Consolidation of the U.S. Automobile Retailing Industry

The Wave of the Future, or a Short Lived Dream?

By Shane Dever

Over the past three years, significant change has occurred in the retailing side of the American automobile market. An industry traditionally run predominately by private franchisees is quickly being taken over by public conglomerates. Or is it? Opinions vary regarding the threat that these companies impose on the private dealer. The vast amounts of Wall Street capital that they can attain certainly gives them a competitive advantage, but many think this advantage is canceled out by their lack of knowledge in the car business. These companies are trying to capitalize of the great inefficiencies within the current system by being more cost effective than the private dealer. Billions of dollars are wasted annually by private dealers on overhead, advertising, vehicle and part logistics, and other redundancies. The pubic companies feel that by reducing these inefficiencies, they could create a market with lower prices, as well as higher margins per car sold.

The American automobile retailing market hit $661 billion in 1997, and is growing at an estimated 3-5% per year. If finance, parts, and service are also included, the market well exceeds $1 trillion. This market, though, is very fragmented for its size. The one hundred largest dealer groups only account for less than 10% of market share. These same hundred groups control less than 5% of all franchised dealerships. This fragmentation is one of the many examples that makes the auto retailing industry remarkably unique.

Another interesting aspect of these changes is the manner in which the manufacturers are dealing with these new companies. Initially, the manufacturers feared that the consolidators would run the smaller dealers out of business and thus attain

bargaining power with the factories on both invoice price and inventory requests. Gradually, manufacturers granted contracts to consolidators that were more restrictive than standard franchise agreements to prevent them from dominating a market. This strategy stopped these companies from threatening the factory's freedom of action. Presently, only Jaguar and the Saturn division of General Motors continue to impose significant restrictions.

Private dealers have now reached a crossroads. Soon every dealer must decide whether or not he wishes to sell out to these companies. The consolidators have been offering the private dealers goodwill premiums that are hard to resist. There is also a large group of owners who were granted dealerships in the 1950's and 1960's and are approaching retirement age. These dealers may already be looking for a market exit opportunity, and selling out to the consolidators is a great way to cash in.

The buying patterns the consolidators have undertaken, though, have seemed careless to some observers. Same-store statistics, which compare dealership financial data before and after the takeover, have been quite disappointing to the consolidators. The main question is if investors will continue to support their expansion. The stock price of these companies has reflected the careless attitude of acquisitions. All but three of the companies' stocks are trading below the price of the initial public offering. The conglomerates feel, though, that they need to get to a certain size to achieve the necessary economies of scale. Without more capital, however, they cannot get this expansion.

Opinions also vary on whether a company whose focus is stock price can be successful in the auto market. The market is extremely sensitive to customer satisfaction. Customers may like the attention they get at a family-owned business as opposed to the

no-haggle, one-stop shopping strategy that some of the public dealerships have implemented. Many see the importance of customer satisfaction in the auto retailing industry as a unique barrier to "Wal-Mart" style mass merchandising.

This is a critical period in these companies' quest to overtake the American auto market. With stock prices slumping, something has to be done to build consumer and investor confidence in the entire consolidation strategy. There was an article written in April, 1997, entitled, "On the Precipice?" which explained the possibility that the new consolidators may soon overrun the private dealer. [1] Only two years later, the tables may have turned, and the consolidators themselves may be "On the Precipice."

Before starting the research for this study, I hypothesized as to what my results would be. I believed there would be no revolution in the car business because auto retailing is a unique industry that could not be successfully streamlined. I thought the consolidators would have a hard time achieving the necessary economies of scale. Wal-Mart is only able to succeed because it gets significant discounts from the food manufacturers, but such preferred vendor agreements in the car business are not feasible. Therefore, my conjecture was that public ownership would not survive for long in the American auto retailing industry.

Six months ago, however, two regional public consolidators entered the marketplace. They have changed my stance on this matter because I do believe they have a successful strategy. My new opinion is that the public condolidators will not take over auto retailing, but they will prove that there is plenty of room in this trillion dollar

[1] Bohon, C.D. "On the Precipice." *Ward's Dealer Business* (April): p. 13-20.

industry for both types of ownership. In the following sections, I will attempt to show why the auto market of the 21st century will not be revolutionized, but it will rather evolve into an industry with both public and private ownership.

CAUSES OF CONSOLIDATION

Before we look at the firms involved in the trend toward public control of the auto retailing market, we must understand why a group of companies would want to change an industry that has thrived for so many years. The broad reason why these firms enter this marketplace is they see an industry with great inefficiencies. They believe they can exploit the industry fragmentation with a major rollup of dealerships. Robert Thomas, president and CEO of Nissan Motor Company, USA, uses the Los Angeles metro Ford dealers to convey the inefficiencies of the present auto industry.[2] He explains that in Los Angeles, there are 70 Ford dealers who together sell about 100,000 vehicles per year. This means that there are 70 owner and top managerial payrolls, estimated at $1.5 million a year each, for a total of $105 million. An amazing $1,050 of the sale price of each vehicle is going to pay just these salaries. Furthermore, analysts estimate that an additional $3,000 per car is going to pay other redundancies, such as overhead costs. This is a huge amount of redundant management and administrative overhead, and is the major reason for consolidation in the auto retailing business. If a firm is able to capitalize on these inefficiencies, it could increase its margins and reap huge financial rewards. United Auto Group, one of the main public groups, even says in its investor prospectus that its key strategy is "to lead the consolidation of the automotive retail industry by growing higher-margin business."[3]

Through my research, I have identified four areas where the consolidators are

[2] Bohon, "On the Precipice." p. 15.

[3] United Auto Group's *1997 Securities and Exchange Commission Form 10-K.* (For fiscal year ended December 31, 1997): p. 4

attempting to achieve greater economies of scale. The first, and most feasible, is through centralized financing. To be cost effective, a car dealership does not pay for the product until after it is sold. Therefore, it must finance the inventory while it is on the lot, and this is a major expense for the dealership. Financing is attained through revolving credit agreements known as floor plan facilities. By consolidating the financing needs of the dealerships, the public dealers believe they can significantly reduce the rate they are charged for floor plan interest, thereby increasing their margins.

Another way they are attempting to achieve economies of scale is through centralizing administration. Millions of dollars are wasted annually by the fact that each dealership group has its own owner, controller, lawyers, and other administrative management. Consolidation could tremendously cut this expense as a percentage of sales. Having one administrative office for fifty dealerships is more cost effective than having one for each dealership.

By bulk purchasing of insurance and advertising, the consolidators can attain more benefits of size. For example, Republic Industries Inc., a leading consolidator, just introduced a extensive advertising campaign in Denver, Colorado, for its seventeen AutoNationUSA dealerships in the metro area. Undoubtedly, a purchase of this magnitude contained a reduced price per minute.

The final area where consolidators are attempting to use their size to reduce costs is on the invoice price from the manufacturer. Unfortunately, price reductions in the cost of goods sold are not as promising to the consolidators as the other areas. Most of the manufacturers have already stated they would not negotiate invoice price with their dealer base. However, if companies such as Republic get a huge market share, they may

be in a position to demand lower prices. This has resulted in numerous lawsuits and ill will between the manufacturers and the consolidators. This topic will be addressed later in much greater detail.

Out of the consolidators, Republic Industries is the company that should be able to benefit most from these economies of scale. This is because it is by far the biggest dealer group in the country, with over 400 franchises. Wayne Huizenga, the CEO of Republic, is further capitalizing on its size by vertically integrating. Huizenga's plan, which he calls the "cradle to grave" strategy, is to convert Republic into an auto retailer at all points in the automobile's life cycle. This lets Republic get as much profit out of each automobile as possible. Huizenga says the strategy entails creating synergies between the "building blocks" of the auto industry: new cars, used cars, rentals, finance, and service. Initially, one of Republic's new car dealers will lease the car through a finance company owned by Republic. After the lease is expired, Republic will claim the car and send it to one of its recently acquired rental-car stores, Alamo or National, to be used as a rental car. After three to six months as part of the rental fleet, the car will be reconditioned at a Republic-owned reconditioning center and shipped to an AutoNationUSA used car superstore. There, Huizenga believes it can be leased again through a short-term, used car lease. Finally, after one more reconditioning, the car is sold as a used car. Another reason this kind of a system would be beneficial to Republic is because Huizenga believes that access to high-quality, low-mileage, late-model used cars is the biggest issue facing new car retailers. The "cradle to grave" strategy would supply Republic with a constant supply of quality used cars to sell. Besides Republic, the other public retailers are using their Wall Street capital to vertically integrate by

purchasing finance companies and reconditioning centers. Their ability to do this is a significant advantage public firms have against the private, family-owned dealer.

Many analysts of the auto retailing market see a decrease in brand recognition of the different manufacturers. People are now looking for the best car for their money, and the brand influence may be losing its significance. The consolidators see this as another place to capitalize by implementing their own *retailer* brand name into the minds of the consumer. They believe that the existing lack of consumer confidence in the auto retailing market is in part due to the absence of a nationally branded retailer. Tom Gibson, CEO of the Asbury Automotive Group, says, "Dealer branding is going to be a whole lot more important than manufacturers' brands. I'm not saying the manufacturer's brand isn't important. You still need that national halo out there. But what we're seeing evolve is less and less loyalty to the manufacturer, and more brand loyalty developed by the dealer."[4] Using a common name for the dealer outlets, such as AutoNationUSA, and CarMax, the companies are attempting to become this nationally branded retailer. By doing this, they feel they will acquire "customers for life." Other consolidators, such as Marshall Cogan of United Auto Group, disagree with the claim that the dealer name could be more important, and thus refrains from changing the name of the well-reputed dealerships that he acquires. The dealership naming decision is controversial, but it may greatly relate to the overall success of the consolidator's marketing strategies.

Some of the consolidators are attempting to change the actual sales process of the car as well. They believe that consumers are dissatisfied with the current retailing and

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[4] Henry, Jim. "Dealers differ on which brand leaves lasting mark." *Automotive News.* (May 25, 1998): p. 62.

service experience. Some are abandoning the traditional negotiation system and adopting a "no-haggle" policy, expecting to boost customer satisfaction. This is a fragile topic in today's auto market. No one is completely sure which pricing policy is more accepted. As will be shown later in this study, the pricing method chosen may have a huge effect on whether a dealership succeeds or not, and may have a long-term effect on the industry as a whole.

Consolidators are also using their Wall Street capital to purchase technology that most private dealers cannot afford. They believe these innovations will be fundamental assets in the future of the retailing business. In-store kiosk systems are an example that will help the customer shop the inventory, select his desired options, and even arrange financing. In addition, many analysts believe the Internet is where most car transactions will take place in the 21st century. The consolidators have the capital advantage to afford an extensive Internet program that will ease the buying process for the customer.

The consolidators believe this is the time for an overall change in this fragmented, over-dealered industry. Manufacturers, who were originally opposed to the idea, may benefit from consolidation in the long run. Some manufacturers believe there are too many outstanding franchises, and they would like to see this number substantially decreased. Some of them have even tried consolidating themselves. The public dealers may be a no-cost solution to the manufacturers' plan to reduce the number of franchises.

The public dealers see even more consolidation potential by looking at the history of the overall retailing sector. Every other segment of the retailing industry has been

successfully streamlined, and the consolidators are trying to set the trend in the auto-retailing segment. With margins in the business reaching all-time lows, retailers have to find a way to keep expenses down to survive. The consolidator thinks a publicly owned mega-dealer is the medium by which this can be accomplished. See Appendix F for graphs portraying declining dealership numbers and margins.

DISSENT OF CONSOLIDATION

The main argument against consolidation is that the car business is a unique industry that cannot be run by Wall Street. Most present owners have been in the business for over thirty years and know how to run a successful enterprise. When a company buys a dealer out, he is most likely looking for a profitable exit, and therefore would have no reason to manage the dealership for the consolidator. A man who has been his own boss for his whole life does not wish to start working for someone at age sixty. Managerial expertise will become diluted as the public companies continue buying. Even if the owner does decide to manage the dealership, he will not work nearly as hard to maximize its profit. Certainly, he cared more about the operation when his name was on the dealership, and his money was running it.

Skeptics also believe that customer satisfaction will be lower at a public dealership. Traditionally, a bad connotation is associated with family-owned dealers' selling techniques, but the system has changed tremendously in the last decade. Presently, many private dealers are stressing customer satisfaction index scores and are not just concentrating on the profit per car sold. Dealers now realize the long run profits will come from repeat buyers, not one-time rip-offs. The consolidators, however, believe the current process does not lead to satisfaction for the customer. They are trying to change it by reducing sales pressure, and some are even switching to a "no-haggle" pricing system. Recent surveys conducted by Automotive News and Advertising Age, however, show that most customers are partial to the present system.[5] Only 23.5% of the

[5] Ellis IV, John W. "Used car buyers generally happy with purchase." *Adevertising Age*. (April 7, 1997): p. 16.

recent car buyers surveyed feel their salesperson was dishonest, and only 34.5% feel their salespeople were too pushy. 89.7% feel that their salesperson was truly interested in helping them. The most interesting result, however, is that 69.7% of the people polled say they enjoyed haggling over price. 37.9% of the people who actually visited a public "superstore" say that its biggest weakness is that it is too impersonal. These numbers clearly suggest that customers enjoy the personal touch that a family-owned dealer can offer.

In addition, some analysts say that the auto industry is based on the margins that they can achieve through the multiple-pricing strategy. Taking this away would ruin profitability, no matter what the scale is. In other words, the mega-dealers will not be able to sell enough cars to compensate for the loss of profit per car due to using the one-price policy. Furthermore, if a dealer has a one-price policy and quotes a non-negotiable price on a car, a traditionally priced dealer could continually undercut this price by a couple hundred dollars and corner the market.

The initial dissent from the auto makers was an unexpected hurdle that the consolidators had to overcome. Manufacturers have strict policies concerning how many franchises a single entity may own. This is to protect their own freedom of action to ensure a franchisee cannot demand a lower invoice price or product line. When the consolidators entered the market, they believed the auto makers would not enforce these policies. Unfortunately, the manufacturers have consistently used their power to stop acquisitions. This has resulted in numerous battles and lawsuits between the consolidators and the manufacturers. This issue, which will be discussed later in detail,

has been extremely burdensome to the consolidators, and has had a grave impact on their stock prices.

After observing the initial attempts at consolidation, critics of public ownership in the auto industry became much more numerous. The public companies' acquisition strategies have been poor in the eyes of many analysts. Initially, the consolidators, such as Huizenga's Republic Industries have been carelessly spending money on any dealer that will sell out. Because they are attempting to maximize shareholder value, their only goal is expansion, no matter what the cost is. If statistics were released concerning the individual acquisition prices, as well as realistic future cash flow projections for the acquired dealerships, I believe many of the transactions would have a negative net present value. Huizenga and the others seemed to be ignoring their own cost of capital, and acquiring any dealership that would add revenue to their income statement.

Profitable dealerships do not necessarily make profitable public companies. The consolidators need to find dealerships that fit in to their specific strategies. The public companies that have implemented a "shopping spree" acquisition strategy have seen significant devaluation in their stock prices. On the other hand, the public companies that have been successful, such as Sonic Automotive and Lithia Motors, have stuck to their detailed acquisition strategy and remained in a certain geographic area. The most important statistics to show the value of an acquisition strategy are what is called same-store numbers. These compare financial statistics from before and after the dealership changes hands. A company with a good acquisition strategy and capable management

should be able to continue or improve the dealerships' financial numbers. However in 1997, only one of the public companies experienced growth in its same-store revenues.[6]

Since the entry of the consolidators, the United States auto market has been booming. Interest rates have been low and sales have been high. 1998 was the second best sales year ever in the United States.[7] If the public firms cannot be profitable in these times, they cannot possibly succeed when the inevitable downturn strikes? This all suggests that dealerships may fare better in the hands of a private entrepreneur.

Critics also believe that merely bunching dealer groups together will not promote the necessary economies of scale for a consolidator to survive. They claim that manufacturers will never grant preferred vendor agreements on cars, parts, and financing. This would be completely unfair and unethical toward the other franchisees in the market. The other areas of cost trimming, such as centralized administration and advertising and insurance purchasing, are feasible, but may not be enough to achieve the economies of scale necessary for the overall concept to be successful.

The automobile retailing industry is the only retailing industry to remain fragmented. Besides buying a house, a car purchase is the biggest retailing decision a consumer has to make. An automobile is more than just a means of transportation, it is a status symbol, thereby making the purchasing decision even more significant. A customer should have the right to haggle for what he feels is the best price on such a big-ticket item. This is why the one-price system will not work. The fact that manufacturers will not grant bulk-purchasing agreements also sets the industry apart from its retailing

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[6] Harris, Donna. "Public chains see declines in same-store sales results." *Automotive News*. (April 27, 1998): p. 3.

[7] Henry, Jim. "1998 wasn't a record breaker, but second place isn't so bad!" *Automitive News*: (January 11, 1999): p. 1.

counterparts. The uniqueness of the auto retailing industry is the biggest barrier to "Wal-Mart" style streamlining. The auto market is mature, saturated, and has extremely low margins. This leads to an environment in which the growth rates are too low to support companies whose main priority is impressing Wall Street.

THE CONSOLIDATORS

REPUBLIC INDUSTRIES, INC.:

Wayne Huizenga, Chairman and CEO of Republic Industries, Inc., is renowned for his history in consolidating industries, but is now facing his biggest consolidation challenge. Before entering the car business, Huizenga brought the video rental industry into the public marketplace with his extremely successful Blockbuster Video. He also successfully created operational and financial synergies in the waste management industry with the solid waste segment of Republic. In 1996, when he entered the car business, he seemed to be on his way to building his third Fortune 500 company in 25 years.[8] Although in 1997, auto retailing only accounted for 59% of revenue and 19% of operating income for Republic, the company states it is planning to expand operations, and make this industry the focal point of the company.[9] In just three years, Republic has become by far the largest automobile dealer in the United States, with almost 400 dealerships and revenues in excess of $18 billion.[10] Of all the consolidators, Republic has the best chance of producing economies of scale due to its immense size. Therefore, Republic may be the best barometer to gauge the success of the overall concept of consolidation in the auto retailing industry. Republic is diversified inside the auto retailing industry as well. Besides its almost 400 new car dealerships, it owns over 42 AutoNationUSA used car superstores, and National and Alamo rental car companies.[11]

[8] Telsey, Dana and Zachary Warren. "Specialty Retail: Hard and Soft Lines." *Bear Stearns Equity Research Report.* (March 1998): p.91.
[9] Telsey, "Specialty Retail: Hard and Soft Lines." p. 91.
[10] Excite Web Site (found at http://www.excite.com/).
[11] Excite Web Site (found at http://www.excite.com/). These numbers are the most recent, but due to the rapid rate of acquisition, they are continuously changing and may be outdated

Headquartered in Ft. Lauderdale, Florida, Republic started its acquisition spree in the South, but has quickly spread into all parts of the country. Republic attempts to establish itself in the top 50 markets in the United States.[12]

Republic has realized over the last three years that consolidation in the auto industry will not be as easy as its other successful ventures. After its stock hit an all time high in late 1996 of $42 per share, investors have lost confidence and its shares are currently trading below its IPO price at $15.[13] Republic believes that the benefits from its rollup will take longer to achieve than previously thought. See Appendix A for graphs of all of the public companies' stock performance.

UNITED AUTO GROUP, INC.:

UAG, who owns and operates 96 dealerships in the United States, is the second largest automobile retailer in the U.S.[14] UAG completed its IPO in October of 1996, and focuses on acquiring well-run, profitable dealerships in the "underdealered" markets of the South.[15] UAG has expanded beyond its southern focus, however. UAG says that currently 2000 dealerships in America meet its requirements for acquisition. United Auto Group also owns United Auto Finance in order to vertically integrate and create financial synergies. The New York City based dealer group uses a "clustering" acquisition strategy in specific markets to exploit local economies of scale. UAG's acquired dealerships usually keep the names they operated under before the acquisition. UAG

[12] Hymowitz, Jordan and Kirstin Jensen. "Auto Retialing – The Consolidation Shifts into High Gear." *BancAmerica Robertson Stephens Equity Research Report.* (November 10, 1997): p.34.
[13] Excite Web Site (found at http://www.excite.com/).
[14] Excite Web Site (found at http://www.excite.com/).
[15] Telsey, "Specialty Retail – Hard and Soft Lines."p. 127.

says keeping the name raises the chance of keeping the incumbent management. Realizing that a national branded name could produce benefits, UAG may nationalize the "United Auto" name. This marketing strategy is still in discussion.[16] Since going public in 1996 at an excessively high price of $34, the stock has plummeted to around $9 per share.[17] On April 12, 1999, due to lackluster stock performance, United Auto Group announced plans to sell 38% of the company to Roger Penske and Penske Capital Partners for $83 million. Roger Penske is a well-known figure in the automotive world, and UAG believes that his knowledge and commitment to the auto industry will turn the company around.[18]

CARMAX GROUP:

In the fall of 1993, Circuit City open its first CarMax used car superstore in Richmond, Virginia. After offering shares to the public in 1996, CarMax has expanded to 28 used car superstores and entered the new car market and owns 15 franchised dealerships.[19] Circuit City has cloned its customer satisfaction strategy of selling electronics to the automobile business, believing that consumers are dissatisfied with the traditional way of selling cars. CarMax offers no-haggle pricing, a quality guarantee, and efficient, customer-friendly service. CarMax is also trying to achieve financial synergies by acquiring its own finance unit, First North American Credit.[20] Stock performance has

[16] Telsey. "Specialty Retailing – The Hard and Soft Lines" p. 127.
[17] Excite Web Site (found at http://www.excite.com/).
[18] Business Wire. "UnitedAuto Enters into Agreement for $83 Million Investment From Penske Capital Partners." (April 12, 1999).
[19] Excite Web Site (found at http://www.excite.com/).
[20] Telsey. "Specialty Retailing – The Hard and Soft Lines." p.55.

been similar to its large counterparts, going off at almost $20 per share, and then dropping to below $5 per share.[21] CarMax's acquisition strategy contains a goal of 80-90 used car super-stores in the top 45-50 markets by 2002. Originally, CarMax intended to expand its new car franchises to 25 by 2002. However, the company has recently decided to make new car operations a higher portion of their sales, so this number may be conservative.[22]

CROSS-CONTINENT AUTO RETAILERS, INC.

This firm, based in Amarillo, Texas, was the first dealer group to go public in October of 1996.[23] In January of 1999, Cross-Continent was acquired by Republic, becoming part of the first public acquisition in the auto retailing consolidation trend. Because Cross-Continent had over two full years of operation, and because this fledgling industry does not have many participants, its numbers and actions will still be included in this study. Republic reportedly bought Cross-Continent for $145 million.[24] Unlike the previous three companies, Cross-Continent had more of a regional focus, concentrating its operations in the states of Texas, Oklahoma, Colorado, and Nevada. Cross-Continent acquired above average dealer clusters in "underdealered," middle-income markets in order to exploit local economies of scale. In making acquisitions, Cross-Continent considered the quality of the brand, the strength of the incumbent management, and the likelihood that the management will stay as employees. Cross-Continent also had a

[21] Excite Web Site (found at http://www.excite.com/).
[22] Telsey. "Specialty Retailing – The Hard and Soft Lines." p.55.
[23] Telsey. "Specialty Retailing – The Hard and Soft Lines." p.75.
[24] PR Newswire September 3, 1998.

policy of keeping the names of the dealerships after they were acquired.[25]

LITHIA MOTORS:

Lithia Motors, headquartered in Medford, Oregon, is one of three public dealers that is performing extremely well. Lithia is a regional dealer group that focuses its operations in Oregon, California, and Nevada. This region is well suited for a company such as Lithia because it has a rapidly growing population, profit margins tend to be higher, and competition is less intense. Lithia's strategy is different from the previous companies in that it acquires average to below average dealerships, and uses its managerial expertise to boost sales and margins. Because of this, Lithia can acquire these dealerships at "bargains." Lithia spends only 2-4x pretax dealership earnings on the new stores, which is considerably below the consolidator average. Lithia's management team has been together in the car business for over 26 years, which is a valuable resource for Lithia. Lithia is generating pretax margins of 3%, compared to an industry average of 1.5%. Analysts believe this is because of their geographic positioning in the West, and their focus on the higher margin segment of used cars[26]. All of this success is reflected in its stock price, which has risen from an IPO value of about $11 to $20 per share. Lithia is a good model to follow for newcomers into the public auto-retailing scene.

SONIC AUTOMOTIVE, INC.:

Sonic is also a regional consolidator with its corporate headquarters in Charlotte, North Carolina. Sonic's performance has been way above the industry average since its

[25] Telsey. "Specialty Retailing – The Hard and Soft Lines." p.76.
[26] Hymowitz – "Auto Retailing – The Consolidation Shifts into High Gear." p.40.

IPO price of $12 in November of 1997. As of earlier this year, the stock price for Sonic escalated to over $36 per share, leading to a stock split by the firm. Sonic's stock price appreciation made its market capitalization rise to $424 million.[27]

Some analysts have labeled Sonic's growth strategy and organizational process "unique". It uses what is known as a "hub and spoke" strategy, where it first acquires a well-run, profitable, and highly reputed dealership in a new market. Sonic then builds around this with numerous sub-par dealerships, which it plans to turn around with the help of its own management team, and that of the "hub" dealer.[28] Sonic's "unique" goal is to increase market share in existing markets, as opposed to continuous expansion into new markets.[29] Sonic's management team seems to have the most auto retailing experience out of all of the public retailers. This is a necessary asset in order to implement such an internal growth strategy.

Until Sonic entered the market, analysts were beginning to be skeptical about the public auto retailing industry. Sonic's performance, however, has swayed some analysts to be in favor of the trend once again. This is shown in a quote from a report on Sonic from BancAmerica Robertson Stephens: "We believe Sonic will quickly distinguish itself as a leader that is revolutionizing the auto retailing industry."[30]

GROUP 1 AUTOMOTIVE

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[27] Excite Web Site (found at http://www.excite.com/).
[28] PR Newswire August 17, 1998.
[29] Sonic Annual Report 1997, p. 3.
[30] Nelson, Jr., Richard N. *Stephens Inc. Equity Report.* (May 29, 1998): p. 17.

There are many similarities in strategy and performance between Sonic and Group 1 Automotive. Group 1 is a regional firm that, like Sonic, went public in November of 1997, at a price of around $13 per share. Upon completion of all announced acquisitions, Group 1 will own 83 dealership franchises in Texas, Oklahoma, New Mexico, Colorado, Florida, and Georgia. It will also own over 17 collision centers in these same regions to capitalize on this higher-margin business. One of Group 1's company strategies is to increase revenues from these types of high-profit, counter-cyclical services. Group 1's stock price has appreciated much like Sonic's has, escalating to over $27 per share in January of 1999, bringing the company to an over $500 million market capitalization.[31]

[31] Excite Web Site (found at http://www.excite.com/).

MARKETING STRATEGIES

Although each individual firm has its own marketing strategy, the public groups as a whole are trying to accomplish some basic marketing goals. For the purposes of this essay, the four P's of marketing (product, price, place, and promotion) will be helpful in summarizing these goals.

PRODUCT:

Obviously, the product will be the same no matter wherever one buys a car, but the consolidators are hoping to add value to the cars by easing purchasing process. Republic's Huizenga predicts that he will change the way cars are sold in the same way that McDonald's transformed the fast-food industry.[32] The public dealer groups have large inventories to choose from, and they capitalize on this by implementing computer kiosk systems to help the customer shop. Computer screens in all of the showrooms will allow the customer to input the car he wants, which options he would like to add, and how much he wants to pay, and the computer will display the store's current inventories and the car's position on the lot. Some private dealers are also buying this technology, but access to vast amounts of Wall Street capital makes it much easier for the consolidators. Most of the companies are also adopting an exchange policy that allows dissatisfied customers to return the car free of charge. These policies are not without cost, however. For example, some analysts believe that these amenities have pushed the

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[32] Wernle, "Republic plan: Profit from peaks and valleys." p.3.

break-even point at an AutoNationUSA superstore to 550 cars per month, which is well above target monthly sales.[33]

Consolidators are also focusing on quality service, which will add more value to the product. Not only is the service and parts business blessed with much higher margins, but it is also counter-cyclical to the economy and thereby car sales. When people do not have the funds to buy a car in an economic downturn, they simply service their old car more. This business keeps many dealerships from going bankrupt during a major recession.

PRICE:

If the public dealers can achieve the desired economies of scale, they believe they can charge a lower price to the consumers. Manufacturers have consistently said, though, that no matter how large the dealer groups become, they will not give bulk purchase rates to them, which reduces the potential benefits from economies of scale. Another aspect of the pricing strategy that needs to be addressed is the public dealers' policy on the industry trend toward a one-price, "no haggle" policy. This controversial subject is becoming a major policy decision for the public dealers entering the marketplace. The consolidators are beginning to switch more and more dealerships to a no-haggle system. Republic believes that it is the sales strategy of the future, and that one-price selling on automobiles will soon be the rule, not the exception. If Republic, the nations largest dealer chain, completely switches all of its stores to this system, it could be the catalyst leading to change in the entire industry. Another push toward no-haggle pricing may be

[33] DeGeorge, Gail. "Car Trouble." *BusinessWeek.* (May 5, 1997): p.35.

the Internet. Because customers can now go online and find actual dealer invoices, they are in a much better position to negotiate a low price. This means that the non-negotiated price becomes the one with the higher margins. Addressing this issue, Morgan Stanley auto analyst Steve Girsky says, "The knowledge that consumers have drives prices down and accelerates the move to one-price selling."[34]

After a successful no-haggle test at a store in the Houston market, Sonic has begun switching some of its dealers to this system. The test occurred at a dealership where the average selling price was about 4% over invoice (which does not include the holdback). Sales people earned a flat fee and bonuses for meeting quotas and repeat customers, thereby removing some of the selling pressure from the customer.[35] Scott Burton, president of Sonic, says, "The test was hugely successful. The store has some of the largest margins I have ever seen for a domestic franchise-6.6% percent net profit (as a percentage of sales)."

However, Sonic realizes the potentially controversial nature of completely switching to a no-haggle policy, and is letting others, such as Republic and CarMax, pioneer the transition. Sonic is worried that if they do switch to no-haggle selling across the board, some private dealers may not sell the dealership to them because of the conflicting selling strategies.

For all of the advocates of one-price selling, there may be more non-believers. Mike Jackson, president of Mercedes-Benz of North America, says, "It's very difficult

[34] Harris, Donna. "Internet, Republic, others push no-haggle pricing." *Automotive News*. (January 18,1999): p. 18.
[35] Harris, Donna. "One-price is a winner in Houston, but Sonic won't go all the way." *Automotive News*. (January 4, 1999): p.4.

for an individual dealer to implement one-price selling and stay with it because of competitive pressure."[36] If a dealer adheres to a one-price policy, a main competitor who negotiates with his customers can simply quote them prices a hundred dollars less, and steal much of the business. Ed Wesche, General Manager at John L. Sullivan Chevrolet-Geo in Sacramento, agrees by saying, "People who want a better price will find no shortage of other people in the market willing to offer one."[37] Negotiation allows a dealers to keep the customer interested. If a customer does not like the deal offered, and leaves the dealership, a salesperson can call him the next day and offer a better price to make the sale. This is a very powerful tool for a retailer. John Schenden, president of the Metro Denver Automobile Dealers Association, says, "I don't want to be a one-price store. That is a take-it-or-leave-it proposition to the customer."[38]

As previously mentioned, new surveys have also shown that a majority of customers enjoy haggling over price.[39] They want to take credit for the deal that they achieved. To reiterate, 69.7% of customers polled in an Automotive News survey enjoyed haggling over price. This may be the key point that will keep negotiations alive in the automobile industry of the future. No matter how much a dealer wants to use a one-price policy, the overall fate of the system rests in the hands of the customer.

[36] Harris, "Internet, Republic, others push for no-haggle pricing." p. 18
[37] Harris, "Internet, Republic, others push for no-haggle pricing." p. 18
[38] Harris, "Internet, Republic, others push for no-haggle pricing." p. 18
[39] Ellis IV. "Used car buyers generally happy with their purchase." p.16.

PLACE:

Although the public firms are moving into geographically diverse locations, they do try to concentrate on certain areas. The unwritten rule for the consolidators is to start operations in the top 50 markets in the United States. They believe they can achieve greater margins in these areas. The only consolidator not completely in agreement with this philosophy is Lithia Motors, who prefers entering undervalued markets and improving the margins in a less competitive atmosphere. The public dealers have begun to consolidate in the South, West, and Southwest, because they believe that this reduces some of the detrimental seasonal effects of auto retailing. This leads to a more constant stream of earnings, which is attractive to investors. The pressure continually expand, though, may make the consolidators push into the largely untapped markets of the Midwest.

PROMOTION:

Because the companies are trying to achieve national brand recognition, their promotion strategy is vital to their success. The most important aspect of this promotion is the naming decision of the acquired dealerships. There seems to be a tradeoff in this decision. On one side, giving every dealership a single name would improve the brand recognition of the companies. This capitalizes on the belief that customers are losing loyalty in the manufacturer brand and searching for a nationally branded retailer. The other side argues that customers do not wish to shop at a huge conglomerate, but at a traditional family-owned dealership where they receive more of personal attention. Republic subscribes to the first idea, so it has created a nationally branded name,

AutoNationUSA. Initially, they wanted only to use this name for their used-car superstores, but now they have begun converting new car dealerships to this name as well. At the 1998 annual meeting for Republic, CEO Steve Berrard says that Republic will soon have the AutoNationUSA logo on every new and used dealership. This may be a "sub-brand," however; meaning that the previous name of the dealership will be highlighted on the sign with a smaller AutoNationUSA logo below it.[40] They may be trying to achieve the best of worlds with that strategy. CarMax uses its name on all of its used car superstores, but due to its recent entry into the new car market, is unsure as to its future naming policy. United Auto Group says that since it pays premiums for such highly regarded dealerships, it should keep the previous name on the dealership to take advantage of its reputation. The regional firms tend to do the same, leaving the previous name on the dealership.

Republic and CarMax have produced very aggressive ad campaigns to target customers who are frustrated with the current process of buying a car. TV spots for CarMax "poke good-natured fun" at traditional selling techniques. Its used car superstore slogan is "CarMax - the new way to buy used cars." Recently, after its acquisition of a number of Denver dealerships, Republic launched an advertising campaign called "the guys in plaid." These ads portray two sleazy car salesmen dressed in plaid suits pressuring customers into buying a car. The ad then jumps to show a AutoNationUSA store, where the customers are treated well, the kids are playing in the showroom playground, and everyone is smiling. Of course, the ad is endorsed with Denver's city hero, John Elway, from whom Republic bought all of dealerships. Other dealers in the

[40] Smith, Bradford. "Republic aims to rule retail." p.1.

Denver area are angry at this ad campaign and believe it gives the car dealer a "black eye."[41] For its used car operations, Republic's slogan is very similar to CarMax's: "AutoNation - the better way to buy a used car." The other companies have chosen not to run a universal ad campaign, and instead are using their discretion on a market to market basis.

There are major marketing decisions that the public companies must address before entering the car business. It seems clear that there are two categories of customers in the automobile market. One of the types enjoys the intense negotiation process, as well as the personal touch of the smaller dealership. The other customer wants a quicker process, and would rather shop at a dealership that offers one-price selling. The auto industry is in the process of examining the demographics of each group. This knowledge would help the dealers with their meaningful promotional decisions. For instance, people in the South may prefer a longer, more personal process in order to get a good deal. Therefore, the dealers in this area should offer multiple price selling and leave the previous owner's name on the store. The problem with identifying the demographics is that this type of research is in its initial stages. It is too early to tell where the customer segments are, so the public groups are in a stage of trial and error.

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[41] Harris, Donna. "Dealers fume over 'plaid' ads." p.32.

MANUFACTURER'S FEELINGS

The highest unforeseen hurdle that this concept had to overcome was the initial stance of the manufacturers. When the public groups first entered the market, they believed that the manufacturer would be supportive for two reasons. The first reason is that a public takeover of the retailing industry would help alleviate many of the problems in the industry. They maintained that huge dealers could be like distributors for the cars, thereby making the process much less troublesome for the manufacturer. This would offer the customer better access to the car he actually wants, as opposed to something he has to settle for. In addition, the consolidator thought that the new economies would help the industry's struggling margins. The second reason that the consolidators were convinced that the manufacturer would back them was the fact that manufacturers believed the market was over-dealered. The consolidators thought their success would drive the smaller dealers out of business, thereby producing a market with less overall dealerships. Both the consolidators and the manufacturer would benefit from this.

As it turns out, some of the manufacturers did not agree. They rigorously opposed sales of franchises to the public dealerships. This limited the consolidator's growth potential, which is the main aspect that Wall Street is looking for. Ford, Toyota, Honda, Land Rover and Jaguar initially denied public ownership of their dealerships. Addressing this issue is Jim O'Conner, the general manager of the Lincoln-Mercury division of Ford: "We prefer to stay with private capital investors. The owner's name is on the building, his life is there." This lack of acceptance has led to intense negotiations and lawsuits. Manufacturers claim they have the right to refuse any entity from acquiring

a franchise. In their bylaws, most manufacturers have regulations preventing an entity from owning a certain number of franchises. Public companies are a direct threat to these regulations.[42]

Manufacturers are afraid of losing control of the franchises to the consolidators, who could put themselves in a position where they could demand what cars are produced, and at what price. Addressing this point, Robert Thomas, president of Nissan Motor Corp. USA, says, "As superstore chains add or buy more franchises, they could control enough shelf space to demand drastic price reductions from manufacturers."[43] Manufactures also fear the exit strategy of the consolidators. Huizenga has a pattern of building up a company and then selling it, and manufacturers would not like a significant portion of their franchises changing hands at one time. The manufacturer's fears were realized on April 12, 1999, when United Auto Group agreed to sell 38% of its equity to Roger Penske and Penske Capital Partners LLC.[44] The manufacturers also are concerned that if the public dealers attempt to sell to one of their competitors, they would have no say in the transaction. Losing control of the dealership base would be extremely detrimental to the operations of a manufacturer.[45]

The two largest battles in this conflict were between Republic Industries and both Honda and Toyota. These manufacturers are not as over-dealered as their American counterparts, and this is why they are so opposed to the concept of public ownership. Although other factories had told the consolidators to slow down, Toyota was the first

[42] Wernle, Bradford. "Chrysler asks Republic: Slow down…a little." *Automotive News.* (June 2, 1997): p.42.
[43] Wernle, "Chrysler asks Republic: Slow down…a little." p. 3.
[44] Business Wire. "UnitedAuto Enters into Agreement for $83 Million Investment From Penske Capital Partners." (April 12, 1999).
[45] Wernle, Bradford and Mark Rechtin. "Honda sues to curb Republic shopping spree." *Automotive News.* (May 12, 1997): p. 44.

manufacturer to tell Republic to stop buying franchises. Toyota said they would stop the sale of any dealership that would violate Toyota's franchise agreement, hurt the public interest, or threaten Toyota's market representation. Toyota implemented a regulation in the summer of 1996 that a single entity has to wait 9 months between Toyota franchise purchases. Toyota claims that these policies are designed, "to protect the long term interests of our customers, Toyota dealers, and Toyota by establishing reasonable, uniform requirements regarding ownership, management, capital, performance…"[46] Yale Gieszel, Executive Vice President of American Toyota, addresses the relationship with Republic: "Republic is making a clear statement that it intends to acquire Toyota dealerships in disregard of Toyota's policies." Republic said it intends to buy 5% of all Toyota dealerships, which could convert to as much as 20% of sales, depending on the nature of the dealerships included. Legal analysts believed that local and state politics favored the dealer as opposed to the big corporation, so they thought Republic was the favorite in this suit.[47]

Toyota was willing to risk $100 million in counter-suit damages in a July 1997 hearing. Here is Toyota's claim: "The actions of Republic have demonstrated in various ways that it does not meet the standard because its actions and conduct since announcing its entry into the new-car retailing market would cause a reasonable person to have substantial doubts about its honesty, fairness, and respect for the rights of others and for the laws of the state and the nation."[48] The investing community has expressed its doubts

[46]Reding, Michael B. General Manager of Toyota Motor Sales USA, Inc. From cover letter of the actual multiple owner policies sent to Toyota dealers.

[47] Rechtin, Mark. "Toyota tries to block Republic deal in Texas." *Automotive News.* (April 7, 1997): p.60.

[48] Wernle, Bradford. "Toyota, Republic go to war." *Automotive News.* (July 21, 1997): p.41.

in Republic because its stock price has plummeted from $44 in January to $23 in August of 1997. Analysts believe the manufacturer lawsuits are the reasons for this. The lawsuits may indirectly create speed bumps to acquisitions because Republic depended on its stock to fuel its purchases.[49] Owners will be less willing to take stock as compensation when the price is falling.

Even before the actual trials, there were major differences between Republic and American Honda. "They don't even negotiate in good faith. While we were negotiating with them, they went out and bought a Honda store," says Dick Colliver, General Manager of American Honda.[50] In May of 1997, Honda sued Republic in a US District Court in Los Angeles, claiming Republic was attempting a "hostile takeover of American Honda's dealership network."[51] Honda says that Republic wishes to acquire 20% of its national sales volume, a figure that Republic denies. Honda wants a settlement of an undisclosed amount, but more importantly, an injunction permitting Republic to buy any more Honda dealerships. The main legal question in this case is if a manufacturer can stop a qualified buyer from buying a franchise. Honda has been concerned that, "the "mega-dealerships" that might result from public ownership could depersonalize the car-buying experience and endanger the company's unique and outstanding Honda and Acura brand images."[52] Honda says that Republic does not have either the auto experience or

[49] Wernle, Bradford. "Toyota-Republic legal feud spreads." *Automotive News.* (August 18, 1997): p. 8.
[50] Wernle and Rechtin, "Honda sues to curb Republic shopping spree." p.1 .
[51] Wernle and Rechtin, "Honda sues to curb Republic shopping spree." p. 44.
[52] From American Honda's "Policy on the Ownership of Multiple Honda and Acura Dealerships."

the long term commitment that it requires in its dealers, but it may have a hard time proving that Republic is doing anything illegal.[53]

In response to Honda and Toyota's lawsuit actions, Republic says, "We view this as somewhat of an annoyance, an irritant, but we don't view it as a setback." Republic plans to create joint ventures with private dealers if it must to bypass the franchise ownership limits imposed by Honda and Toyota.[54]

Last year, Toyota and Republic were able to settle their suit out of court, and both sides claimed victory. Toyota rewrote their Multiple Owner policies, permitting an entity to acquire more dealerships and in a shorter time span. In return, Toyota demanded that Republic act in good faith in their acquisition strategies. Republic agreed to abide by the new Toyota policies.[55] Honda and Republic also settled out of court, and Honda raised their ownership limitations as well in a new Multiple Ownership Policy. Honda claims that this policy, "paves the way for ownership of multiple Honda and Acura dealerships by larger corporations and dealer groups while reconfirming certain procedures and guidelines aimed at reinforcing the personal qualities of the individual dealership, protecting and strengthening the Honda and Acura brand names, and making sure that American Honda's customers continue to get the excellent service they deserve."[56]

The Big Three manufacturers, however, have a less confrontational view with Republic and the other public consolidators. All they are asking for is a slower

[53] Wernle and Rechtin, "Honda sues to curb Republic shopping spree." p. 44.
[54] Wernle, "Republic plan: Profit from peaks and valleys." p.37.
[55] From the Toyota Division One Multiple Ownership Policies
[56] From American Honda's "Policy on the Ownership of Multiple Honda and Acura Dealerships"

acquisition pace so that they can better assess the consolidator's performance. In June of 1997, a spokesman for General Motors said, "So far they've been able to accomplish everything they've said they would do. There is no reason why we should not continue to have a good relationship with them."[57] GM has also said, "We have some dealers who want out. This is a way to get them out in a way that's helpful to us. I think it's a pretty convenient setup for all parties." Jim Nasser, president of Ford Automotive Operations, likes different ownership structures in Ford's dealer base. He says, "Huizenga's primary strategy and vision is built on enhanced customer satisfaction and service. We're all for that. We also believe that he can help the overall Ford distribution strength. My personal view is that there is a lot of goodness in having a mix of different types of ownership in the distribution area: small, family-owned companies, medium companies and larger companies that have public ownership. That's healthy."[58]

It seems quite odd that there could be such a difference of opinion between these two groups of manufacturers. The difference stems from the various levels of benefit consolidation would provide for each manufacturer. The dealer networks are quite dissimilar between the American manufacturers and the Japanese manufacturers. The Japanese entered the American market 20 years ago with a relatively superior product. This led to high demand of Japanese franchises by the American car dealers. The Japanese auto makers could then choose the best dealers to offer franchises to. This also let them select the optimal locations for the dealerships. Since then, the Japanese have been able to be more selective in the franchising process than their American

[57] Wernle, "Chrysler asks Republic: Slow down…a little." p. 42.
[58] Jackson, Kathy. "GM sees benefits of expansion." *Automotive News.* (May 19, 1997): p. 37.

counterparts. This gives them more reason to complain when an untested dealer tries to buy out all of their hand pick entrepreneurs. The American manufacturers, on the other hand, have dealer networks that are both old and immense. They have awarded franchises to lesser skilled dealers and in poor locations. This has led to an over-dealered environment that consolidation could remedy.

MANUFACTURER CONSOLIDATION

Some manufacturers are seeking another avenue to escape the problem of having too many dealers. They feel that they can reduce the dealer count by consolidating the market themselves. The Big Three manufacturers believe that if they reduced competition by buying out existing dealers, they could create a market with a narrower range of prices. The reduction in competition would raise prices a little, which would combat the falling margins in the auto industry.[59] Once the plans of manufacturer consolidation were publicly announced, investors changed their views of the concept of the public consolidators. They started to believe that manufacturers may be the medium of consolidation. This shows the manufacturer's ability to consolidate has a direct effect on the success of the public consolidators.

In the spring of 1997, Ford announced its plan to consolidate two of its over-dealered markets, Indianapolis and Salt Lake City. The reason for picking these cities is based on the population to dealership statistics. For example, Indianapolis has a population base of only 1,476,865, but has 21 Ford dealers. There is no need for a dealership for every 72,000 people in a city. Ford believed excessive price competition, bad service, and a negative goodwill towards Ford Motor Company defined the Indianapolis market. Ford saw this as a great opportunity to test no-haggle selling, salaried salespeople, and the concept of manufacturer consolidation in general. Ford's plan was to decrease the number of dealerships to five superstores.[60]

To Ford's surprise, the dealers did not like the concept of manufacturer

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[59] Hymowitz, "Auto Retailing – The Consolidation Shifts into High Gear."p.6.
[60] Hymowitz – "Auto Retailing – The Consolidation Shifts into High Gear." p.40.

ownership. The 21 dealers generally had two responses, "no way", or "show me the money." Ford was offering 3-5 times earnings for the franchises, but the dealers would only sell our for 7-10 times net income. The attitude of the dealers in Indianapolis set a precedent and created a burden for any manufacturer's attempt at consolidation. [61] This failure may have convinced the factories that the best way to carry out the goal of fewer dealers is through the public companies. Recently, there has been another wave of attempts of manufacturer consolidation, but they began too late to be included in this analysis. The public groups must closely watch these attempts because if they prove successful, Wall Street could easily be convinced again that manufacturers are the better medium for consolidation.

[61] Hymowitz – "Auto Retailing – The Consolidation Shifts into High Gear." p.40.

DEALERSHIP VALUE

The demand for dealerships has been extremely volatile since the rollup trend began in 1996. This has produced dramatic price fluctuations of the acquired dealerships. The price of an individual dealership seems to be directly related to the current success of the consolidators. Historically, dealerships were valued at their net assets, plus 2-4 times pretax earnings or 3-7 times after tax earnings (using LIFO based accounting).[62] This goodwill premium is known in the car business as the "blue-sky." When consolidation began in 1996, some of the best dealers were bought out for as much as 10-12 times after tax earnings. In February through June of 1997, stock prices of the public consolidators as a whole started to drop. This led to the depreciation of dealership value to 7-9 times after tax earnings, a lack of new capital for the firms, and a delay or cancellation of initial public offerings in this market. When public groups like Sonic and Group 1 entered the industry in late 1997, demand for the dealerships was re-stimulated. Private owners that wished to sell out once again demanded blue-sky premiums of 8-10 times net income. This created another sellers market for dealers who were thinking about exiting.[63]

Currently, dealership value is higher than when the consolidation trend began, but has been steadily declining over the past 12 months. Analysts estimate that the blue-sky premiums paid for dealerships have dropped from 5-20% over the past year. The main reason for this is the depreciation of the stocks of Republic and the other larger consolidators.[64] The regional public companies like Lithia, Sonic, and Group 1 are

[62] Harris, Donna. "Blue sky's the limit." *Automotive News.* (November 3, 1997): p.1.
[63] Harris, "Blue sky's the limit." p.1.
[64] Harris, Donna. "Buyers Market." *Automotive News.* (February 2, 1999): p. 38i.

performing well, but these companies do not constitute as much demand as the suffering, larger consolidators. When the consolidators' stocks drop in value, they have to rely more on cash to fuel the acquisitions. Such a cash transaction does not include as high a premium because of the relative lack of risk. This chain of events leads to a lessening of blue-sky premiums. Another reason for the price reduction is that many more dealers want to sell out, thereby pushing the supply curve out. In addition, the consolidators as a group may be copying the successful regional firms' strategies by acquiring more "tuck-in" dealerships. These are smaller, lesser known, dealerships that the consolidator can buy at a bargain and attempt to improve. The more firms that participate in this strategy, the cheaper the average blue-sky premium becomes.[65]

Blue-sky premiums have been a widely debated topic since the IPO of the first consolidator. Analysts could not believe the prices Republic and the early entrants were paying for dealerships in 1997. In late 1996, for example, the National Automobile Dealers Association claimed the average price for a dealership was $3 to $4 million. At that same time, United Auto Group was paying an average of $12 million for its Atlanta acquisitions. Many looked at the consolidators as making very careless acquisitions, and this was reflected in the stock price.

Now, a buyers market may again be on the horizon, and this may stimulate another stepped up acquisition campaign. The regional consolidators, however, may be the firms that are able to capitalize fully on the reduced prices due to their high stock prices. It will be interesting to see the extent to which firms such as Republic can expand

[65] Harris, "Buyers Market." p. 38i.

with such suffering stock prices. We know Huizenga's pockets are deep, but his wealth as well as his commitment to the car business is going to be tested in the coming years.

OUTLOOK FOR THE FUTURE

Although the trend toward public ownership has matured past its first two years, opinions continue to significantly vary on the impact it will bring. Some analysts still maintain that the public consolidators will revolutionize the industry. Others think they will create a new stage in its evolution, while a third group believes the companies will fail. This study will attempt to make a conjecture about the future of public capital in the auto retailing industry, fully realizing the difficulty in predicting the outcome of such a fledgling business segment. The final section of this study has two parts. First, I will convey the opinions of other researchers who have analyzed this topic. Second, using extensive research and analysis of industry data, I will make my own forecast.

In November of 1997, BancAmerica Robertson Stephens had this to say on the future of public companies in the auto retailing sector: "the lackluster performance of the auto retailing stock during the past year is less indicative of the long-term outlook for the group than reflective of weak performance from several less well run auto dealership groups and negative industry trends." This reasoning points to a number of events that have occurred over the previous 12 months that have helped the public groups:

1) reduced manufacturer opposition
2) abandoned attempts at manufacturer consolidation
3) margins improving as economies of scale are reached
4) developing brand identity
5) softening car market pushing out smaller dealerships
6) car business moving to high-tech kiosks and internet resources

7) good customer satisfaction numbers for the public dealerships.

I will give my own critique of this reasoning in the following section because it raises several inconsistencies with the stance of this thesis.[66]

Kathleen Allen, professor of clinical entrepreneurship at the University of Southern California, makes an interesting point by addressing some dissimilarity between the auto retailing industry and the rest of the streamlined retailing industries. She says that consolidation occurs in retail industries when the products they sell come to be viewed as fungible commodities by consumers.[67] When the products become more similar, customers shop for price only, and a mass merchandiser has an advantage over the stand-alone store. The automobile is a product that is far from interchangeable, which builds a high barrier to mass-merchandisers in this industry. On this issue, Yale Gieszl, executive vice president of Toyota Motor Sales USA, remarks, "We are entering an era of increased consumer expectation and sophistication, but we are not entering a time when the car becomes a commodity. In many ways, they (customers) feel defined by them."[68]

The National Automobile Dealer Association (NADA) has also sided with the traditional franchise system. They point out that although average dealership gross profit has dropped from 10% twenty years ago to the current level of 6.5%, 1996 profits increased 25% over the previous year. A past NADA president comments, "Not only is the franchise system alive and well—it's thriving!"[69] Ramsay Gillman, the current

[66] Hymowitz, "Auto Retailing – The Consolidation Shifts into High Gear." pp. 1-2.
[67] Bohon, "On the Precipice." p. 15.
[68] Bohon, "On the Precipice." p. 16.
[69] Bohon, "On the Precipice." p.18.

president of the NADA, believes that the attack of the superstores gave dealers a "wake-up call. I think we all took another look at our used-car and new-car operations."[70]

Alex Trottman, chairman of Ford, explains, "A really well-run, privately capitalized dealership has an advantage over these big mass retailers. It's the local dealer serving a local marketplace and having very personal contact with the customer that is most successful."[71] Yale Gieszl agrees: "Large retail chains or automobile department stores are not the answer to the problems we face…There is nothing a large retail chain can do that a traditional dealer can't do as well—or better." He identifies numerous advantages that traditional dealers have: an existing geographically broad dealership network, well-established relationships with its customer base, and adequate after-sale service.[72] Gieszl goes on to say, "The dealer principal whose name is on the building, whose energy drives the business, and who personally develops strategies and policies will lead the evolution to the next era of automotive retailing."[73]

I will now relay my own findings and predictions on the future of public ownership in the auto retailing industry. As a good starting point, I will address the points made in the BancAmerica report found in the previous section.

I agree with their stance that manufacturers have reduced their opposition toward public ownership, but see substantial inconsistencies with the other points. BancAmerica's research is slightly outdated, and much has changed since its publication. For example, Republic's stock was $30 per share when the report was released. Brand-

[70] Bohon, "On the Precipice." p. 18.
[71] Bohon, "On the Precipice." p. 19.
[72] Bohon, "On the Precipice." p. 20.
[73] Bohon, "On the Precipice." p. 20.

new industry segments change rapidly, and any report concerning them will be out of date within months of being published.

The report proposes that manufacturers have abandoned attempts at consolidation. However, recently the auto makers have once again started consolidating. Although it is still in the formulation phase, this round of manufacturer consolidation may be more aggressive than the previous one. The public groups need to remain attentive to the consolidation actions of the manufacturers. BancAmerica also states that margins are increasing for the public groups through recent realization of scale economies. The report hints that these margins are higher than the traditionally run dealerships. I feel the issue of margins is extremely important, and I will return to this topic later in this section. For now, I will simply maintain that my data suggests otherwise.

From a volume standpoint, 1998 was the second-best sales year for automobiles in history, and analysts do not see a downturn in the near future. This counters BancAmerica's claim of a softening car market. In addition, the private dealers have already survived an economic downturn. This gives them an experience advantage if the economy does again enter a recession. The concern should be directed at the consolidators because they have been struggling through the best times the industry has seen in over a decade.

I also believe that most private owners have the resources to afford the necessary high-tech kiosks and other innovations. Wall Street is not needed for this. As for the Internet, the consolidators have not yet seriously entered this area. This segment could hurt the traditional car dealership, but these public firms are not the ones competing in it.

The firms that threaten the traditional dealers in this market are new companies like Autobytel.com, but this is not in the sphere of this thesis.

One of the main benefits of consolidation that the consolidators cite is the realization of brand identity for the retailers. They believe this is feasible because people are losing their identity with the manufacturers. However, there is no empirical evidence to suggest this. In my own view, automobiles are as big of a status symbol today as they have been in the past. I do not foresee a time when people will measure status by the name of the retailer who sold them their car. Like Yale Gieszl of Toyota, I believe the automobile will never be a commodity.

Not only do customers merely identify with the car's manufacturer, but many customers are also extremely brand loyal. In my experience selling Hondas three summers ago, I noticed that many of my customers had only bought Hondas for many of their previous purchases. Many of them made comments suggesting their strict brand loyalty to the Honda product. I see no evidence supporting the consolidators' claim that auto consumers need something to identify with.

The recent public entrants to the industry agree with this stance. Group 1 and Sonic Automotive, who were the latest entrants in 1997, adopted a policy of not marketing a single name on their dealerships. They must believe there are more detriments than benefits to using a single name. In other words, these two companies realize that there is no reduction in brand loyalty to the manufacturer, and so they do not try to force a retail brand name that may repel consumers.

Along the same lines, the bigger consolidators are in fact targeting customers who are dissatisfied with the current process of buying cars. One major method they are using is adoption of a no-haggle pricing policy. Unfortunately, as seen in the previously mentioned Automotive News survey, 90% of the customers thought the salesperson was interested in helping them, and 70% enjoyed haggling over price.[74] Thus, I believe that the national consolidators are targeting a market segment that is a strict minority in the overall market. I also believe that this segment does not constitute a market share large enough to make the consolidators profitable in the long run.

The consolidators entered this industry to capitalize on the market fragmentation by achieving significant economies of scale. I think that the creation of financial synergies to improve margins has proved more difficult that the companies expected. At this point, they have discovered the impossibility of bulk discounts and preferred vendor agreements from the manufacturer. This was a major factor in their initial consolidation plan. The consolidators have created synergies in advertising, insurance, and floor plan interest rates, but it is doubtful that these synergies alone can justify the concept of public ownership.

Distinguishing between the "national" and "regional" consolidators is crucial in an analysis of this industry. The national consolidators include Republic, CarMax, and United Auto Group and the smaller regional consolidators are Sonic, Group 1, and Lithia Motors. A simple calculation of Market Capitalization to Total Assets demonstrates the differences between these two groups of companies. This calculation shows the way the

[74] Ellis IV, "Used car buyers generally happy with purchase." p. 16.

investment community values the company in relation to its balance sheet size. The ratio for the larger firms is .26, which means the equity value of the companies is one-fourth of their total assets. For the regional firms, this number is much higher, at 1.45. I feel these figures represent the level of success that each group has experienced. Additionally, these numbers prove the need to split the firms into these two categories to achieve a legitimate analysis.

There are many factors that must be considered to predict the impact of the public consolidators, such as economies of scale, brand identity, customer preference, marketing strategy, recession tolerance, and many more. The main factor that will decide the outcome of this battle, however, is profitability. Thus, if public dealers are inherently more profitable, they will eventually revolutionize the industry. However, if the margins between public and private dealers are similar, then there will be enough room in the market for both types of ownership. Finally, if the public companies cannot succeed in their plan to increase margins, then they will fail. For these reasons, an extensive margin analysis, comparing the average private dealer to the public dealers as a whole, is essential.

Several problems arise in producing this analysis, however. First is the difficulty in attaining private dealer numbers. I was able to compile financial data from an undisclosed source on above-average private dealers across the country. I will use this information, along with the private dealer data from the Bear Stearns report, to benchmark the private dealer's financial numbers.

A second problem is determining the authenticity of the public dealer's financial statements. A public company's numbers can be camouflaged to show Wall Street or the IRS what they want to see. For instance, most public companies add future acquisitions into their statements before the deals are complete, which adds income and assets to the statements that really do not exist. Also, when a company acquires a dealership, it can quickly take its profit and its LIFO reserve, and transfer these monies into its own net income. Showing these "fake" numbers is one way to improve the firm's reputation on Wall Street. In my analysis, I attempted to eliminate such inconsistencies before comparing the private numbers.

To examine the margins from the private firms, I first averaged the data from the samples that included numbers from all major types of franchises in America. Next, I made an income statement from each data set in order to see the average margins. This produced income statements for an average private dealer in 1996, a better-than-average private dealer in 1996, and a better-than-average private dealer in 1998. The first category, the 1996 average private dealer, made a gross profit margin of 12.79% and a pretax profit margin of 1.53%. The 1996 above-average-private dealer had better profitability, with a gross profit margin of 12.91% and a pretax profit margin of 2.42%. Notice that gross margins are very similar, but the pretax margin of the better dealer is much higher. This shows that cost control differentiates the better dealers from the average dealers. In 1998, the better dealers were even more profitable, jumping to a gross margin of 12.92% and a pretax margin of 2.57%.[75] See Appendix C for the private dealer income statements.

[75] The private data set in these calculations came from the Bear Stearns Report, page 43, as well as an unnamed source. The public data is from the various annual reports of the consolidators.

In calculating the margins for the public companies, I used the most recent financials available for the public groups, which were the 1997 financial statements. Although I could have used 1996 numbers to compare to the private dealers, I decided that the most recent numbers would be a better representation of the overall health of the companies since this industry only began in 1996. See Appendix B for public dealer income statements. I also experienced difficulties with Republic Industries, because its consolidated financial statements include its other businesses (waste management and rental cars) as well as automobile retailing. I was forced to use the segment percentages they provided in the annual report to "back out" an income statement that only included numbers from auto retailing operations. I discovered that this segment of Republic was extremely unprofitable in 1997, and its addition into the data set would produce unreasonable results for the industry as a whole. If included in the data set, the overall net income for the public companies is negative, and therefore would have no profit margins. Therefore, I deleted this outlier to get a more reasonable picture of the public consolidators. My findings for the public companies minus Republic Industries are as such: a gross margin of 13.04% and a pretax margin of .81%. While they are making more profit on the car sales, their bottom line is merely half of even the average dealers. Thus, the public companies are having a very hard time controlling their costs. Ironically, cost control was initially intended as a chief reason for consolidation.

Realizing that the regional consolidators went public after the national consolidators, I decided to calculate an income statement to see if the regional firms alone would compare to the private dealers. Again, I wanted to use the most recent data, so I chose the 1998 financials. Only two of the three regional companies, Group 1 and

Sonic, had released 1998 financial statements, but I felt that these companies would be a good representation for the group. My findings are that these companies have good profitability, with a gross margin of 13.73% and a pretax margin of 1.99%. Again, expenses seem to be a problem, but overall they are doing a better job than their public counterparts. See Appendix D for a summary of the profitability ratios.

Judging by these numbers, the private dealer wins the war of the profit margins. The only promising statistic for the public consolidators is the above average margins of the regional firms. These firms may be the sole hope for the concept of public ownership in the automotive retailing industry.

When I began research 9 months ago, I made a hypothesis on the future of the industry. I projected that the concept of public ownership would not work because consolidators cannot achieve the economies of scale that they need to justify their huge capital expenditures. At first, my prediction seemed to be accurate. The consolidators' stocks were either stagnant or dropping, and analysts were losing faith in the concept. The only firm that seemed successful was Lithia Motors in Oregon. Approximately six months ago, however, the other regional firms began to pick up momentum. Since then, both Sonic and Group 1 have doubled their stock prices. Sheldon Sandler, managing director of Bel Air Partners, an investment banking firm that specializes in the auto industry, says, "Sonic's performance will restir the interest among dealers who are thinking about going public and will communicate that you can really do this right."[76]

[76] Geist, Laura Clark. "On Wall Street, Sonic looks bionic." *Automotive News.* (January 4, 1999): p.6.

The recent performance of the regional consolidators caused me to rethink my stance on the impression that public ownership will leave on the auto industry.

I conclude that public ownership will succeed, but it will not revolutionize the auto industry as analysts once believed. There is plenty of room in this trillion-dollar industry for both private and public dealers. I also feel, however, that the larger consolidators need to reevaluate their strategy. The market that they have been targeting is people frustrated with the traditional car buying process. By this time, it should be apparent that this group is not as large as they first imagined. Instead of consolidating simply for the expense benefits of consolidation, they are attempting to change the entire concept of buying a car. Unfortunately for the consolidators, the consumer is not ready for such a drastic conversion. Sonic and Group 1, on the other hand, have used their public capital to take advantage of economies of scale and to employ managers with the best car business experience. This is the public ownership strategy that will succeed in the future.

The public consolidators have entered an industry with anemic market growth, so they must to rely on growth by acquisition or by taking market share from competitors.[77] The key to such a rollup strategy is not speed of growth through acquisitions, as Republic believes, but rather how well the company grows internally, through individual store income growth. For instance, Republic's auto retail segment has increases its revenue from below $2 billion in 1995 to over $6 billion in 1997.[78] Though this seems

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[77] Hymowitz, Jordan and Kirstin M. Jensen. "Sonic Automotive." *BancAmerica Robertson Stephens equity research report.* (January 7, 1998): p.11.
[78] Republic Industries 1997 Annual Report.

remarkable on the surface, but all of this growth has come from careless acquisitions. Republic, who hopes to impress Wall Street with growth, is neglecting the bottom line. Obviously, Wall Street has not been very impressed.

Republic, as well as the other national dealers, has not been able to support this revenue growth with solid internal managerial resources. The important statistics indicating internal growth are the same-store numbers. These statistics are somewhat ambiguous and are kept confidential by most of the public companies, but the numbers the national firms have released have not been good. Of the companies that have released this information, only Lithia Motors and Sonic Automotive showed improvement. Lithia improved the average store income by 4%, and Sonic showed a 13% increase in same-store sales.[79]

In order to improve their same-store numbers and internally grow, these companies need to have extremely decentralized management structures. To do this, extensive automobile industry experience is essential. Sonic Automotive, for instance, has a very capable management team led by Bruton Smith, a man who has been in the car business since the mid-1960's. This is in glaring opposition to Wayne Huizenga, who is a very successful businessman, but entered the auto industry in 1996. The bigger companies are now realizing that an experienced management team is vital to cope with the problems of the auto retailing industry. The auto industry is unique, and it takes time to learn how to run a successful franchise. Republic has become cognizant of this, and is now instituting a lucrative incentive plan to keep the owners of the acquired dealerships in the company.

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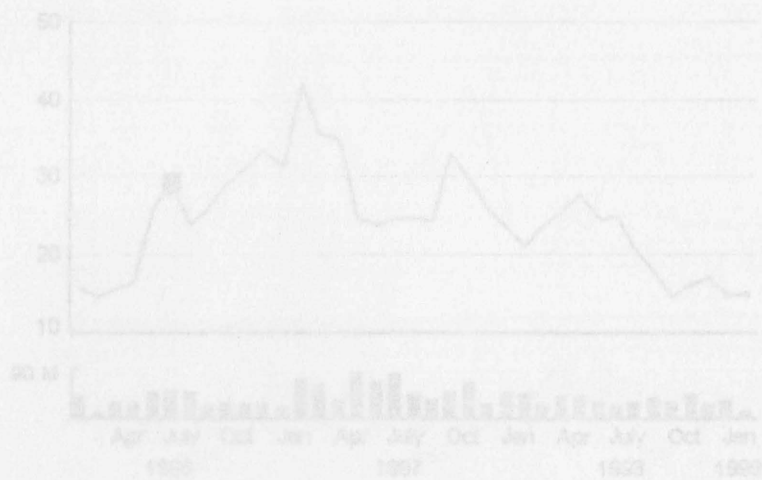
[79] Harris, "Public chains see declines in same-store sales results." p. 3, and Hymowitz, "Sonic Automotive." p.1.

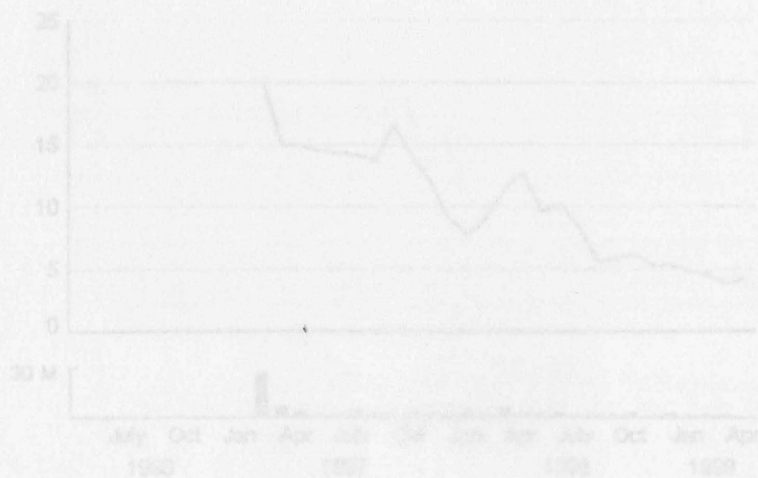
CONCLUSION

For its size, the American automobile retailing industry is highly fragmented. There are massive opportunities for consolidation, if done correctly. Presently, only a few firms are on the right track to a successful market position. The strategy of these firms is to be a leading seller of cars, not a leading acquirer of new dealerships. They realize that internal growth is essential to success, and have quality managers to achieve this growth. They are capitalizing on the benefits of consolidation, but not entirely changing the concept of buying a car. Sonic, for instance, is already seeing rate reductions in both floor plan financing and advertising. This further propels internal growth by widening the margins.

In the auto market of the next decade, there will be no revolution. There is enough room in the market for both private and public firms to operate profitably. The public firms that will continue to operate in ten years are the ones that exemplify the characteristics stated above. The poorly run, larger firms will soon be forced to change their strategy. If they do not, the market will see them sell their dealerships as quickly as they bought them. They must soon understand their concept of public ownership is not ideal. Republic has already started selling some of its under-performing stores, and UAG recently sold 38% of its stock. These may be indications of the future of the industry. In addition, competition in the auto industry will be decided as in any industry: by margins. As shown in this analysis, the larger companies cannot compete in profitability, so they will be forced to change, or go bankrupt. Companies can successfully capitalize on the

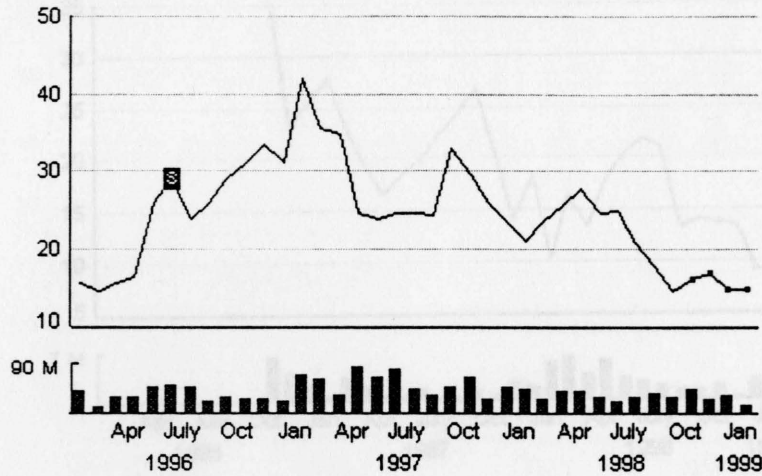
economic benefits of consolidation, but no amount of Wall Street capital can ever change the way cars are sold.



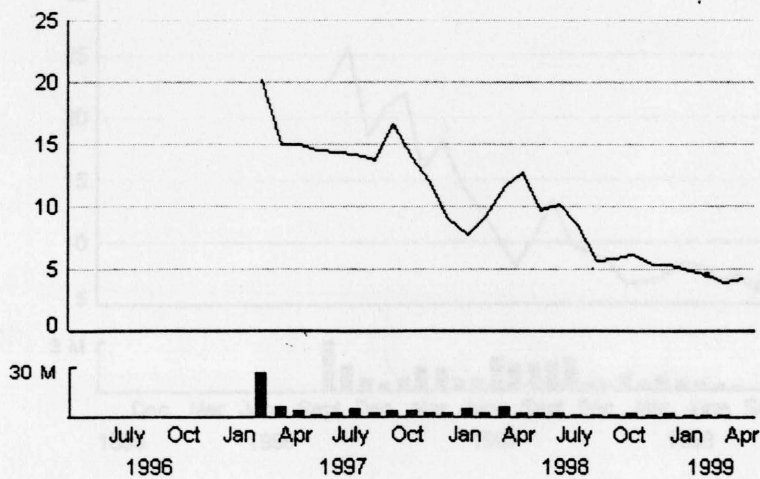


Appendix A: Public Consolidator's Stock Performance

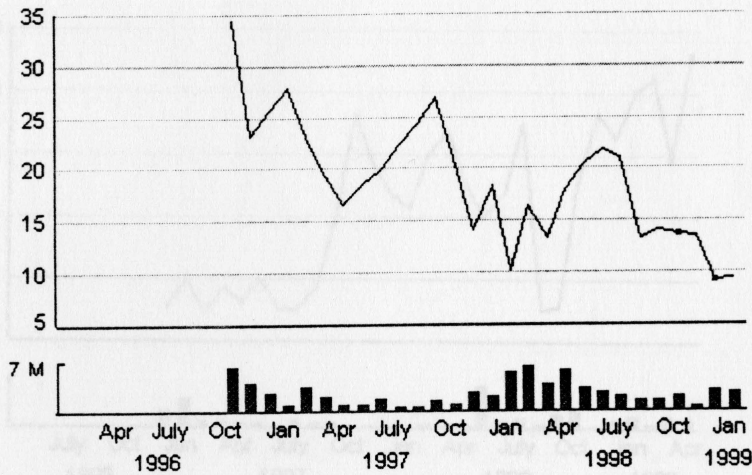
Republic Industries (RII)



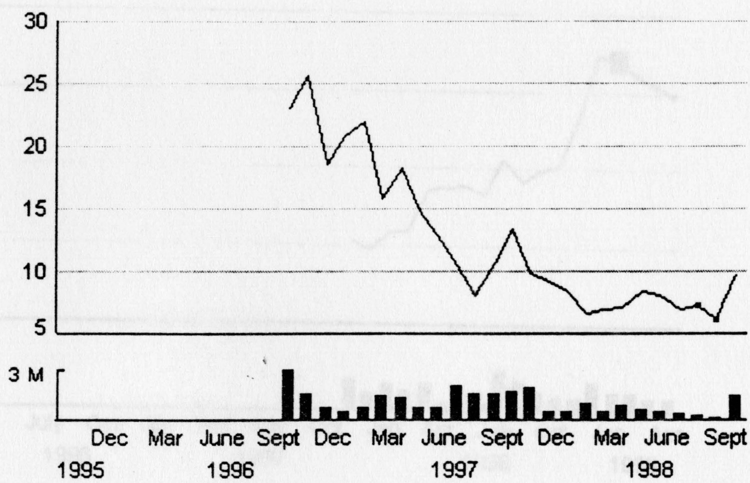
Circuit City Stores—CarMax Group (KMX)



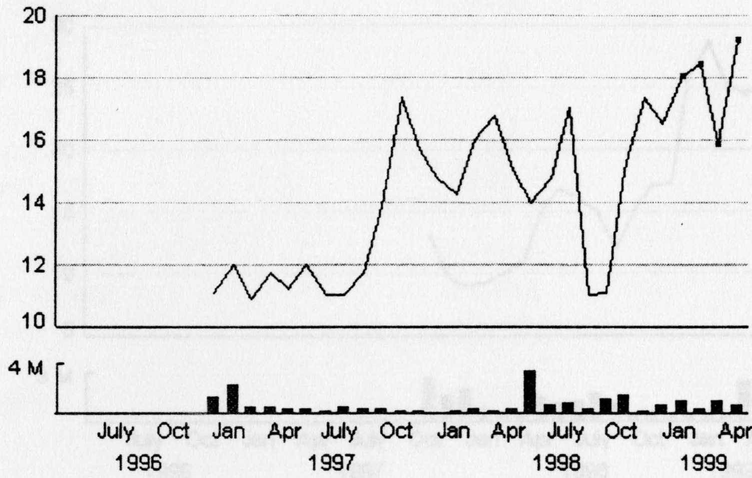
United Auto Group (UAG)



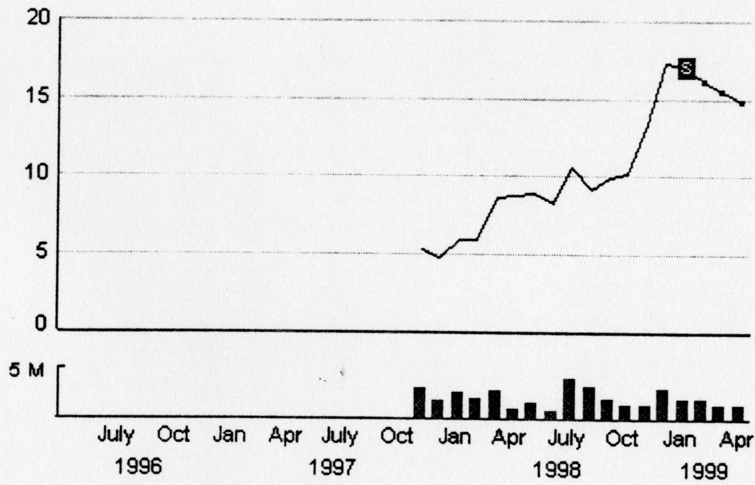
Cross Continent Auto Retailers (XC)



Lithia Motors 'A' (LAD)

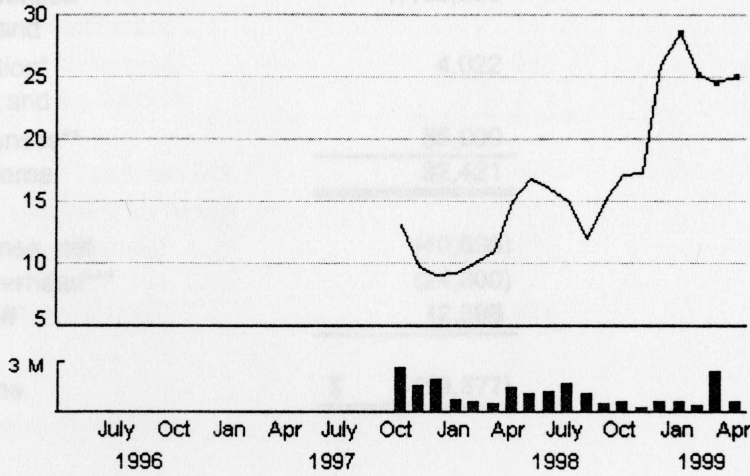


Sonic Automotive 'A' (SAH)



Appendix A

Group 1 Automotive (GPI)



Appendix B: Public Consolidator Income Statements

1997 Public Firm's Consolidated Income Statement
($ in thousands)

Revenues	$ 10,451,963	
Cost of Sales	9,223,582	
Gross Profit	**1,228,381**	
Sales, General, and Admin. Expenses		1,106,938
Depreciation and Ammortization*		4,022
Restructuring and Other Expenses**		85,000
Operating Income		32,421
Interest Expense, net		(40,696)
Corporate Overhead***		(24,000)
Other Income#		12,398
Pretax Income		**$ (19,877)**

Gross Profit Ratio: 11.75%

Pretax Profit Margin: N/A

* From Cross Continent and Sonic Automotive
** From Republic Industries
*** From Carmax
# From Republic Industries and Sonic Automotive

1997 Public Firm's Income Statement(excluding Republic)
($ in thousands)

Revenues	$ 4,329,163	
Cost of Sales	3,764,582	
Gross Profit	**564,581**	
Sales, General, and Admin. Expenses		459,738
Depreciation and Ammortization*		4,022
Operating Income		100,821
Interest Expense, net		(42,096)
Corporate Overhead#		(24,000)
Other Income@		298
Pretax Income		**$ 35,023**

Gross Profit Ratio: 13.04%

Pretax Profit Margin: 0.81%

* From Cross Continent and Sonic Automotive
** From Republic Industries
*** From Carmax
# From Republic Industries and Sonic Automotive

1998 Regional Public Firm's Income Statement
($ in thousands)

Revenues	$ 3,233,758	
Cost of Sales	2,789,806	
Gross Margin	**443,952**	
Sales, General, and Admin Expenses		40,355
Other Expenses		339,201
Pretax Profit		**$ 64,396**

Gross Profit Ratio: 13.73%

Pretax Profit Margin: 1.99%

Appendix C: Private Dealer Income Statements

1996 Above Average Private Dealer Income Statement
(in $)

Revenues	$ 33,498,760	
Cost of Sales	29,175,187	
Gross Margin	**4,323,573**	
Total Expenses		3,513,203
Pretax Income		**$ 810,370**

Gross Profit Ratio: 12.91%

Pretax Profit Margin: 2.42%

1996 Average Private Dealer Income Statement
(in $)

Revenues	$ 21,791,419	
Cost of Sales	19,004,624	
Gross Margin	**2,786,795**	
Advertising		226,069
Rent & Equivalent		207,043
Floorplan Interest		73,597
Payroll		1,521,041
Other Expenses		425,365
Total Expenses		2,453,115
Pretax Income		**$ 333,680**

Gross Profit Ratio: 12.79%

Pretax Profit Margin: 1.53%

Source: NADA Industry Analysis Division and
Bear, Stearns & Co. Inc. estimates

1998 Above Average Private Dealer Income Statement
(in $)

Revenues	$ 50,084,990	
Cost of Sales	43,616,309	
Gross Margin	**6,468,681**	
Total Expenses		5,184,001
Pretax Income		**$ 1,284,680**

Gross Profit Ratio: 12.92%

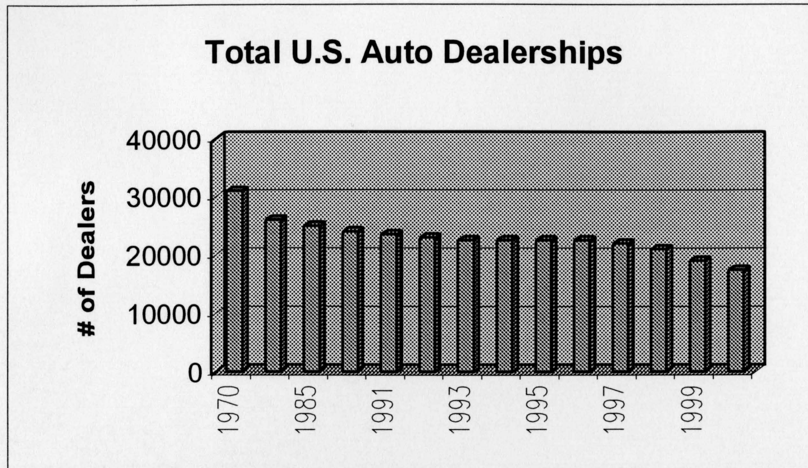
Pretax Profit Margin: 2.57%

Appendix D: Changing Ownership Restrictions:

Manufacturer	Oct-96	Oct-97	Present
General Motors(w/o Saturn)	Consented to public ownership/ 90 dealerships maximum	Public ownership okay/ broad aggrement--not disclosed	
Ford	Opposed public ownership	Public ownership okay/ broad aggrement--not disclosed	
Chrysler	Consented to public ownership/ 10 dealerships maximum nationwide/no more than two in a maket/ 6 in a zone	Consented to public ownership/ Larger limit not disclosed	
Toyota/Lexus	7 Toyota, 3 Lexus max/ 9-month waiting period between acquisitions	Public ownership okay/ broad aggrement--not disclosed	Larger Limit
Honda/Acura	7 Honda, 3 Acura max and geographic restrictions/ no more than 49% of the stock can be publicly traded	7 Honda, 3 Acura max and geographic restrictions/ no more than 49% of the stock can be publicly traded	Larger Limit
Nissan/Infiniti	Consented to public ownership 6 dealership limit	Consented to public ownership/ Larger limit not disclosed	
Saturn	Public ownership okay, but ownership of Saturn dealer restricted to authorized Saturn retailers	Public ownership okay, but ownership of Saturn dealer restricted to authorized Saturn retailers	
Jaguar	Opposed public ownership	Opposed public ownership	

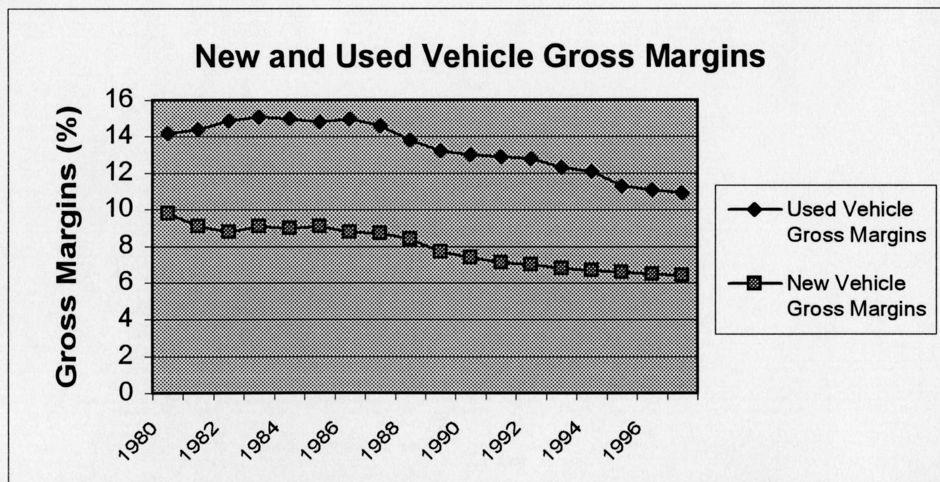
Appendix E: Other Graphs

Figure 1



* Source BancAmerica Robertson Stephens

Figure 2



* Source: BancAmerica Robertson Stephens