

**Surviving
an
Automotive Retail
Recession, “A Primer”**

*Four Rules for Success
from
OCD Consulting, LLC*

OCD Consulting, LLC

Serving the Retail Automotive Industry

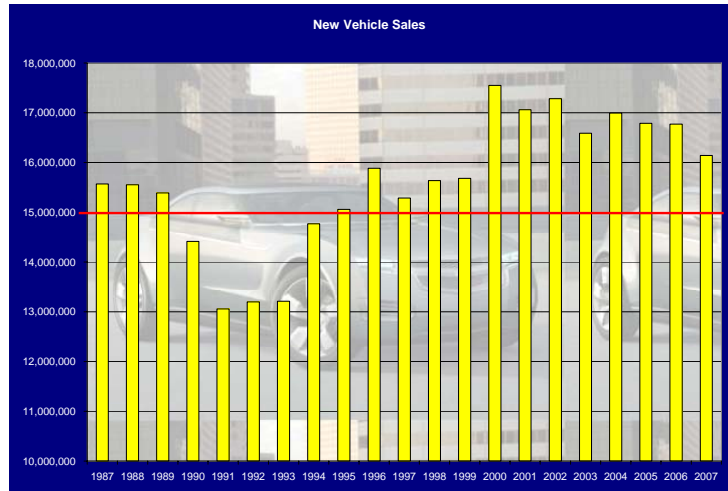
1515 Hancock Street

Quincy, Massachusetts 02045

www.oedconsulting.com

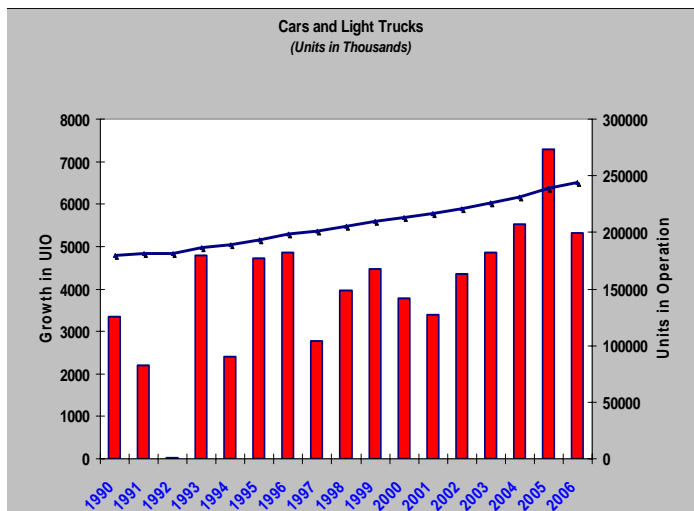
The Premise: *Recession: A decline in business activity. Often defined as two consecutive quarters with a real fall in gross national production.*

Sales figures for 2007 are in at just over 16.1 million cars and light trucks. Predictions for 2008 are, let's say, not optimistic. If the forecast of a 15.0 or even 15.5 million sales rate is correct, 2008 will be a challenge for even the best automotive retailers. There is plenty of conventional wisdom to support these predictions; sub-prime mortgage crises, volatile stock market, \$100 a barrel oil prices, unpredictable election year. These externalities certainly influence



consumer confidence but are they the core determinates of vehicle sales volumes or are there other economic factors that more directly relate to the conditions and needs of the automotive consumer?

First, it is important to remember that the total fleet of vehicles in service in the United States grows at an average rate of 2.3% per year and is now approaching 250 million units.



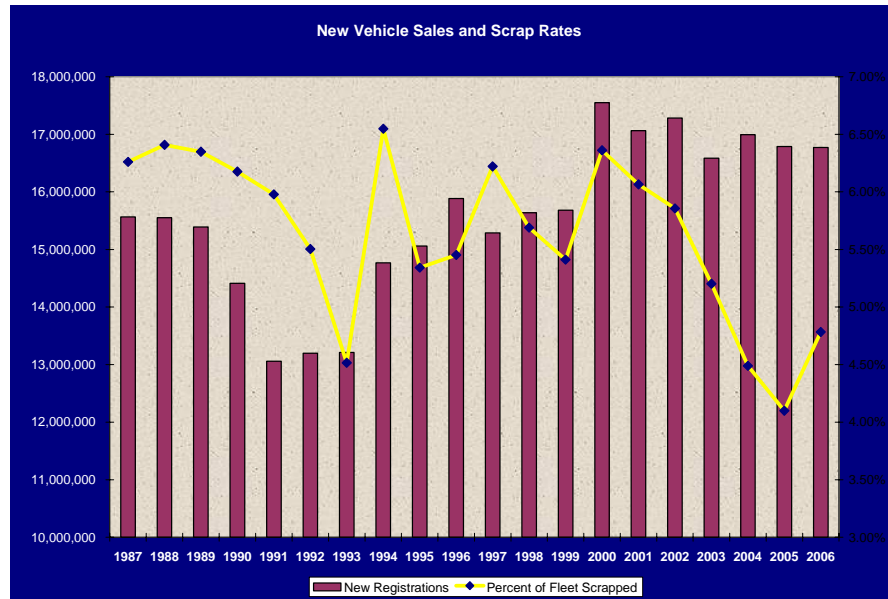
This growth rate of course while consistently rising is subject to volatility, which is a major contributor to the risks associated with automotive retailing. This fact is demonstrated by the red bars in this chart showing the number of units by which the U. S. fleet grew annually over the last 17 years.

It is also important to remember that fleet growth is not just a function of production but is also determined by scrap rates; that is to say, the vehicles that go to the junk yard. In fact, we

believe that the scrap rate, as measured by the total percentage of the U. S. fleet that is junked annually, is the essential predictor of future new vehicle sales. This is not to say that catastrophic events do not influence the market place because clearly they do but in spite of economic conditions or consumer attitudes, if the average age of the vehicle on the road becomes so old that the vehicles are no longer serviceable, consumers will find the means by which to replace them.

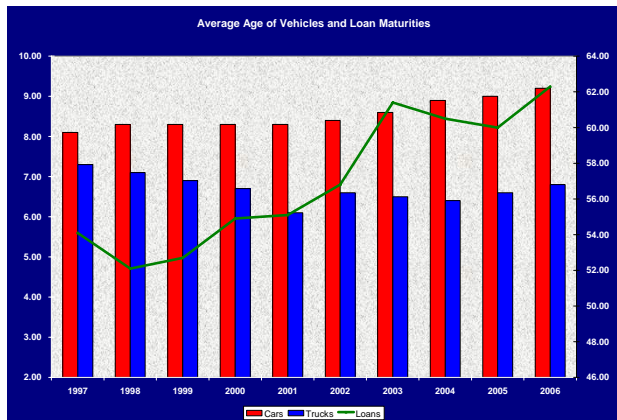
Consider this chart showing historical new vehicle sales volumes and annual scrap rates.

During the period from 1988 to 1993 scrap rates steadily declined. As consumers kept their cars longer the average age of the fleet became older. Eventually these older vehicles had to be replaced and the industry enjoyed annual sales increases, peaking in 2000 at 17.5 million units. We believe it is significant, and perhaps encouraging, that scrap rates have again declined steadily since 2000 and for the years 2004-2006 were at or below historical lows. Scrap rate data for 2007 is not yet available.



Scrap rate data for 2007 is not yet available.

The average age of the U. S. fleet is again at an historical high. Conventional wisdom says vehicles are more durable and this increase in reliability is causing consumers to lengthen their trade cycles.



We are not totally convinced by this logic. Consider this chart showing the historical average age of cars and light trucks and the average auto loan maturity, which now exceeds 62 months. The primary cause for ever increasing loan terms; consumers refinancing negative equity. Manufacturers keep plants running by offering deeper discounts and more attractive financing arrangements including not only reduced rates but also longer terms. While these incentives may keep sales volumes high they also depreciate trade-in values and the net impact on the consumer can be devastating. While reliable statistics are unavailable, we believe based on anecdotal evidence, negative vehicle equity is at an all time high and that today's consumers are either unwilling or unable to put up enough cash to make trading into a new vehicle affordable. Additionally, Automotive News reports that indirect auto loan delinquencies are now at a 16 year high. While there are certainly many contributing factors, we believe the combination of negative vehicle equity and the illiquid position of the average consumer is the primary cause for today's depressed sales volumes.

While these incentives may keep sales volumes high they also depreciate trade-in values and the net impact on the consumer can be devastating. While reliable statistics are unavailable, we believe based on anecdotal evidence, negative vehicle equity is at an all time high and that today's consumers are either unwilling or unable to put up enough cash to make trading into a new vehicle affordable. Additionally, Automotive News reports that indirect auto loan delinquencies are now at a 16 year high. While there are certainly many contributing factors, we believe the combination of negative vehicle equity and the illiquid position of the average consumer is the primary cause for today's depressed sales volumes.

Unfortunately we do not see any miracles on the horizon; gas prices are not going to fall, home prices and homeowner equity are not going to rise, income for discretionary spending is not going to increase, and manufacturers are at the end of their incentive ropes. So what will turn this around? Time. In 1994 the age of the average vehicle was so old consumers were forced to make an economic choice; replace or repair. The rational decision was to replace and sales increased.

With the average age of the car on the road now in excess of nine years, today's consumers will soon be faced with the same choice. The duration of this cycle has been lengthened by the impact of improved durability and increased negative equity positions but the pattern of sales increases seen during the period of 1994 to 2000 will be seen again. When? We believe a prudent strategy would be to plan for decreases in sales volumes in 2008 and 2009 and look for improvements thereafter.

The Strategy: There are numerous strategies available to dealers in a down market and reactions will certainly vary depending upon the particulars of the dealer's situation; local economy, financial strength, etc. But any plan for survival and success in a prolonged down market must follow these rules.

Rule No. 1 – Learn to live with the market share you actually have not the one your factory rep fantasizes about. No single dealer or dealer group has the resources, influence, or horsepower to turn around a declining sales trend so model your business plan for the market share that is actually available to you. In short, cut your conventional media ad budget and focus on driving traffic to your web site. Reduce your new vehicle inventories to a factual 60 day supply including what is in the pipeline. Remind your sales organization of their responsibility to bring traffic into the showroom and replace anyone who doesn't believe in prospecting. Keep in touch with your market share numbers; an indicator of good performance is keeping your actual sales in excess of 100% of your market registrations.

Rule No. 2 – Make your balance sheet your new best friend. You have invested millions of dollars in assets for a reason; to make money. Take a moment to look at the left-hand side of the first page of your financial statement. For what ever reason accountants have chosen to list your assets in an order that gives preference to liquidity; cash, the most liquid is on the first line, next come receivables and inventories, then other current assets, and finally equipment, etc. the least liquid.

Liquidity is great if you want to liquidate but it has no bearing what so ever on making money. So, take a minute and make a list of your assets using a new system of prioritization; that being rate of depreciation. Why? Because a company

makes money by turning over its assets and those assets that depreciate the fastest are the ones that need to be turned over most frequently.

Using this line of thinking, the first asset on your list, the most perishable of all, should be work-in-process. On any given day your shop has a quantifiable number of labor hours available for sale. You buy a labor hour from a technician, put it into inventory and then sell it to a customer, hopefully at a profit. The point to be made here is that the shelf life of time is zero; any available hour that is not sold will remain a lost sale forever. Available shop hours versus hours sold must be tracked continuously and keep in mind, labor is the highest profit margin product your dealership sells.

The second asset on your new list should be used vehicles. If you do not have a 45 day or better turn rate then you are not the low cost supplier in your market and you are losing both sales and gross profit per unit. "There's an ass for every seat" has been a cliché in our business since we were trading for horses and buggies. The difference today, thanks to a plethora of Internet resources, is the ass now knows what the seat is really worth. Customers know the real market value of the vehicles on your lot and that is what they are willing to pay. If you are wrong in a car, holding it in hopes that the last uneducated consumer will stumble on you lot and buy it is no longer a viable business model. Constantly price and reprice (at least every 10 days) your vehicles to the market, stock for a 45 day turn, and watch your profits go up.

The third item on your new list should be receivables of all types; contracts-in-transit, customer (especially wholesale parts), factory, warranty, advertising co-op, etc. Consider your true cost of carrying receivables by determining your cost of capital. Most private capital dealers consider their cost of capital as either their floor plan rate or the rate at which they can borrow money. But in fact, the true cost of capital is much greater.

Cost of capital is the opportunity cost of having money invested in one place when it could be invested in another, with similar risks, at a greater return. Presently, the cost of equity for the publicly held retail automotive companies is about 10.3%. But the stocks of these companies are all traded on the NYSE and are very liquid. After making adjustments for lack of marketability the equivalent cost of capital for a typical privately held dealership is closer to 19.0%.

Now take the total amount of receivables presently on your balance sheet and multiply it by 19.0%. This is your true annual carrying cost, before bad debt write offs and this is why receivables are third on your new list of priorities.

Fourth on the list is the new vehicle inventory. What a great business you're in. What other retailer allows its manufacturer to produce more product than the market can bear and then agree to buy the excess inventory at retail in hopes of someday selling it at wholesale? Nancy Reagan had it right; when your road rep wants you to take those extra 50 units, "just say no".

Sure, under the terms of your Sales and Service Agreements you have an obligation to properly represent the manufacturers' products and earn market share and you should do your best to live up to this understanding but nowhere in that agreement does it say you have to carry a 180 day supply of iron that no one wants to buy. Too many times we hear clients complain that a sales manager buried them in inventory. In a down market you can not sell your way out of your manager's mistakes. Take personal responsibility and control over your new vehicle inventories and stock to the sales potential you truly believe you can achieve.

The bottom line of asset management is this; forget liquidity, that's for the accountants, think turnover, that's how businesses make money.

Rule No. 3 – Protect and invest in your valued employees. Our dealer clients universally will tell us that their employees are their greatest asset. If this is true, where do you find them on your balance sheet? You don't but just because the accountants don't want to treat employees as assets doesn't mean you shouldn't.

In a down market, managers accustomed to earning big bonuses on big bottom lines are going to be stressed. Sales people unable to earn a living wage are going to look for alternative careers. Sure, a down market is a good time to get rid of the dead wood but it is also not the time to lose your good people.

Communicate with your employees and share your expectations with them. Involve them in the business planning process. If there are going to be some tough decisions to make let them share in the agony. Change compensation plans to protect the income levels of your best people. Expect that your personnel expenses as a percent of gross profit are going to rise. Look upon this as a time to strengthen the resolve and determination of your team. Remember, the number one driver of customer loyalty is employee loyalty. In a down market you need your best people more than ever. Don't lose them.

Rule No. 4 – Forget about CSI scores; manage for customer loyalty. A satisfied customer will shop everywhere; a loyal customer will only buy from you. You and your employees need to know the difference and your factory CSI reports should not be relied upon as a resource. "Top Box" CSI scoring is a cynical device used by manufacturers to micro manage their dealers and is meaningless to the promotion of customer retention.

Every employee in your company needs to be trained in and focused on customer service. Every connection a customer makes with your company via, phone, e-mail, or physical visit, needs to be an exceptional experience. Out of necessity, all dealers have good CSI scores, yet as an industry, retail automotive, because of its highly competitive environment, has one of the poorest rates for customer retention.

Managing for and achieving customer loyalty is always a challenge in our industry but if there was ever a time to make it the focus of your undivided attention, that time is now.

Pick a strategy, make a plan, execute, and follow the rules. Who knows, 2008 might just be your best year yet.

About the Author: Michael McKean, (mmckean@ocd.com) President of OCD Consulting, LLC, developed his dealership management skills during fifteen years of service with the Ford Motor Dealer Development organization. As a dealer and consultant, working with some of the largest and most successful dealer groups in the country, Mr. McKean created and refined the Customer Based Management System, which is the Company's hallmark solution for achieving superior sales and profit performance.

About the Company: OCD Consulting, LLC was created by retail automotive professionals to help its clients survive and succeed in the ever changing and demanding automotive retail environment. Services include; Virtual Board Member Program, Management Development, Strategic & Business Planning, Sales, Mergers, and Acquisitions, Accredited Business Valuations, and Litigation Support. The Company is a joint venture partner of O'Connor & Drew P.C., one of the country's most recognized and experienced automotive accounting firms.

OUR MISSION IS:

To give to our clients . . .

The vision with which to see the future . . .

The courage to break through the barriers of change . . .

The knowledge and skills required for superior performance.

We encourage the reprinting and distribution of this article, with appropriate credits, of course. Thank you. © OCD Consulting, LLC 2008