Covid, Brexit and the Dealership System

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In June 2020, Patrick Pelata, former COO of Renault, expressed doubts about the future of the franchised dealership system, so dear to all vehicle manufacturers. The automotive industry faced huge adaptation problems, including the need to short-circuit the dealer system, whose economics he did not understand. Liberated from his former obligation to toe the party line, he could of course now think the unthinkable and say the unspeakable. These doubts have, however, been around for a long time.

As its then new model T sold across urban and rural America, Ford found an urgent need to do something to organize cost-effective maintenance and repair for owners, rather than just leave this to local blacksmiths and mechanics. This was the origin of the franchised dealer system, conceived as an assurance of quality after-sales support for the motoring public. We have come a long way since then and not entirely for the best.

The system has become entrenched throughout the world but more in support of new vehicle sales and of the manufacturers' individual brands than anything else. In other words, now on the side of the supplier and not that of the consumer. There is also an inevitable imbalance of power between the local dealer and the huge corporation.

In the US, dealers are often significant local businesses and their have traditionally been protected by State laws that enshrine their exclusive right to sell new cars, often of more than one brand. In Europe, exclusive vertical distribution arrangements are formally illegal under the provisions of the Treaty of Rome.

Manufacturers flouting this prohibition eventually led to the first Block Exemption Regulation, which allowed them to continue the practice. The framers of that first regulation were, however, also at pains to prevent manufacturers from intervening in the final sales transaction with the end customer.

While this distribution model was effective in an age of demand for new cars exceeding supply and appropriate while they were still somewhat mysterious and delicate technically, it has aged and become outdated as the new car market has matured and become saturated.

Manufacturers have responded by adding more models and replacing them more often, which is a zero-sum game, given that they all play it. The result has been to inflate costs, increase pressure for discounts and depress margins. In Europe, franchised dealers are only notionally independent of their brand franchisors – who are also at liberty to by-pass them in serving the ever larger fleet market. Importer-distributors are normally under the control of the brands. There is no-one to talk back and force marginal models, brands or even manufacturers out of the market. Incumbents are protected against new entrants.

These brand-specific retail monopolies are inefficient (how much traffic do you see in the average showroom ?) and costly – up to 30% of the pre-tax price of a new car. But they have enabled manufacturers and dealers to seek to make up for inadequate margins on new cars (at least for volume brands) through attempted abuse of monopoly power in the aftermarket. This has involved both attempts to coerce new car owners into using franchised dealer workshops rather than independent repairers, and to deprive the independents of the increasing amounts of technical information needed to maintain and repair modern cars.

All this has caused perennial trouble with consumer bodies and with the extremely powerful anti-trust authority of the European Commission, which grants the Block Exemption. While the Commission has given up on its earlier attempt to redress the balance of power between manufacturers and dealers in new car sales, it is adamant in its intention to keep the independent aftermarket in existence, so as to provide an alternative to car owners. It should be remembered that 3 of 4 car sales transactions are of used cars. New cars are increasingly bought by the fleet sector. 70% of the aftermarket is independent. The dealer aftermarket essentially supports cars in their first cycle of ownership only.

The gross margins granted by manufacturers to dealers on new cars are severely limited, with ex-post facto bonuses awarded for achieving pre-agreed sales targets – with the obligation to sell the full product range. No cherry picking the attractive models only. This is still not a living wage. As in new cars, the manufacturers are the de facto monopoly suppliers to their dealers of the necessary ranges of spare parts, exercising similar margin control.

Even in a good year for new car sales, parts (mainly not made by the manufacturers but by their suppliers) form 10% of their turnover but 40% of their gross profit. The dealer's showroom and parts department are cross-subsidized by disproportionately high margins on labour hours, out-pricing independent repairers by 50% or more. Dealer workshops are generally well equipped and trained but price-uncompetitive and and made less accessible in practice through fragmentation between brands and the tradition of collocating them with showrooms.

They are used to pre-ordering parts for known service jobs, enabling fairly tight spare parts distribution chains but these then bear an estimated 20-25% penalty through redundancy across 30-40 car brands. The independent repairers are more friendly and accessible – and much cheaper – but come under no brand umbrella. Schemes to chain them and reassure consumers about their quality have never really succeeded.

These garages are used not to having to order their parts until the car is on the ramp, as these have been made available almost instantly from competing local independent parts factors. This has traditionally involved large amounts of local stocks. As they cover all makes and models, there is not the lateral brand-based fragmentation but high vertical distribution chain costs. The increasing grouping of factors through acquisition or trade groups has not solved this problem but has simply resulted in increased pressure on the parts suppliers for discounts.

The franchised dealer and independent aftermarkets in effect almost collude not to compete directly with each other. In fact spare parts price lists on the two sides have been tacitly kept in close alignment, although there are some signs this breaking down in some places.

This house of cards, while internally metastable, is highly vulnerable to a major external shock. New car sales have taken a tremendous knock because of Covid 19 and a bad Brexit will not help either. Newly impoverished consumers who furthermore have more incentive to work from home will have much less to buy new cars.

Apart from the impact on showrooms, there will be a double shock to dealer workshops – fewer first-owner cars entering them, more used cars deserting them. This will destroy the already slender profits of dealers and dealer groups. Internet parts direct sales to repairers by suppliers are a deadly threat to the independent parts distributors, collapsing prices and margins.

Again, Covid 19 has sharply accelerated the general development of e-commerce. If parts prices collapse, the vehicle manufacturers are in trouble. They will have a strong incentive to unbundle the costly single-brand exclusive dealership system, sell direct to consumers and accept the emergence of powerful independent importer-distributors, who will not tolerate marginal products.

The potential knock-on effects on the whole automotive sector, which is already not in good shape financially and struggling with the new technologies, will be enormous.