IMPACT OF BLOCK EXEMPTION ON CAR DEALERS

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EU Regulation 1400/02

The latest revision to the Block Exemption regulation set a new framework for the operation of vehicle franchised networks. The regulation established from October 2003 the following core changes:

1. Dealer contracts are now split into three: sales, service and parts with no requirement that a dealer holding one has to hold the others.
2. Most carmakers can no longer designate dealer territories
3. Dealers can sell multiple brands in the same showroom
4. Service dealers (authorised repairers) are admitted into the network on the basis of meeting defined standards (qualitative criteria). Manufacturers can therefore no longer control the size of their service network by quantitative selection.

1400/02 also stipulated that from October 2005 a dealer holding a sales contract can set up one or more additional delivery locations for that make anywhere in the EU. These additional locations can be required to meet relevant standards but may be multi-franchise.

Manufacturer Response

Manufacturers were required to go through a major revision of all their dealer contracts in the EU, including those markets that were joining the EU in 2004. They also revised their dealer standards.

Many makes used the issuing of new contracts as an opportunity to restructure their dealer networks. 1400/02 makes it tougher for manufacturers (or their national distributors) to fire dealers and grants dealers a longer period of notice. So this was a last chance to winnow out weak or surplus dealers. As we will see below, the result was that the mix of Europe’s dealer population shifted considerably over this 2-year period of change.

Problematic for the manufacturers was where to pitch their new dealer standards. If service standards were too weak, many new entrants might apply to join their authorised repairer network, taking business away from their core dealers. If the standards were set higher, to deter unwanted applicants, then existing dealer might struggle to bear the cost.

Manufacturers still have quantitative control over sales outlets but showroom standards now have to factor in the prospect of sharing with other car brands. In addition, what standards should apply to the additional delivery locations? Full showroom standards or something different? Collectively, the manufacturers rather hoped that the ‘location clause’ would not be implemented in 2005. In the end, they failed to find any effective grounds for having it dropped.

Individual makes have responded to 100/20 in different ways. Some have tried to perpetuate as much as possible of the ‘command and control’ spirit of running the franchise. The result has been complex standards that have left many dealers gasping for breath. Alongside changes in standards, many makes also revised dealer margin structures. Nominal margins for dealers have been declining anyway from the heyday s of 18-20%. Most new cars have effective margins of 10-14%, depending on bonuses. Actual retained gross margins are rarely above 8%.

Other makes, with a more sympathetic approach to the partnership with dealers, have been less fussy with their standards. Among the 38 major brands on sale in Europe, many have enough problems recruiting and retaining good dealers. For them, dealer viability was of as much, if not more, concern than control.

Manufacturers have been rightly concerned to protect the technical integrity of their franchise and their products, especially in the service workshop. On the other hand, there has been no haste in meeting another requirement of the regulation: to make technical information quickly and easily available to independent workshops.

As the dust settles on all the changes wrought by the new Block Exemption, some makes are quietly re-examining some of their standards and margins. They have also generally softened their attitude to multi-make dealer groups – these typically operate a portfolio of single-franchise dealerships of various makes. Not only does the new regulation abolish the manufacturer's veto against one of its dealers taking over any other of its dealerships, but also manufacturers are more keen to have groups help to fill vital open points.

Dealer Response

During the flurry of contract changes, dealers were not in the driving seat. At best, they could decide whether it was worth continuing with a franchise under the new terms. However, the point of the new regulation was to give dealers more freedom of action and more independence from the manufacturer.

In practice, dealer response to these new opportunities has been muted:

1. Most dealers are small businesses. They do not have the management or financial resources for new ventures. They rely on the support of their manufacturer and know that it is not a good idea to be on the 'bad boy' list, whatever their new legal protections. Many are innately conservative, used to surviving the ups and downs of a fickle car market.
2. Larger dealers and dealer groups have mostly held fire, adopting a 'wait and see' approach. They see it as being in their best interest to be good corporate citizens within the franchise. This is not to say that they will not use their enhanced power at a later stage. Many are focused on expanding sales of used cars independently of manufacturer control, either through their dealerships or their multi-make sites (actual and on the Web). Used car trading is generally more profitable but it is riskier and requires more talented management.

The number of dealers who have so far completed the application process to become additional authorised repairers appears to be low. Some franchises have been more encouraging than others. The cost of entry for the more desirable franchises can be significant.

Dealer Population

The precise total of actual dealerships in Europe remains unknown, due to uncertainties about the extent of multi-franchising. The following data, covering the 38 car brands accounting for over 98% of new passenger vehicle sales, is based on totalling the franchise points of all the makes separately. At market level, the physical population of franchised dealerships is some 16% to 20% lower.

Net Total of All Franchised Outlets – West Europe	
January 2003	105,150
January 2004	100,907
January 2005	104,434[1]

The rise in total outlets 2004/5, to a level close to that of 2003, is at first sight surprising. This phenomenon is not common across all markets. Germany accounted for more than half of the net gain in West Europe, while the French total declined:

Franchised Dealer Points Change 2004 to 2005	
(38 Makes)	Total Net Outlets
Germany	1,881
Italy	785
Spain	408
UK	328
France	-122
West Europe (16)	3,522
Central Europe (16)	648
EU (24)	4,469

[1] The 2005 figures pre-date the demise of the MG Rover franchise in April 2005. Some of the 1,361 abandoned dealers have taken up other franchises, others not.

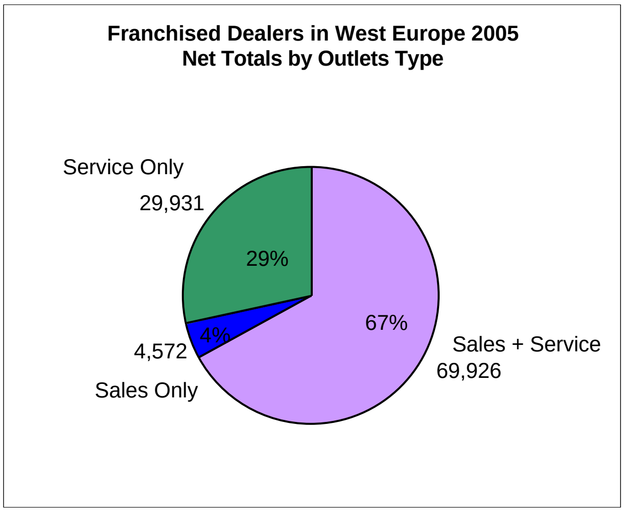
Within each market, the overall dynamics of the dealer population mask the differing trajectories of the various car brands. As might be expected, Korean brands such as Kia, Hyundai and Chevrolet are expanding their network coverage. Yet the dealer numbers for Ford, Seat and Opel have grown too:

Change in Net Total of Franchise Points (Sales/Service) in the EU 2004 to 2005			
Make	Variance	Make	Variance
Kia	734	Mini	242
Ford	686	Renault	209
Seat	432	Hyundai	163
Daewoo Chevrolet	379	Mercedes Benz	156
Daihatsu	311	Suzuki	154
Opel/Vauxhall	264	Smart	127
Skoda	262	Lancia	124

The EU dealer totals have declined for Peugeot (-175), Fiat (-167), Nissan (-156), Audi (-48), Land Rover (-42) and Mazda (-27) over the last year. For all other makes there has been a net increase.

Part of the answer lies in the shift from multi-purpose sales/service dealer outlets to single purpose outlets offering sales or service, but not both.

By the start of 2005, two thirds of Europe's dealers still combine sales and service but the total has declined by nearly 2% since 2004.



Sales-only outlets remain relatively rare but increased by 50% since 2004. Service-only dealers increased by a larger numerical amount that added 12% to the total.

Among the major markets, Germany saw a major growth in service-only points over the last year, mostly due to more sharing of more outlets by Audi and Volkswagen (the net total of outlets changed much less). The UK was least affected, with a slight growth in service-only outlets.

Change in Outlets Types 2004 to 2005			
(38 Makes)	Sales + Service Outlets	Sales-Only Outlets	Service-Only Outlets
Germany	-403	155	2129
Italy	-979	813	951
UK	2	33	293
France	-109	93	-106
Spain	935	176	-703
West Europe (16)	-1190	1548	3323
EU (24)	-450	1707	3371

Demise of the Sub-Dealer

Many of today's service-only dealers are either former sub-dealers promoted to main dealer status or former full main dealers that have lost their sales contract.

Sub-dealers are garages within the franchise whose contract was with a main dealer, not the manufacturer or importer. Mainly to be found in rural areas of southern Europe, they traditionally have handled a large proportion of authorised servicing but a much smaller share of new car sales. They had long disappeared from the UK and few luxury brands or new entrant Asian brands have bothered with them. The Block Exemption restructuring has accelerated the decline of the service sub dealer. Under the new contract structures, most makes prefer to have a single standard for authorised repairers.

West Europe's population of service sub dealers crashed from 54,903 in 1999 to only 21,558 today. During the recent cull, those not promoted to main dealer repairers (about half of them) lost their franchise. Some became independent garages, a few took on another make, and the remainder ceased trading.

Under the new contract structures, authorised repairers who have do not have a sales contract still handle a proportion of new car sales. Those with official agency status (the new car is supplied and invoiced by the main dealer, not the agent who negotiated the deal) are counted in the sales point totals. Others have more informal arrangements with official sales dealers.

In France, led by the domestic brands, sub-dealers still account for around half of all franchised sales outlets and service outlets. In Germany, the service sub-dealer has all but disappeared but many authorised repairers sell new cars on an agency basis. In Italy, the proportions are almost inverted. Historically, Italy consolidated its main dealer sales network some years ago, but main dealers still rely significantly on sub-dealers to service the cars they sell. Spain has a large remnant of sub dealers but in the UK the sub-dealer population has all but disappeared.

	Sub-Dealer Sales Agents as % of All Sales Outlets	Sub-Dealer Service Agents as % of All Authorised Repairer Outlets
France	50.3%	46.4%
Germany	28.7%	8.6%
Italy	14.4%	43.7%
Spain	38.0%	22.6%
UK	4.4%	2.3%

Impact on Customers

Car buyers already have an unprecedented choice of make and model – and the Chinese and Indians brands have yet to come – and this should not change in the medium term. The current dealer system also means that they have a very wide choice of available specifications that can be supplied to order. This compares favourably with electrical retailers who stock a handful of brands but at the expense of having much choice of model type.

It would be surprising if the customer has noticed much difference in car buying or servicing since the new Block Exemption came into force. This is to be expected. The regulation was designed to promote evolution, not revolution. Think glacier, not earthquake. So we must look further into the future.

At ground level, property transactions, planning permits and a host of other delaying factors inhibit rapid progress in dealer redevelopment. Nevertheless, Europe's dealers are being encouraged to invest in new, often larger facilities, as they are in other parts of the developed world. With most franchises adding more niche models, more space is needed to display the full range. Over time, European customers will note that there are fewer car showrooms, probably smarter and larger, and they will have to travel farther to buy a new car. They can compare prices on the Internet but they will have fewer chances to play off one local dealer against another for the best trade-in deal for a particular new car.

Franchised service dealers will remain much more common, so customers will not have to travel too far from home for authorised service or repair. Labour rates will continue to rise, as dealers face higher operating costs to meet new standards and qualified service mechanics remain in short supply. Average service bills will not rise as quickly, however, since new cars require much less maintenance than their predecessors. (In contrast, repairs to older cars will become more expensive, even though most of these are carried out by the independent sector.) More dealers will take on one or two additional service franchises – more than this will probably prove too complex to handle.

The key factor driving change over the next 5 years will be economics, not the regulation. Dealers are struggling to survive under the old business model. The Block Exemption has, indirectly, raised dealer operating costs. Fierce inter-brand competition will continue to keep new car prices and margins down.

The major 'waste' factor in the cost of new car distribution arises from difficulties in matching supply to demand. These problems are more likely to be solved within the franchised system, though neither dealers nor manufacturers are achieving much profit on new car sales.

Multi-franchise showrooms will gradually become more common in the larger markets (they are already much more prevalent in smaller markets), as some dealers are forced to spread overheads across a higher throughput. So the change will be most noticeable in metro areas, among the showrooms of lower volume makes.

To combat this trend, some major manufacturers will continue to take direct ownership and control of dealerships in key locations. Unlike the US, the EU allows manufacturers a free hand to retail new cars in competition with independent dealers. In 2005 manufacturers controlled 1,335 dealers in the EU (2.4% of main dealer sales outlets). A further 1,062 belong to their independent national distributors but total volumes handled by these distributors account for only 10% of new car sales in the EU.

The number of factory-owned stores is likely to rise, as manufacturers find they have to rescue insolvent dealers in key markets, but large increases are not expected under the current Block Exemption. Some makes have a policy to only use independent dealers where possible, others cannot afford the investment. From the customer point of view, the difference between a factory-owned and independent dealer is not obvious. CSI scores indicate that factory stores achieve only average ratings.

Outlook for the Next Block Exemption

The current Block Exemption expires in 2010, so discussions over its successor will start within the next 2 to 3 years. The EU Competition Directorate would prefer to have no special case for vehicles. If the general rules for vertical integration were applied, manufacturers would lose quantitative control over their retail networks. However, such an outcome would reflect the regulators' philosophical bias rather than the realities of the marketplace. Factors relating to the single market arguably should not overshadow other issues about the efficient provision of customer choice and good service within each market.

It is hard to find a robust economic or consumer argument against the continuation of the dealer system. Inter-brand competition keeps prices and margins down; new brands have easy access to the market. Large numbers of new car buyers already use the Internet to compare specifications and prices. So the virtual multi-brand car superstore already exists on-line, for new and used cars. Moreover, the dealer system operates under benign regulations in all other parts of the world, where there are no 'single market' issues and therefore no need for a Block Exemption.

None of the EU Directorates have shown any interest in protecting independent dealers as small enterprises. For example, should manufacturers be permitted to sell cars to fleets and rental companies at prices below those they charge to their own dealers? Even the termination of dealer contracts is subject to varying national laws - it is much harder for a manufacturer to fire a German dealer than a British one. Smaller dealers have enough problems sustaining a viable business in a highly competitive and often unstable market. It would be a pity if future regulations favoured large companies and dealer groups.

Both dealers and independent garages appear to be facing a growing shortage of qualified mechanics in Europe and the US. Manufacturers could usefully be encouraged, through their dealers, to expand their support for training initiatives, as they are in the US.

Among consumers, opinions on new car dealers are mixed. Satisfaction ratings of dealer sales and service departments across the world tend to compare well with other types of retailers, even though car buyers probably have higher expectations of customer service at a dealership than at a supermarket. Active value-driven shoppers might think they would prefer a market without the restrictions of the franchise, but many others value the reassurance of the manufacturer standing behind its dealers.

There is still much inefficiency in parts distribution for the after-market, where the main value of the market lies increasingly in parts for older, used cars or in supplies to accident repair bodyshops. Parts logistics remain sub-optimised and dealers are still encouraged by manufacturers to carry much more stock than necessary. For independent repairers, achieving US levels of access to for technical information and diagnostics would be beneficial to the market.

It might be assumed that car manufacturers are huge monoliths that can easily cope with the complexities of new regulations affecting dealers. In practice, their central network planning departments are generally under-resourced and in any case a large share of the burden of adapting to 1400/02 fell on their small national distributor companies across the 25 EU markets. Given the importance of effective car retailing to their bottom line, manufacturers arguably should invest more in boosting their retailing expertise and dealer support systems at European and national level.

At dealer level, the new contracts and new standards arising from 14400/02 added an unwelcome level of uncertainty and complexity. Their hope will be that any changes in 2010 to BER will not be as disruptive to their businesses.

The Competition Directorate has commissioned an independent econometric study on the impact of 1400/02, due to be published in spring 2006. It will no doubt influence what happens to Block Exemption in 2010, so we await its arrival with great interest.

Dealer data in this paper comes from the 'GMAP European Car Distribution Handbook 2005', researched and published by HWB International Ltd, sponsored by GMAP Automotive.

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