

Income shift: Surviving the volatility of new car sales

The past five years have been eventful for most companies in the automotive industry. Soaring petrol prices and consumer concern about the environment have increased demand for fuel-efficient cars. Domestic motor vehicle manufacturers – locked into production of large, relatively fuel-inefficient cars thanks to the scale of investment in R&D and government support for the jobs they preserved – took a long time to turn the ship around, and watched in horror as large vehicle sales fell and import figures rose.



Almost two years on from the GFC, the motor vehicle industry in Australia continues to feel the pain. Notwithstanding the number of vacant car yards, competition remains high, global economic conditions continue to be less than optimal, securing finance has become even more challenging given the movement of the Big Four banks away from operational funding, and consumers are cautious about parting with their disposable income.

Those car dealers that built their empires on debt are now facing rough seas, as questionable decisions about their debt-to-equity mix come home to roost. Add to this the natural disaster in Japan – an international focal point of the automotive industry – and there is a recipe for challenging times ahead for all those vested in the motor industry in Australia. For dealers, the volatility of car sales underlines the importance of establishing and maintaining alternative sources of regular income to cover the fixed-cost base. To this end, service, parts and finance and insurance revenue have become critical to the ongoing viability of most dealers across the country.

In this edition of Ferriers Focus, we highlight some of the recent trends in the automotive industry, outline the key factors impacting the sector and identify the strategies

that can be implemented and key areas of focus for motor vehicle retailers in negotiating periods of financial difficulty.

Industry trends

Between January and July 2011, a total of 577,227 new passenger cars, SUVs and commercial vehicles were registered in Australia, representing a 5.8% decline compared with the same period in 2010.

Supply issues from Japan since the March earthquake and tsunami have had a big impact. Sales at the beginning of 2010 were also very strong, as Australia continued to emerge from the GFC and import tariffs were halved to just 5%.

Market share by brands – July YTD

	2011%	2010%	Difference %
Toyota	17.0	20.3	(3.3)
Holden	12.9	12.7	0.2
Ford	9.2	9.2	-
Mazda	8.2	8.8	(0.6)
Hyundai	8.0	8.7	(0.7)
Nissan	6.1	6.8	(0.7)
Mitsubishi	6.1	6.3	(0.2)
Volkswagen	3.6	4.1	(0.5)

Source: VFACTS



As economy and fuel considerations become more important in consumer's minds, the small and light car segments have grown commensurately. The small car segment alone now represents close to a quarter of total sales and in excess of 40% of all passenger vehicle sales, with small cars now representing seven out of Australia's 10 best-selling models.

The reduction to the large car segment is evident. Historically, this part of the market has been supported by subsidised fleet sales and a strong local manufacturing market. But fleet sales have changed. As employees become more transient, companies are less inclined to come in and buy 20-30 cars at one time, with the trend now for vehicles to be novated, with the employee taking on the risk and having greater say in the choice of model. With the growing popularity of smaller cars, this has swung the focus of fleet purchases away from the traditional large vehicles.

The relaxing of tariffs and the establishment of Free Trade Agreements, combined with a strong Australian dollar, have also had a significant impact, resulting in one of the most open and competitive automotive markets in the world – and one which is increasingly interested in smaller, more economical vehicles, no matter where they come from.

13,000 utilities and SUVs, and with the first diesel models now on the market in Queensland, those figures will grow. Chery is offering very low price-point models that will compete on the market with used cars, making the decision-making process for consumers more complicated.

While trend in new car sales is the commonly applied barometer in assessing the health of the motor vehicle industry, in reality the new car component of a motor vehicle retailer's business is more a means to an end as opposed to the primary contributor to profitability.

Key revenue elements

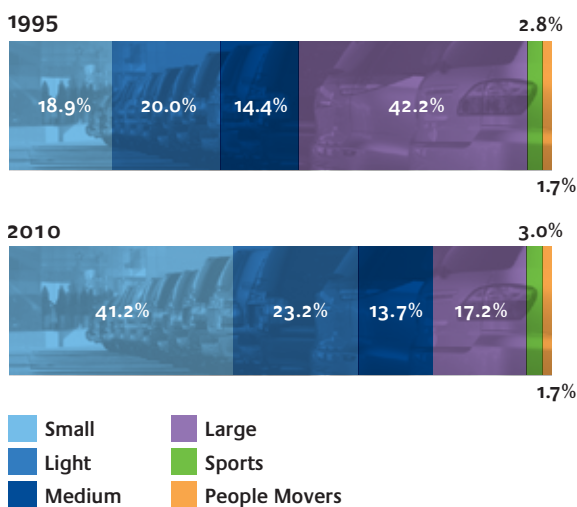
The business model for motor vehicle dealerships generally consists of five revenue streams:

- New car sales
- Used car sales
- Parts
- Service
- Finance and Insurance

Margins on new vehicles are minimal, with the industry average ranging somewhere between 7% and 9%. After overhead expenses are allocated, many dealers are actually losing money on new vehicle sales. Strong relationships with the manufacturers are essential as the ability to claw back some of this margin through holdbacks, marketing and advertising rebates and sales incentives from manufacturers are critical to the bottom line. While the margins on new cars of themselves do not appear attractive, a strong performing, high-volume new car department is the cornerstone of all strong dealerships. New car sales open the doors for the higher margin aftermarket and service areas whilst also providing opportunities for establishing relationships with vehicle financiers.

While used car sales are generally a smaller component of a dealership, the ability to be selective and effectively dictate the price at which the market is entered provides for higher margins than new car sales. Trends in used car sales are largely counter-cyclical to those of new cars, primarily due to economic conditions and consumer sentiment. An experienced sales force is critical to any used car department, particularly in identifying opportunistic buys from other wholesalers/auction houses.

Australian passenger vehicle sales

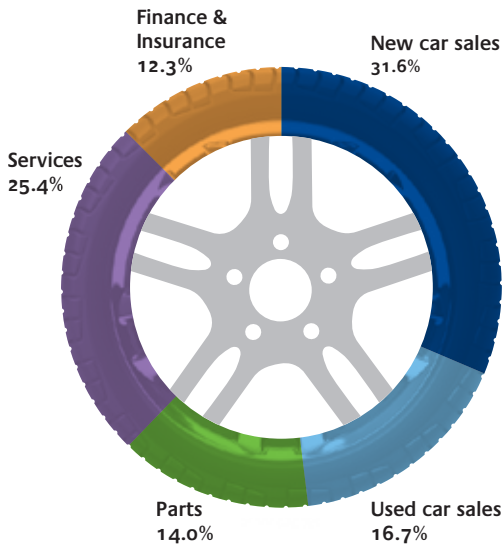


Source: VFACTS

Another new factor likely to have an impact on the local car market is the arrival of vehicles manufactured in China, such as Great Wall, Chery, Geely, Foton and Higer. In the two years since its launch in Australia, Great Wall has sold



Contribution to gross profit Industry benchmark



Source: VFACTS

Irrespective of trends in the market and economic conditions, one constant remains – anyone that owns a car needs to have it serviced. This was demonstrated during the GFC where gross contributions from parts and service departments generally held steady while vehicle department profits plummeted. This regular, more certain contribution clearly demonstrates the importance of building up strong parts and service operations in order to provide a buffer in volatile times. Astute dealers have long recognised this and have devoted more time to the so called “back-end” of the business.

The ability of parts and service income to cover fixed expenses of the dealership is particularly critical – most dealers target a 60% parts and service/fixed expenses coverage. In recent years, dealers have re-focused their efforts on being that one-stop shop for all service requirements, including tyres, body shop and full mechanical servicing with a view to maximising customer retention. The importance of the back-end business relies to a degree on the dealership brand. Volume brands are more reliant on service and parts to cover lower sales margins than the prestige brands where margins are higher and back-end revenue streams less critical.

While the conditions of many new car warranties require the owner to return their vehicle to the place of purchase

Key success factors

During 2011, the combination of weak consumer confidence, supply push for volume and the impact of natural disasters on production have created one of the most challenging periods for dealers. This combined with the transition out of floorplan financing by the Big Four Banks and tighter controls imposed by those financiers over financial information, security and covenants, further highlights the importance of both macro (strategic planning) and micro (operational assessment) management by dealer principals.

During such times of financial uncertainty, we consider that the key factors that both dealers, and their lenders should remain conscious of in fostering a business that remains viable both now and in the long term include:

- Critically assess the key management and sales staff and ensure they are appropriately incentivised.
- Robust “back-end” operations, focusing on competitive pricing and quality and timeliness of service in order to ensure customer retention and obtain new service clients.
- The dealership’s property footprint must be aligned to the scale of the operations – the holding costs of occupying excess property is too great a burden for any successful business, particularly in a weakened commercial property environment.
- Where there is a sound business case, expand the dealership to incorporate a broader range of brands/manufacturers, as this could enhance opportunities for obtaining finance.
- Regularly assess stock holdings, turnover and consumer buying patterns to ensure the right mix of product.
- Develop a marketing and advertising strategy that appeals to the target market (ie: electronic vs print) and is consistent with the manufacturer’s strategy in order to maximise the potential for subsidies/rebates.
- Ensure management information systems are being used to their potential in order to deliver accurate and meaningful financial reports.
- Use industry specific benchmarks, not the business’s own historical performance, to drive and monitor asset management, gross selling and operating expense levels.
- Prepare comprehensive and regularly updated financial forecasts in order to clearly identify areas of strength and weakness in the business and potential cash stress points.
- Promote a transparent dealer/financier relationship in order to ensure a healthy working relationship.

for a service, the ability to attract customers from other servicers can often be the difference between a profitable and loss-making business. Given the relatively low cost of labour, service departments should aim to operate at a GP of 65%-70% (industry benchmark) with mark-ups on spare parts ranging between 25%-30%. Given the extensive competition in the service area, pricing is fundamental to both customer retention and enhancing market share.

The contribution to total dealership profit of finance and insurance (F&I) is very significant. For a well balanced dealership, F&I should contribute at least 12% of total gross profit and may be a significant contributor to bottom line profitability. Research indicates that over 80% of vehicle purchases are financed in some form, and accordingly, trained and informed staff in this area are critical to a dealership in order to ensure that this income stream is optimised.

How we can help

Ferrier Hodgson is able to assist motor vehicle dealers and their financiers to:

- Better understand operational issues and the financial requirements of lenders.
- Review operating cost structure and the allocation of these costs to ensure that the financials appropriately reflect the contributions made by each area of the business.
- Assess business risk, identify underlying problems and suggest strategies to improve margins and performance.
- Understand the nature and magnitude of all costs related to holding inventory.
- Assist with the management of working capital to free up cash.
- Assist with the management of strategic and organisational change.
- Recognise the importance of quality financial information and management information systems.
- Provide a guide for responsible management during times of financial distress.

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