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AS DRAMATIC DISRUPTION COMES TO AUTOMOTIVE SHOWROOMS, PROACTIVE DEALERS CAN BENEFIT GREATLY

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Dealers can survive—and thrive—by putting the customer at the center and pursuing dynamic, new ways of working.

Dealers are operating in an increasingly disrupted environment, creating the need for dealers to review their own operating model, identify and unlock operational efficiencies, and discover new ways to operate in a digital, omnichannel environment. Over the past five years, we have worked with dealer groups, individual dealerships, and OEMs to study the impact of disruptions on automotive retail and the traditional dealer model; this article synthesizes our perspective on the space and its likely evolution. While we see several challenges to dealers and the traditional automotive-retail model, we also see opportunities for dealers to pivot the model in one of four ways to succeed in the new reality, including centering it on one of the following: luxury brands in tier-two cities; geographic scale and increased scope; ecosystem platform development; and less disrupted, rural markets. But no matter which future model dealers chose, now is the time to lay the groundwork, build the required capabilities, and capture near-term opportunities.

Automotive retail is changing

Retailing is changing fast for many car dealers—and their bottom lines. Average dealership operating profits plunged from 8.9 percent in 2015 to 1.7 percent in the first half of 2018, while gross profits fell from 3.3 percent to 2.4 percent over the same period. Dealership sentiment is also shifting from optimism to pessimism based on the most recent industry research.

Two forces are limiting dealer profits. First, automakers continue to boost incentive pressure as they face growing price competition and thus squeeze the margins of their dealer networks. Second, third-party digital channels for research (for example, Autotrader, CarGurus, Cars.com, and TrueCar) and digital vehicle purchases (for example, Carvana, Shift, and Vroom) are increasing vehicle pricing transparency and enabling consumers to make product comparisons easier, thus limiting the ability of dealers to capture margin on the vehicle and to influence customers' buying behavior.

Dealer margin pressures multiply

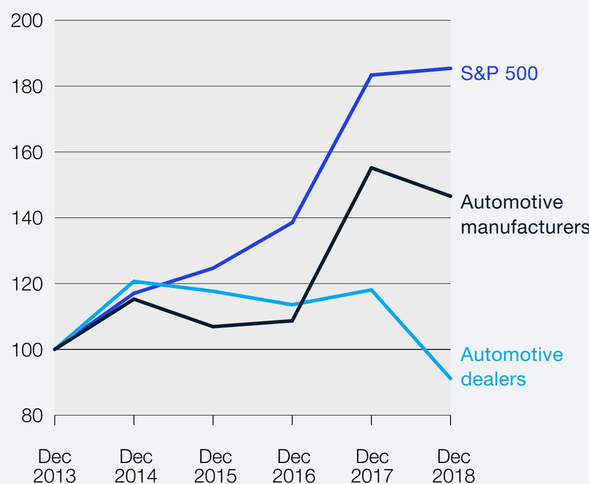
Likewise, used-car retailing is also digitizing rapidly as disruptive new entrants (such as Carvana, Roadster, Shift, and Vroom) launch price-competitive business models that simplify the buying and selling experience for consumers. Compounding the problem, dealership organizations continue to face operational challenges that include high turnover rates and consolidation pressures. As a result, dealer profits have decreased over time, and most dealer stocks are underperforming the market (Exhibit 1).

Dealers have historically relied on revenues generated by vehicle service work and financing and insurance (F&I) to offset the profit pressures and accordingly have grown their business in these areas. For example, F&I as a percentage of new- and used-vehicle gross profits increased from about 45 percent in 2015 to roughly 53 percent in 2018, driven by greater emphasis among dealers on F&I products (for instance, service contracts) as well as compression of vehicle margins. At the same time, dealership-parts-and-service-profit contributions continue to advance, with their share of total gross profits expanding from 45 percent in 2015 to over 49 percent in 2018. However, dealerships will likely soon reach the limits of further growth in these areas as automakers apply increasing pressure on parts and service and F&I penetration reaches a saturation point.

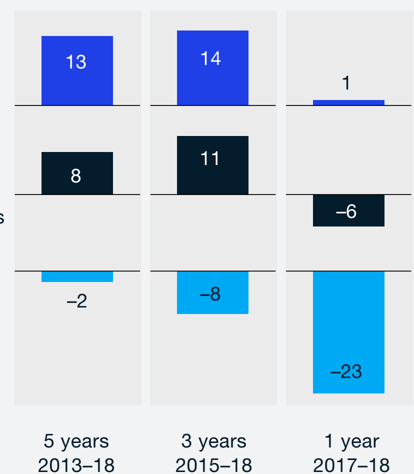
Exhibit 1

Dealership stocks have been performing weaker as a result of margin pressure.

Total return, index (Dec 2013 = 100)



Total return to shareholders, CAGR[1] %



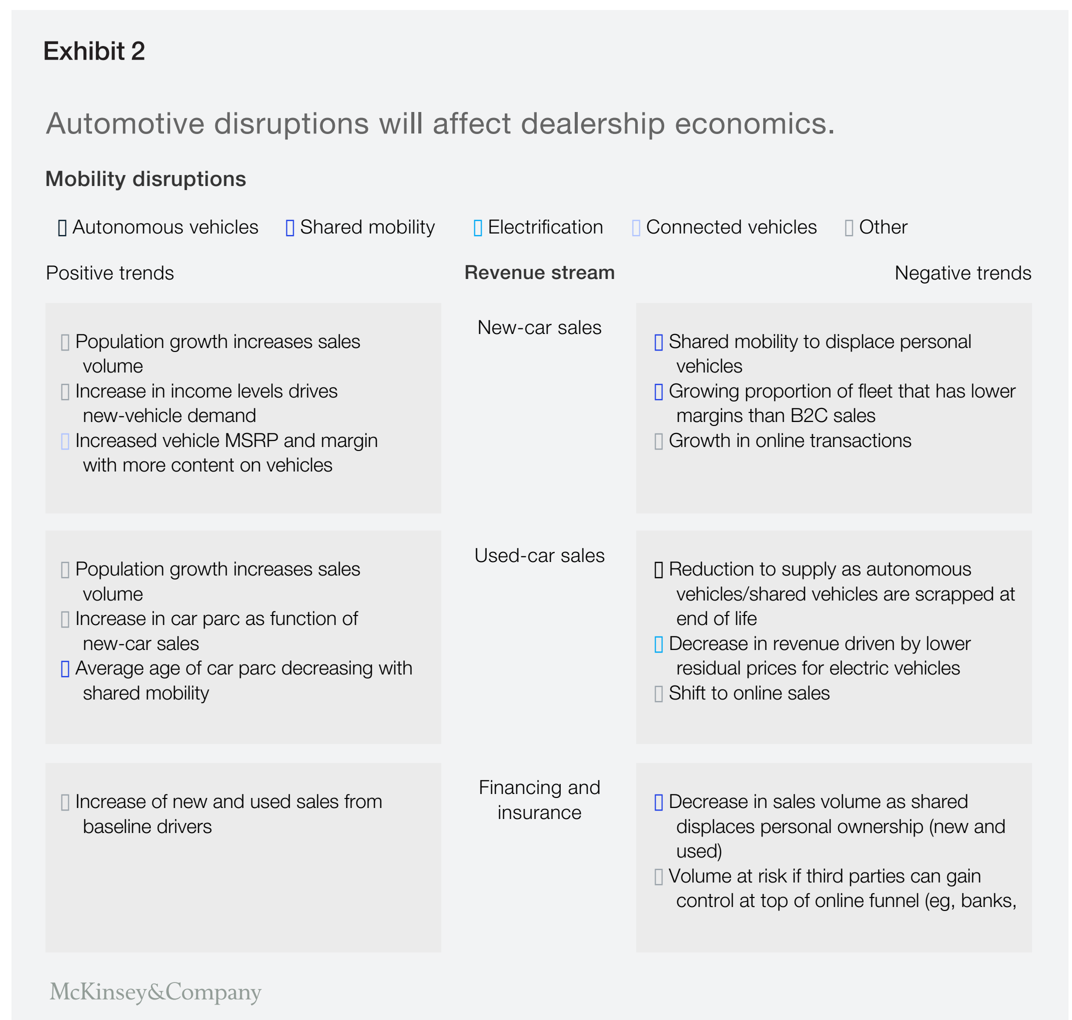
[1]Compound annual growth rate.

McKinsey&Company | **Source:** S&P Capital IQ

Disruptions to accelerate quickly

We believe the disruption of automotive retailing is just beginning and will accelerate rapidly in the coming years mainly due to the following three developments (Exhibit 2):

- **Four automotive industry megatrends—autonomy, connectivity, electrification, and shared mobility (ACES)—will** reshape the overall automotive ecosystem. At the same time, the digitization of the customer experience and dealership franchise dynamics will cause changes to automotive distribution in the short to midterm. Influenced by evolving consumer expectations, these trends will occur in parallel and mutually reinforce one another. For example, the increasing availability of autonomous capabilities will transform shared mobility as robo-taxis become more ubiquitous.



- **Automotive retailing's continued digitization and the growing importance of omnichannel marketing will put further pressure on margins**. For example, we estimate the new-car purchase journeys will shift to 10–25 percent digital from 0 percent today, with used cars increasing to 25–50 percent digital from around 6 percent today. Used-vehicle

profits could suffer due to greater price transparency and vehicle availability across markets. However, these innovations could offer better ways to serve customers and extract more lifetime value via tailored F&I offerings or the up-sale of parts-and-service contracts during vehicle negotiations.

- **Disruptive and nimbler high-tech playerswill introduce new business models quickly, thus further reinforcing disruptions in the automotive ecosystem.**

Disruptions will affect each traditional dealer profit pool

These disruptions will put additional pressure on industry earnings over the coming decade (Exhibit 3). For instance, in a "do nothing" situation, dealerships could see their total operating profit as a percentage of total gross earnings decrease to –0.3 percent due to shrinking traditional franchise dealership profit pools.

New-vehicle sales

We expect US franchise-dealer new-vehicle profit pools to decline about 9 percent during the next ten years. However, a disproportionate share of the decline will likely occur in densely

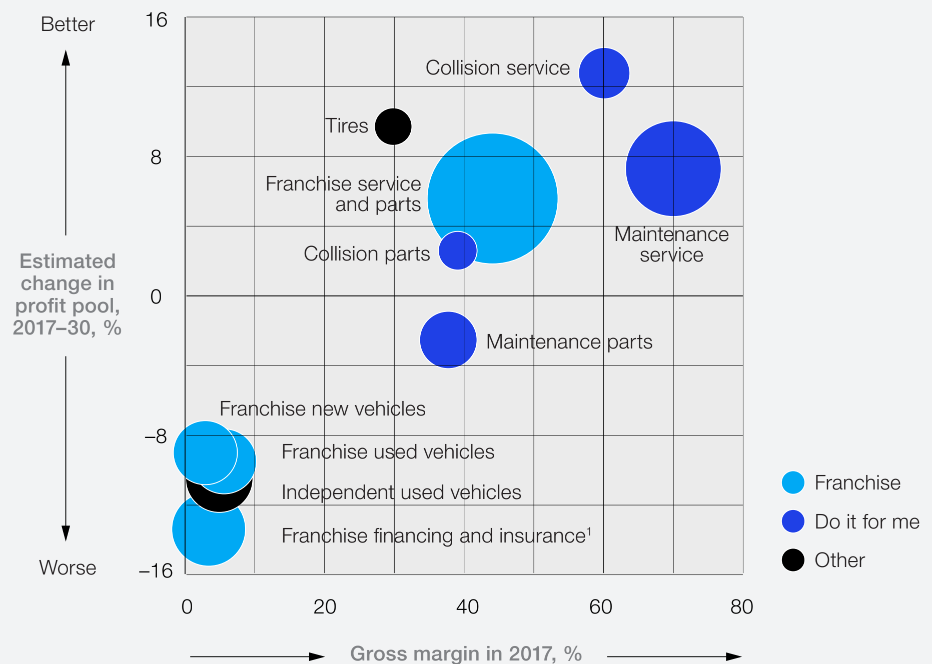
populated urban areas like Los Angeles, New York, and San Francisco, primarily due to a decline of up to 17 percent in private new-car ownership and increased sales of used vehicles through e-commerce channels with lower margins.

In the medium-to-long term, autonomous vehicles (AVs) and shared mobility will negatively affect new-car volumes. We believe AVs could make up as much as 13 percent of new-car sales volumes in 2030—a significant change from today. The resulting growth in fleet ownership could depress already low dealer front-end margins on new cars as well as F&I earnings.

Exhibit 3

Disruptions in the automotive ecosystem are shifting profit pools.

Estimated 2030 profit pool, bubble size = size of profit pool



[1]Gross margin as % of new- and used-car sales.

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Used-vehicle sales

The independent used-car profit pool of $16 billion today will likely decline an estimated 9 percent by 2030 as online penetration increases from around 6 percent to as much as half of all transactions. Every 1 percent increase in channel switching from in-store to online could result in an approximately $40 million decline in the profit pool due to the increased pricing transparency offered by online channels. Franchise dealers currently capture about 38 percent

of the used-car market, concentrated among larger players in several subsegments. Several attackers are using digital technologies to connect buyers with used-car inventory to simplify the customer purchase journey (both connecting businesses to consumers as well as enabling consumer-to-consumer transactions); existing players experiment with the digitization of their operating model. Overall, the used-vehicle industry is heading toward further consolidation as large players continue to gain market share.

We believe e-commerce (for example, Carvana, Shift, Vroom, and traditional players enabled by software solutions), characterized by single pricing and streamlined processes, will grow more than 100 percent, taking business away from brick-and-mortar operations. Low-mileage, off-lease vehicles will represent prime digital territory due to their high quality and their prices.

Parts and service

We also project that the combined "do it for me" maintenance-service and aftermarket-parts profit pool will grow from about $40 billion to between $42 billion and $46 billion in 2030, while franchise service and parts will grow from $54 billion to between $57 billion and $60 billion, due to the growing number of cars on the road and increased parts costs. These factors should more than offset the potential impact of e-commerce (reducing part margins) and the extension of service intervals. However, by 2030, the increased penetration of battery electric vehicles (BEVs) and hybrid-electric vehicles (HEVs) will reduce car maintenance-related outlays—BEV maintenance spending is about half that of current internal-combustion-engine (ICE) vehicles.

Collision parts and service

Likewise, collision parts-and-service profit pools should grow from a combined $13 billion in 2017 to between $14 billion and $15 billion in 2030 due to increases in miles driven, which will more than offset reductions in accidents per mile, combined with an increase in the sophistication and price of parts.

Dealers need drastic business-model changes in the approaching age of autonomous, electric, shared vehicles

Leading dealership groups have so far focused on driving operational excellence and making the shift to increased F&I and parts-and-services businesses. However, to win in the rapidly evolving retail landscape, all dealerships need to adopt drastically different business models and pursue new revenue streams.

In the near term, we believe dealerships should continue to optimize the dealership footprint based on mobility trends and create multibrand showrooms focused on luxury brands to conserve real estate in large cities. It makes sense to improve the in-store customer experience as rapidly as possible, introducing digitization, making online and offline changes possible throughout the purchasing journey (a true omnichannel experience), and enabling flexible test-drive plans and other innovations. Dealers should also work to reduce operating costs via improved operating efficiency, which could mean taking steps such as upskilling sales consultants in phone and internet lead management or integrating the sales manager and F&I manger roles (within regulatory limitations).

Potential midterm goals could include offering a seamless, digitized experience along the entire vehicle purchase and ownership experience to create stickiness and link shoppers to the dealership. Moving from a view based on vehicle or vehicle identification number (VIN)[1] to a customer-based view for marketing and creating more personalized customer outreach will further help dealerships grow share of wallet. Companies could also expand their presence in maintenance parts to increase the average lifetime value of customers and strengthen their offering of collision services and crash parts to offer customers a one-stop shop for vehicle sales, service, and collision repair.

Dealers that take an aggressive stance on operational efficiencies and redesign in-dealership operations to cater to a more digitized customer base often capture greater sales volumes and profitability (for example, capturing larger share in or beyond territory, up to 300 basis points higher return on sales than comparable dealers). Approaches include the following:

- **Extensive training regarding the management of digital leads**. This includes the introduction of lead scoring, response-time optimization (with best in class measured at less than ten minutes with a tailored, personalized response), and after-hours touchpoints.

- **Rigorous, data-driven performance dialogues with sales consultants and managers**. While this approach is often considered basic, many dealers miss opportunities to identify the specific problems of individual sales consultants by sales-funnel stage and lack targeted one-on-one coaching and training.

- **Integration of the sales-manager and finance-manager roles and sales-consultant upskilling to manage more of the process**. This will reduce head count, creating a more seamless customer experience with fewer hand-overs and ultimately resulting in a shorter overall sales process. Dealers that have implemented this approach successfully have maintained F&I attachment rates and front-end or back-end gross margins while reducing head count and process times, improving customer satisfaction, and increasing sales conversion.

- **Digitization of the in-dealership process**. For example, this can be done with virtual trade-in appraisal, scanning of customer ID upon arrival for easy document preparation, and use of external data to create a more comprehensive view of customers). The dealership should put all available customer data at the fingertips of the sales consultants, including prior transactions and service histories, insights into sociodemographic elements, and so on, to enable a highly customized sales interaction. It also means using dealer and third-party data to reach out proactively to customers with the right marketing offer at the right time.

With the entry of new digital disruptors, customer expectations are rapidly changing. Dealers can no longer simply post their inventory online and hope for the best. Instead, they need

1 Many dealer systems and processes today are focused on the VIN number or a specific vehicle, versus starting from the customer and providing a holistic view of the customer, for example, integrating all internal transaction data, service history, and average ownership time, as well as external data, like other vehicles owned or socioeconomic data, to form a holistic view of the customer and truly tailor marketing messaging and in-dealership experience.

to build the capabilities required to engage customers both online and offline via an omnichannel strategy. They must fine-tune their e-commerce solutions and enable customers to dig deeply into the offering online before coming into the dealership. Dealers should also think about their marketing spending efficiency including not just lead count but also lead quality, conversion, and customer insights provided by third parties. As the digital universe expands with online retailers and software offerings from established and newer players, dealers need to approach partnerships strategically to strengthen their digital presence and their omnichannel purchase path.[2]

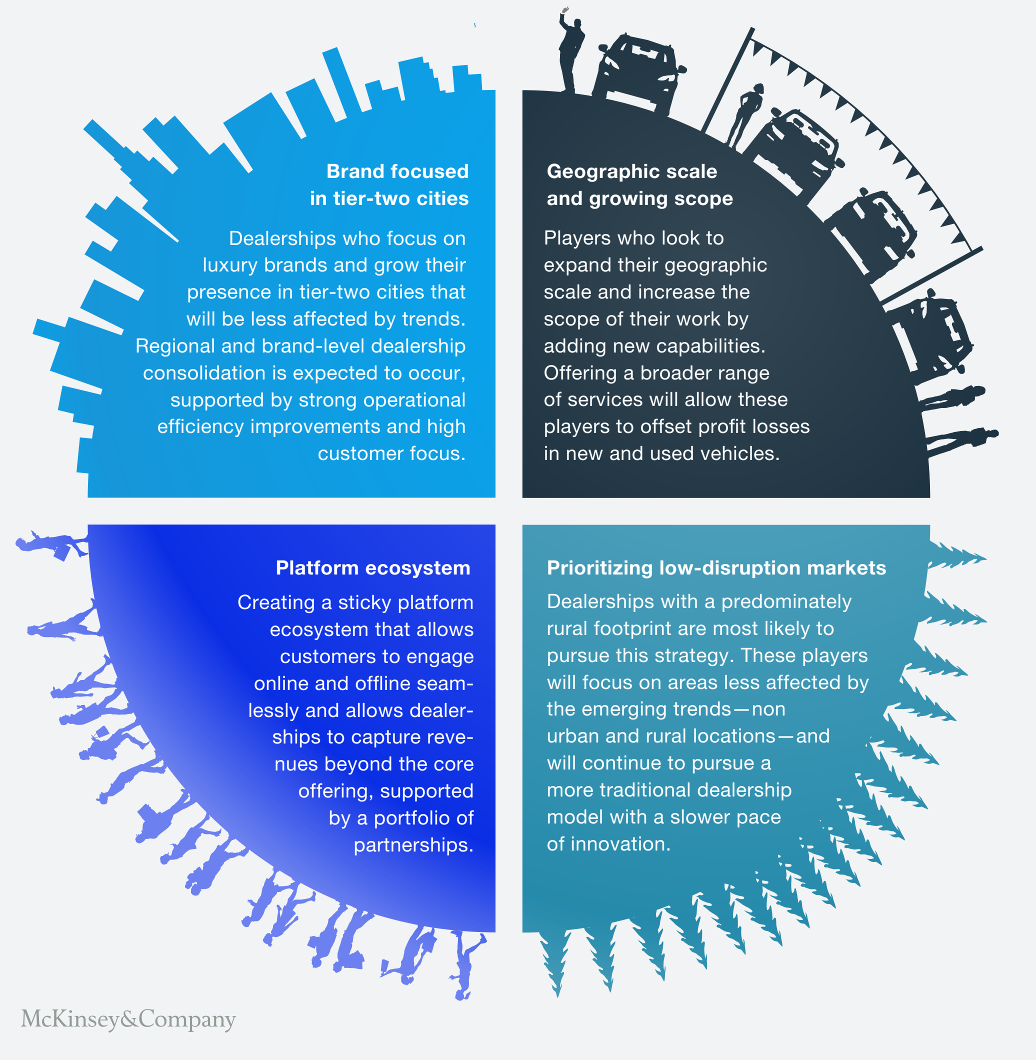
Models for a new retailing space

As dealers confront these changing realities, we see the potential for four new dealership models to emerge over the next decade (Exhibit 4). These models will likely center on luxury brands in tier-two cities; geographic scale and increased scope; ecosystem platform development; and less disrupted, rural markets. As these new models come to life, we expect the total dealer count and number of dealer groups to decline.

2 Consumer platforms could play an important role in realizing this approach going forward, since end-to-end digital platforms offer consumers a streamlined and tailored experience throughout the customer journey.

Exhibit 4

We see four potential dealership models emerge.



- **Brand focused dealerships in tier-two cities.** Dealerships pursuing this strategy will focus on luxury brands that will likely withstand more severe disruptions due to consumer loyalty and the differentiated brand and customer experience they offer. They will likely grow their presence in tier-two cities less severely affected by the trends discussed above. We would expect regional and brand-level dealership consolidation to occur, supported by strong improvements to operational efficiency and high customer focus.

- **Building geographic scale and growing scope.** Dealerships pursuing this strategy will look to expand their geographic scale (inorganically) by moving into adjacent geographic markets and increasing scale in their current market. They will increase the scope of their

work by adding new capabilities—increasing penetration of white-label F&I products, or becoming stronger players in collision services and crash parts, for example—or forming partnerships with local mobility providers to provide services and parts. Offering a broader range of services will allow these players to offset profit losses in new and used vehicles while creating new capabilities to make the business more resilient.

- **Creating a platform ecosystem**. During the past three years, as other retailers have experienced several pressures that automotive retail is starting to experience, successful players have focused on leveraging an in-depth understanding of their customer (including loyalty and share of wallet) and created personalized offerings to grow share of wallet instead of just number of transactions. Supported by stronger customer-relationship-management models and customer insights, retailers have developed tailored product and service propositions that appeal to different customer segments and help drive consolidation of spending with one retailer. The propositions can be effective if they are delivered in a seamless, high-transparency, high-control mobile environment with high convenience. Applying this to dealerships could include one-touch updates on current finance payments and equity position, a seamless service process, insurance management, and so on.

  Dealers pursuing this strategy should consider developing a sticky platform ecosystem that allows the customers to engage online and offline seamlessly and creates opportunities to capture revenues beyond the core offering while working across a broad portfolio of brands beyond luxury OEMs. Customers should be able to access all dealership services and fulfil their transportation needs in one central location. Examples of potential consumer propositions to be developed by dealers could include creating personalized offerings based on customer loyalty, behavior, or a specific affinity group (for instance, offer concierge services to luxury customers such as pickup and drop-off for cars and increased service loaner availability). The platform would also bring benefits to customers such as automatic discounts to service and opportunities to generate revenue (for example, peer-to-peer car sharing supported by the dealer group with a free car wash and automatic refuel before the car is returned to the owner). This in turn provides a higher frequency of touchpoints with customers for the dealer to create a stickier environment. Creating a portfolio of mobility-services-related partnerships, potentially via equity stakes, will be a key part of this strategy.

  Aftermarket parts could become as important as financing was 20 years ago, with captive OEM brands retaining warranty-related market share while dealers increasingly access the independent aftermarket and their own in-house white-label brands to lure off-warranty customers to replace declining used-car profits. To further participate in this parts profit pool, dealers might look to build new capabilities in parts management, for instance, a seamless parts-ordering and logistics experience to existing as well as potential new parts customers, to grow share of wallet.

- **Prioritizing low-disruption markets**. Dealerships with a predominately rural footprint are most likely to pursue this strategy. These players will focus on areas less affected by the emerging trends—nonurban and rural locations—and will continue to pursue a more

traditional dealership model with a much slower pace of innovation. They could become customers of dealer groups who have developed parts and platform capabilities and purchase these assets rather than building them in-house.

To build a successful business model, dealers might choose to combine more than one of the outlined models, especially if they already have a diverse geographic or brand footprint and want to maximize value from existing assets and capabilities.

Dealerships must find a balance between protecting their existing business while finding growth in what is becoming a disruptive space. Experience suggests that heavily focusing on new mobility models only could be unsuccessful as the residual risk is difficult to manage. Consequently, we believe dealers should focus on growing share of wallet from customers through better insights, capturing new revenue streams in adjacent markets while implementing operational improvements and digitizing traditional segments.

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