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Surviving the PLATEAU

BY DAVID E. ZOIA

The pressure is on.

At least, as much as it can be in a new-vehicle market still expected to hover around – if not surpass – the record sales posted in each of the past two years.

Industry forecasts for 2017 run from 17.1 million to 17.6 million, compared with 2016's 17.5 million. *WardsAuto* projects light-vehicle volume right in the middle of that range at 17.3 million this year.

But it's what's lurking beyond those numbers that has industry insiders and dealers wary of what's to come in 2017.

Even if automakers eke out another record year, they probably can't do it without increasing retail incentives. That's likely to erode margins for both manufacturers and retailers, and dealers will have to look deeper and try harder if they are to maintain current levels of profitability.

No one's expecting a 2009-like crash, which saw vehicle sales bottom out at 10.6 million units. But enough headwinds are beginning to swirl that many industry-watchers predict tougher times ahead after seven solid years of growth.

Among factors that could curb showroom traffic: saturation of pent-up demand; eroding used-vehicle prices; potentially higher interest rates; problems at the sub-prime lending level; lengthening loan terms; and contemplated moves by the new Trump Admin.

FACTORS THAT COULD CURB SHOWROOM TRAFFIC

- Saturation of pent-up demand
- Eroding used-vehicle prices
- Potentially higher interest rates
- Problems at the sub-prime lending level
- Lengthening loan terms
- Contemplated moves by the new Trump Admin.

It's been a steady recovery for the auto industry from the devastating 2008-2009 Great Recession, as buyers who long had postponed new-vehicle purchases returned to the market in waves.

The pent-up demand was enormous, considering the precipitous drop in vehicle sales when hard times hit last decade. "Nineteen million sales went missing in the Great Recession," says David Laterza, a senior vice president at ratings agency DBRS.

Maybe more importantly, when buyers did return to the market, they weren't afraid to spend. Average transaction prices rose markedly, reaching a record $34,077 per vehicle last year as consumers loaded up on optional equipment and migrated from lower-cost sedans and coupes to higher-priced CUVs, SUVs and pickups.

Automakers did their part, pumping up new-vehicle values and retail prices by slashing production capacity and keeping incentives and rental-fleet volumes in check.

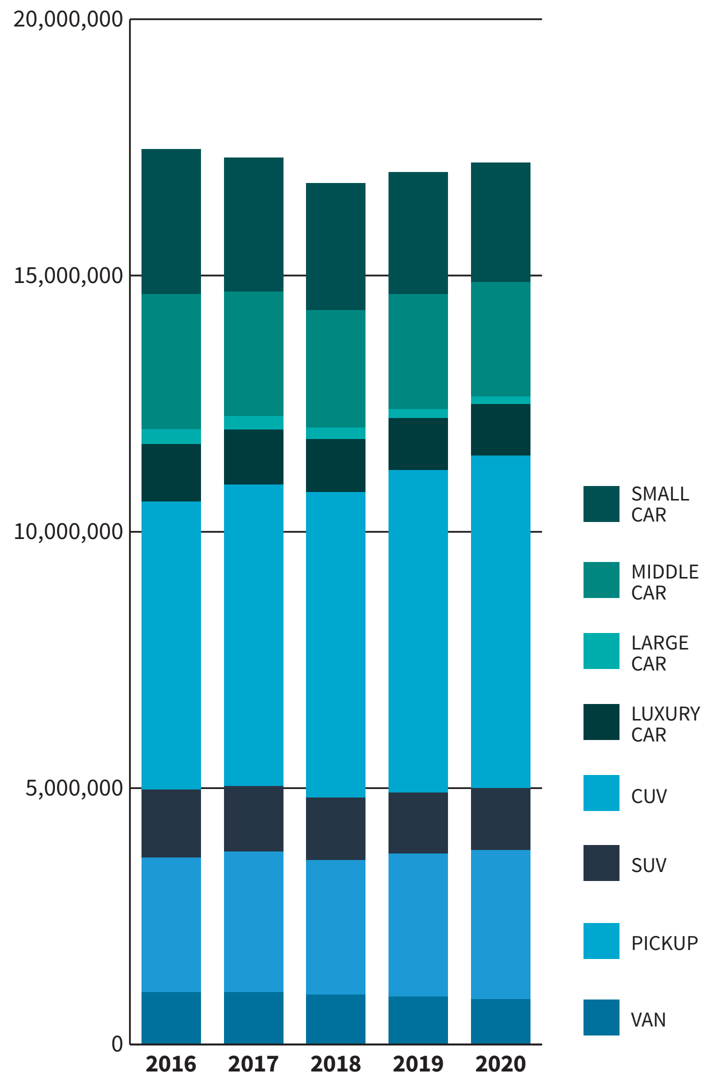
All that proved a boon to retailers.

The average dealership's total sales reached $56.7 million in 2015, an increase of 7.1% over the previous year, according to the National Automobile Dealers Assn. The average total gross was about $6.6 million, a 5.3% increase. Net profit after taxes was 2.7% compared with 2.6% in 2014.

Greystone Valuation Services says dealer profitability netted a compound annual gain of 23% in the seven years following the Lehman Shock in 2008.

"We should feel pretty good about (the last couple of years)," says Dale Pollak, a former dealer and now chairman and founder of vAuto, a producer of dealership-inventory management software. "(But) it would be wise to look at

U.S. Light-Vehicle Sales Forecast by Segment Group



Source: WardsAuto/AFS

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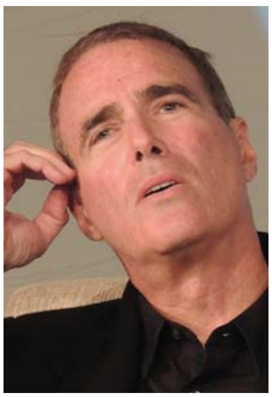

"Look at the underlying fundamentals that suggest challenges (ahead)," Pollak says.

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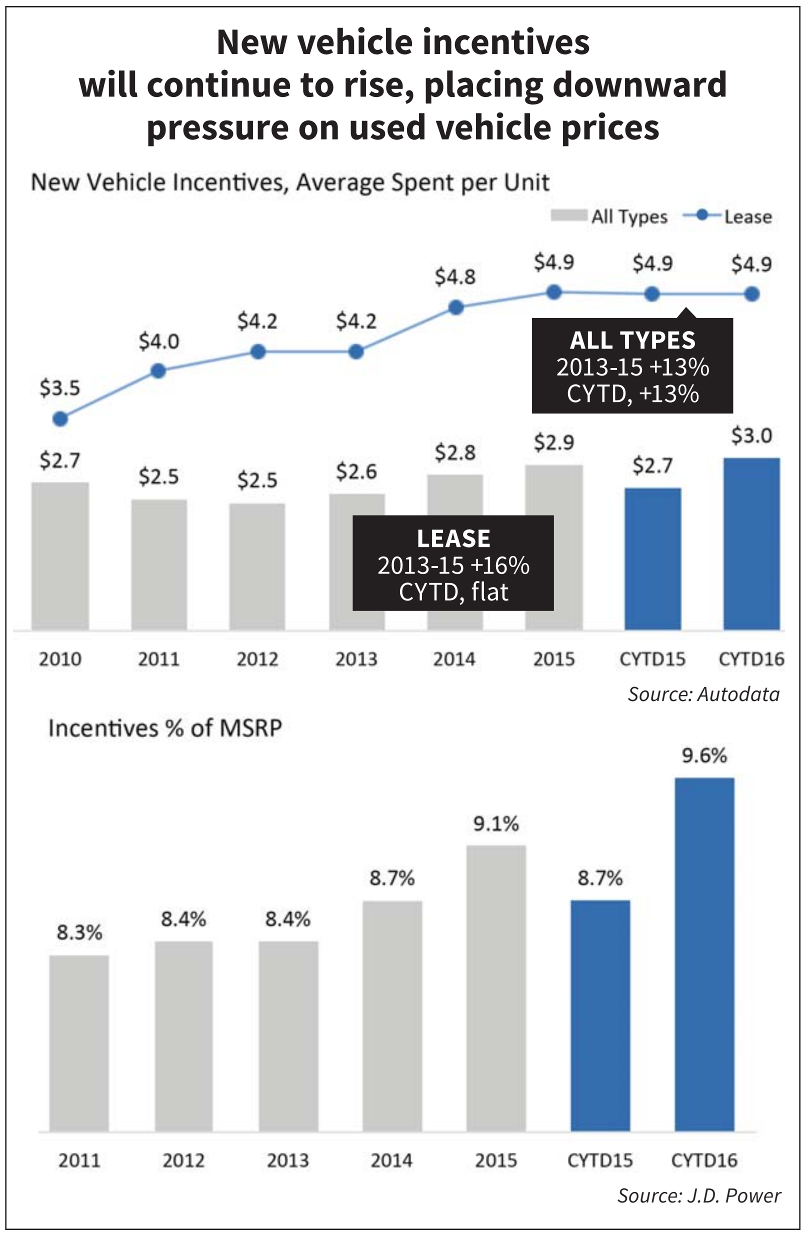
The winds Pollak cites began shifting in mid-2016. That's about the time pent-up demand that had been driving record new-vehicle volumes finally appeared sated. Signaling the boom's impending end were rising inventories and incentives that began clamping down on OE and dealer profit margins.

"If this is a plateau, it's got one hell of a view, and the business looks good going forward," American Honda Executive Vice President John Mendel says. "But I have to ask, how is it that so many in the industry, including dealers, are struggling for profits and not surviving?"

Retailers already have begun voicing concerns about squeezed margins on new cars.

"Dealers are under incredible profitability pressure," says Nick



Stanutz, a senior vice president at Huntington Bank.

INCENTIVE, INVENTORY LEVELS RISING

By December, new-vehicle spiffs averaged $3,957 per unit, a new high that has market-watchers worried the one-time incentive-addicted industry could be on the verge of falling back on some old, bad habits in order to keep the metal moving.

"This is not a good situation for the industry," sums up J.D. Power vice president and analyst Thomas King.

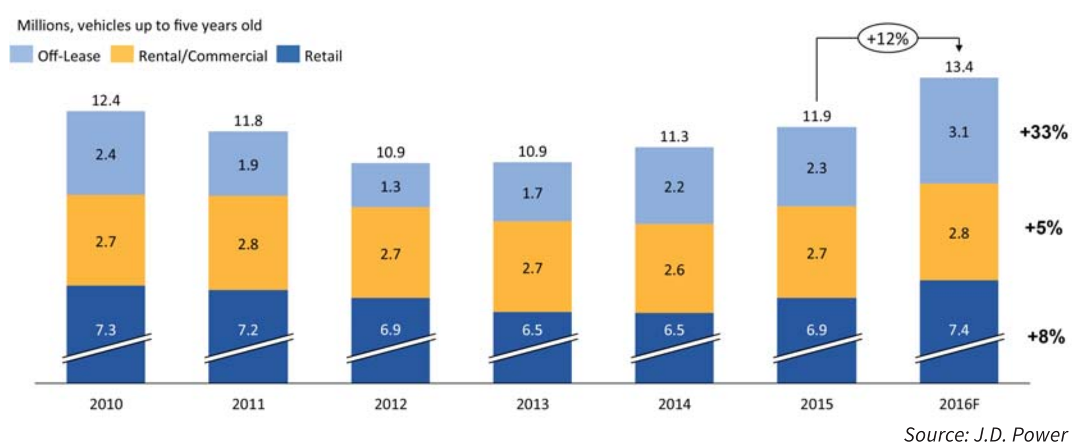
Automakers will be forced to put even more money on the hood if they don't find a way to check rising inventories. Typically, current-model-year vehicles account for 76% of December sales, but that rate was only 67% at the close of 2016, King says, noting dealer stocks ended the year at a too-high 3.9 million cars and trucks.

"That's a problem," he says. "We have a bubble of inventory the industry needs to work through."

Pressure is expected to come from the used-vehicle side as well, where off-lease models continue to flood the auto auctions, pushing prices down all around and luring a NADA-estimated 300,000-400,000 former new-car buyers into the pre-owned market. Some 3.1 million late-model lease vehicles were returned to inventory last year, and 3.4 million more are

Used-Vehicle Inventory

An 800,000 unit rise in off-lease supply will push late-model supply to its highest level since 2008



Source: J.D. Power

headed back to showrooms this year, according to J.D. Power.

Auction-service specialist Manheim estimates off-lease returns will hit 4 million in 2018.

"The used-car market (now) is very prime," says Melinda Zabritski, senior director-automotive finance for credit-tracker Experian. "Prime buyers (those with credit scores of 661 or above) are very attracted by off-lease vehicles."

Used-vehicle supply is expected to outstrip demand again in 2017. Last year was the first since 2008 that saw used-vehicle sales and prices decline, a slip of 4% on both counts, according to Jonathan Banks, vice president of J.D. Power Valuation Services. There will be 14 million used vehicles on the market in the U.S. this year, up 6% from 2016, he says.

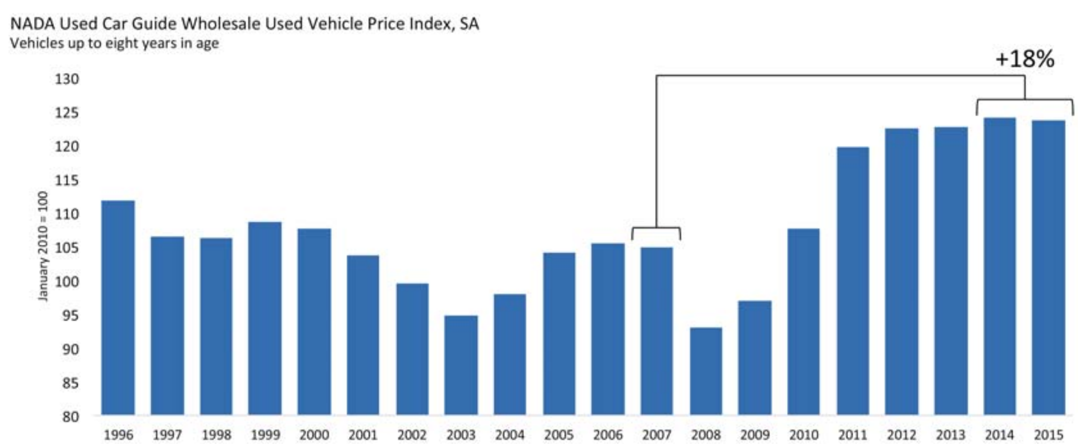
When used models are in short supply, it increases their market value, and that helps keep demand and transaction prices high on new vehicles. The reversal of that trend has analysts concerned the industry could head toward a margin-killing negative pricing spiral.

It could be a "vicious cycle" if low used-car prices are countered by a rise in new-vehicle incentives and the process repeats again and again, Banks says.

Depreciation rates are escalat-

Used vehicle prices have been very strong over the past 5 years

Low used vehicle supply, fantastic credit conditions have been pillars of support for used prices.



Source: NADA

ing as supply increases, notes Anil Goyal, senior vice president-automotive valuation and analytics for used-vehicle valuation service Black Book, which forecasts 17.8% depreciation this year. That compares with 17.3% in 2016 and 13% or less in each of the preceding five years.

The erosion continued into January, as car depreciation dove another 1.8% and truck valuations fell 1.4%.

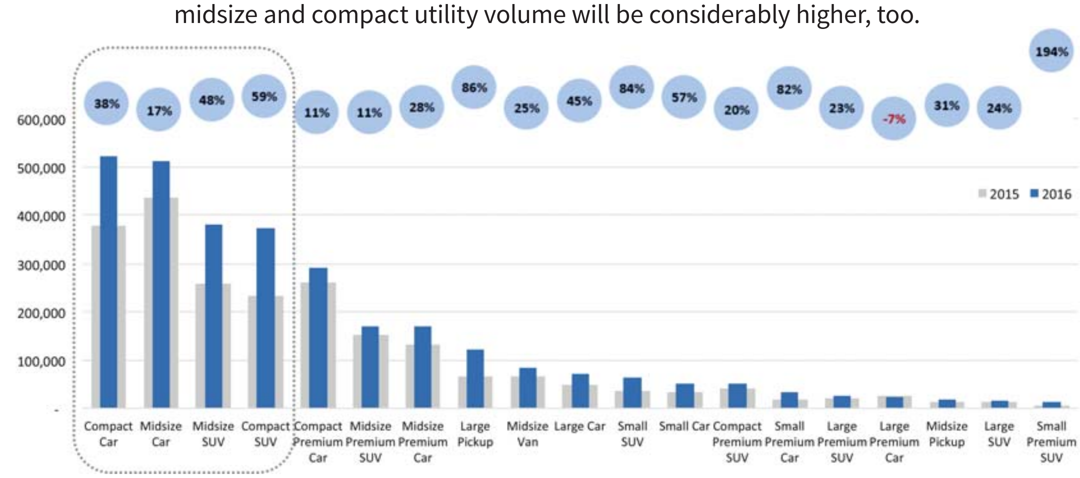
"But what worries us more is the incentive levels and subprime loss levels increasing," Goyal says. "You can plan for (used-vehicle) supply increasing, but when the OEMs start to push sales through incentives, then you know there's more underlying concern around demand and growth in that demand."

LENDING, LOAN TERMS AMONG WORRIES

Lending patterns raise a number of red flags. Leasing could contract in 2017 as automakers look to better align the flow of returning vehicles with the softer demand expected over the next several years. Falling used-vehicle prices also will make it harder for automakers to offer attractive lease deals, and that could make it more difficult for returning lessees to sign the dotted line on

Lease maturities are up virtually across the board

Off-lease volumes will be dominated by compact and midsize cars; midsize and compact utility volume will be considerably higher, too.



Source: J.D. Power

another 36-month contract.

SwapALease reports lease credit applicants registered an approval rate of only 50.0% in January, down from 54.2% in December and 63.6% year-ago. That marked the lowest level in three years.

"Leasing penetration has hit a peak," Black Book's Goyal says, calling it "irrational" for automakers to continue incentivizing leasing – now at a 30% share of the retail market industrywide.

With used-car valuations falling, "consumers no longer have their (next) down payment right in their driveway," J.D. Power's Banks says.

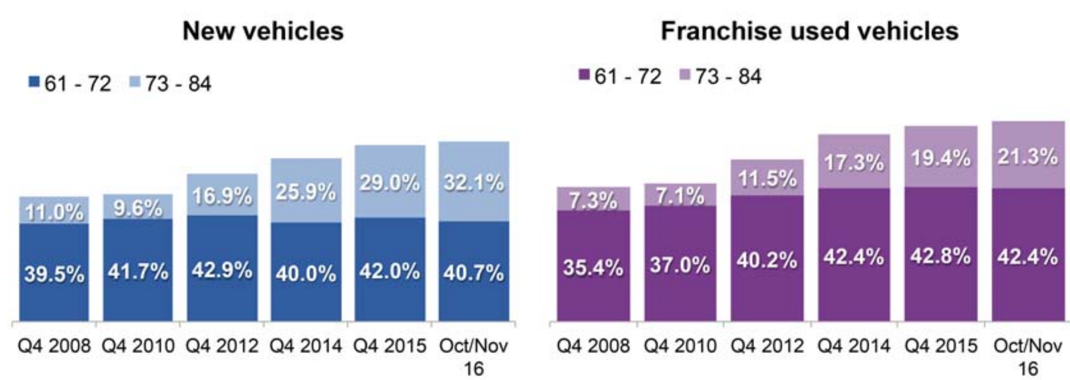
Some industry executives also have begun speaking out against lengthening loan terms. Experian says contracts of 73-84 months accounted for 32.1% of new-vehicle loans in November, compared with 16.9% in Q4 2012.

"For some brands, 60% of their loans are now over 75 months," says Honda's Mendel, who also notes subprime lending accounts for a "dangerous" 10% of new-vehicle purchases. "That's over 1.5 million customers in 2016 alone."

Mendel points to rising rental-fleet sales, running above 40% for some makes and models, as another concern. Fleet deliveries climbed 210,000 units last year to a third-highest total of 3.4 million, according to J.D. Power.

"We made an incredible recovery as an industry, but I am afraid

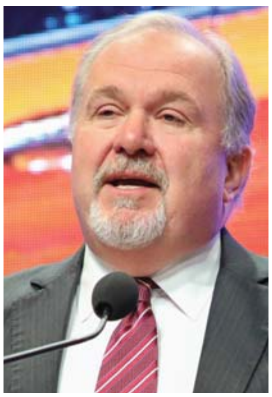
Longer-term loans become the loan of choice to accommodate affordability



Source: Experian Automotive

many have lost sight of how we got here," says Mendel, who will retire from Honda on April 1.

Trump is an additional wild card. Many automaker executives and franchised dealers believe the president's direction on tax reform and regulatory relief could aid the industry if put into action. But the specter of a stiff border tax as part of that reform has many worried new-vehicle prices could balloon out of control.



"Many have lost sight of how we got here," Mendel says.

Such a tariff would be damaging in particular to international automakers, which have a higher percentage of imported models in their mix. That has the American International Automobile Dealers Assn. calling on members to lobby Washington against this "too complicated and poorly thought out" tax measure "before it moves any closer to law and to our bottom lines."

Toyota North America CEO Jim Lentz says such a levy would be bad for business all around.

"Obviously, we're not in favor of the border tax," he says. "We don't think it's good for this industry. We have an industry that (this year) is projected to be 17.2 million. (If prices rise), it is going to be substantially less than that."

HOW DEALERS CAN SURVIVE PLATEAU

So with all these negative market forces mounting, what's a dealer to do? Look past the new-vehicle showroom, industry insiders say.

"When we go on a down sales cycle, fixed ops is what carries you through," says Jim Roche, senior vice president-Marketing and Managed Services for Cox Automotive' s Xtime operations, which provides service-department management software to dealers.

Retailers long have been focused on the F&I and fixed-ops sides of the business for profitability. But executives and analysts say it's time they step up their games, updating technology and revising business practices that will help maximize service-side margins and better retain customers.

"Dealers by and large come from the sales side – so they love that," Roche says. "But they've got to be more balanced in their

Despite sales concerns, it was mostly smiles at this year's NADA convention. From left, General Motors sales vice president Steve Hill, 2017 NADA Chairman Mark Scarpelli and 2016 NADA Chairman Jeff Carlson. Behind Scarpelli is Wes Lutz, 2018's designated NADA chairman.

focus, because fixed ops is truly the foundation of the business.

"(They) have to do that," he says, pointing to fixed-ops blended gross margins that average 46%, compared with 5% on the new-vehicle-sales side. "For dealers who don't, it's existential."

At the NADA Convention and Exposition in New Orleans in January, there was no shortage of products and digital tools on offer from the more than 600 vendors exhibiting. Those doing the selling say they are beginning to detect heightened interest from dealers who already are feeling the effects of the approaching new-vehicle sales plateau.

"The sense that I'm getting from prospects – our current customers already are talking this way – is that they really feel like their gross profits are under pressure," says Patrick McMullen, senior vice president-strategy and innovation for MAXDigital, which is marketing a new sales tool designed to stretch revenue margins on pre-owned vehicles.

McMullen sees three storm clouds approaching: the glut of used vehicles in inventory; the changing consumer, who is better informed and less patient; and the emergence of retailing disruptors such as Carvana and Vroom, which are looking to get a bigger piece of the $70 billion automotive market.

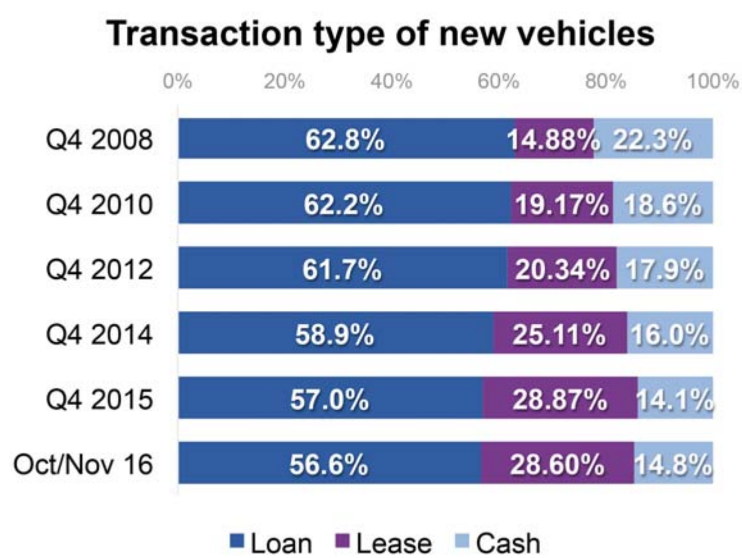
"There's some really smart people out there, some investment bankers, who are looking at a really big industry that's ripe for disruption," McMullen says. "They're building a model around the way consumers actually want to do business. That's what they're banking on."

Dealers need to do the same, he adds, noting, "We've changed our pricing tools (in the auto industry), but we haven't changed the way we sell."

GIVING CONSUMERS WHAT THEY WANT

Consumers want a trusting experience, and data-driven digital technology will help dealers take customers off the rollercoaster ride that is the car-sales process, says James Maynard, vice president-product for VinSolutions, a

Automotive financing plays an increasingly larger role while nearly 1 in 3 new vehicles are leased



Source: Experian Automotive

Cox Automotive enterprise that markets dealership-management software.

"If we can provide tools to help (dealers) eliminate (buyer) frustration, the trust levels go up," he says, suggesting higher margins and customer loyalty will result.

"Efficiency is essential, but there's only so much you can get out of that," says Berman.

That pattern is true off the sales floor as well, where consumers are starting to demand similar transparency and convenience. The service side is where customer retention really begins and ends, industry executives say, and how well a dealership survives the plateau may be determined in the back shop.

"Most executives know profitable growth is the objective," says Xtime's Roche, pointing out advertising costs dealers $617 for each new vehicle sold – and that spending is accelerating.

"That's unsustainable," he says. "So if your objective is profitable growth and you know retention has to drive it, what drives (retention)? It's the ownership experience."

A 2016 Cox survey shows 54% of consumers would be willing to pay more for their vehicle and service, if they deem the dealership experience satisfactory.

"Give me the experience I want and I'll pay you more, which is a fascinating thing," Roche says. To that end, vendors are pushing a long list of new analytic, sales and communications software to help retailers better meet client needs in every department.

Maynard says, "If I have a good (sales) experience, I'm likely to come back and service here. If I service here, I'm probably going to come back and buy another car."

Roche says car buyers want the same smartphone-driven satisfaction they get when hailing rides with Uber or making restaurant reservations via OpenTable.

"How can you survive if you don't keep pace with what consumers expect?" he says, advising dealers to "take two steps back and pay attention to this."

Many inside the industry speak of the need for retailers to improve efficiencies as a way to cope with a potential sales plateau. But that has its limits, says Bill

Berman, president of AutoNation, the country's largest dealership chain.

"Efficiency is essential, but there's only so much you can get out of that if you are running out of levers to pull," he says.

John Garff says his dealership group in several ways is preparing for a potential sales downturn.

"It's not one thing we're doing, it's probably 20, but nothing big," says the president of the Salt Lake City-based Ken Garff Automotive Group, No.10 on the 2016 *WardsAuto Megadealer 100* with 52 stores in six states and total revenue of $4.1 billion.

"We're doubling down on listening to our employees, customers and vendors, and making sure we're delivering what the customer wants," says Garff.

He's a third-generation dealer who understands the cyclical nature of the business. "It happens," he says of ebbing sales. "We're focusing a lot on service and parts. The retention strategy there probably has been our No.1 priority for three years. That gives us the momentum to prepare for the plateau."

Goyal advises dealers to concentrate even more on the used-vehicle side, because there will be opportunities to maximize margins on the glut of returning low-mileage lease vehicles if retailers stock the right models.

"Keep an eye out on the inventory you're buying and assure you're tracking trends that are changing," he says. "(Make) sure you're using data and analytics to drive your decisions. What worked last year or a few years before may not work this time around."

"Right now, it's all optimism," says Jackson, president of Colorado's dealer association.

NOT ALL DOOM AND GLOOM

But the 2017 picture is a long way from bleak.

"Right now, it's all optimism," says Tim Jackson, president of Colorado's dealer association. "There seems more potential for growth than we anticipated. And if CAFE is just moderated a bit, there will be bigger sales for SUVs and pickups, the types of vehicle people want to buy. Those are more profitable vehicles for the automakers and the dealers."

On the energy side, "increased oil production will keep fuel prices lower. So all the things we've had issues with are going to be relaxed," Jackson says.

Analysts already are encouraged by the market shift from cars to higher-margin CUVs and light trucks, pointing out automakers are beginning to catch up to the movement with additional model entries in the hot segments and better alignment of capacity with consumer demand. This year manufacturers will launch 27 new or refreshed truck and utility vehicles, up from 16 in 2016, J.D. Power notes.

Even if there is a slight downturn, it might not be all that bad for automobile dealers, some contend. Retailers might benefit from a little market pressure if it persuades them to shore up operations, adapt to new ways of retailing and ward off the coming competition from well-financed disruptors looking for a piece of the action.

"I don't think it's hit (dealers) in the face that they need to move now," MAXDigital's McMullen says. "The problem is they're still making money. So if it's not broke don't fix it, right?

"But they're starting to dabble in it, they're starting to explore."

VinSolutions' Maynard puts it this way: "Maybe a plateau or even a little bit of a (downturn) will actually cause dealers to think about their process and think about how they start to bring customers back in (and) how they interact with the customers they have.

"If the market just keeps going upward, everybody's making a lot of money and we probably don't focus on some of the things that are going to improve the customer experience." **WA**

This story was written by WardsAuto Editorial Director David E. Zoia, with additional reporting from Steve Finlay. Zoia can be reached at dzoia@wardsauto.com