuses of rooftops vary somewhat, but arrive at similar trend directions and levels.

Also a surprise? As a group, the public chains have not been major consolidators over time (defined as share of new vehicles retailed).

UNLESS SOMETHING CHANGES, PUBLIC CHAINS WILL NOT DRIVE CONSOLIDATION

- In 2000, total USA new light vehicle sales were 17.3 million, of which about 2.8 mm were fleet, leaving 14.5 mm as retail. Of those 14.5, the 6 public chains sold just under 1 mm, or about **7%**
- In 2018, once again total USA light vehicle sales were 17.3 mm, of which about 3.6 mm were fleet, leaving 13.7 mm as retail. Of those 13.7, the public chains sold about 1.1 mm, or about **8%**
- Thus, in 18 years, the public chains' share (measured in retail units sold), has moved only from 7% to 8%, hardly a scorching pace of consolidation.
- There are numerous reasons for this, not all of them within the control of management (e.g. OEM framework limits)

Notes: 1. Berkshire Hathaway qualifies as "public," but is excluded from this analysis due to limited data disclosure; 2. For 2000 UAG and Penske were not fully merged, but for this analysis were combined into one firm, Penske; 3. fleet sale figures are not as reliable as total sales figures, due to definition issues (e.g. what is the lower limit of vehicles purchased to be considered a "fleet"?)

Sources: Automotive News for total sales, Automotive Fleet and JD Power for fleet sales

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CHANGES IN DEALERSHIP ECONOMICS: SOUND, BUT LIKELY NOT AS STRONG AS TODAY

Original forecast: by 2025 P&L profitability ratios somewhat lower than today. Revised forecast: unchanged. Drivers:

By shop:

- New cars: margin flattened by internet; partly offset by OEM money and F&I
- Used car: higher margin than new, under pressure from competition
- Service: high margin, large revenue upside; pressured by improving car quality, replace-versus-repair, etc.; dealers historically unable to grow market share; collision repair healthy, though threatened
- F&I: at historic highs; major profit driver; regulatory risk significant

Overall:

- Some regression to the mean (NPBT/sales closer to 2% than 3%)
- Natural diversification of dealer lines of business reduces risk
- ROIC may hold up better *if* facility capex controlled, inventories shared
- Mid-sized undifferentiated over-leveraged stores most at risk; large groups well capitalized; smallest stores benefit from low cost basis

Net: the 2010s were the decade of sales growth, thriving in a boom; the 2020s will be that of cost reduction, working on a plateau

NEW CAR: DEALERS MORE DEPENDENT ON OEM PAYMENTS THAN EVER

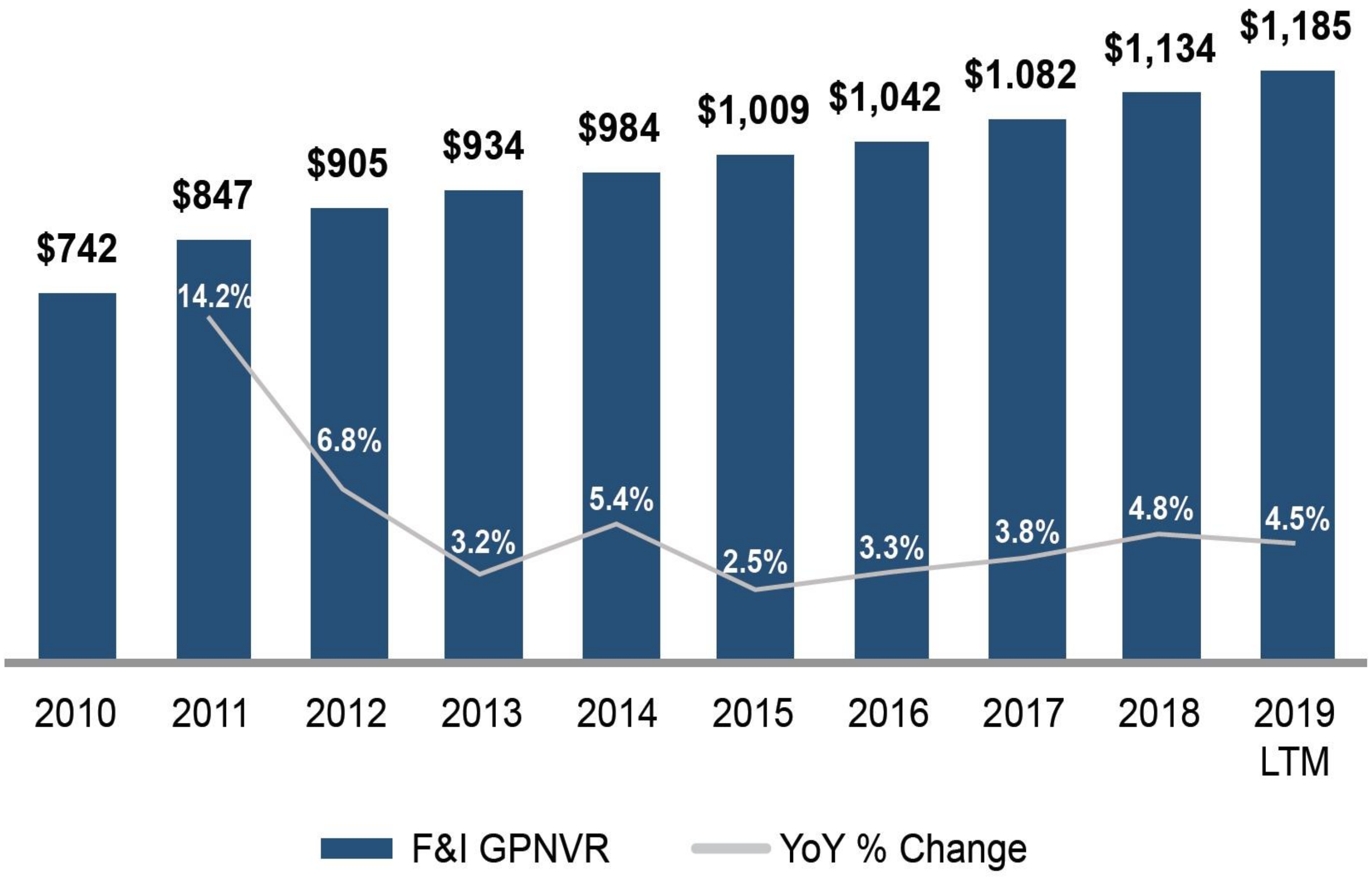
Today's strong bottom lines conceal inherent fragility, since new-car margin, has been replaced by below-the-line/back-end OEM dealer incentive payments. The average store has become wholly dependent on such payments for its bottom line.

In order to maintain or grow market share, OEMs are increasingly employing monthly sales bonus programs which are primarily dependent upon hitting a certain sales target. The more reliant dealers are on other income derived from the OEM, the less control they have over their profitability, particularly if these bonus programs vary from month to month.

Source: Kerrigan Advisors Blue Sky Reports

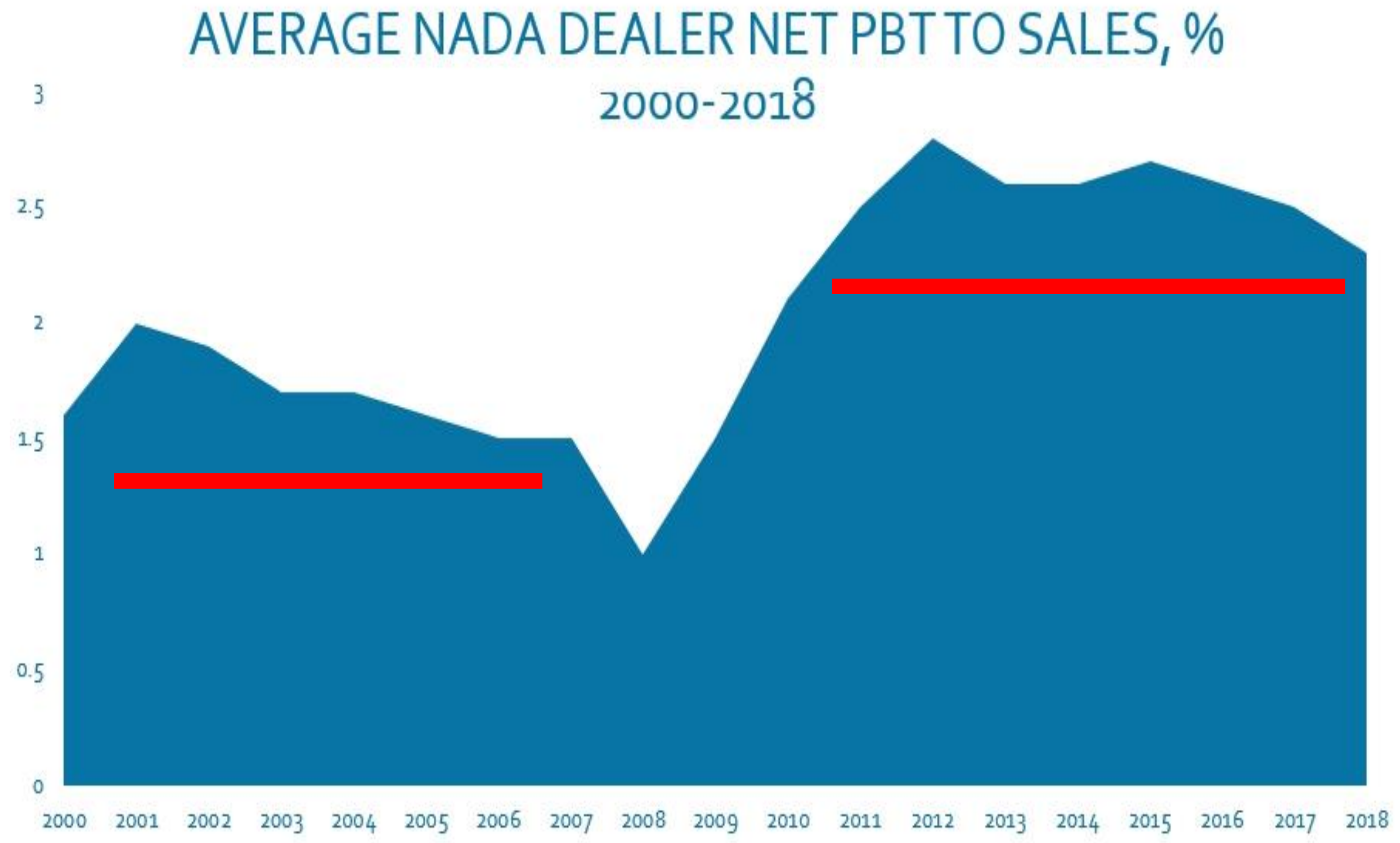
F&I OUTLOOK: AMAZING GAINS, ALWAYS AT RISK

Average F&I PNVR vs. Annual % Change



Source: Kerrigan Advisers

OVERALL: DEALERS HISTORICALLY RESILIENT, BUT TODAY'S PROFITS MAY BE HARD TO SUSTAIN



Source: NADA; note this series is periodically recomputed, so data by year may vary

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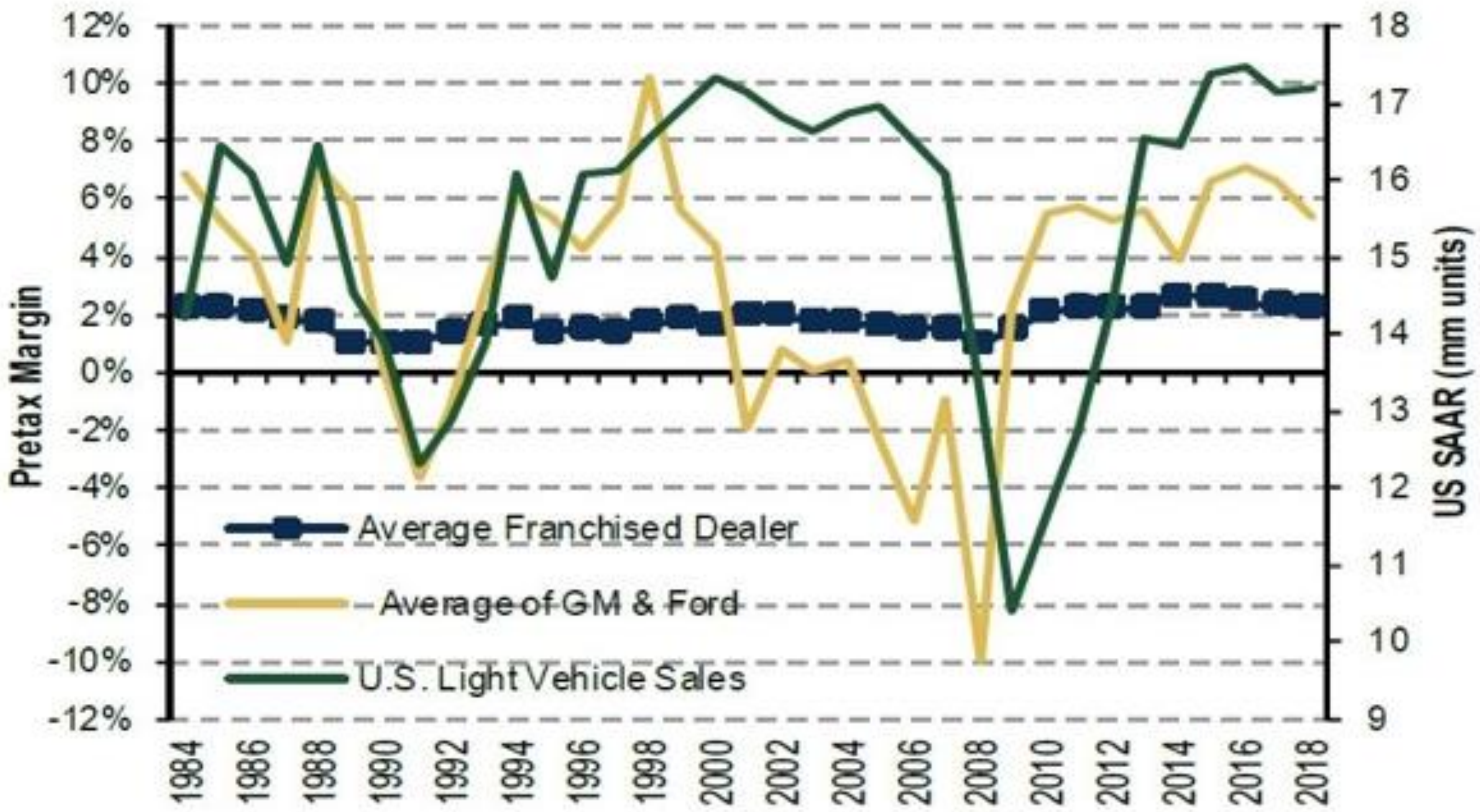
PRE-TAX MARGIN OF DEALERS AND OEMS, COMPARED TO SAAR



Source: Company filings, WardsAuto InfoBank, NADA

Source: "Auto Dealer Manual," Bank of America Merrill Lynch, October 2019.

SUMMARY OF “INSIDE” THE STORE

- Overall profit levels should be good, if lower than today, as dealers use their natural hedge of diversified operations to offset profit pressures.

- With transparency in prices everywhere, there is an ongoing shift from holding price to cutting costs: if price cannot go up, expenses must fall to keep the bottom line intact. We expect to see immense investments in productivity. The 2020s may be the decade of the Most Efficient Operator, not of the Best Salesperson (the 2010s).

- Earnings will be generally more fragile, in that profits from fees is less in the control of dealers than profits from margin. OEM payments can be altered by the factory at will, F&I caps can be set by regulators, etc.

BRIEF COVID UPDATE: ANYTHING DIFFERENT?

- Acceleration in provision of online sales techniques: "the website becomes the dealership, the store becomes a delivery & service point."
  - Not expected to *replace* physical sales, but provide more customer options
  - May lead to *higher* dealer profits, due to greater efficiencies
- Some increase in the rate of ownership consolidation, as individual owners become exhausted, but no more than a modest acceleration in store closures, as decline in city densities speeds up.
- Acceleration in OEM control: 1970s dealers became 2000s retailers, and are now "company stores locally owned." In short, American car dealers become McDonald's franchises.