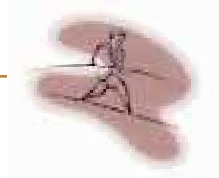

Changing Channels in the Future of Automotive

The business of selling cars is changing. New competitive rules will apply. With these changes comes a shift in power.

WHO WILL BE the winners and losers in the revolution that is radically reshaping the marketing, distribution and selling of automobiles? Will the vehicle manufacturers and their franchised-dealer networks be able to overcome years of inertia and complacency to pioneer and execute new concepts that will strengthen and extend the value of their brands? Or will nimbler, more imaginative retailers or software companies get there first?

The transformation of the business of selling cars and trucks is happening before our eyes at an incredible pace — promising to change forever an industry that has long been noted for its high costs, poor service and extremely unpleasant selling process. Auto manufacturers have competed fiercely among themselves to drive out cost and meet consumer needs for cheaper and better cars and trucks. Now the survivors face new threats from outside the industry that might thwart their renewed interest in building strong, lasting relationships with their customers.

Entrepreneurs have dissected the cost-value equation and come up with new retail concepts. Their stories have been persuasive enough to attract hundreds of millions of dollars in public equity investment and persuade dozens of fiercely independent car dealers to sell out. Internet technology has lowered entry barriers for other entrepreneurs with new ideas about helping customers find, evaluate and buy new vehicles. These patterns are consistent with revolutions in other consumer durables markets that effectively transferred market power from manufacturers to retailers.

In response, vehicle manufacturers finally are getting serious about marketing, and about confronting the weaknesses embedded in their traditional franchised-dealer distribution channels. The manufacturers want to expand their participation in the customer life-cycle value chain to improve profitability and grow in markets that have been largely stagnant. This changes the basis of competition from designing and making good products to providing services and managing consumer purchase and ownership experiences for which the products themselves are only partly responsible.

Consumers are the only clear winners in this battle. While we are not sure which vehicle manufacturers will survive, we are confident that winning will require a better understanding of the life-cycle value equations of both cars and buyers, and

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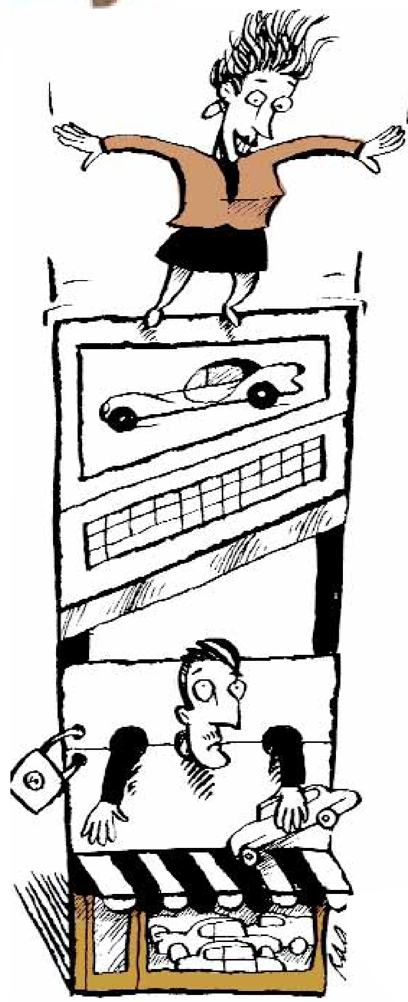
Automotive Industry

MARKETING AND DISTRIBUTION

By Evan R. Hirsh, Louis F. Rodewig, Peter Soliman and Steven B. Wheeler



the development of innovative strategies to capture that value.

FORCES OF CHANGE

From the days of Henry Ford's production line, the automobile industry has been based on a "supply-push" philosophy — a strong bias toward "filling the factories" to cover high fixed costs.

Dealer networks were created as logical extensions of the "supply-push" model. The networks were designed to hold inventory, leverage private capital (without threatening the manufacturers' control) and service and support what was then a less reliable and more maintenance-intensive product. Those networks generally were built around entrepreneurs focused on a defined geographic area, selling one or at most two brands.

This distribution model has been remarkably resistant to change. Historically, dealer networks have become ingrained and protected over time by a web of habits, contracts, regulations and laws. In the United States, state franchise laws limit the manufacturers' ability to act unilaterally to revoke or consolidate franchises. In Europe, strong national distribution laws and other rules help protect the established channel. Even the new dealer networks created by the Saturn division of the General Motors Corporation and the Lexus division of the Toyota Motor Corporation with such fanfare during the past decade or so have accepted the fundamental model. They have achieved their superiority in channel-driven customer service by avoiding mistakes (such as locating too many dealers too close together) and institutionalizing best practices in customer care.

Despite its longevity, the traditional dealer channel leaves many people unhappy. High customer acquisition costs motivate dealers to convert store traffic to sales using aggressive tactics that extract differential margins based on customers' willingness to pay. Frequent well-publicized rebates have taught buyers to mistrust sticker prices and negotiate from cost up, rather than sticker down. As a result, dealers often find themselves competing not against another brand, but against a same-make dealer across town. This acute competition has almost bid away dealer profit on the sale of new passenger cars in the United States (with some profits still available on sales of trucks, sport utility vehicles and luxury cars).

Shrinking dealer margins do not translate into happy customers: Most customers (approximately four out of

Illustrations by Richard Goldberg

five) dislike the purchase process, and many still come away feeling cheated and mistreated. This strong antipathy is largely responsible for the rapid growth of Internet-based services that offer alternative means of gathering information on cars, soliciting price quotes and, in some cases, conducting transactions.

The decline in profits on new cars has forced dealers to make up the shortfall by looking at what many have historically considered "filler" businesses: parts and service, used cars, financing and insurance, and fleets. The problem is that a conventional dealership is not necessarily positioned well to conduct all of these businesses because of their different economics, bases of competition and consumer purchasing patterns. Some dealers, for example, have set up dedicated bays to offer no-appointment quick-lube services to compete with independent outfits such as the Pennzoil Company's Jiffy Lube and the Midas International Corporation's muffler shops. However, the optimal retail density and overhead structure for the oil-change business are very different from those for new cars. (See Exhibit I.) Brick-and-mortar and real estate constraints will make it difficult for traditional dealers to develop truly competitive offerings in each individual dealer business even if they manage to overcome longstanding consumer mistrust.

SURFING THE NET FOR PROFITS

Obviously the Internet is a major enabler of change in auto distribution. Many of the most important auto industry innovators today are developing Web-based services, leading some to predict that the most important automotive company of the next century will be a software-based company. Republic Industries, for instance, expects sales to reach $1 billion on the World Wide Web by the year 2000. Estimates vary, but some studies have shown that with some cars, as many as 40 percent of customers gather information from the Internet. A smaller but growing percentage of customers demonstrate what is called shopping behavior, or soliciting price quotations and availability information prior to the actual purchase.

The dramatic growth and power of Internet technology have greatly reduced the cost of obtaining information on features, price and availability. Consequently, customers are better equipped to extract what they want from dealerships. One of the pioneers of Internet marketing, Autobytel.com Inc., is working to speed response time from its participating dealers because it has learned that a staggeringly high proportion of its customers — 64 percent — buy within 24 hours of using its service to get price and availability quotes. The In-

EXHIBIT I
OPPORTUNITIES TO OPTIMIZE BUSINESS AROUND CUSTOMER REQUIREMENTS

	New-Vehicle Sales	Used-Vehicle Sales	Finance and Insurance	Service	Parts	Lease/Loaners/ Fleets and Rentals
Economics/ Drivers	• Two to three pooling locations for marketing/test drives (manufacturer operated) per metro area • High through-put with minimal fixed costs • Information technology intensive • Purchasing process – New communication technology provides information – Financing pre-approval via Internet/ phone – Test drive at central site – New-car sale assigned to closest dealer	• Suburban area with enough space to show all vehicles • Low-cost access to used cars (e.g., rental agencies) • Scale in overhead and reconditioning	• Direct sales or via new-car channel • Accurate assessment of vehicle retained values and credit risk	• Many easily accessible locations • Long opening hours • Maximized parts turnover and bay/equipment utilization • Centralized auto diagnostics to allow more service points at lower costs	• Wide range of parts available • Quick delivery of parts • Classical retail business	• Quick resale of vehicle, before depreciation overtakes purchase discount • Access to used-car outlet

Source: Booz-Allen & Hamilton

ternet offers new and better ways to perform many sales and marketing functions and makes it possible for manufacturers to have more and richer two-way communications directly with consumers. It has also provided, for the first time, the capability for channel marketing on a national or even international scale, attacking further the value of the traditional, geographically defined channel.

DEALERS STILL PART OF EQUATION

No one is suggesting, though, that auto dealers will disappear. Ironically, changes in cars and trucks themselves are making dealers more important. Consumers have more choices of brands and models than ever before. Improved durability and reliability and faster design cycles have narrowed the differences among competing products in the same category. Brand loyalty increasingly derives not from the product itself but from the total purchase and ownership experience. Numerous studies show that customer satisfaction has become a much more critical competitive differentiator and a greater influence on repurchase loyalty than the car itself. And it is the dealer that controls these levers today. (See Exhibit II.) This explains the intense efforts many vehicle manufacturers have made to set standards for, measure and even base some dealer compensation on customer satisfaction scores.

As a result of the high-cost, low-satisfaction proposition provided by the traditional dealer channel in general, many players have recently moved to capitalize on opportunities afforded by improving the channel-value equation. Entrepreneurs with access to public capital have strategic designs to modernize auto distribution. Six dealer groups in the United States went public in 1996-7. Collectively they soared past the $4 billion mark in revenue in 1997, up by more than 30 percent from 1996, with most of the growth coming from additional acquisitions of existing dealers.

EXHIBIT II
WHAT MAKES CUSTOMERS LOYAL

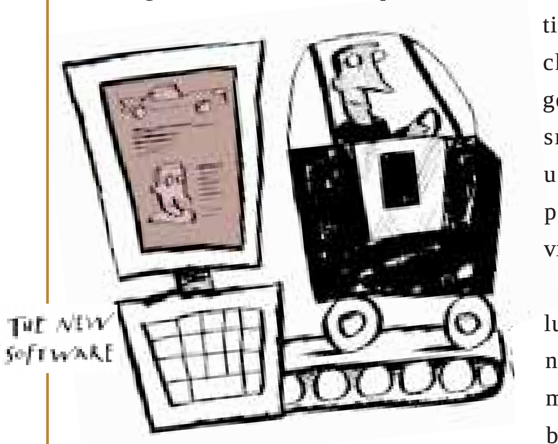
Source: R.L. Polk 1997 Manufacturers Loyalty Survey

The most prominent new automotive industry entrepreneur in the United States is H. Wayne Huizenga, chairman of Republic Industries. Mr. Huizenga has a proven track record as an innovator who has revolutionized the waste disposal and video rental industries. Republic owns the nation's largest group of franchised automotive dealerships, operates the AutoNation USA used-vehicle megastore chain and owns and operates several car rental businesses. Republic is currently on an extraordinary acquisition campaign for new-car business dealerships. Even though Republic has almost single-handedly doubled the market price for dealerships, it does not appear to be slowing down.

Unlike the dealership consolidators that are trying to reduce costs through scale economies in administration, advertising and service, Republic's stated strategy is to manage actively the vehicle life cycle while developing a proprietary channel brand. Another example of a company involved in external channel evolution is G.E. Capital Services, an extremely accomplished innovator. It has purchased Autobytel.com and is moving into used-car leasing.

In the face of all these changes, manufacturers have not been idle. Most have stepped up their efforts to improve their distribution systems. Almost every manufacturer has made some effort to restructure its network, improve the consumer experience or experiment with new formats. The Ford Motor Company, for instance, has been enlisting dealer support in several metropolitan markets in the United States and Britain to sell out or pool their interests in new ventures that will feature multi-line showrooms; centralized body and repair shops, and distributed quick-service maintenance facilities. Sweden's Volvo AB is taking a more radical approach: It is testing factory-direct sales over the Internet in Belgium.

Nonetheless, manufacturers seem to be following, not leading, the revolution. Many are still being pushed or kicked along the path of change. There are real questions



whether their late — and in some cases half-hearted — responses will be enough to protect the traditional position of the vehicle manufacturer as the caller of shots in the auto industry.

VISION FOR THE FUTURE

Now that we see serious cracks in the walls protecting the traditional automotive distribution model, what will the future bring? Both the underlying drivers of change in automotive retailing and the trends already under way help answer that question. In addition, it is helpful to compare the automobile industry with other industries that have experienced distribution-channel evolution and look at the lessons they learned.

Most consumer-durable industries have undergone substantial distribution-channel evolution resulting from changes in economics, regulations or technologies. Each one has unique circumstances, but we can see three relatively common, distinct stages in these channel restructurings:

Stage One: This is marked by major improvements in value delivered, mostly reductions in cost. Usually the cost reductions stem from consolidation and rationalization in the channel as better concepts or bigger players drive out marginal or small players. The bigger players use their cost advantage to reduce prices and often to improve service, variety and convenience.

Stage Two: Here channel evolution is focused on meeting the needs of specific customer segments. Channel functions are unbundled and restructured into more efficient or more appealing formats for defined groups of customers. Customer value is further enhanced through lower prices, better service or greater variety.

Stage Three: This brings dramatic new paradigms not just for distribution but for the entire value chain. Full-service leasing ("power by the hour") in the heavy-duty-truck market is an example of this type of game-changing concept.

We anticipate five major changes in future automobile distribution patterns and practices:

1. Multiple channels and formats will coexist to satisfy different market segments. Channels are distinct paths between a manufacturer and a customer through similar economic entities (in new car sales, for example, traditional dealers vs. factory-direct Internet sales or a multi-brand discount outlet). Formats are distinct combinations of points of sale, service offerings and business processes within a general channel definition (for example, the Lexus format versus the Chevrolet format). We expect much more variation in channels and formats in a physical sense and more distinct positionings in terms of the purchase and ownership experience they provide, further shifting the basis of competition from product to services and brand attributes.

Undoubtedly, the traditional dealer channel will continue to play a major role, although most of the innovation and volume growth will occur elsewhere. In many other consumer-durables markets, multiple channels with different value propositions coexist quite happily. (See Exhibit III, page 9.)

2. The six separate businesses under the roof of the traditional dealership will be unbundled. The integrated model — new-car sales, used-vehicle sales, finance and insurance, service, parts, fleets — was established early on when automobile retailing was still a new industry. In today's world it makes little sense. Different operational structures will be required to serve a variety of customer needs and economics.

3. The cost of distributing and marketing automobiles will be cut significantly. New formats and channels will discipline the current system to drive out non-value-adding cost. Dealer consolidations may unlock substantial economies of scale in back-office functions and purchasing

continued on page 9

REPUBLIC: EVOLUTION OR REVOLUTION?

Does Republic Industries, the largest holder of new-car dealerships in the United States, parent of the AutoNation USA used-car megastore chain and owner of multiple rental car companies, represent the future of automotive retailing? Yes, it is out in front of the pack, but no, it has not, at least not yet, demonstrated the radical changes we believe will be required to excel in automotive retailing.

Republic is clearly a leader in first-stage channel restructuring, forcing cost reduction through aggressive rationalization and consolidation. Automotive industry observers for the most part view Republic as a leviathan, swallowing up auto dealers at will. For the first three quarters of 1998, Republic reported revenue of \$12.7 billion, up 72 percent from \$7.4 billion during the first three quarters of 1997. Its income from continuing operations for the same period totaled \$384.2 million, up 68 percent from 1997. Automotive operations, which include National Car Rental, Alamo Rent-A-Car and CarTemps USA, account for about 92 percent of revenue and 78 percent of operating income; solid waste services contribute the rest.

As is typical for retail innovators, Republic is now striving to greatly improve the car-buying and ownership experience for consumers. Republic announced in September 1998 that it was not going to sell cars the old-fashioned way in Denver. Under the Denver plan, Republic will switch to a one-price, no-haggle sales approach similar to the one pioneered by the Saturn division of the General Motors Corporation. But Republic goes further than Saturn. Republic's customers, the company announced, are to be offered "membership-style benefits that will give them access to a wide range of automotive retailing, service and financing options, along with vehicle rental discounts and other related products and services." As the program develops, Republic says it will "introduce an integrated e-commerce shopping alternative and a comprehensive customer service center." Republic plans to roll out the program nationwide to the more than 350 franchises it has acquired since 1995.

"Customers are tired of the high-pressure, low-satisfaction sales model," the company's president, Steven R. Berrard, said. "They want a simple, less time-consuming sales process. They want paperwork that's easy to understand. They want service that's done right the first time. They want a dealer who will stand behind the product, no matter where they travel."

Most vehicle manufacturers in the United States and Europe have done benchmarking studies of Republic Industries and AutoNation. Some, such as G.M., the Ford Motor Company, Mercedes-Benz and the Nissan Motor Company, have entered into formal franchise agreements or even business relationships with Republic. A few manufacturers, such as the Honda Motor Company, Toyota Motor Corporation and Nissan, resisted Republic's overtures at first in the courts and with state agencies. Yet each has come to terms in one way or another with Republic.

Much of Republic's progress so far resembles the natural evolution of retailing that has occurred in a host of other consumer-durables categories. In these categories, smart and aggressive retailers have created "category killer" formats that offer both lower costs and better selection. Examples of the "category killers" include Home Depot Inc. (home improvement products) and Circuit City Stores Inc. (appliances and consumer electronics). In fact, it was Circuit City that invented the CarMax Group, the first used-car superstore chain.

Our evaluation of the growth of these category-killer formats reveals that they are characterized by significant experimentation, not necessarily by great success and profits in their early development. However, once the format is perfected, these retailers rapidly replicate outlets across geographies. When observers look at the financial teething pains of Republic and argue that they are stumbling and will stop expanding, they ignore the lessons of the past.

The second stage of retail evolution is driven by the recognition, again usually by smart retailers rather than manufacturers, that consumers differ in the way they want to buy and own their products. This leads to the creation of multiple formats and distribution channels, each with tailored bundles of services and associated economics. These formats can coexist with each other over time, because consumers select the format best suited to their needs. These can range from exclusive brands and very high service to minimal service, a broad selection and low prices.

For example, Home Depot is attempting to capture additional market segments with new channels and formats, such as its Expo design stores, home installation services and Internet sales. In the consumer durables categories, the "category killer" format typically captures 30 percent to 40 percent of the market, leaving most of the rest spread among two or three other formats.

Republic appears to recognize these second-stage requirements, at least in used cars. In April 1998, Republic acquired Driver's Mart Worldwide Inc. The Driver's Mart concept is not the same as AutoNation's; it features more participation by the local operator, improved selling and reconditioning processes and smaller lots with lower inventory. Republic is also experimenting, through AutoNation, with a format called Value Stop (older cars, lower prices) and a dedicated center in Houston for used trucks, vans and sport utility vehicles.

The third stage of retail evolution involves changing the fundamental retailing paradigm. The prevailing paradigm in the automotive industry is that car companies design and build cars; their dealers distribute and service them. An alternative paradigm is that car manufacturers are in the business of creating economic assets that must be managed over the life of the assets to create and capture value. Leasing forces manufacturers to confront this new paradigm, and some creative automakers are beginning to think about how to exploit its value more fully. With its extensive business base and multiple automotive operations, Republic has the capacity to test and pioneer such new concepts. Republic also brings other critical elements to the party — an outsider's perspective and an innovative spirit.

To date, Republic has focused primarily on pursuing the benefits of consolidation typical in the first stage of retail channel evolution. But some of its actions suggest the potential for truly game-changing retail evolution. When channel players, as opposed to manufacturers, are the winners in retail evolution, most often the one that leads in the first stage is the one that leads in other stages and reaps substantial benefits. Republic could be the first in the automotive industry to create an independent retail brand that actually "owns the customer." SB

continued from page 6

leverage. Much larger savings are possible, however, by driving out inventory; reducing investment in brick-and-mortar and real estate investments, and optimizing the delivery of services.

4. Marketing and distribution will concentrate on establishing durable customer relationships. Customer acquisition costs are high and going higher; it is logical for manufacturers and their channels to work harder to hold on to the customers they have. We see these relationships developing on two axes: “follow the car” and “follow the customer.”

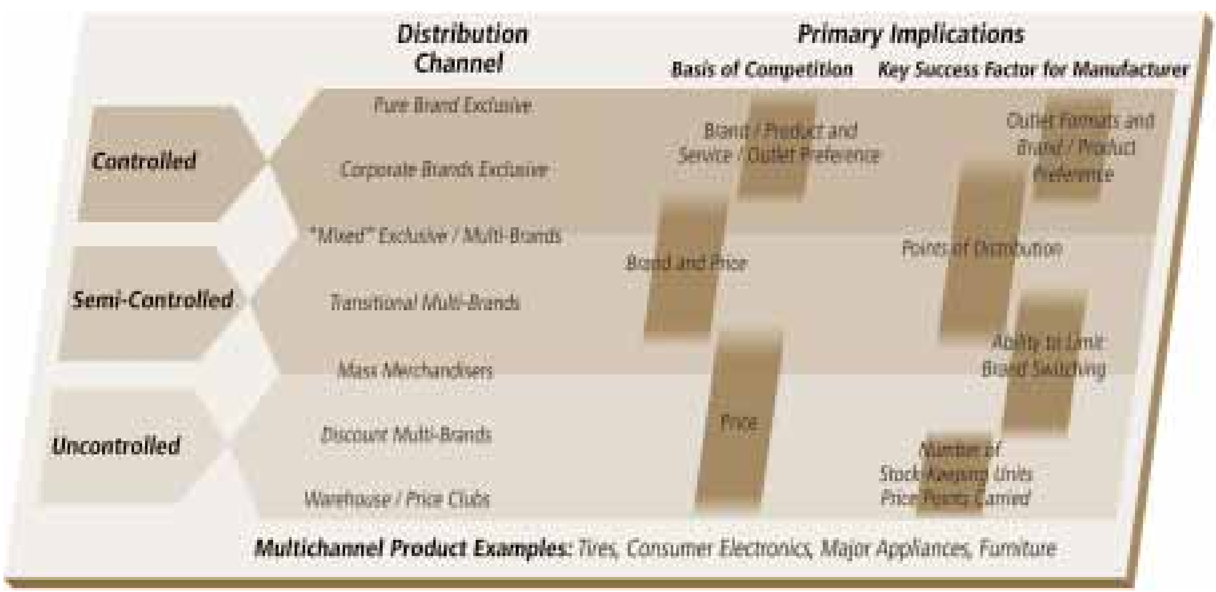
The “follow the car” axis will take manufacturers more actively into the second and third transactions in a vehicle’s lifetime. Used-car certification programs are a “follow the car” concept increasing in popularity today as a means of supporting initial sale prices.

The “follow the customer” axis means building more direct relationships with a targeted set of customers to define their needs, develop tailored marketing programs and stake out unique brand positions. Identifying these customers and keeping them happy will require substantial investments in market-understanding capabilities that go far beyond the functional, demographic and pyschographic information that most manufacturers study today.

5. Manufacturers will seek and attain much closer contacts with consumers. We have no doubt that someone will figure out the riddle of consumers’ needs, aspirations and experiences as they relate to cars; the tenuous part of this prediction is that manufacturers, and not other channel players, will get there first. Manufacturers are surprisingly — if not shockingly — cut off from their consumers today. Their dealer partners spend much of their energy figuring out ways to disguise the product-push allocation system in a way that conceals true market demand from the manufacturer. Manufacturers spend small fortunes on advertising, sponsorships, customer clinics and surveys but continue to introduce market duds.

Internet technology enables more effective and efficient direct contact between manufacturers and their ultimate customers. If, however, manufacturers fail to exploit this and other technologies to establish meaningful relationships with consumers, more powerful channel intermediaries

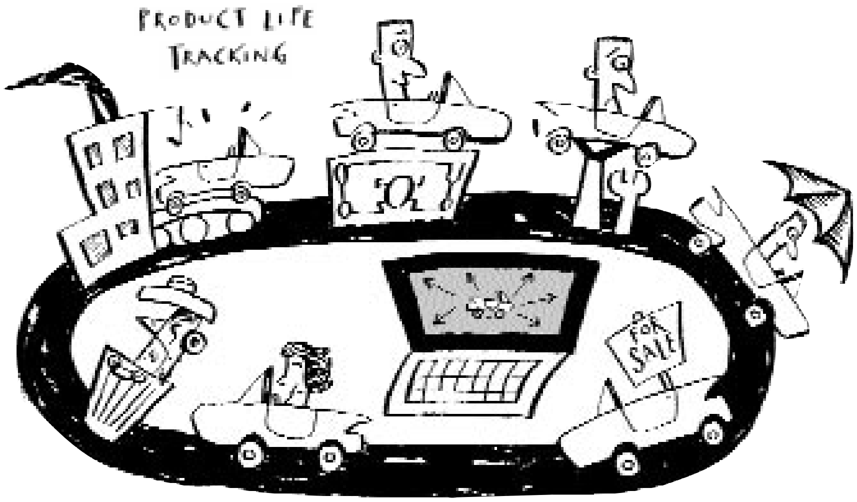
EXHIBIT III
IMPLICATIONS OF CHANNEL ALTERNATIVES



Source: Booz-Allen & Hamilton

will gain the upper hand and end up dictating customer needs to their suppliers — the manufacturers.

These transformations will not be easy, and many of today's players will fight them aggressively. But the revolution in automotive retailing has begun, and now that it is under way it will be impossible to stop and nearly as difficult to contain.



FORMING A STRATEGIC RESPONSE

Given this view of the future, what should a manufacturer or major channel player do? Appropriate responses are to some extent situation-dependent, of course, but we believe the three stages of channel evolution observed in other industries provide valuable insight into what is and will be required to prevail in the automotive industry.

In fact, first-stage channel evolution activities are rampant in automobile retailing in the United States and Europe, and second-stage changes have begun to emerge for used cars. We expect that participants who fall behind in this evolutionary process will suffer severely, particularly as more and more of the value creation and differentiation in the industry occurs downstream. The future winners in the automobile industry likely will be the ones that drive third-stage evolution.

Accordingly, we recommend the following strategic responses consistent with the three stages of channel evolution and the future automotive distribution vision described above:

1. Aggressively and systematically pursue functional improvement beyond the factory gate. The most prominent opportunity is cost.
2. Develop a vision of a desired end-game distribution channel strategy and begin making progress toward that vision, taking care to achieve consistency between the long-term vision and short-term functional improvement agendas.
3. Build the means to create and capture much more of the "downstream" value associated with the automobile — and, in so doing, strive to innovate "game-changing" approaches to the business.

FUNCTIONAL IMPROVEMENTS

In the conventional dealer networks, tremendous improvement opportunities exist along two basic functional paths: reducing costs and raising customer satisfaction. Most manufacturers and many large channel players are jumping at these opportunities, given their magnitude. However, these players tend to select a limited number of programs, and they typically concentrate on single functional improvements independently or on a single functional path.

A better approach is to address systematically the whole realm of possibilities with an integrated view of benefits within and across specific functions. This is not easy. Even programs with moderate scope and ambition typically require reforming entrenched business philosophies; coordinating several organizational groups with disparate incentives; managing complex and imposing legalities, and facing up to dealers resistant to change. But manufacturers must recognize that new players unencumbered by these constraints are raising the bar and traditional players must reach higher or fall behind.

Based on our experiences and analyses, we estimate that about 7 percent of the total cost to serve consumers, or nearly one-quarter of automotive marketing and distribution costs, can be reduced based on a typical traditional dealer operation. (See Exhibit IV.) The cost reductions derive from three sources:

1. The consolidation and rationalization of channel activities to achieve economies of scale and eliminate inefficient operations. Large numbers of small competing dealerships impose significant cost penalties.
2. The unbundling of dealer businesses, for instance used-car selling, to optimize the operating model for a specific business.
3. The application of best practices across outlets. Given the wide variation and the resulting large differences in efficiency and effectiveness in operations among dealers, the application of best practices is a powerful cost-reduction lever.

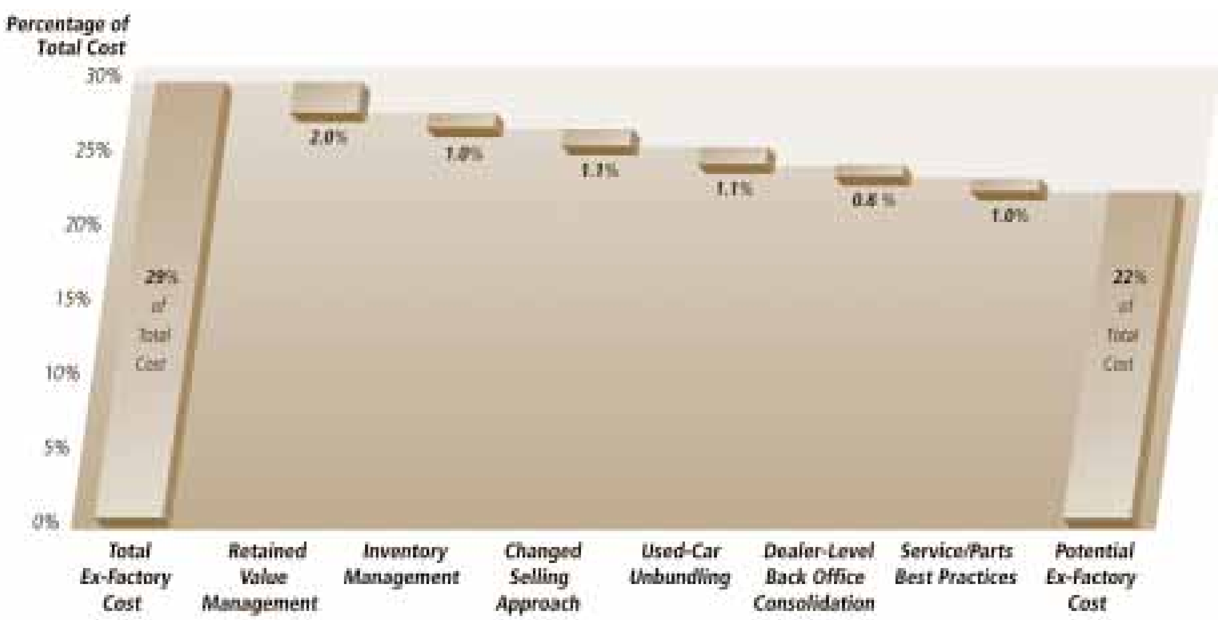
Here are some examples of potential functional improvements:

Reduce inventory costs. Dealers can cooperate among themselves and with the manufacturers to pool inventory in regional centers. Also, analytical methodologies, information-systems tools and best practices can be used to evaluate the dealer-level sales history to determine the best amount and mix of vehicles, including option packages, to hold in inventory. Finally, to improve future demand visibility and forecasting accuracy, dealers can use improved information systems and marketing techniques to track customer and sales-promotion information, lease-renewal marketing campaigns and historical data on sales-promotion effectiveness.

Leverage purchasing power. Dealers can also capitalize on economies of scale. The economies result from lower costs in areas such as financing, advertising, management personnel, payroll handling, insurance, supplies, administrative functions and parts purchases. The reported cost savings from these economies alone can be as high as 20 percent of a dealer's total costs. B.B. Hollingsworth Jr., chairman of Group 1 Automotive Inc., one of the leading consolidators in the country, says that his company has "discovered more economies-of-scale savings than [it] initially expected."

Manage used-car values. Most manufacturers today have some sort of certified used-car program, although the programs vary in effectiveness. These programs are critical to managing the risk of large losses

EXHIBIT IV
TOTAL EX-FACTORY COST REDUCTION OPPORTUNITY (UNITED STATES)



Source: Booz-Allen & Hamilton analysis

from inflated lease residuals that have become commonplace, and to minimizing the huge cost of incentives.

There is a direct link between the value of the used car and new car prices for the same model. In one case for two comparable high-end sedans, we found a difference of 8 percent in the used-car price between the make with a certified used-car program and the one without, despite the fact that they were priced the same when new. This used-car relative discount was then reflected directly in the new-car pricing differential between the two models in subsequent years.

Unbundle used-car sales. A large-scale operation designed specifically for used cars can achieve efficiencies relative to the conventional dealer's used-car format. These include economies of scale in areas such as advertising, management, personnel, facilities and systems. In addition, there is the obvious savings of a lower-cost location. Joint ownership and operation by dealers and manufacturers can make an unbundled used-car operation plausible for existing franchised dealers.

Use best practices to sell cars. The traditional selling approach for new cars is replete with cost (and effectiveness) opportunities. The car-buying process entails six successive phases: continuous, subconscious information intake; active, focused information collection; test driving; vehicle selection; purchase/negotiation, and post-purchase support. Manufacturers and dealers typically use expensive shotgun approaches

EXHIBIT V
SELLING PROCESS COST-REDUCTION OPPORTUNITIES

Phase	Trends/New Options	Cost Implications
Continuous, Subconscious Information Intake	• Event marketing to target specific consumer segments, e.g., Ford's attempt to target women and minorities • Trend marketing to build awareness, e.g., Audi loaning new cars to affluent individuals	• Reduction in advertising through mass media • Increase in more cost-effective targeted marketing • Overall reduction in advertising costs
Active, Focused Information Collection	• Traveling product display with computer kiosks, e.g., Chrysler Showcase/Plymouth Place; interactive information dissemination • Internet sites — vehicle manufacturer, dealer and third party for product information and lead generation • Referral/research services — Autobytel.com	• Reduction in sales force providing basic information • Less reliance/need for dealer advertising • Reduction in vehicle manufacturer field sales force
Test Driving	• Centralized to metro area, manufacturer-run lots • Expanded loaner fleet car operations • Conceivable to outsource to third parties (?)	• Fewer salespeople • Fewer assets tied to test driving
Vehicle Selection	• Internet and other interactive technologies to select options/features/colors/styling	• Fewer salespeople
Purchase/Negotiation Experience	• Currently, technology exists to handle all negotiation/paperwork including credit application, approval, warranty and signing through e-mail • Saturn no-haggle pricing	• Reduction in sales force and back-office operations
Post Purchase	• Lexus Web site — with special features for Lexus owners	• Increased efficiency in generating/influencing leads/decisions for future purchases

Source: Booz-Allen & Hamilton

to these phases; alternative, more cost-effective information exchange mechanisms are available for each.

These include information technology tools and approaches such as:

- Direct marketing databases
- Kiosks for interactive customer information exchange, vehicle selection, pricing, delivery-date promise, order checking and "soft offers" (warranties, financing, insurance, service packages, etc.)
- Internet sites for some of these same functions

Benefits include reduced mass-media advertising expenditures, more effective targeted marketing and reduced sales force resources for almost every phase of the process. (See Exhibit V.)

Use best practices in service and parts. Techniques for parts inventory management, service personnel staffing practices, service bay scheduling and repair and maintenance procedures typically vary greatly from one dealership to the next. Systematically identifying the differences and meticulously implementing revised practices results in an average parts and service cost reduction of 15 percent to 20 percent with only nominal investment.

Increase customer satisfaction. Customer satisfaction and loyalty are rich veins of potential functional improvement. Manufacturers' efforts are usually unsuccessful when they try to bribe the channel to improve customer service. Good performers in the channel end up getting paid for what they are already doing and the poor performers undertake short-lived, superficial steps to "manage the measurements." Customer service in auto retailing is mostly about executing the basics well — fixing cars right the first time, keeping commitments, offering conveniences like pick-up and delivery where feasible. Service advisors and computer-driven follow-up calls will not regain ground lost to sloppy execution.

DISTRIBUTION CHANNEL STRATEGY

Cost and customer-service improvements are necessary but not sufficient to transform auto retailing channels. Realizing the full potential of these programs is not possible without a reasonable view of the different customer segments that should be targeted; the appropriate mix and level of marketing and distribution functions needed for each segment, and the best portfolio of distribution formats and channels to reach the targets.

Just as specific groups of customers have their own product requirements, different consumer segments have their own requirements for the purchase and ownership experience. These requirements can be effectively targeted with channel, format and "soft offer" package variations such as service contracts, financing or sales incentives. Ultimately, the consumer-segment requirements will drive the service requirements and in turn help determine the best cost and operating structure for the specific distribution format and customer-value proposition.

Creating purchase and ownership experiences to meet the needs of specific consumers has two other significant implications. First is the need for parallel formats and channels in a given region, each with its own pricing and bundle of service offerings. Parallel sales channels can range from the traditional dealer to the Internet or to direct sales. Similarly, parallel service channels could be created through specialized quick-fix workshops, independent dealers and do-it-yourself stores/garages. (See Exhibit VI.) Parallel channels and formats raise the possibility of channel conflict and the need for expanded skills to manage and reduce it.

The second implication of serving multiple, service-based customer segments is the need to avoid cannibalization. For example, a Mercedes "A" class owner with a limited guarantee and no branded service must be recognized as such and managed appropriately. This requires a system for identifying and distinguishing the "soft offer" packages sold to individual consumers. Mercedes is testing such a system in the form of a chip card. The chip card stores a description of the "soft offers" purchased and requires an explicit payment for additional services.

Creating a more flexible and targeted mix of channels and formats will be hard to do. But it will also require manufacturers to collect continuous and rapid feedback for new retailing ideas and approaches, consistent with a strategic path that is flexible enough to change as the organization learns over time.

DOWNSTREAM VALUE CREATION

The biggest winners in the automotive channel evolution will be those that drive substantial value improvements by creating real innovations in the retailing of vehicles. In many other industries, distributors and retailers have driven and benefited from channel evolution at the expense of manufacturers.

The cost-reduction potential in the traditional network is huge. But even more exciting is that more than 90 percent of the profits associated with a car or truck occur after the first sale. Innovative ideas that tap this potential may well dominate the evolution of the automotive channel. Such innovations can be achieved by recognizing the causal drivers of the value and the linkages among them. This new life-cycle value paradigm represents one way that a leading-edge car company might approach the problem of creating value through its marketing and distribution activities:

- Most vehicle manufacturers offer a variety of "soft offer" services to complement their products — financing, insurance, extended service contracts and the like — in a standard package rather than crafting high-value bundles tailored to specific consumer purchase/ownership segments.
- Leasing is one of the best ways to package and market "soft offer" services, but manufacturers have also begun to rely on short-term lease programs to reduce inventory peaks (first for new cars but also increasingly for used cars).
- Many vehicle manufacturers have adopted certified used-car programs to support retained values as their lease portfolios and residual-value risk have grown. However, such programs are ineffective without a concentrated effort to manage the supply of both new and used vehicles.
- The need to manage supply leads to order-to-delivery initiatives. These offer two potential benefits: a reduction in new-car inventory levels throughout the supply chain, and, perhaps more importantly, sharp reductions in the cost of sales-incentive programs over the inevitable peaks and troughs of the sales cycle. But these benefits cannot be realized fully without managing

EXHIBIT VI
ALTERNATIVE USED-CAR CHANNELS

Format	Description
AutoNation	• Carries up to 1,000 used vehicles at each of its 26 locations • Initially offered 1- to 2-year-old, low-mileage cars • Expanding into older (more than 4-year-old) cars • No-haggle pricing • Amenities such as eating area and child play area
Car Max	• Three formats of used car superstores, with 400 to 1,200 vehicles on each lot • Focus on 1- to 3-year-old cars • Cars inspected and certified • No-haggle pricing • Emphasizes ease of process through use of its proprietary information system • Offers on-site financing • Cash offers for used cars • Can search inventory on the Internet
Driver's Mart	• Owned by a group of new-car dealers • Provides late-model used cars • Driver's Mart Superstores are franchised to the dealers • Emphasizes interactive, high-tech process in the stores
Drive 1	• Specializes in used cars less than $10,000, more than 4 years old • Startup chain, with franchises to be sold to new-car dealers • Stores will have 50 to 100 cars each • Franchises to be concentrated in strong used-car areas: the Midwest, South and Southeast
Independent Used-Car Dealers	• Sell a wider range of used cars in terms of age and mileage • No financing offered on site, referred to as buy-here, pay-here dealers • Typical customer has a limited credit history, low income or past credit problems • Smart Choice, a publicly traded group of buy-here, pay-here dealers, lost money in 1997
Auctions	• Some auctions open to the public

Source: Booz-Allen & Hamilton

used-car inventories as well.

- Similarly, order-to-delivery systems require more and higher-quality data about the state of the market through enhanced dealer systems that are especially critical to supporting selling, merchandising and promotions processes.
- The quantity and quality of information collected at the dealer interface level is key to developing and maintaining an actionable customer database and accompanying marketing-decision support systems, replacing the somewhat primitive socio-demographic data that most vehicle manufacturers rely upon today.

In the heavy-truck industry, the advent of full-service leasing ("power by the hour") was a game-changing shift in value creation and capture. Alternatively, the models developed to sell the Dell Computer Corporation's or Gateway's personal computers directly to consumers fundamentally altered the competitive arena in favor of the innovators. Our research indicates that a major portion of the leading companies in shareholder-value creation have innovated new models of distribution channels.[1] In some industries it has been a manufacturer (for instance, Dell), and in other cases it has been a retailer (for instance, Home Depot Inc. or Wal-Mart Stores Inc.). Notably, it is either one or the other, but not both, that has led the way and prospered, and it is typically a single company that captures the benefit. Most other competitors and partners suffer as a result.

What might such a game-changing revolution be in the automotive context? Marketing and selling extended-mobility service to consumers as opposed to pushing new cars? Life-cycle management of automobiles through multiple transactions? Selling cars and support services directly to consumers? We're not sure, but evidence suggests that only those companies that are experimenting with such innovative concepts have a chance to be the future leaders of the industry.

ANTICIPATED CHANGES

Change and innovation are the lifeblood of most retail businesses, but the automobile retail industry has been remarkably resistant to transformation. As a result, the industry suffers from an outdated and expensive channel, and most consumers feel short-changed and ill-treated in the bargain.

This situation is changing. Automobile retailing is evolving at an unprecedented rate. At one level the future implications are clear. These include multiple alternative formats and channels; greater unbundling of dealer businesses; increased value through the channels (improved service and selection at a lower cost); more emphasis on life-cycle relationships, and probably tighter relationships between manufacturers and consumers. Specifically who will win and lose is much less clear. The odds are not with the manufacturers, but the game is not lost. To win they must shake off old habits and practices and then visualize and implement revolutionary ways to sell cars. SB

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[1]Charles E. Lucier, Leslie H. Moeller and Raymond Held, "10X Value: The Engine Powering Long-Term Shareholder Returns," Strategy & Business, 3rd Quarter 1997, pp. 21-28.