ICDP Special Report Number 01/2012

Business model innovation in automotive distribution
by Leonardo Buzzavo

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Foreword

by Steve Young, Managing Director, ICDP

The automotive distribution model has changed little over the last century. Whilst the products themselves and how they are developed and manufactured has changed dramatically, the industry generally still uses a system of franchised dealers offering sales, service and spare parts, as the core of its distribution system. Despite recognised challenges in Europe and North America, the same model has been rolled out in the newly developing markets such as Brazil and China in largely the same form.

ICDP has researched the distribution system for almost twenty years, and we now believe that a combination of circumstances have created an environment where new business models will emerge in a process of disruptive change. On the market side, this will be driven by sustained demand weakness and structural decline in aftersales demand due to longer service intervals, improved reliability and lower annual driving distances. This will be compounded by the impact of the digital age on consumer behaviour, and communications with cars through telematics. We therefore anticipate that new distribution business models will emerge in this decade based around different physical network structures and integration with more sophisticated online channels.

Leonardo’s paper provides a helpful perspective on business model change, in confirming that change is inevitable, and that the current, almost universal, single distribution model will be replaced by a number of differentiated models. Our research is intended to evaluate those opportunities, and work with manufacturers and dealers to address the constraints that Leonardo identifies.
Executive summary

As competitive contexts evolve in a given industry, firms are required to adjust their strategies accordingly. This implies taking decisions that determine changes in the business model adopted, in one of the components or in more than one, determining a new combination. Business models have become a popular category as it draws attention towards the identification of the basic constituents of a strategy, and particularly of the way in which a firm does business at the system level: how it creates value and how it aims at capturing it from its target market. In the automotive industry a profound reorganization has been in place for quite some time, however it has only recently started to structurally affect the distribution system that has traditionally been based on family-owned franchised dealerships. The market downturn triggered by the global recession has exacerbated an already critical situation of diminishing profits in Western European countries.

This report argues that the new context is inducing relevant transformations in the traditional business model, outlining some key directions of change in the individual components (target, offering, chain of activities and profit model). Also, the new context is likely to trigger greater differentiation across brands and specific situations. In this regard, some fundamental types of business models are outlined (low cost, premium, volume, scale), identifying their respective key characteristics.

1. Business models as a tool to understand how strategies work

Business models have become a popular concept both in the strategic management literature and among practitioners over the recent decade. To a considerable extent the growing diffusion of the concept stems from its capability to represent a more operational translation of the notion of strategy and to better capture the way in which the overall architecture of the business generates a profit. Most contributions in academic literature, starting from the seminal works on the subject by Timmers (1998), Amit and Zott (2001) and Magretta (2002), revolve around the fact that a business model is broadly based on three major elements: “who are the customers”, “how is the company intending to provide value to them”, and finally “how is the company extracting value out of it”. As many have pointed out, this approach inevitably finds its roots in the works of Drucker (1954) when defining a business.

Early introduction of the business model category took place within the domain of information management and ICT contexts. As a matter of fact, the term grew very popular during the internet boom in the 1990s, and it became a building block of almost every company operating in internet environments during the fervid years of the e-business revolution. At that time, it was typical for companies to develop innovative ways of arranging production and distribution activities, and the business model category acted as a sort of interpretative (as well as normative) element to discuss the way in which the firm was going to generate value and extract it from target customers. Business models then rapidly spread outside e-business contexts and gained a key spot within the theoretical and practical frames of business strategy (Osterwalder and Pigneur 2010; Teece 2010).

The usefulness of a business model, however intended, is to draw attention towards the identification of the basic constituents of a strategy, and particularly of the way in which a firm does business at the system level: how it creates value and how it aims at capturing it from its target market. Within the scope of this work we can consider a business model as made of the following components:

- The target: who is the target of the company
- The offering: what is the company providing the intended target with
- The chain of processes involved, both inside and outside the company, that are generating the offering in question
- The profit model: how a company is extracting value from the target customers in a profitable manner.
As conditions change in a given industry, firms are required to adjust their business models accordingly. This implies taking decisions that determine changes in one of the components or in more than one, determining a new combination. This leads to situations of business model innovation or “strategy innovation” (Casadesus-Masanell and Ricart 2011; Buzzavo 2012) where a recombination takes place in order to achieve dynamic consistency with the new context.

The automotive distribution system provides an interesting opportunity to look at how the typical traditional business model of automotive dealerships (that represent the key link between manufacturers and customers) must evolve in accordance with the changes in the competitive scenario. The two major arguments brought forward in this paper (that focuses on Western European markets) are:

a. The business model that has characterised the rise of the dealer system is no longer sustainable in the new competitive context; this determines a drive towards business model innovation along some key dimensions;

b. Besides pushing towards a new business model, the changes in the context and in the industry structure trigger a broader degree of differentiation so that more variation occurs across types of business models adopted by different types of players.

In order to properly develop these arguments, we will need to provide an overview of the key features of the distribution system, including a brief summary of how the dealer system had originated in the past.

2. Distribution under the spotlight in the reorganisation of the automotive system

During the most recent decades of its century-long history, the automotive distribution industry has been undergoing a set of profound changes induced by a set of pressures mainly arising from the saturation of demand, increased globalization, enhanced competition (with the entry of new players) and developments in information and communication technologies (ICT). Manufacturers have spent the last two decades or so adopting the lesson of lean manufacturing so vividly promoted by research undertaken by the IMVP (International Motor Vehicle Program) that identified the set of principles lying at the basis of Toyota’s superior performance (in terms of efficiency, quality and flexibility) that has become a world-class benchmark (Womack et al. 1990).

In automotive distribution, however, most challenges and strategic puzzles have remained unsolved, and in most recent years the worldwide financial crisis triggered a credit squeeze and an increase in oversupply that has seriously undermined the foundations of the economic indicators of franchised dealerships. On the whole, the transformation of the value creation architecture of the automotive chain has just started to affect distribution (Dietl et al. 2009; Waller 2012).

Manufacturers’ views of distribution channels have been mixed, with some players increasingly keen to experiment with direct distribution (through directly-owned stores) and others increasingly keen towards the potential lying in internet-based relationships as enablers of new forms of customer dialogue and distribution schemes. But manufacturer-owned dealerships are still an exception (approximately 3% of total in Europe, and none in the USA), and the few existing cases often serve as a solution for high-cost metropolitan areas and/or as marketing and retail laboratories. Also internet-based schemes have not yet shown a solid case on how to establish a new distribution system for manufacturers: in most cases these tools act as important complements to dealer activities rather than substitutes of their role in the chain (Bailey 2012).

Distribution is highly relevant both on the business and on the strategic levels, for two major reasons. Firstly, it represents a considerable portion of the automotive value chain: its cost is generally estimated by industry
observers between 25% and 30% of the vehicle list price, and the number of employees involved in sales and servicing activities in mature markets (such as Western Europe) is usually higher than those involved in manufacturing and assembly (Volpato and Zirpoli 2011). Secondly, the distribution chain is also a focal point for the effectiveness of the whole automotive system as it is a territory for value creation (the value of the whole “automotive product” perceived by customers is not just determined by the vehicle itself but depends on many factors linked to the point of sale and service) as well as a means to match supply and demand, not just “shifting metal downwards” but rather activating intelligent “market sensing” mechanisms that are beneficial for the whole system (Volpato 1986). It must also be said that franchised dealers are not just involved in sales and physical distribution but have become more and more involved in marketing dimensions that revolve around the much touted brand experience that manufacturers want to promote, in order to enhance the purchase experience and their loyalty, possibly “for life” (Sewell 1990).

3. Flashback: the origins of the dealer system

In order to better understand the transformation in place it is worth briefly sketching how the current distribution system originated about one century ago. At the beginning (late XIX and early XX century) manufacturers operated a mixed distribution structure with multiple channels (Pashigian 1961) including: a) branches (manufacturers’ wholly owned sites used for direct sales); b) distributors (wholesalers who managed large stocks of cars in relevant geographic areas and channelled cars to consumers through retailers – dealers – who could be either owned by a distributor or by an independent operator, and offered a wide range of services to the consumer, in particular repair and maintenance activities); c) agents (in charge of collecting orders from customers, but with a very simple and cost-effective organization).

With the market expansion that took place after World War One manufacturers aimed at exerting greater control over the increasing number of dealers, who were assigned an exclusive sales territory and a set of operating standards. When the large growth in demand after World War Two created a mass market, dealers faced rising investments for vehicle and parts stocks and for brand-specific items (e.g. tools, signs), often representing sunk costs. The distribution contract was full of so many obligations that it determined a sort of vertical quasi-integration (Volpato 1989): dealers were independent operators, however their policies were heavily influenced by manufacturers.

The development of such an asymmetric situation was made possible by favourable market conditions (a seller’s market), which created opportunities for high profits for car manufacturers. These profits have partly been channelled to dealer networks, which in substance have accepted to give up their entrepreneurial independence that was basically wiped out by the restraints entailed in the franchising contract, in exchange for high profitability levels.

Starting in the 1970s a series of changes occurred in the automobile market, which gradually led to a buyer’s market, and started undermining the sustainability of the traditional structure. Among the most relevant factors of this transformation there are the oil crises, the entry of Japanese competition in the international automobile market, and the gradual disappearance of first-time buyers, switching to replacement demand in mature markets. Later on, at the turn of the century, pressures grew with increased globalization and competition, technological transformations and the effects of the worldwide recession. But while the pressures for change in the 1970s and the evolution from a seller’s to a buyer’s market started increasing the degree of competitiveness and eroding margins without inducing significant changes from a structural standpoint, the set of changes unfolding in the new century have brought a more radical set of pressures for a model change. The following paragraph will explore the traditional business model of automotive distribution so to be able to understand the effects of these pressures.
4. The traditional business model of automotive dealerships

Franchised dealers represent the backbone of the distribution system, with the vast majority being family-owned (with limited exceptions, mainly in the US and UK markets). The family-owned nature of the business operates as a two-edged sword: on the one hand, it ensures a relative stability in the ownership structure and in the strategic direction, with a “hands-on” approach to managing the company. However, such structure can also hinder change, create too much dependence on the principal entrepreneur, and problems can arise during transitions between generations undermining the chances for business survival.

Let’s now draw some considerations on the characteristics of the traditional dealership business model. It should be underlined that this exercise implies some necessary simplification: as a matter of fact, when considering the entrepreneurial foundations of the business, it is not surprising that when one looks in close detail at franchised dealers one finds a considerable variation in terms of size (units sold, total turnover), number of brands represented (size of brand portfolio), number of outlets, geographic scope, ownership and governance structure, not to mention management style, rate of adoption of new technologies, etc. This means that franchised dealers, even when operating under the umbrella of the same manufacturer brand, feature a considerable degree of variation and are far from homogeneous. Also, variations exist across different European markets (Buzzavo and Volpato 2003).

All this considered, and bearing in mind this necessary simplification, we could sketch a standard model of the building blocks of the traditional business model adopted by franchised dealers (see Figure 1).

Automotive dealerships are assigned exclusive distribution rights for vehicles of a given brand in a territory: traditionally, sales territories have enjoyed a considerable degree of protection, so that customers in the area, unless they were prepared to travel to great distances, represented a sort of “natural” market. The dealers’ offering has been typically based on the sale of vehicles, with the provision of after-sales service (warranty work, maintenance, repair) and parts generally featuring as a support activity to the sale. It must be noted that dealerships have been exploiting some additional businesses for some time. This is the case of service (that for example has traditionally been a stronger component of German dealers), parts (that has represented an important stream of revenues for some Italian dealers) and used cars (where UK dealers tended to be more actively involved). But while these streams have existed for a while and have acted as profit generators capable of supporting down cycles, they have generally been subservient in business model design to the fixation on “moving the metal”.

Fig. 1. Traditional dealership business model (standard features)

<table>
<thead>
<tr>
<th>Element</th>
<th>Target (customers)</th>
<th>Offering (product provided)</th>
<th>Chain (value building)</th>
<th>Profit model (value capture)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target (customers)</td>
<td>New car customers within the sales territory</td>
<td>Sale of new vehicles of the represented brand (with selective provision of after-sales support, parts sales and used cars)</td>
<td>Order management, finance management, delivery management</td>
<td>Predominantly the margin on new vehicle sales (considerably influenced by the manufacturer)</td>
</tr>
</tbody>
</table>

Source: own elaboration
It should be noted that given that dealers’ focus has traditionally been on new car sales, a wide network of independent players operating in vehicle servicing and repair has grown to meet the demand that has increased along with the increase in vehicle parc. Similarly, the limited degree of involvement of franchised dealers in the used car business has allowed many independent players to grow in this sector.

On the whole, the profit model is centred upon the margin that is made on the difference between the selling price (that the customer pays) and the cost paid to the manufacturer: such margin, after the costs borne by the dealer (structural and operational) generates a profit.

But towards the end of the XX century a set of changes brought considerable pressures on the traditional dealership model triggering the need for a new strategic response.

5. Pressures for change

The saturation of demand in mature markets has determined the transition from a seller’s to a buyer’s market, with changes on the quantitative side (a drop in the volume of demand) and on the qualitative side (consumers becoming more sophisticated and therefore more demanding). The drop in demand led to an overall increase in competition that has generally driven down margins, while the increase in sophistication pushed dealers (with their human resources, their procedures, their services) to become more professional and supportive of customer needs, usually incurring in higher costs.

The intensity of the competitive confrontation has started to push manufacturers to reduce their cost structures in all sides. Besides intensifying the focus on reorganizing their manufacturing and component chains, they have started to operate policies of marked reduction of new car selling margins: broadly speaking, the industry has shifted from a typical gross dealer margin of over 15% in the mid-1990s (with some extra bonuses, mainly volume-related), to a gross dealer margin of less than 10% in recent years, with a vast increase of variable margin elements (often representing one third or more of the total margin available). The variable margin elements are linked to the dealer’s ability to fulfil certain requirements, such as customer satisfaction levels, additional brand-related investments and procedures, customer information reporting, and so on, with schemes that can become highly complex (Buzzavo and Montagner 2005). The increased competition has caused rebates to customers to grow, so that they tend to wipe out the diminished gross margin, and dealers must cover their costs (and possibly try to earn a profit) on the variable component, with the result of greater uncertainty.

Other pressures on the dealer business model have come from the legislative side, as the European rules governing vertical agreements (contracts between manufacturers and their distribution networks, generally referred to as “Block Exemption”) over the years have brought along lower territorial protection and more intense competition (Tongue 2010).

In parallel, the extreme acceleration in the growth of information and communication technologies (ICT) and the rise of social networks have altered the quantity and quality of information available among customers, and the mechanisms governing advertising and shopping. The greater level of transparency has dramatically reduced the information asymmetry between customers and dealers (e.g. with respect to the dealer margin and the presence of additional manufacturer campaigns), while electronic media can stimulate aggressive comparison-shopping and can drive down margins. Dealers are currently striving to improve their familiarity with new media (particularly social media) and possibly to take advantage of the new opportunities arising, switching the focus from mass marketing to targeted tools.

Finally, the business of franchised dealers has been undermined by another type of threat: with the growing
importance of the financing (and insurance) element in the purchase of vehicles, both in terms of appeal for the customer and also in terms of actual profit margin, and with the rise in company cars and long-term rental segments, larger players operating in the finance and leasing market have developed more attractive and sophisticated packages to lure growing portions of customers, eating out shares of the dealer business.

All these developments (saturated market, intense competition, regulatory changes and lower territorial protection, developments in ICT, threats by finance and leasing players) have contributed to make the dealer business generally less profitable and more complex, requiring dealers to gain efficiency (i.e. typically reduce costs), to boost other profit generators (such as service, parts, used cars, finance etc.) and also to reconsider their strategy by innovating their traditional business model.

One consequence of the pressures for change over recent years has been a trend towards retailer concentration (Buzzavo 2008): the average new car sales per dealer in mature markets such as the USA and Europe had started to increase following a process of gradual concentration. Such concentration has been partly driven by manufacturers who started aiming at a reduced number of more solid entrepreneurs, with a stronger equity structure, and with more professional facilities and systems.

The concentration process has accelerated due to the enormous pressures created by massive drops in sales volumes. However as it will be discussed later the overall degree of concentration is still low when compared to other industries and it seems that growth does not represent a viable strategic solution but some changes in the business model are required.

6. Strategic trend #1: business model innovation

As said, many pressures have undermined the viability of traditional dealerships, creating pressure to transform their business model (Amit and Zott 2012). We will now explore how individual elements of the business model are evolving in order to adjust to the new context.

With respect to the target, the new business model requires dealers to become much more proactive, to operate a finer level of segmentation and to broaden the target.

The attitude of being more proactive, in line with the much diminished territorial protection, implies the use of more professional marketing techniques (such as geo-marketing) plus the exploitation of new approaches that move away from mass-marketing in favour of targeted initiatives, also leveraging on the potential of new technological tools (i.e. using social media). Secondly, a finer level of segmentation depends on the need to investigate in greater detail the profile of customers, their needs, and their willingness to pay for specific products and services. This means a major departure from a traditional way (usually reinforced by less professional salespeople) of conceiving customers as subjects merely in search of the lowest possible price. While such a view of customers induces greater discounts, at the expense of retained margins, it also inhibits the search for opportunities to extract customer’s willingness to pay by providing a more tailored response to their preferences and offer them value elements other than price in the overall transaction with the dealership. Broadening the target relates to the need for dealerships to consider not just new car customers as targets, but also used car customers and service customers, in order to feed their customer portfolio and business activities that have evolved from secondary to new car sales to being fundamental.

With respect to the offering provided, the major building block in innovating the business model is a re-conceptualization of the dealer business, where new car sales is not the dominant portion (with other elements such as accessories), and where the dealership is a portfolio of businesses revolving around customer mobility.
This implies the need to take advantage of business possibilities that include new car sales, used car sales, finance and insurance provision, service and repair work, parts, accessories, sale of extended maintenance packages, rental services, and any other possible revenue stream associated with the above. This determines a gradual reduction in the dealership's dependency on the new car business that is on the one hand highly volatile, and on the other hand highly dependent on the manufacturer. The high volatility is associated with the swings in demand in line with key variables such as disposable income and consumer confidence. The high dependence on the manufacturer and the low degree of dealer control over the new car business is considerable because: volumes are heavily determined by the market and pushed by manufacturer objectives, buying prices are set by the manufacturer, selling prices are set by the manufacturer (and influenced by market conditions, in terms of discounts), operating costs are heavily influenced by manufacturer policies (in terms of required brand standards).

With respect to the chain of activities, dealers must adapt their activities and processes to the nature of the offering that has been just described above. While the traditional business model requires dealers essentially to focus on managing the order-to-delivery pipeline, in the new context dealers must enhance their ability to manage processes revolving around customers in a proactive way (e.g. lead management, geo-marketing techniques, etc). For example, they should improve their ability to manage customer data from prospect to sale, they should develop capabilities to manage the processes involved in the broader set of ingredients included in the automotive offering, and so on. While in the traditional business model the dealer is basically required to be a sort of passive subject implementing with attention to detail the policy specified by the manufacturer, in the new situation the dealer must become an active agent defining its own set of processes, steps and indicators for the more complex set of situations involved.

This leads to some considerations on the generation of the profit model at the dealership: with the development of other business streams, dealers reduce their dependency on manufacturers and can exploit varying ways of capturing revenues (and profit margins) with greater control, where the shape of the business portfolio to pursue becomes an integral part of the dealer’s own strategy depending on its capabilities and on the exploitation of market opportunities. While in new cars the structure and the operating standards and procedures are heavily determined by the manufacturer (whose interest is often to enhance the branded experience rather than to ensure an adequate level of dealer profit), in the other set of businesses dealers can make more autonomous decisions in their cost structures and operating processes. In other words, their structural choices and processes will be shaped on the basis of the expected revenue streams, so to ensure (at least in principle) the desired profit margin. To some extent, more and more dealers aim at gaining a greater share of the customer wallet, often adopting a logic of business provision “from cradle to grave” by aiming at all the revenues (and profit streams) related to all the spending revolving around the automotive purchase and ownership experience throughout their lifetime (Bloemer and Lemmink 1992, Huber and Hermann 2001).
7. Strategic trend #2: business model differentiation

As seen, changes in the context require franchised dealers to transform the features of the traditional business model. As previously pointed out, this argumentation is valid at a general level, as in any specific situation one should consider a set of variables that include: a) the brand represented; b) the specific traits and resources of the dealership in question and c) the local competitive conditions (both at the country and at the local market level).

The brand that is represented by the dealer matters as it tends to influence some basic traits of the dealerships, such as its orientation to volume, its customer care, its ability to customize the offering, and so on. In other words one would expect (at least in principle) a dealership representing a premium brand to be more inclined towards segmentation, customization and customer care than a dealership representing a volume brand. But a great degree of variation can relate to the traits of the specific dealership (its strategy, its resources, its entrepreneurial characteristics, its management and employees, etc.). Finally, also geography matters, as distribution systems feature some degree of variation across countries (Buzzavo and Volpato 2003). But also within the same country local conditions matter, because two similar dealers representing the same brand could behave quite differently in a market where competition is fierce compared to a market that is relatively insulated from highly competitive dynamics.

So, while dealers in general are required to adapt their business model to the new conditions, each dealer must carefully fine-tune its choices depending on the represented brand, its heritage and unique characteristics, and its geographical location.

While in the previous paragraph we have outlined some common features that characterise business model innovation for franchised dealers, we now focus on how business models are likely to feature more differentiation. In other words while the transformation of automotive distribution is unfolding with some common traits that have
been outlined in the previous paragraph, there are some important aspects of differentiation that seem to be acquiring greater importance and that should be carefully considered.

In very simple terms, automotive dealers operate as intermediaries and their margins (prices minus costs) times volumes (quantity) must cover overheads and have the potential to generate a profit. By operating some degree of simplification we can identify some “standard types” of business model:

a. A *low-cost* approach, whose main focus is to minimize total costs (both structural and operating costs)
b. A *volume* approach, whose main focus is to maximize the number of units sold
c. A *premium* approach, whose main focus is to maximize prices (with an emphasis on repeat customers)
d. A *scale* approach, whose main focus is to increase the total scale of the business by controlling multiple dealerships (brands, geographic areas, etc.).

Let’s examine these types of approaches in more detail.

The low-cost is characterised by a marked focus on keeping costs low. In some cases the emphasis is on reducing operating costs (e.g. advertising, customer amenities), in others on reducing structural costs (e.g. quality of facilities, administration). A policy of low costs derives from a search for efficiency (e.g. higher stock turn) but also from the elimination of customer amenities and services often “stripping” the basic product. Low-cost approaches, by determining lower prices than direct competitors, can also provide chances for greater sales volumes, but the major emphasis is on keeping costs low. Dealers focusing on this approach sometimes operate employee incentive policies focusing on cost reduction. Broadly speaking, an emphasis on low costs implies a reduced ability to invest in brand standards, both tangible (i.e. signage, facilities) and intangible (i.e. competences and customer support), and this might clash with the need by the manufacturer to ensure proper brand representation and intermediation. A limit to this approach is achieving the minimum threshold to ensure brand representation, with the danger of the manufacturer voiding the franchise.

The volume approach is driven by a focus on a high sales throughput by achieving scale economies at the outlet level. This is typical of dealerships that place considerable emphasis on aggressive market penetration. It must be borne in mind that while this approach can be combined with a focus on low costs (that is, the previous approach described above), this is not always the case. In fact a volume approach can unfold without an excessive cost reduction, and rather through an investment in initiatives and marketing efforts aimed at maximizing the number of customers, be it inside the geographic area of influence, or outside it. Clearly, employee policies are likely to revolve around volume-based incentives, while the manufacturer, whose managers are heavily concerned about meeting targets in given time periods, is generally happier with dealers featuring high unit sales performances. The barrier to this approach is clearly the limit of market penetration that the dealer can achieve.

The premium approach basically focuses on maximizing retail prices (that is minimizing discounts) and loyal customers. In economic terms, it aims at extracting the maximum possible customer surplus by providing customer with product and service contents that they consider of value, so that they are willing to pay an extra for it. Employee incentives usually revolve around customer satisfaction: this approach aims at differentiating the offering from competitors, while trying to promote repeat purchases by satisfied and loyal customers, and is well depicted in the “customer for life” scheme as defined by the widely-known automotive dealer Sewell (1990). In general, dealers focusing on this approach tend to provide an enhanced brand experience that manufacturers view rather favourably (provided that the customer experience is in line with the specific brand standards), and in extreme cases they are seen as “brand laboratories” where elevated service standards can be piloted, even though sales volumes might be compromised. On the whole, the limit to this policy lies in the customers’ willingness to pay so that equilibrium is maintained between costs and revenues.
The scale approach is adopted by entrepreneurs who expand the size of their business. We hereby refer to the scale of the whole company intended as number of franchises and/or locations. This approach differs from the volume approach (described above) as it aims at scale economies at the company level and not at the outlet level.

As previously argued, data on the degree of concentration in automotive retailing indicates that it is still quite modest when compared to other industries (Buzzavo 2008). We believe that the reasons are basically twofold. Firstly, the benefits of scale in terms of reduction in purchasing costs are rather low for automobiles vs. other sectors. In other words, a dealer who buys for example ten times the volume of cars than its competitor obtains a price reduction that is far lower than the price reduction that it could achieve in other industries. Secondly, the reduction in operating costs along with the larger scale of operation is also limited, given that there are substantial duplications involved, mainly due to the heavy restraints imposed by manufacturers. Moreover, the scale increase achieved by occupying other territories tends to suffer from dis-economies of scale (marketing, coordination costs, systems) that often outweigh the associated benefits. This implies that differently from other industries, automotive retailing does not feature huge retail chains, and we would argue that it is not likely that retail chains can acquire a dominant share of the business in the near term, unless some of the above mentioned terms change (for example, if a manufacturer decides to operate a serious volume-discount policy in its distribution strategy).

The basic elements of each type of business model are summarized in Figure 3 shown overleaf.
<table>
<thead>
<tr>
<th></th>
<th>Low-cost</th>
<th>Volume</th>
<th>Premium</th>
<th>Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target</strong></td>
<td>Customers with lowest willingness to pay, looking for bare product, limited/standard service</td>
<td>Populated customer segments</td>
<td>Customers expecting high level of service in a customized way, plus after-sales care</td>
<td>Broader audience in terms of geographies and brands</td>
</tr>
<tr>
<td><strong>Offering</strong></td>
<td>Simple, standard</td>
<td>Serial</td>
<td>Complex and value-adding</td>
<td>Broad</td>
</tr>
<tr>
<td><strong>Chain of activities</strong></td>
<td>Simple, streamlined</td>
<td>Push focus</td>
<td>Complex and value-adding</td>
<td>Standardized, aimed at exploiting synergies</td>
</tr>
<tr>
<td><strong>Key marketing lever</strong></td>
<td>Low price</td>
<td>Penetration, low price</td>
<td>Content of extended product, relationship</td>
<td>Availability, coverage</td>
</tr>
<tr>
<td><strong>Structure and processes</strong></td>
<td>Minimal, stripped</td>
<td>Marketing and sales focus</td>
<td>High quality, care, segmentation</td>
<td>Shared facilities</td>
</tr>
<tr>
<td><strong>Employee incentives</strong></td>
<td>Cost control</td>
<td>Volume-related</td>
<td>Customer satisfaction (CSI)</td>
<td>Outlet performance</td>
</tr>
<tr>
<td><strong>Profit model</strong></td>
<td>Lowest possible variable and fixed costs</td>
<td>Highest possible volume to cover overheads</td>
<td>Highest possible margin to cover relatively high variable and fixed costs</td>
<td>Reduction of some variable and fixed costs through scale and scope economies</td>
</tr>
<tr>
<td><strong>Major focus</strong></td>
<td>Lowering structural and operational costs</td>
<td>Maximizing number of units sold</td>
<td>Maximizing selling price and repeat customers</td>
<td>Expanding the size of the business</td>
</tr>
<tr>
<td><strong>Barrier</strong></td>
<td>Imposed standards</td>
<td>Market limit</td>
<td>Willingness to pay (value perception by customers)</td>
<td>Cost structure, scale dis-economies</td>
</tr>
<tr>
<td><strong>Dealer’s relationship with manufacturer</strong></td>
<td>Variable</td>
<td>Generally positive</td>
<td>Brand ambassador, “laboratory”</td>
<td>Greater bargaining power (lower risk and dependency on individual brand)</td>
</tr>
</tbody>
</table>

Source: Own elaboration
8. Perspectives

We have discussed how the new competitive context pushes for a transformation in the business model of automotive dealerships. Some of the key common elements are a more proactive and segmented relationship with a broader target of customers, an extended mix of offerings constituting of a set of inter-related businesses, a more complex set of margins derived from these businesses. Within this type of effort a key task consists of relating differently to individual customer segments, each featuring own characteristics, willingness to pay and wait, and margin potential. Within this perspective, the dealership needs to install and operate a knowledge-management system where the accumulation of information on customer characteristics and segments is used to fine-tune the offering based on different combinations of the individual business elements. The capability to install a knowledge-management approach is based upon an extended range of initiatives, including the training and incentives of salespeople (who must be become aware on the relevance of customer information), the database tools, and a constant orientation among all employees to continuously feed and update the knowledge base of the dealership (customer profile, preferences, forms of interaction, type of products purchased and future interest, other relevant information, and so on).

In a context where the degree of product differentiation and segmentation operated by manufacturers have achieved dramatic levels, with an astonishing proliferation of product lines, derivatives and room for option customization, it becomes key for franchised dealers to add value by assembling the right business package for each customer by integrating the vehicle into a broader concept of offering, that spans across all possible elements related to customer mobility that represent a profit opportunity for the dealer.

Also, in the new emerging business model for dealerships, sustainability has become a critical aspect, with the need to review the foundations of the business, to be based not just on an “after-sales” or “additional to sales” way but rather on a “between sales” approach. This means to look at both customer- and vehicle- lifecycles as continuous opportunities to extract margins. As a matter of fact, dealers are businesses featuring heavy fixed costs, and they must secure higher and more stable levels of cost absorption by focusing on businesses that are less volatile than mere new car selling. As previously noted, profits from the new car business are subject to many ups and downs: demand volumes are subject to the attractiveness of the manufacturer's product line and to the quality of its marketing strategy, while the prices (the transaction prices) are driven by the ratio between supply and demand, which also falls outside the dealer's domain of influence. In other words, in the new car business the two key elements (volume and price) are to a large extent dependent upon external factors. On the contrary, in other businesses such as after-sales, demand volumes can be more stable (as a given vehicle parc in a territory is rather stable over time), as are transaction prices. On top of that, the dealer's profit in after-sales depends more on its own internal efficiency (e.g. in scheduling repair and managing productivity) rather than on manufacturer's policies.

The truly relevant dynamic capabilities (Teece et al. 1997) for automotive dealers are to continuously adjust the business offering to the appropriate customer segments. The fact that the business contains a highly local dimension makes it difficult for manufacturers (or large retail chains) to appropriate the value that lies in the transaction (unless they manage to achieve considerable volume discounts in purchasing). Clearly, dealers must invest in the processes and information systems in place to accumulate (and use as necessary) the relevant customer information, with more effective learning capabilities (Nonaka 1991).

On the whole, effective dealers are asked to manage the set of inter-related businesses by achieving a proper cross-functional fit by taking advantage of complementarities, so that they become less and less "local vehicle shifters" on behalf of the manufacturers, and more and more "intelligent customer managers", acting as a key link in the automotive distribution chain.
We have tried to operate some simplification by sketching out the common drivers that are affecting the transformation in the dealership business model, but we have also discussed how different routes could be adopted (a low-cost, a volume, a premium and a scale approach) as choices and initiatives must be consistent with the specific situation.

There are some important issues to be addressed in perspective.

The first relates to how automotive distribution will evolve in different geographies. Europe is still not a single market, and more distant markets are undergoing different stages of development. In China, for example, the growth in demand is triggering an explosion in dealer numbers that somehow mirrors what has happened in now mature markets over the last century. Different geographic situations and market lifecycles will determine different paths of evolution for automotive distribution, whereas in this document we have focused on Western European mature markets in particular.

The second relates to the pace of transformations. While consolidation is being accelerated by the market downturn (albeit total consolidation levels are still low when compared to other industries), the intensity and speed of transformations in retailing and in manufacturer-customer relationships induced by the digital revolution across all industries will be mirrored to some extent also in the automotive sector. There are some critical elements that characterise it as different from other industries (average unit price, frequency of purchase, safety implications, after-sales care, need to trade-in a used car, etc.) but automotive retailing, albeit with some peculiar traits, will not be insulated from how retailing is transformed on a broader level.

The last point relates to whether the degree of differentiation across business models will be driven more by the type of brand represented or on the specific choices adopted by the retailer. In other words, this means the need to determine whether the type of brand or the individual dealer will most influence the type of business model adopted. For example one might find it reasonable to expect a low-cost approach, as described above, to be more consistent with a brand like Dacia or Skoda, while a premium approach is more in line with brands such as BMW, Mercedes and Audi. Other brands (such as for example Ford, Toyota, Volkswagen) might be seen in between a volume and a scale approach. Therefore it makes sense to envision such differentiation in business models occurring in line with the type of brand. However, one could also argue that a dealer representing a premium brand might adopt a low-cost business model or a volume model. In other words, the choices at the dealer level are not automatically associated with the type of brand. This basically relates to the strength of the automaker to coordinate the whole value architecture and steer the system (Dietl et al. 2009). As previously said, in the past automotive dealership entrepreneurs were willing to accept a subordinate position in exchange for satisfactory profits. Now that those profits have been eroded by the new context, manufacturers will retain or dilute their degree of control over the distribution chain depending on their ability to adjust the economic foundations of the business model in distribution in accordance with the specific profile of intermediaries that they need to have and with the strength of the brand.
9. References


ICDP is an international organisation carrying out research and providing strategic advice, specialising in the automotive retail sector. Its collaborative programmes investigate all aspects of vehicle distribution, including the supply and retailing of new and used vehicles, after sales, network structures and operations. Separate programmes focus on cars and on commercial vehicles. ICDP is funded by participants from vehicle makers, dealers, suppliers, and associations. ICDP does not represent any of its members or their individual policy views.


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ICDP Special Report Number 01/2012
Price €25.00