Get Back

To Maximize Profit with Inventory Low and Prices High, the Back End is the Place to Start

BY GARY BISKUP

Independent auto dealers are facing some interesting market challenges these days.

A recent email from a client summed up the situation:

Dear Gary,

I'm barely breaking even. Can you help?

Between rising pre-owned vehicle prices and lack of inventory, my unit sales and profit margins are shrinking. I can't compete with large auto groups to pay thousands over normal market price for vehicles at auction.

While I used to sell at least 50 units a month, I'm now down to having barely 10 units on my lot. Increasing the cost of the vehicle to make ends meet prices most of my consumer base out of the market. I'm getting squeezed on all sides.

What's your advice?

Signed – Concerned Independent Dealer

There is cause for concern these days. Independent and franchise dealers alike are experiencing market forces largely out of their control.

But there are many things a dealer *can* control to maximize profit potential across the board and on each sale.

Let's break it down into manageable pieces.

INVENTORY CHALLENGES AND OPPORTUNITIES

According to data and analysis from Manheim, while wholesale used vehicle prices fell slightly in August, they rose again in September to another record high. The Manheim Used Vehicle Value Index reached 204.8 – 27 percent higher than September 2020.

JPMorgan estimates the supply of new cars won't fully normalize until mid-2022, and Cox Automotive predicts the microchip shortage will continue to plague the auto industry until at least the beginning of 2023.

With a lack of new inventory, higher than normal used vehicle prices are here to stay for the foreseeable future. That makes it more important than ever for independent dealers to stay informed and aware of market fluctuations and to respond accordingly and rapidly.

If auction values decrease, dealers will have more leeway to decrease their own pricing to increase their profit margins on the back end.

If levels remain tight, stock those vehicles you know you can turn quickly. A great deal at auction quickly becomes a bad deal on the lot when it sits for 40-plus days.

PRICE ELASTICITY IS NOT A ONE-WAY STREET

With fewer vehicles for sale, it's tempting to follow the crowd and raise the price on each unit.

The math seems simple enough. You paid more for the vehicle at trade-in or auction, so you need to sell it for more to recoup your money and maintain your margin.

Consumers see fewer available vehicles and they're hearing reports of rising prices, so they'll be willing to pay more. Plus the competition down the street raised its prices, so why not raise yours?

Free enterprise says price what the market can bear – right?

There are, however, a few flaws in that thinking.

Consider this all-too-common scenario.

To make up for lost income, an independent dealer marks up vehicles $3,000-$4,000 above the NADA value. Once set, they dealership does not budge, does not negotiate and takes a "take it or leave it" approach with its customers.

After all, dealers are secure in knowing customers simply won't find a better deal when everyone is taking the same pricing approach.

So what are the flaws in that scenario?

Fewer finance options: Let's start with fewer financing options with high loan-to-value ratios.

According to Experian, auto lenders are requiring lower LTVs. Its latest State of the Auto Finance Market Report shows while used vehicle values rose in the second quarter of 2021, the average used vehicle LTV dropped 10 percent year-over-year.

When broken down by risk tier, LTVs dropped 8.34 percent in the deep subprime category and 9.17 percent in the subprime category.

How is that possible?

Simple. In order to qualify for an auto loan on a higher-priced used vehicle, customers must significantly increase their down payment and/or roll over little to no negative equity into the vehicle purchase.

Additionally, little to no finance products can be included in the financing.

With the majority of consumers still paying off their current vehicles, working with negative equity has become a way of life for most dealerships.

But wait, you might say. The consumer savings rate increased in 2020. We all saw headlines about shockingly high personal savings rate statistics.

Unfortunately, according to the World Economic Forum, NextAdvisor and *Time* magazine, poorer Americans are still spending nearly as much of their money as before the pandemic.

That means despite federal stimulus packages, non-prime consumers are in no better position now to afford a high down payment on their vehicle than they were before the pandemic.

Additionally, they most likely were unable to reduce the negative equity in their current vehicle at the same rate as prime or super-prime consumers.

So if we go back to our scenario, as lenders tighten their lending requirements with lower LTVs, those subprime and near-prime consumers with negative equity simply cannot secure funding.

In fact, those LTVs barely cover the cost of the vehicle itself, meaning deep subprime consumers will find it that much more difficult to qualify for funding.

Shrinking consumer base and profit margins: Now think about how fewer finance options affects your consumer base and back-end profit margins.

By pricing many subprime consumers out of the market, implementing an inflated vehicle pricing model significantly reduces the pool of potential buyers. That places independent dealerships in more direct competition with franchise dealerships, which offer larger inventories for those prime consumers.

Additionally, even with prime consumers, LTVs are still falling. In fact, according to Experian, super-prime consumers experienced the largest decline in LTVs at 12.4 percent.

That means vehicle values have become so inflated that in some cases dealers don't have room to add consumer protection products on the back end.

Poor customer service: Between the inflated prices of vehicles, lack of available funding options and limited consumer protection options, the customer service experience suffers tremendously under the current model of prioritizing front-end profit.

Put yourself in your customers' shoes.

Aside from the sticker shock, the finance conversation starts off pretty rocky when they discover how much more of a down payment will be required to secure funding and keep the monthly payment affordable.

At the end of the day, the taste in their mouth has most likely soured from one of excitement to one of annoyance and frustration.

How likely do you think they will be to return to you for their next purchase, or refer you to their friends and family?

Under the current scenario, they have no reason to do either. That further harms the dealership's reputation in the community and hampers customer retention.

But that's not all.

Repeat purchase disruption: As a final caveat to our scenario, those subprime consumers who buy inflated vehicles today will be in a much weaker position to buy their next vehicle in three years.

Between now and 2024, used vehicle prices are expected to return to normal, meaning their trade-in values will be significantly reduced and negative equity will jump up.

That could force many consumers out of the three-year buying cycle, disrupting your repeat business model.

That long-range planning might seem like little comfort now, when inventory, sales and profits are down. But taking the long view is strategically smart.

Essentially, by jumping on the inflated vehicle price bandwagon, independent dealers are cutting off their nose to spite their face – and leaving a significant amount of back-end profitability on the table.

A BETTER APPROACH TO PROFIT

Clearly, dealers need to make a profit on each sale. But rather than increasing the sticker to the top of the market, consider adding $1,000 over invoice to the price.

Now you might be thinking, "The invoice is still inflated, so why would I reduce my profit margin that much?"

There are several reasons.

Moving metal: Think about how the inflated vehicle pricing model impacts your inventory.

Do you have vehicles that have stayed on your lot for more than 30 days? You can't make money on a vehicle you can't sell. Reduce the sticker price simply to move metal.

Increasing your pool of buyers: By taking a more deliberate approach to pricing, independent dealers can ensure their inventory can be financed within a broader range of credit tiers, enabling dealers to maintain their corner on the subprime market.

The competitive advantage: A lower pricing model also provides a competitive advantage over franchise dealers to draw in those high-demand consumers.

Back-end profit margins: Reducing the profit margin on the front does not mean giving up on the profit margin altogether. Rather, this approach supports back-end profitability.

With lower LTVs, vehicle pricing adjustments need to be made in order to sell consumer protection products.

The prioritization of back-end profitability over front-end profitability opens the door to maximizing your revenue at all stages of the sales process.

Consider this scenario: An average independent dealership makes $1,500 per vehicle service contract sale alone. On the low end, with an average of 33 percent penetration on 50 cars sold in a month, dealers are losing approximately $25,000 a month by not leaving room for VSC sales.

That's truly money left on the table.

Better customer service: Consumers are smart. They know they're getting the raw end of the deal when vehicles are priced well over their actual value.

By pricing vehicles with consumer affordability in mind, you're simply providing better customer service and a valuable reason for them to shop with you again – and refer their friends and family to you.

Additionally, by providing those consumers with valuable protection products to protect their investment, you're helping them preserve their resale value as much as possible.

You're also helping them stay current on their auto loan payments when unforeseen breakdowns occur, giving them greater confidence in their decision to shop with you.

Maximizing profitability is all about taking care of the customer. That means making the car affordable and financeable, and providing protection to give consumers added security in their investment.

The more you put your customers first, the more profitable you will become. ■

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