Auto Dealerships: Destined for Disruption

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- Lowering restrictions on direct distribution could benefit consumers and promote innovation
- Autonomous cars and over-the-air updates offer safety and convenience gains
- Prevalence of ride-sharing services demonstrates shifting perception of purpose of cars
- Greater understanding of the connected consumer will give dealers the ability to stay relevant and profitable

Introduction

At over 100 years old, the auto industry is considered mature and stable, but the opposite actually holds true, as it remains a very dynamic industry ripe with disruptive technology and consolidation. Several once-household names have exited the U.S. market such as Plymouth and Oldsmobile, while Tesla, Apple and Google have entered the field. Dealerships have not been altogether isolated from the changes in the industry. The number of franchise dealerships has declined 65% since 1950, due in large part to the closing or selling of very small establishments. Today, large dealer groups control a greater share of the market.\(^1\) Franchise dealers continue to be the intermediary between the manufacturer and the public, creating a relationship of high interdependence. They also provide a valuable service to consumers in the form of after-sales service and used car sales. However, new manufacturers, particularly in the electric vehicle space, are opting to go around the traditional franchise dealer network and target the consumer directly. Moreover, emerging technology, in the form of self-driving vehicles, vehicle-to-vehicle communication and ride-sharing services are changing consumers’ perceptions of car ownership, threatening the relevance of the dealer.

Birth of the Dealership – Regulation

All 50 states have very complex and comprehensive statutes that regulate the relationship between dealers and manufacturers, which have expanded and deepened within the last 40 years. In 2015 alone, 36 bills regulating the auto industry were introduced or re-introduced in 22 states. State statutes were enacted in the 1950s because of perceived unequal bargaining power between dealers and manufacturers and the desire to level the playing field between them. The statutes were designed to add a framework for, rather than to prohibit, relocations and additions of dealerships. Under the statutes, manufacturers wishing to terminate dealers must present good cause for doing so—for example, a breach of agreement—and are required to buy back physical assets if a dealer goes out of business. In addition to protecting the dealer, this regulation is also designed to protect the interests of the customer by ensuring that dealerships are in locations that would maximize the convenience of obtaining vehicle care in the case of recalls and warranty work.

In some ways, state statutes ensure intra-brand competition, thus affecting retail pricing in a very positive way by eliminating horizontal price fixing. In addition, the dealers’ investments aren’t easily repurposed, so requiring manufacturers to buy back assets after terminating a dealership makes sense. But is the protection of weaker-
performing dealers in the interest of anyone? More importantly, can these state regulations keep up with changing expectations? The statutes were designed at a time when the Big Three (Ford, GM, and Chrysler) dominated the industry; however, the current reality is that dealers are not small, but rather major players, selling cars from many different manufacturers and possessing considerable market power. In addition, restraints on manufacturers have expanded beyond their original scope, e.g. protecting mom and pop dealers, as dealer groups have become larger and more powerful. By no means are terminations of dealers commonplace; dealers considered for termination usually rank among the bottom five in the state. In most cases, manufacturers actually avoid closing dealers because of reputational concerns, as they don’t want to make it more difficult to create dealer relationships in the future. Some studies such as Lafontaine and Scott Morton (2010) argue that exclusive territories give dealers local monopoly power and limit choices for consumers.

Direct Distribution: Death of a Salesman?
A few states still mandate the use of traditional franchise dealers, thus prohibiting the ability of manufacturers to sell their cars directly to the consumer. New entrants into the market, such as Tesla and Elio Motors, are actively lobbying states for the ability to bypass dealers. Currently, there are a handful of states that prohibit the direct distribution of automobiles—Texas, Arizona, Iowa, West Virginia and most notably, Michigan, home to the Big Three. Most of these states have recently passed laws banning direct distribution, coinciding with the growing popularity of Tesla’s vehicles; Michigan and Iowa passed their laws in 2014 and West Virginia in 2015. Texas’s restrictions stem from a ruling barring online sales by manufacturers in 1999, while Arizona addressed the issue in 2000. On the other hand, last year, New Jersey and Maryland ruled to open their doors a crack and overturn previous bans on direct auto sales.

For its part, Tesla argues that it prefers the direct distribution model in order to accelerate the transition to sustainable transportation. Traditional franchise dealerships are often located in non-central locations; whereas, Tesla’s dealerships are in high-traffic areas, such as the mall, in order to bring the technology to the consumer. In addition, a high-volume sales model wouldn’t work for Tesla’s cars because of an extensive education process for consumers, which lengthens the sales cycle. Finally, Tesla argues that franchise dealers would
struggle to make money from Tesla vehicles because of the limited need for servicing the car and the difficulty of marking-up the price even further.

Although Tesla was the first manufacturer to test the legality of direct sales in many states, it is not the last, as the direct distribution model appears to be gaining popularity with other new entrants in the industry as well. Elio Motors, which has scheduled production of a $6,800 vehicle for late 2016 and currently has over 49,000 in pre-sales, has implemented a just-in-time distribution model. Customers visit the Elio store and personalize their vehicles, after which the order is sent to a local production facility and is ready for pick-up the next morning. This just-in-time system, similar to Tesla’s model, saves on carrying costs and allows these manufacturers’ showrooms to be noticeably smaller and in less need of investment.

Despite the increasing prevalence of direct distribution, as a whole, state statutes remain somewhat biased towards the dealers; the FTC, along with Tesla and Elio, argue that these regulations are frozen and stifle innovation to the detriment of consumers. In fact, consumers themselves seem to be on board with the direct distribution model; about one in three consumers said they would be willing to buy a car online, with the top two reasons for doing so being price savings (45%) and an easier and faster transaction (24%). In addition, 40% of consumers in mature markets would consider buying their car directly from the manufacturer, while 50% of those in developing markets would be willing to do the same.2

The biggest opponents to the direct distribution model are the existing franchise dealerships, who argue that the model would give manufacturers a monopoly and lead to sub-par after-sales care. A few states’ statutes have protected the interests of these dealerships, but in reality, there is little reason why public policy should favor a specific mode of auto distribution. The ideal solution would be to let markets decide which model serves the customers better. For consumers that prioritize lower prices, the direct distribution model could be the better option, as there is no mark-up in the vertically-integrated retail model. On the other hand, consumers who prefer customer or after-sales service might find the dealership model more appealing. Although dealers serve an important purpose, especially when it comes to warranty work and used car sales, the availability of additional

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2 Capgemini
options ultimately benefits consumers. In addition, the choice of distribution method is an important component of competition, and companies offering breakthrough technologies should be allowed to distribute innovatively. However, given the comprehensive state statutes currently in place, proliferation of the direct distribution model will take time.

**Emerging Trends: The Connected Consumer**

**Autonomous Cars:** In addition to electric vehicles, the development of autonomous cars will also shake up the auto industry. The introduction of this technology has already begun to spur further innovation, as large car manufacturers offer increasingly sophisticated advanced driver-assistance systems in their vehicles in order to compete. Autonomous cars could also boost demand, as new customers who were once unable to drive, such as the disabled and the elderly, enter the customer pool. These vehicles could be especially appealing to the commercial driving segment characterized by long trips and driving time limits. The autonomous car offers all consumers the value propositions of time and safety, which is particularly relevant as 94% of auto accidents involve human error.\(^3\) According to the National Highway Traffic Safety Administration (NHTSA), in 2010, motor vehicle accidents resulted in 32,999 deaths and $242 billion in economic losses, including the costs of medical care and productivity losses.\(^4\)

One barrier that has impeded the proliferation of autonomous cars is the lack of clear regulation, especially in the liability space. Some progress has already been made on this front, with the NHTSA releasing a letter sent to Google on February 4\(^{th}\) stating that the computer piloting a Google car could be considered the driver under federal law. In another step to making autonomous cars more mainstream, the Obama administration proposed nearly $4 billion in R&D funding for driverless cars in its budget released last month, which would cover pilot programs to test the vehicles, among other initiatives.\(^5\) In addition to regulation, another key issue for autonomous technology is cybersecurity, but the potential gains to the consumer, in terms of safety and fuel efficiency, could outweigh this manageable risk.

Toyota has promised to put autonomous cars on the road by 2020, with Nissan planning to do as early as this year.\(^6\) While automakers have entered the race to put driverless vehicles on the road, tech companies like Google and Apple are still major players in this space with the software know-how to compete against auto industry veterans. As new entrants into the auto industry, high-tech companies would most likely opt to bypass the dealership in getting their cars to the end consumer.

**OTA Updates:** A complementary technology that is in even closer reach is the over-the-air (OTA) software update for cars, which will set a new precedent for the automotive recall. Tesla has already successfully implemented these updates several times, upgrading the car’s software as it sits in the owner’s garage or driveway.\(^7\) OTA updates could help consumers conveniently improve the safety of their vehicle, and all major carmakers are expected to implement OTA technology within the next five years.\(^8\) As in autonomous vehicles, cybersecurity remains an issue here as well, because hackers could use the update as an entry point to the vehicle system.

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3. Google
5. Brookings Institution
6. BBC
7. Wired
8. TU-Automotive
Dealerships generate the greatest share of their profits from providing parts and repair services. If manufacturers can provide upgrades and check-ups remotely, then the adoption of OTA software could put the profitability of dealerships at risk. However, OTA updates are not a cure-all, and the ability to physically obtain after-sales service should remain a necessity as many recalls and upgrades focus on physical issues such as brakes.

**Chart 4**
**Consumer Preferences in Connected Cars**

<table>
<thead>
<tr>
<th>Preference</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Streaming music</td>
<td>40%</td>
</tr>
<tr>
<td>Surfing internet</td>
<td>30%</td>
</tr>
<tr>
<td>Identifying congestion</td>
<td>20%</td>
</tr>
<tr>
<td>Allowing passenger to stop car</td>
<td>15%</td>
</tr>
<tr>
<td>Collision warning</td>
<td>15%</td>
</tr>
<tr>
<td>Night vision</td>
<td>10%</td>
</tr>
<tr>
<td>Fatigue warning</td>
<td>5%</td>
</tr>
<tr>
<td>Social media</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: BBVA Research & BI Intelligence

**Chart 5**
**Estimates of Global Car Shipments**

Source: BBVA Research & Crowd Companies

**Ride-Sharing:** Another trend that is already mainstream is ride-sharing, which has been driven primarily by urban migration and also by the shifting perception of the purpose of cars (see our brief on the sharing economy [here](#)). Millennials in particular are not focused so much on owning a car as an asset, but rather on getting from point A to point B. In an independent survey, one third of Millennials expressed interest in renting out their belongings to supplement their income, and they ranked car rides second only to books as the things they are most open to sharing. This is exemplified by the growing popularity of uberPOOL, in which riders who happen to be requesting rides along similar routes share a ride and split the cost. uberPOOL trips make up roughly half of all Uber rides in San Francisco and a third in Los Angeles. In addition to gaining a solid consumer base, ride-sharing is also popular among investors, who have invested more in transportation services than in any other sharing economy sector.

The popularity of ride-sharing could result in fewer car sales for dealerships, as fewer consumers see the necessity of owning a vehicle. Although dealerships have not yet responded to this trend, more automakers are beginning to understand and adapt to this changing dynamic of car ownership. For example, Ford implemented its Smart Mobility Plan last year in which customers can sign up to rent their Ford Credit-financed vehicles to pre-screened drivers for short-term use. In addition, ride-sharing services could also effectively serve as a group-purchasing mechanism if drivers come together to purchase cars from specific brands. GM and ride-sharing company Lyft just entered into a strategic partnership this year, through which GM agreed to invest $500

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9 IBISWorld
10 Ibid.
11 Ford Motor Company
million in Lyft and become a preferred provider of rental vehicles for Lyft drivers, with both parties collaborating on the development of a network of on-demand autonomous vehicles in the long-run.\(^\text{12}\)

Bottom Line: Implications for the Dealer
In order to maintain relevance and profitability, the auto dealerships of the future should not bet on regulation to support their business case; rather, they should look at market conditions, understand consumer values and adapt to changing preferences. In at least 11 states, the traditionally highly-regulated retail distribution model has adapted to allow for direct distribution in order to offer more options to the customer valuing a personalized and convenient experience. Manufacturers have started to form strategic alliances with players in the on-demand economy, but traditional franchise dealerships lag behind in convenience and accessibility to consumers. In addition, the emergence of the connected car offers the ability for dealerships to amass a new set of data about their customers, such as customers’ driving habits or in-car technology preferences. Obtaining this data from manufacturers could be critical in the dealer’s ability to retain the customer of the future, while also supporting other industries such as risk analytics and auto insurance. Understanding how technology innovations impact their business and their customer relationship will allow dealerships to stay relevant and retain the connected consumer for life; however, only time will tell if the dealership model truly has a place among shifting auto distribution and ownership trends.

\(^{12}\) General Motors
References

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