

Automotive News

THE FRANCHISE SYSTEM: MODERN ERA

Up to the minute: System survives challenges, emerges stronger than ever

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It was a big deal when CarMax Inc. opened a used-vehicle superstore in Atlanta in 1995.

How big? Cutting the ribbon at the dealership was U.S. House Speaker Newt Gingrich, who had won national attention a few months earlier by engineering the Republican takeover of Congress.

Revolution was in the air. Circuit City Stores Inc., which ran CarMax, had launched four superstores since it got into used-vehicle sales in 1993. The big-box electronics retailer vowed a shake-up in auto sales practices that would leave traditional franchised dealers in the dust.

It didn't happen. The dealer franchise system has faced massive changes and challenges since the 1990s - not only used-car superstores but also the rise of multifranchise megadealers and publicly traded dealership groups, Internet retailing and factory-owned stores.

But each confrontation ultimately strengthened the franchise system. Dealers adapted to new technology, found better ways to sell used vehicles and lobbied successfully for tighter franchise laws. The value of dealerships soared.

Super threat

Gingrich's fame drew attention to the CarMax business model, says George Hoffer, a professor of economics at Virginia Commonwealth University.

"When it hit the national spotlight, people suddenly got the impression that CarMax was going to drive dealers out of business," says Hoffer, an automotive researcher. "There was this panic."

Superstores boasted of their consumer-friendly sales environment, huge selection of late-model used vehicles, no-haggle pricing, extended warranties and inventory searches on computer kiosks. Their technology was formidable to typical dealerships, which were still making do with old-fashioned "green screen" computers.

In response, some of the nation's largest and most successful dealers formed their own used-vehicle chain in 1996. They named their company Driver's Mart Worldwide Inc.

Billionaire Wayne Huizenga, chairman of the waste management behemoth Republic Industries Inc., also entered the fray. He called his chain of used-car dealerships AutoNation USA.

On the way to dominance, though, the superstore chains displayed serious flaws. CarMax is thriving today, but it took some hard knocks before it finally made a \$1.1 million profit in its 2000 fiscal year. AutoNation USA and Driver's Mart collapsed.

Despite its retail sophistication, Circuit City proved to be unfamiliar with the mechanics of used-vehicle sales. AutoNation's leaders also lacked essential knowledge of the car business. Driver's Mart, even though dealers conceived it, launched too hastily, Hoffer says.

Marshall Chesrown, a former dealer in Denver, says the superstores' huge, multimillion-dollar facilities inflated the dealerships' breakeven point. Chesrown sold his dealerships to Republic, AutoNation's parent company, in 1997. He was the company's senior vice president of megastores before he resigned in 1999.

"The overhead was crazy," Chesrown recalls. "The business model was sound, but the problem was the way they built their expense structure."

Bill Wallace, a dealer in Stuart, Fla., and a former Republic dealer, says AutoNation spent too much to recondition vehicles.

100 candles

Some facts about the dealer franchise system as it enters its 2nd century

- There are nearly 22,000 franchised new-vehicle dealerships in the United States.
- Those dealerships employ more than 1.1 million people, with a total annual payroll of more than \$50 billion.
- Franchised dealerships generate 21% of the nation's total retail sales, constituting the largest U.S. retail industry.
- More than 750 million cars and trucks have been sold in the United States since Henry Ford's first Model T in 1908.
- Since then, U.S. consumers have spent more than \$8.2 trillion to buy new vehicles.

Source: National Automobile Dealers Association

Creating a monster

CarMax opened 14 superstores with 100,000 square feet of space and 1,000-vehicle inventories, Hoffer says. But the company quickly discovered that most markets could not support such a vast inventory, and it killed the concept. Only two of the stores survived.

At AutoNation, inventory didn't turn quickly enough, and the cars depreciated, Chesrown says. "The superstore operators never took into consideration that used cars aren't like wine," he says. "They don't get better with time."

Conventional franchised dealers could match or beat their superstore competitors handily. They already had used-car operations, they had access to late-model trade-ins, and they understood auto auctions.

"The used-car business is not like the videotape business, where the more you buy the cheaper price you get," says Ramsay Gillman, chairman of Gillman Cos. and a former president of the National Automobile Dealers Association. "When you buy a used car at auction, you are the highest bidder."

Ultimately, the superstore threat vanished - but not before dealers learned better ways to sell used cars and trucks and to make better use of customer databases, Hoffer says.

As NADA president in 1997, Gillman insisted that franchised dealers would win their war with the superstores.

"As fate would have it," Gillman says, "I was right."

Going public

In 1996 and 1997, several dealership groups went public, raising millions of dollars through stock offerings. As publicly held Republic Industries experimented with used-car superstores, it also snapped up new-vehicle dealerships.

Many dealer entrepreneurs feared the public retailers because of their access to capital and aggressive acquisitions. They worried that public dealers could sell vehicles at cut-rate prices because of economies of scale. Some sold their dealerships to consolidators rather than compete with the public groups.

"I wasn't sure what the impact of public ownership was going to be," says Chesrown, one of the first dealers to sell out to Republic. "My concern was that if (public dealers) executed the business plan as stated, I thought they would be tough competitors. Because of their size, I thought they would have a benefit in hiring good people."

Dealer Wallace says he sold out to Republic because he wanted to expand his operation with public money. But a few years later, he bought back part of his operation and returned to being his own boss.

"It sounded so wonderful," Wallace says. "We thought we could do all the things we wanted to do. Republic would supply the capital and let us run their districts. But it didn't work out that way."

Many dealers also suspected that automakers would favor public groups with big discounts. But car companies fought public retailers in court and with ceilings on market concentration, says Dan Myers, a franchise lawyer in Tallahassee, Fla.

Some factories limited the number of the franchises that public groups could own, nationally or in a particular market. Other automakers imposed more stringent standards for sales volume and customer satisfaction on dealership groups than they did on individual dealers, Myers says.

"We've seen the factories revert to working with smaller dealers," Myers says. "Everyone wanted to do away with Mom and Pop, but they're the core of the franchise system."

Big overhead

Public retailers' efficiencies turned out to be limited. Some economies of scale, such as group discounts on advertising costs and wholesale finance rates, also are available to owners of smaller, private groups.

"Any economies of scale are at the regional or market level," says Todd Berko, a partner at Bel Air Partners, a Skillman, N.J., brokerage that works with dealerships.

"A single-point Chevy store doesn't have the economies of scale of AutoNation," Berko says. "But the guy who has 10 stores might have similar economies of scale."

Public retailers have higher costs associated with public ownership that offset some advantages of their size, Berko says. Publicly held companies also face increasing government regulation, he adds.



Large dealership groups that once considered going public backed off. Many concluded they could meet their expansion goals without having to answer to shareholders and regulators.

Wallace notes that auto retailing is essentially a local business, requiring strong store managers who are familiar with their markets. The best private dealers can compete effectively with the public giants, he says.

Room to grow

"The public dealers increased the value of the average automobile dealership," Wallace says. "They set the benchmark with the prices they paid."

Financial institutions that funded dealership acquisitions began to make loans for intangible "blue sky" assets. Before public groups launched their shopping sprees, dealerships fetched little beyond their hard assets.

Bel Air Partners estimates that dealerships in major metropolitan markets can fetch three to six times their pretax earnings for blue sky, depending on the brand.

"I believe we have made the businesses we've operated better," says Roger Penske, CEO of UnitedAuto Group Inc., the No. 2 U.S. dealership group.

Adds Mike Jackson, CEO of AutoNation Inc., the nation's largest dealership group: "If I were an independent entrepreneur, I would be rooting for the public companies to do well.

"The existence of the publicly traded companies has fundamentally enhanced the value of" privately owned dealerships, Jackson says. "And if they build up a large business, there is somebody to write a check to buy it."

Marty Rood, a Seattle car dealer, attended a University of Washington seminar in early 1994. Its topic: the information superhighway. The room was packed. "That gave me the first inkling that the Internet was going to be big," Rood says.

Later that year, Rood established DealerNet.com, one of the first dealer Web sites. He envisioned a virtual showroom that would enable consumers to buy cars and trucks online.

Rood was not alone in that vision. "e-dealers" boasted that they would slash vehicle prices by reducing overhead.

The newcomers said brick-and-mortar dealerships soon would be obsolete. And venture capitalists believed them, dealer lawyer Myers says.

"All the Internet players came with \$100 million to \$300 million of backing from people with lots of cash," he says. "Millions of dollars were lost because investors bought into that simplicity."

Internet marketers met roadblocks along the information superhighway. They included legal restrictions, vehicle trade-ins and auto finance.

State franchise laws require dealers to be licensed and to meet facilities standards. Internet marketers had to change their fee structure to comply with anti-brokering restrictions in many states. Those restrictions prohibit online referral sites from charging a fee per transaction.

Most important, automakers came to the aid of their dealers. They thought customers were best served through local dealerships. Manufacturers denied franchises to some Internet marketers and fought others as brokers, Myers says.

In addition, Rood says, the dot-coms naively assumed that car transactions would be simpler for them than for dealers. But many buyers owe more on their current vehicles than they are worth, he notes. An "upside down" customer makes an online sale much more complicated, he says.

It's also hard to evaluate the condition of trade-in vehicles online, Rood says. Shipping cars to buyers on a flatbed is impractical and expensive outside a certain distance, he adds.

"The car deal is very complicated," Rood says. "It's probably that process that protected the car dealers, more than state franchise laws."

Dealers discover Web

Again, franchised dealers learned from their competitors. They learned to market cars and trucks online. NADA reports that 94 percent of new-vehicle dealers have Web sites.

"I always said dealers need to embrace the Internet," says dealer Gillman. "We can advertise for a fraction of the cost to advertise on TV, radio and newspaper."

Internet marketer Scott Painter once viewed dealers as rivals. Now he sees them as clients.

Painter founded the online buying service CarsDirect.com. He recently established Zag, an Internet service that helps dealerships sell to members of credit unions and auto clubs.

"I think most online companies recognize dealers are their customers," Painter says.

Adds Paul MacDonald, a computer consultant who owns an interest in a Salt Lake City Mazda dealership: "Dealers turned the Internet threat into something positive."

Automakers sided with their dealers against consolidators and Internet brokers. But in the late 1990s, General Motors and Ford Motor Co. launched retail initiatives that competed with their own franchisees.

GM developed a plan to buy as many as 10 percent of its dealerships - about 770 stores - over a decade. The company intended to use the retail network in its largest markets to test sales innovations, including Internet projects.

"We felt that if we understood the retail business better, we would be a better supplier," says Frank Dunne, a former GM lawyer. "We felt we could help enhance customer satisfaction. ... We also thought that we would be an alternative to the mega public dealer in particular towns."

But GM failed to predict the firestorm that the company retail network would create among its dealers, Dunne concedes. GM dropped the plan a few weeks after announcing it.

"I spent a good deal of the rest of my life at GM trying to rebuild relationships with dealers," Dunne says.

Dealers feared competing with factory stores, believing that manufacturers would favor their own operations. Ford entered a joint venture with Republic, called the Ford Retail Network, which also annoyed dealers.

In response, dealers mustered their formidable lobbies in state legislatures, Myers says. Virtually every state banned or restricted factory-owned dealerships, he adds.

MacDonald co-owns one of the stores Ford acquired for its Salt Lake City Auto Collection, an outgrowth of the Ford Retail Network. Before Ford took over, he says, the Mazda store sold 50 vehicles a month.

While Ford operated the dealership, its monthly volume sank to five units, MacDonald says. When his brother regained control of the store, its sales volume rose to 103 vehicles a month.

The lesson? Dealerships are best run locally rather than from Detroit, MacDonald says. "When an entrepreneur puts his own money on the line and his own efforts, it makes a whole lot of difference."

The dispute over factory ownership also had positive effects. Factory bids on dealerships helped prop up their valuations, dealers say.

The system works

AutoNation CEO Jackson began his career as an auto mechanic, found success as a car dealer and became president of Mercedes-Benz of North America Inc. before he joined the dealership group.

"I've been in meetings, as a manufacturer," he says, "where you have these top-flight consultants, and you have a discussion: What if the (franchise) system didn't exist? What if we had a clean sheet of paper and we could do whatever we wanted?"

"At the end of the day, we came all the way back to, hey, you know, this is not a bad system," Jackson says. "I defy you to find another retail industry that is as effective and as efficient as this model. It works for everybody. That's why it's still here."

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