Changing Times: A Look at Trends Impacting Canadian Automobile Dealerships and What it Means for Insolvency Professionals

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The COVID-19 pandemic brought about monumental changes to how we live and work as a society, affecting every business in some way, shape or form. The automotive industry was particularly impacted and continues to face considerable headwinds and uncertainty. The initial lockdowns and work-from-home opportunities practically eliminated many consumers' need for an automobile for an extended period and restricted dealerships' ability to sell cars the traditional way (through showrooms).

By the middle of the pandemic, the story changed for automobile dealerships. Historic government stimulus flooded the marketplace with liquidity. The prevalence of remote work caused an exodus of residents from the downtown core. Canadians eschewed public transportation, preferring to drive to work to avoid close contact with others. Demand soared in the market for both new and used cars.

As the world re-opens, auto-makers and dealerships continue to struggle to satisfy consumer demand because of well-documented supply chain disruptions resulting in limited supply and delayed stock of inventory for dealerships. The disruptive force of technology, particularly electric cars and e-commerce, threaten to compound the challenges that the pandemic caused for the automobile industry. Dealerships have had to adapt to this "new normal", and there will undoubtedly be winners and losers.

In this article, we explore some of the challenges that Canadian automobile dealerships have experienced since the pandemic, while looking ahead at what is to come and considering the implications for insolvency professionals. In preparation for this article, we interviewed business owners and industry stakeholders to get a "boots on the ground" account of the commercial reality that auto dealerships face. The insights we gained from these interviews lead us to believe that opportunities will certainly arise in the automotive industry.

INVENTORY MANAGEMENT WOES

One of the great surprises of the pandemic's early days was the explosion in demand for consumer goods, including automobiles, as the lockdowns eased. Initial fears of inventory gluts and dealership insolvencies were replaced by stories of frenzied demand and price increases. This spike in demand was soon aggravated by the semiconductor shortages and supply chain disruptions that have dominated headlines for the last 18 months. Some manufacturers had an early advantage due to more integrated supply chains, but inventory shortages have since become a universal challenge for dealerships.

Similar dynamics are at work in the used car market. As new vehicles became harder to find, cash-rich consumers turned to used vehicles, driving the average price of a used vehicle up by more than 14% from 2019 values. Used vehicles in recent months have bizarrely begun to appreciate in value. The combination of increased demand and lower trade-in volumes has led to reduced inventories at dealerships.

Inventory shortages have forced dealerships to adjust their business models. Historically, North American dealerships relied on large, well-stocked lots and glittering showrooms to attract customers. Dealerships centred their operating models on a spectrum bounded by margin and volume; the dealership made money by either selling fewer units at higher margins or

more units with steep discounts. At the core of this decision was the customer: customers had infinite selection and would shop around for the best deal, fiercely negotiating discounts.

COVID turned this model on its head. Customers no longer have the option of going across town for a better deal. Inventory has become a flow-through; dealers desperately vie for allocations of manufacturer shipments that may or may not arrive, and what vehicles they do secure are subject to sale agreements long before they hit the lot. The financial impact of this change has been to force dealers to the 'margin' end of the spectrum – there are no deep discounts and no carrying costs. The strange result of this change is that many dealerships find themselves in a better financial position than before COVID.

CUSTOMER RETENTION / ACQUISITION – A NEW MODEL

Our interviews revealed a dynamic shift in customer acquisition and retention strategies. Traditionally, dealerships covered a particular automobile brand within a geographic segment. Foot/car traffic was an important driver of new customers. The traditional dealership model already faced disruption with the rise of e-commerce (think Tesla), and the pandemic accelerated and exacerbated that trend as lockdowns and the post-pandemic world practically eliminated foot/car traffic.

With the supply chain shortages causing a significant reduction in available inventory, customer buying habits are also changing. Our interviewees reported a significant uptick in "out of region" customers inquiring about specific inventory, and customers doing significantly more of the "marketing leg work" to educate themselves about the different options. Well-researched customers often contact or visit a dealership knowing exactly what they want, and what's available. This has led to a need for dealerships to make significant investments to bolster their e-commerce platforms. Suddenly, a user-friendly, accessible website is paramount to generating sales, and dealerships that fail, or have insufficient resources, to enhance their e-commerce capabilities and online presence may find themselves with precipitously declining sales.

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While the geographic expansion of potential customers for dealerships is, in some ways, a "good problem" to have, dealerships view this trend as temporary, maintaining that their core customer base remains primarily local. Dealerships reported focusing their business development efforts "inward", with a preference towards ensuring inventory remains available for the dealership's current customers when their lease or financing expires.

For insolvency professionals, these changing dynamics in how dealerships acquire and retain customers, and how cars are marketed and sold through e-commerce, represent significant shifts in the business model that dealerships must accommodate in order to stay competitive.

THE ROAD TO RECOVERY

As profitable as the last year has been for many dealerships, the COVID model is unsustainable. Prices cannot continue to increase without pushing customers out of the market, and dealerships can only rely on their existing customer base for so long. Looking past COVID, there are a number of significant changes on the horizon that will have a profound impact on the industry.

The first of these is the shift towards electric vehicles (EVs). While internal combustion engine (ICE) vehicles will continue to make up the majority of auto sales over the next 10 years, particularly in North America, dealerships will need to start adapting now. This shift will have an outsize impact on service operations, which dealerships rely on to fund working capital. Not only will technicians need a new skillset, shifting from mechanic to programmer, but the layout of service bays will need to change. At weights often exceeding 1,000 lbs, EV batteries require a forklift for removal – something most dealerships haven't had to accommodate. The frequency and nature of maintenance and repair work on EVs will also change a dealership's working capital base.

In addition to improvements required to accommodate EVs, our interviews suggest there are a large number of older dealerships in Canada that will require significant capital investment in order to bring showrooms and operations up to modern standards. This investment pressure takes place against a backdrop of uncertainty, as dealerships and automotive brands try to determine how broader societal pressures will impact the dealership model. While recent moves by the federal government to allow the immediate expensing of depreciable property will facilitate investment, many smaller dealerships with older ownership will be reluctant to lay out capital. This, combined with increasingly acquisitive dealership groups leaves the industry ripe for consolidation. The recent acquisition of the remaining dealerships in Ontario of one luxury car brand is a prime example.

Whenever an industry faces structural changes to its business model, existential threats, disruptive forces and consolidation, expert advice from an experienced restructuring professional becomes critical. In the near term, our interviews reflected continued economic strength and elevated demand for automobiles. However, we believe the headwinds we identified through our research – the need for infrastructure investment, technological disruption, changing business models and sales strategies – will undoubtedly result in certain challenges, in particular with dealerships that have historically relied heavily on a high-volume, low margin business model.

As demand softens and the effects of those headwinds take hold, restructuring practitioners should expect auto dealerships to be among the many industries where they can work closely with management to ensure that their business models keep pace with the quick-evolving landscape in the market for automobiles. Whether this means deciding among various restructuring alternatives, facilitating distressed M&A transactions or assisting with the implementation of cost-saving measures, there will undoubtedly be opportunities for restructuring practitioners to add value to the automobile industry.