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What type of dealers?
Different avenues for automotive distribution architectures

By Leonardo Buzzavo, Associate Professor of Management, Ca' Foscari University of Venice

Abstract

Albeit many relevant pressures to change have been arising from many factors, distribution architectures in the automotive industry have featured more evolution than revolution over multiple decades. Recent trends lead to question whether more substantial transformations lie around the corner, with brands seeking more direct involvement, for example by leveraging digital connectivity to customer and/or exploring alternative formats such as agency. We believe that changes ahead may not necessarily feature convergence towards one model, but rather increase the scope for differentiation. This takes into account that brands are likely to find themselves in different situations according to their capabilities to operate pull versus push systems and to their ability - or strategic intent - to control downward stages of the chain. The end outcome may lead to much more variation in distribution choices - both across and within brands - than in the past.

A resilient system that has survived for decades, where evolution beats revolution

The automotive distribution system, albeit featuring some variations by geographic market and by brand, has generally been organised around a franchised network scheme that has shown much resilience over time and lasted for many decades. The sharp increase in globalisation typical of the 1990s has triggered more intense competition, then the explosion of digital technologies in the early XXI century has enabled new forms of coordination and customer interaction, and more recently the global financial crisis of 2008 has exacerbated the quest for efficiency. All these factors have created considerable waves of pressure as well as enablers for change, leading many players and industry observers at various times in history to consider a demise of the traditional distribution system which could be just around the corner. The outcome, however, has been more evolution than revolution.

More recently there seems to be a steeper curve in changes that has ignited even more debate on the need for a major overhaul of the system. We believe the pressure from changes that the system is currently going through now may be the result of three intertwined factors. The *first* is the cumulated effect of all of the major changes outlined above, whose impact may have reached a sort of a tipping point. Think for example of the huge wave of new brand introduction in mature markets, especially by new Chinese players, or consider the refinement of e-commerce platforms and capabilities to accompany customer journeys online. The *second* factor is the sudden acceleration in drivers of innovation that at first seemed just marginal experiments or technological windows, that have actually turned out to be serious actors within the innovation chessboard. We hereby refer to widely known streams of innovation such as electric powertrains, connectivity, mobility-as-a-service platforms. All these do not just impact the vehicle structural features and its upstream production stages, but also the downstream chain of sales and service activities and their related business models. The *third* factor is the prolonged state of the global pandemic starting in early 2020 with its more direct consequences on the automotive industry, one being social distancing that paved the way for more e-commerce, the other being the component and product shortage that dramatically reduced stock levels and therefore the relationship between supply and demand.

In other words, we may be now witnessing the combination of three waves of change, each relating to a different time frame: the first wave encompassing almost half a century (globalisation, ICT and digital, economic and financial shocks), the second wave encompassing almost a decade (electrification, connectivity, mobility-as-a-service), the third wave encompassing the last two years (global pandemic). The combined effect of all transformation undoubtedly calls for greater levels of efficiency (i.e. mainly cost reduction), effectiveness (i.e. customer relationship and value creation), flexibility (i.e. ability to adapt facing volatility and disruption).

It should be said that we have not specifically mentioned the regulatory dimension, namely the set of legislative packages that discipline the design and operation of distribution architectures - for example the VBER Vertical Block Exemption Regulation in Europe - as they tend to vary considerably across geographies. Albeit having some degree of impact over distribution strategies, we believe not all to be substantial, as norms tend to follow the evolution of strategic choices rather than shape it beforehand.

A significant degree of attention is currently being directed towards the strategic plans announced by some manufacturers to adopt agency-based models for distribution. Such an approach – envisaged by both some premium and some volume brands – would considerably change the business model of the dealership, mainly by reducing the costs and margins for intermediaries, and thereby also reducing the scope of their entrepreneurial nature. Many consulting companies seem to be indicating in their industry reports that this is the only way to go in the future, believing agency is capable of achieving the long-intended reduction of distribution costs plus enabling more direct contact with the customer, therefore leveraging the value of customer data. Would this be the answer and how viable is it, particularly for long-standing distribution architectures who do not have the benefit of making choices in a green-field context? How are franchised dealers evolving in the light of these transformations? How are new entrants shaping their distribution systems without legacy choices? Will some manufacturers, including incumbents, be able to make substantial leaps in proximity to the end customer through agency-like approaches or other ways? Will the future continue to feature evolution, or rather a more radical shift towards a new model, or perhaps room for more variation across individual choices?

We believe that in order to shed some light onto an uncertain future we need a framework which allows us to explore some of the strategic avenues and their respective characteristics.

A framework to look at distribution choices: degree of control and supply system

As said, a framework is needed in order to better understand the nature and impact of choices that car manufacturers may adopt when shaping their distribution architectures over the coming years. By making choices on the type of distribution architecture, manufacturers determine different modalities of value creation and value appropriation, each corresponding to fundamentally different business models in the form of different degrees of vertical integration, cost structures, risk and so on. We believe that there are two key factors that shape and/or influence distribution approaches.

The *first* factor is the capability of a brand to exert control over its distribution system. By control we mean the capability to design and calibrate the major elements of the customer journey i.e. transcending through the chain specific brand-related elements around the way in which customers shop, purchase and enjoy a product/service. Such type of control implies determining the major characteristics of the shape, the business model and the business attitude of the actors involved downstream. This capability to shape and/or influence retail activities could take place either through actual vertical integration (i.e. owning and operating sales outlets) or through a quasi-vertical integration (i.e. by operating a selective distribution system of franchised dealers, regulated via standards and well-articulated compensation schemes). The alternative at the other end of the spectrum means shifting control downward in the chain, meaning acting mainly as wholesalers while leaving sales activities and the interaction stages with end customers in the hands of retailers.

The *second* factor relates to how the production system balances supply and demand. On the one side of the spectrum, the automaker is capable of building-to-order and/or keeping unsold stock in its hands (pull). On the other side, the automaker is driven by scale economies and the need to saturate plants thus gennerating considerable levels of stock that is then sold wholesale to retailers (push).

When looking at the franchised dealer system that has been in place for many decades via this framework, we could argue that it falls within a type of hybrid situation. Control falls between the hands of the manufacturer and of the dealer, as the automaker carefully designs its selective distribution network but then dealers enjoy some scope of entrepreneurial freedom and local adaptation. For some brands and geographies, albeit this is more the exception than the rule, there may be direct manufacturer ownership of the sales outlets. The other main factor, that is the production system, has broadly been fluctuating with a mix of push and pull, mainly dependent on individual product life-cycles (typically, aging product lines tend to imply more stock push) and market contexts (disposable income, confidence levels, government incentives).

Interestingly the recent global pandemic, besides understandably depressing sales levels in the automotive as well as in the majority of other industries, has produced two major industry-specific effects. The first effect, that typically characterised the first year of the pandemic, is that lockdowns and social distancing gave room for more e -commerce experiments that at least in principle created more opportunities for more direct control. The second effect, that started during the second year of the pandemic, is product and component shortages which lead to a dearth of vehicle stocks and triggered an unusual season of demand pull that had not been seen in decades, at least to this level.

In summary, the two factors that influence a manufacturer's decision about its distribution system may be seen as the two major core competences a brand may have: managing retail directly (as opposed to operating as a wholesaler) and managing a flexible production system enabling customer pull (as opposed to resorting to stock push). Let's explore in detail what type of situations arise in relation to different configurations of these two capabilities.

More push with less manufacturer control: let them retailers trade

The framework highlighted above provides an opportunity to discuss the characteristics and implications for each individual situation. As said, in most cases today the most common approach – the franchised dealer network – tends to fall somewhat in between all corners. But a context where supply constantly exceeds demand (push), with manufacturers giving up even more control to downstream players, has represented quite a perceived threat to many brands for quite some time, and is a typical feature in many other industries. This is the typical situation where the main objective of a manufacturer is meeting sales targets, with targets often set at too ambitious levels. The presence of excess stock puts the manufacturer in a constant need to dispose of huge volumes of vehicles, often creating room for opportunistic trading by dealers and/or other players who can take advantage of sizable financial assets. Channel players, or at least some of them, act as cushions capable of absorbing excess production which has some consequences. Firstly, albeit this approach might deliver maximum sales in term of units, this comes at the expense of the mix and quality of sales. Secondly, this creates a dilution of the intended branded customer experience making it hard to try and maintain lasting customer relationships. Whilst this may not matter too much for some types of brands (e.g. simple utility products), for others it would. The typical situation with stronger push and stronger retailer control would consist of multi-brand mega-dealers who can take advantage of trading opportunities, as well as large rental companies, often exploiting opportunities for cross-selling. In this scenario, the entrepreneurial scope and of the retailer looks considerable, with the retailer acting as a sort of 'trader' in the marketplace on behalf of a brand that in turn focuses on the design and implementation of some trade marketing efforts to channel its stocks downward (trade marketing and wholesaling).

More push with greater manufacturer control: fostering regional brand hubs

A situation where push is the norm, but manufacturers are exerting greater control, may be seen in the form of distribution networks where a combination of concentration and collaboration makes retailers become regional players, often dedicating most if not all of their efforts to a specific brand (or to a specific brand portfolio). These players would act as a sort of brand stores becoming regional hubs for the products and service range of a specific brand. Scale of operation certainly matters at the retailer level - and this may be the outcome of strong consolidation, often achieved through assisted acquisitions of local same-brand players - but what seems most important here is the quality of the relationship between the brand and the retailer, where requirements for brand control over choices and processes are sort of compensated by a stronger form of partnership and balanced risk sharing. This approach reduces intra-brand competition, so the customer potentially has to travel further to get an alternative offer from a different retailer. While traditionally this might have raised regulatory concerns about reduction of choice/potential dominance, nowadays with customers capable of shopping with different retailers virtually from the comfort of their home, this may not be such a big issue any longer. Surely this partly depends on how much offer variation there is between retailers (and this leads back to the issue of OEM control previously discussed), because the less variation there is, the less it is worth the customer putting in the effort to shop around, as they won't find a better deal.

In this configuration a key element for the brand lies in the ability to deliver consistent retail satisfaction through a calibrated dialogue and partnership for all of its network members, where each retailer acts as a local brand hub, creating a sort of delicate bilateral monopoly in the relationship.

More pull with greater manufacturer control: playing the retail game

When the production system runs in an orderly build-to-order mode, but where manufacturers aim for a greater level of control, we may see situations that can take the shape of direct ownership of sales outlets or tendencies to install an agency-like format. In brief, this makes the manufacturer become more of a retailer itself, therefore bearing the burden in terms of financial investment plus managerial capabilities to operate a retail network. Direct ownership of sales outlets is still the exception, visible only for a limited amount of brands and just in selected geographies. For example when looking at the European context today, one can see brands like BMW, Mercedes and Renault in particular owning a sizable portion of their dealerships but mainly in their domestic market. Another exception is represented by Porsche Holding, a branch only indirectly linked to the manufacturer that over recent years has acquired a very high number of VW Group franchised dealers across many European territories. Tesla represents a different picture, as it is a relatively young brand that could establish a green-field approach, plus counting initially on low sales volumes, with sales mainly targeting a specific segment of brand-aware, upper premium and early-adopter customer profiles. With the product range extending to lower segments and volumes increasing, it is yet to be shown how the model adopted at the beginning can perform well, or otherwise how it could converge with elements of the traditional franchise model.

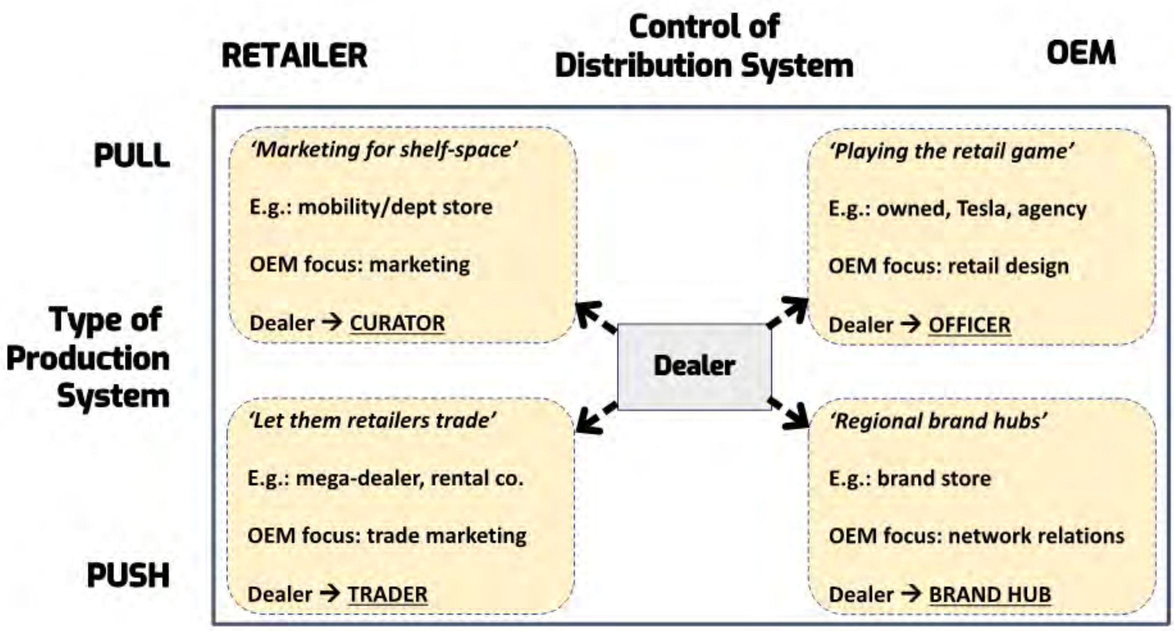
Within the picture of more pull and greater control, as anticipated at the beginning, and considering the product and service complexity that is intrinsic in the industry, some brands have recently identified agency as an interesting format to adopt in some markets. While leaving a detailed description of the agency model aside, and bearing in mind that it is generally associated with different nuances and mechanisms that create different configurations being referred to as 'agency', what we underline here is that this approach fundamentally transforms the nature of the retailer. While the traditional franchised dealer sources vehicles from the manufacturer and then sells them bearing all related investments and risks and making a sales margin, the agent is an entity whose dedicated investment and risk is limited to the time involved and making a fixed commission for each sale. Profit is much smaller – the sales commission – but cost structures are also less. The entrepreneurial scope of the channel actor is considerably reduced since the it becomes more of an officer executing the sale on behalf of the brand, following a set of guidelines.

While some herald agency as the only way forward for an industry that needs to reduce distribution costs and gain access to customer data, we believe that its critical points are often under-emphasised. They are mainly the scale of investments and managerial focus needed in such a system, plus the difficulty in operating an agency scheme while transitioning from a legacy system of franchised dealers with all the uncertainty, litigation and collateral effects of existing channel relationships, with fallout effects over sales and customer satisfaction in the marketplace.

On the whole, a direct or agency route of more control manages the issue of intra-brand competition, but we should ask ourselves whether this option can be sufficiently responsive to market changes, and particularly to a situation when over-supply may arise? Some OEMs may need some sort of safety valve, in the form of a separate outlet-like channel, as many brands do in other industries, to allow surplus product to be channelled without undermining the consistency and pricing of the core channel.

More pull with less manufacturer control: marketing for shelf-space

The last portion of the framework relates to a situation where pull is the norm, but manufacturer opt for lower levels of control that falls more into the hands of retailers. What would this configuration mean? On the strategic side it means that the manufacturer/brand has solved the production flexibility issue achieving pull but does not intend to put its feet in the water in terms of getting involved in much of the retailing side downward in the chain. We could think of situations where the brand designs its products and services, along with placing considerable efforts on the marketing formula, but then leaves the retailers in charge of relating to customers and making the sale. Within this picture, one of the most representative examples may be a retailer operating like a department store: the brand's offering is positioned within a curated selection of brands, according to the retailer strategy for the local market. The brand's aim is to gain sufficient shelf-space through a calibrated marketing strategy, with this approach being most suitable for brands with lower volumes and lower awareness in the marketplace (particularly new entrants), promoting a lighter format, perhaps needing local customisation by the retailer itself. This department store may include a mobility store, providing a range of products and services directly or indirectly linked to mobility. Intra-brand competition may increase in this option, depending on local situations. An open question is how much of a direct relationship the brand has with the customer in this configuration: such relationship would need to be promoted through calibrated choices.



So-what for brands: what type of retailers are consistent with your strategy?

There may not be a dominant design for distribution systems around the corner. While the quest for greater efficiency and for better access to customer data are top of every brand's strategic agenda, the actual strategic position of each brand - when considering its legacy choices plus its intended route ahead - may vary considerably in the near future. On the whole, the design of the distribution architecture embodies a trade-off between efficiency and control, given that increasing the control over the distribution system implies allocating more resources to it, both financially and managerially, and this should definitely not be underestimated by anybody attempting to modify its distribution architecture. It could also be noted that while some observers point at the route of greater control (particularly via agency) as the necessary way to go, if we look at what happened in other industries one may notice that managing to become a successful retailer seems to be the exception rather than the rule. Apple managed to do it with premium technological products and services, and Zara (Inditex) managed to do so in the low-cost fast-fashion area, but again these two brands seem to be among the very few who managed to integrate the ability to steer production capabilities (albeit not necessarily with direct vertical integration) with efficient and effective retailing capabilities.

All this may suggest that when considering elements such as the specific positioning of individual brands – volume, premium and luxury - the complexity of product and service ranges, the differences in geographies, we may see a growing degree of experimentation and differentiation leading to a wide range of solutions being adopted. In other words, we may not witness an abrupt transformation of automotive distribution architectures from an old approach (the franchised dealer network) to a new approach (the agency system), as many appear to advocate. We may instead witness a change from a somewhat uniform attractor system (the franchised dealer network) to a multi-modal system where more differences exist both across brands and within brands. To some extent, this could be in line with what happened in other industries, where for a given brand we may see the co-existence of a variety of formats, ranging from a directly-operated e-commerce site, a flagship outlet, different tiers of authorised resellers plus some other sales options for aging or out-of-season stock. We may conceive for example new way of products being sold, while products that are still new but older in the product range may follow another path, and again some products that are incorporated in more complex services could follow yet another channel route. This would indicate that format and channel orchestration become fundamental strategic activities requiring dedicated skills and focus that considerably surpass the amount that was needed to calibrate an existing network of dealerships.

In any case, whatever the chosen distribution format(s) may be, we believe that some fundamental aspects would play a key role. The first would be the ability of the format(s) to be efficient enough in all processes that are perceived as relevant throughout the journey for the chosen customer segments. The second would relate to the functionality of the format(s) to provide a suitable-enough platform for the input and constant updating of customer data, being an element that undoubtedly lies at the heart of value generation and appropriation at this stage for the industry. The third would be a sufficient degree of flexibility of the distribution architecture, e.g. the ability to operate adjustments and recalibrate itself, in order to cope with the required learning much needed in an era of constant change that has become the norm.

ICDP is an international research-based organisation focused on automotive distribution, including the supply and retailing of new and used vehicles, after sales, network structures and operations. Through our research activities, data services, education, events and consulting, we work with vehicle makers, dealers, suppliers, and related organisations to improve the quality and effectiveness of the distribution model. We believe that changing behaviours, new technologies and market pressures will combine to drive new ways of doing business. We welcome the opportunity to work with like-minded individuals and organisations in pursuit of this goal.

Project Office: Central Boulevard, Blythe Valley Business Park, Solihull, B90 8AG U.K.
Tel.: + 7711 965 739 E-mail: projectoffice@icdp.net Web: www.icdp.net

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