NFDA
NATIONAL FRANCHISED DEALERS ASSOCIATION

LIFE AFTER BREXIT

CHALLENGES AND OPPORTUNITIES FOR UK AUTOMOTIVE RETAIL

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icdp

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Following the triggering of Article 50, assessing the implications of Brexit for the country's economy, is still fraught with difficulties. Within this discussion paper, the NFDA and ICDP, will attempt to identify and make sense of some of the Brexit implications that may fall on UK auto retail and look at the possible challenges and opportunities that both Government and industry should be aware of.

Throughout the debate, the strategic importance of the UK automotive industry as a major employer, exporter, revenue earner, and tax contributor, has been consistently at the fore of the Government's agenda. Behind headline manufacturing figures of over 1.5 million cars per year (over half of which are exported to other EU countries), lies the whole supplier ecosystem, the R&D base, and of course, the domestic market, which itself hit record highs in 2016[1].

The need is to preserve the UK's competitive manufacturing position in a highly globalised sector and to secure continued investment from car makers (OEMs). This will be a major consideration in forthcoming Brexit negotiations. But any holistic view of the automotive industry should also consider what happens 'downstream', beyond the factory gate, to the structures and businesses that operate there. The UK is not only world-class in automotive manufacturing, many of its retailers also lead the way in retail expertise and performance, so what do they stand to lose, or gain, from Brexit? What trading environment and safeguards do they need if they are to continue their recent success? How can this Government support the ever-important UK auto retail sector?

This report looks at the Brexit implications for automotive retailers. Franchise automotive retailers are the key retail interface between the OEMs and their customers and the providers of aftersales services to millions of motorists across the country. We will look at how:

- Retailers exist to serve the market for vehicle sales and aftersales. Any Brexit-induced changes in demand will impact vehicle retailers immediately, affecting growth prospects and the UK economy.

- Retailers source their cars and spare parts from their OEMs. They are also heavily dependent on external sources of funding, changes in trade regime and tariff arrangements that would affect the terms on which they are supplied.

- The automotive sector operates under an extensive and growing regulatory regime at national, European, and global levels. Potential divergence from some European-level policies may open some opportunities for UK retailers but also risks adding costs and complicating trading relationships for the automotive sector and ultimately, consumers.

- Many larger UK authorised vehicle retailers are world-class. The future trading relationship with Europe must protect their competitive position and the conditions they need to grow both in the UK and potentially overseas, not just for their own sake, but also if wider policy goals for the sector and motoring are to be achieved.

UK AUTOMOTIVE RETAILER SECTOR

What is at stake?

Auto retail and the UK economy

- The top 200 UK franchised dealers have a combined turnover of £61.3 billion (up 8.6% on 2015)
- UK auto retail has an annual turnover of £181.7 billion
- UK auto retail has a Gross Value Added of £32.1billion
- UK auto retail pays £1.1 billion in tax
- UK automotive retail is 15th largest employer in the UK, employing 1.7% of the UK's workforce
- There are 4,900 auto retailer franchise businesses

UK auto retail sales

- In 2016, there were 2.69 million new car registrations
- Second-hand car registrations reached over 8.2 million in 2016
- Since introduction of the Plug-In Car Grant in January 2011, 83,052 eligible cars have been registered
- In 2016, 35,447 vehicles eligible for the varying levels of Plug-In Grants were registered
- In 2016, there were 10,264 pure electric vehicles registered

UK auto retail aftersales

- There are 2,364 franchised dealer MOT test stations in Britain
- On average franchise dealers perform 1,541 MOTs on Class 3 and 4 vehicles annually

UK auto retail has an annual turnover of £181.7billion

PART 1

MAINTAINING CUSTOMER DEMAND AND SUPPORTING THE UK'S LEADING EDGE RETAIL OFFERING

Strong demand from all parts of the market – fleet and retail – has provided the basis for the development of the UK automotive retail sector as one of the strongest in the world.

Potential market declines have been addressed by timely Government intervention, in programmes developed jointly with the industry trade associations. Not only has this avoided damage to retailers' finances and networks that have affected other markets, but the strength of the market has resulted in one of the youngest parcs of circulating vehicles in Europe[1], with subsequent gains in environmental performance and improvements in vehicle safety. Healthy competition between automotive retailers and independent repairers brings high quality aftersales support to UK motorists, with continuous innovation in services and keen pricing competition.

It is important that a situation is avoided whereby business uncertainty and weakened consumer confidence has a detrimental impact on the industry – as some are predicting. This could see larger retailers, some of whom are on the point of expanding to other markets, weaken and become targets for opportunistic overseas investors. Current investment in new innovations that address the digital needs of the car buyer and owner, must not be negatively impacted. These businesses are currently attracting interest from overseas. If the market reverses, the parc will again start to age, progress in emission reductions slowed and electric vehicle development stilted.

Beyond the obvious need to avoid a national recession that affects all sectors, there are several specific areas that need to be addressed to protect the UK car market and the retail trade that supports it. Most important of these is accessibility to cars, in terms of pricing and related finance.

Impact of currency and tariffs on UK new car prices and the necessity for free trade

Shifts in exchange rates since the EU referendum have already presented challenges for manufacturers, but this has not yet fed through into significant price increases. Those with UK manufacturing have some degree of natural hedging through exports, but this depends on the mix of their supplier contracts. Exchange rates have been at similar levels in the past, for example, immediately following the financial crisis. However, volatility in exchange rates, particularly for Euro/Sterling, will create uncertainties that may affect the willingness of manufacturers to take risks on production capacity allocation, stocks and incentives for the UK market.

Clearly, the impact of tariffs on terms of trade will not become clear until new trade agreements are reached.

If no trade deal is reached, and the increase in costs were passed directly onto the consumer, then the WTO tariff regime would mean price increases for buying and repairing every car sold in the UK.

Customers will face an additional £2.7 billion per year on imported cars, and £81 million on cars built in the UK which include imported components.

The potential tariff impact on customer pries for aftermarket parts is often overlooked, as for example, 48% of tyre imports into the UK come from the EU (BTMA/HMRC).

If we take a 'worst-case' scenario where exit from the single market would mean that World Trade Organisation (WTO) rules come into effect, then the impact on prices will be a **10% tariff** on finished vehicles imported to or exported from the UK market. In addition, the WTO rules **"stipulate tariffs of 2.5 percent to 4.5 percent on parts"**[1]. As most components within UK assembled vehicles are supplied from continental Europe,[1] this means that regardless of the manufacturing source of the car, there would be some impact from tariffs. **This combined with deterioration in the value of Sterling could see prices rise by over 10%.** This will have a direct impact on consumer costs and industry expansion. As mainland European markets continue to recover, post-recession, there is no business logic in a manufacturer absorbing tariff costs from their own profits to retain volumes in the UK. As the average return on sales for UK retailers is under 2%, there is also no opportunity for retailers to absorb some of these costs either. Since aftermarket parts will also be subject to any import tariffs, there will also be price inflationary effects of tariffs on service, maintenance and repair.

SUMMARY

There is a fundamental requirement for some form of agreement which maintains current zero tariff levels on finished vehicles and parts between the UK and the EU. It is crucial that if access to the single market is not maintained, a bilateral trade agreement that provides zero tariffs on automotive goods, including from the supply chain, is achieved. If this is not achieved for all goods, a sector deal must be considered for crucial industries, such as the automotive industry.

AVAILABILITY OF AFFORDABLE FINANCE FOR VEHICLES OR THE DECLINE OF INDUSTRY

The UK market has high levels of adoption of different forms of leasing for both personal and business customers. For example, the use of point of sale finance for new cars retailed in the UK to private customers has increased from 54% in 2010 to 87% in 2016[1]. This improves accessibility for customers to purchase vehicles, as a large capital outlay is converted into lower monthly payments and drives the UK's dynamic and young used car market as cars usually return to market at the end of the lease period, typically around three years. Most brands also offer service packages (pre-paid servicing which is effectively an add-on finance product), which also ensures that cars are maintained in line with manufacturer recommendations. This provides that emissions and safety standards are maintained throughout the lease period, giving the next owner confidence that the car is in good condition at the point of resale. These characteristics of the new car market are increasingly being offered to the buyer of these 3-year-old used cars, meaning that the benefits of the UK's strong new vehicle market are trickling down into the segment of cars aged four – six years old.

This type of financing is dependent on both consumer confidence (that they will be able to afford the typical £200 monthly outlay for a new small car) and interest rates that determine the cost of money for the finance companies.

For car manufacturers with larger market shares in the UK, the provision of finance for both dealers and customers is typically provided by a wholly owned finance subsidiary of the European parent company. Others use a 'white label'[1] provider, which may be a joint venture with a larger bank, which can offer 'white label' financial services. Independent finance houses are also used to provide finance for business customers and used car finance. Manufacturers tend to raise funds centrally in Europe and currently operate under "passporting rules" to provide financial services in the UK.

There is a risk that tariffs and exchange rates may make new vehicle finance, offered by manufacturers, less affordable as wholesale prices increase.

Any changes which affect financial flows and their ability to provide subvented (i.e. manufacturer subsidised) finance in the UK will have an immediate:

- adverse effect on the consumer offer,
- slowdown in the new car market, feeding through over time into the aftersales and used car markets,
- ageing of the overall parc mix.

Customers who have come to appreciate the opportunity to always run a young car - with the peace of mind a young car provides in respect of safety and reliability - will find that when the current lease term is up, they are unable to replace the car on a like for like basis at the same monthly payment. Or they will be faced with finding the capital to cover the final "balloon" payment that allows them to keep their existing car. From an industry perspective, it will be challenging to explain how Brexit has cut off access to this much-appreciated form of car ownership. However, it would be a direct impact on the millions of private buyers and businesses whose cars have been "bought" using these low-cost forms of finance.

There is a risk that tariffs and exchange rates may make new vehicle finance, offered by manufacturers, less affordable as wholesale prices increase.

SUMMARY

If continued access to finance is not maintained following the UK's exit from the EU, all aspects of the automotive industry will be impacted. This would have grave impacts on both consumers and businesses and thus the UK economy. Automotive finance is the second largest financial sector after mortgages in the UK.

Following consumer demand in both the new and second hand vehicle markets, UK auto retail is now shaped and driven around finance. Continued unfettered access to OEM finance from overseas is essential and should not be underestimated in importance and consumer and business reliance.

MOTOR RETAIL AS A “NATIONAL CHAMPION”

Turning to the motor retail sector itself, the last decade has seen a major transformation in the retail sector with the emergence of a number of well-funded and well-managed retailer groups.

These sector leaders operate anything up to 200 automotive retailers on behalf of multiple manufacturer groups. Their professionalism has had a desirable “trickle down” effect on smaller retailers, who also benefit from the advances of the larger groups in areas like technology and employee development. It is essential that post Brexit, this world-leading retail sector is supported and encouraged to grow further, in line with the Government’s industrial strategy pillar ambitions.

Many of the retailer groups have also established their own training academies and invested heavily in apprentice recruitment. Whilst investing significantly in training, retailers also employ significant numbers of EU citizens, particularly in aftersales roles where availability of UK citizens, with the necessary skill set or desire to work in the sector is limited in certain areas. Changes in the rights of EU citizens to work in the UK in the future, would only exacerbate the current skills shortage, driving up costs for businesses and therefore the pricing of service and repair work for consumers.

The combination of professional retailers and internet-savvy consumers has also made the UK the market of choice for car manufacturers and entrepreneurs looking to evaluate new motor retail and aftersales concepts. As a result, the UK has the opportunity to lead the way in adapting the car buying and service experiences to the digital age.

SUMMARY

Currency depreciation has made UK-based businesses look cheaper to foreign investors. It is already clear that interest from abroad has increased in acquiring UK retailer groups. This is unfortunate, as some UK groups are themselves now at the stage where they feel they can add value to retailers they acquire outside of the UK and wish to launch a phase of international expansion in what is predominantly, a nationally focused sector around the world.

Challenges and uncertainty in the UK market would delay or halt such a transition. This would result in the loss of the jobs and profits, impacting grossly on the UK economy and consumer finance and confidence. UK retailer groups need the confidence that they will not have to allocate additional resources and capital to address issues in the UK market before they will move forward. A stable currency and continued access to skills will be essential to the UK’s automotive retail sector maintaining its status as national and global sector champion.

EU nationals account for around 4.6% of all service and maintenance technicians employed in the UK to work on passenger cars.

(Source: ONS quarterly labour force survey, January - March, 2016)

PART 2

AVOIDING POTENTIAL DISRUPTION AND INCREASED COSTS OF VEHICLE SUPPLY, WHILST MAKING THE MOST OF MANUFACTURERS' UK STOCKING APPROACHES

If tariffs are introduced at WTO levels, this will inevitably impact exports and thus UK production.

Perhaps more obviously, for the brands that both assemble in the UK market and run other European assembly plants. In the long term under this scenario, production is more likely to move to other locations within the EU and more of our domestic demand will be supplied from there. Such a shift will have a knock-on effect on overall logistics costs for the UK market. A decline in finished vehicle logistics outflows would make inflows more expensive, due to the inefficient use of returning ships and vehicles, and increase the need for consolidation of loads. The combined effect would be increased costs and longer lead times for UK customers.

One of the essential benefits for UK auto of access to the single market is easy and fast access across borders. UK and EU finished vehicle logistics operators run on low return on capital, thin margins, and require fast turnaround of journeys. Increased border controls post EU exit, may mean delays in passing through customs borders at ports. It is worth noting that the Channel Tunnel is no longer used for high volumes by any manufacturers, due to delays and issues around border control on the French side of the Channel. Any delays at border points will increase costs and impact on reliability of the timings of vehicle movements.

Cabotage rules allow a truck to utilise capacity for both outbound and return legs of a journey, whether the operator and truck is based within the UK or not.

Any limits to access by EU based finished vehicle logistics providers to the UK market, will also have an impact on costs and lead times, as the industry currently benefits from this broader competitive pool. During peak new car registration periods, such as March and September, manufacturer and retailer networks rely on the use of EU based drivers and finished vehicle logistics providers.

SUMMARY

The cabotage rules in place today across EU markets allow for flexible transporter and driver utilisation. Any restrictions on non-UK service providers will increase cost and capacity shortfalls for UK delivery of cars to UK retailers and customers.

STOCKING COSTS AND LEAD TIMES

The UK has long been the benchmark for use of centralised stocking in Europe, following the introduction of distribution centres in the early

The increase in stock located in distribution centres has allowed a reduction in the inventory physically located at retailers. This has been supported by the appropriate management of orders and financing, enabling an overall reduction in total new car inventory, along with better choice of specifications for customers and retailers and faster and easier virtual swaps of any retailer allocated cars.

Most brands locate their UK inventory within the UK market to allow for rapid order fulfilment, although a number do locate central stock for the UK at continental ports. In the event tariffs make it more attractive to hold stock outside of the UK, there is a risk that there will be delays in stock arriving into the UK. This could mean delays to new car stock allocated to UK retailers and market, creating an increased risk of additional delays and costs due to border checks. This will ultimately impact consumers and be one of availability and finance. For the cost reasons stated previously, tariffs would be adverse for consumers and industry, but if they prove unavoidable, then at least there should be the provision for bonded stock to be held in UK locations. This would allow existing customer service levels to be maintained by avoiding delays, and retaining existing infrastructure and employment.

Alongside centralised stock, has come innovation in stock funding. There are a range of approaches to unsold new car stock in the UK but as a rule of thumb, cars held in central stock up to a certain age are not financed by retailers (or allocated to be owned by the retailer in a number of cases). Instead, these are financed by the manufacturer (or the finance organisation that supports the brand in the UK market).

There are different financing methods, but in general cars are invoiced when they leave central stock, and either not allocated to retailers (free stocking), or subject to an interest-bearing period after a certain period of time (interest free periods). The greater the use of free stocking or interest free periods, the more 'liquid' the new car stock remains, as individual retailers feel less attached to individual vehicles. The result is not only less stock overall for manufacturers and retailer networks, but better turning of inventory and so better return on capital for them and a broader choice of fresher, higher quality cars for the consumer.

SUMMARY

If post-Brexit, vehicle financing becomes more expensive or retailers are expected to source more finance themselves, this will have an impact on retailer financing and stock liability. Retailer and thus consumer costs will increase and the choice of vehicles stocked and thus those immediately available will reduce. This will stifle industry, rather than encourage strong and continued growth, which the UK has experienced post-recession.

PART 3

AVOIDING ADDITIONAL REGULATORY COMPLEXITY, WHILST LOOKING FOR NEW OPPORTUNITIES TO SHAPE THE FUTURE POST BREXIT

Post-Brexit, the regulatory environment for automotive retailers will not change overnight – accumulated regulations will remain in place and will only be changed if there is the political will to do so.

The car itself is a heavily-regulated product at national, European, and even global levels. Covering everything from the tiniest details of its construction, through to how it is used on the road and how it should be disposed of at the end of its life. Much of this regulation has a direct bearing on how the retail automotive sector can approach the sale and aftersales support of its products. At the same time, businesses in the sector, like their counterparts in other product markets, face a raft of regulations governing everything from consumer protection to anti-trust, from free movement of people to working times, and from financial services to commercial contracts. Much of this regulation and legislation has developed at a European level, over many years.

The potential implications of Brexit in this area will be heavily dependent on the nature of the future trading relationship with Europe that is finally agreed. Especially significant will be our degree of membership, alignment, or otherwise, to the Single European Market, which in turn will dictate the level of regulatory harmonisation that will be needed. In this sense, automotive retailers will most likely face the same impacts as retailers in any other sector of business. Nevertheless, it is possible to identify some specific risks but also opportunities for the sector as the post-Brexit situation emerges.

Irrespective of the nature of the future trading relationship with Europe, the detailed regulatory framework affecting how automotive retailers operate cannot change overnight. It will be the same on 'Day One', with all the EU 'acquis' in place, as it was on 'Day Minus One'. Suggestions to the contrary are not helpful in that they sow uncertainty amongst businesses and consumers, damaging market confidence.

From that point on, it will therefore be a question of where, how much, and how fast, the UK regulatory framework will start to diverge from the European standard, either in the direction of more liberalisation, or more prescription, or simply to reflect different priorities. Notwithstanding the potential trading cost implications of less harmonisation between markets (which in any case would be a greater concern for the OEMs than for retailers, very few of whom currently trade internationally), it is possible to identify some areas where the UK might choose to diverge from current EU regulation and enhance the competitiveness of the automotive sector and the players within it, including the crucial retailers.

SOME AREAS TO CONSIDER

Competition policy

Several European markets have identified what they see as a gap in the current Block Exemption regulations governing franchise agreements between OEMs and retailers. Namely, the lack of provisions protecting retailers against unfair termination of contracts, or providing them with any kind of statutory protection for the relationship-specific investments that have made on behalf of their OEMs specifications. There may be an opportunity to fill this gap within the UK, through a new regulatory framework.

Distance selling

Car buyers are conducting more and more of their 'purchase journey' online. Channels that allow the complete transaction to be performed online are starting to emerge. However, distance selling would expose OEMs and/or retailers to significant financial risk if customers can return their unwanted car purchases having used them for 14 days, as is their statutory right today. There may be an opportunity to develop a distinctive regulatory position to encourage the growth of online channels in the automotive sector by establishing that returning a car to a retailer is not the same as returning an unused pair of shoes. This could be achieved by establishing a 'code of fair use', whilst still fully protecting customers' rights online.

SUMMARY

What has some of this to do with automotive retailers? The sector has shown itself to be home to flexible entrepreneurs and increasingly, to solid groups with considerable retail expertise. Both will adapt to whatever changes in the regulatory framework might emerge post Brexit.

But the opportunity also exists post-Brexit to actively shape the future of the downstream automotive sector. How we as consumers will use cars, how our cars will integrate with other transport modes, what technologies they will use; in a way which will confer broad societal benefit and real competitive advantage to UK automotive businesses.

Intelligent transport systems and autonomous cars

The age of connected transportation is fast-emerging. Cars are increasingly able to communicate to their support providers (OEMs/retailers) and soon, to each other and the road infrastructure. The race is on across global markets to 'join the dots' in ways to deliver safer, smarter and more efficient transport systems. Yet, within the automotive sector, there is growing concern at how such services, which rely on the ubiquitous sharing of data, can be delivered whilst still respecting the strengthening requirements for personal data security and privacy. In this emerging field, there may be an opportunity to develop a distinctive regulatory framework around the data needs of intelligent transport and autonomous cars and cement the UK's position as a leading player in this important field.

Environmental policy

Whilst environmental regulation already exists at the global and European levels, and, for example, incentive schemes encouraging electric vehicle (EV) take-up are already well-established, Brexit may provide an opportunity for such policy to be accelerated in a more joined-up fashion. For example, by introducing in-use vehicle emissions testing and specific measures to accelerate the removal of older more polluting diesel engines from the parc. Serious gains could also be achieved by the UK Government supporting the uptake of electric vehicles through investing in infrastructure and grid improvements which are essential. The UK government could then develop its own emission reduction targets, reflecting market demand and investment levels.

RISKS AND CONSIDERATIONS

UK ECONOMY

It is essential that during and post Brexit the economy does not falter. The automotive retail industry and its consumers must be supported with access to finance, a stable currency and free trade with the EU. This will ensure that Brexit does not undo the benefits of growth that have been seen over the past few years from this crucial UK industry.

FREE TRADE

Constraints on existing free trade and movement of automotive and financial flows must be avoided. Failing total unfettered access, constraints must be minimised. If Government is set on leaving the Single Market, a bilateral free trade agreement or sector specific free trade agreement must be reached.

It is imperative to maintain retailers' abilities to source products to sell and 'retail enablers' (such as affordable finance). This should be maintained on the same terms as enjoyed currently.

Retailers' abilities to continue to grow and develop their businesses in both size and retail strategy should not be hindered. Government must not surrender what is arguably a world-leading position – just at a point when international opportunities beckon.

OPPORTUNITIES FOLLOWING BREXIT

- Strengthen an integrated approach to skills and employment in the sector through education, skills training and recruitment, boosting the attractiveness of the sector as a place to work.

- Maintain a regulatory environment that favours business agility, low taxes and minimising redtape where appropriate and conduce.

- Take advantage of new freedoms to create a culture of innovation in the UK, pioneering electric vehicles and infrastructure, autonomous cars, connectivity and new retail channels.

- Reinforce retailer protection at a time when disruptive risks (from Brexit and channel innovation) are increasing through a Code of Practice or legislation which offers investment protection and compensation.

About NFDA

The National Franchised Dealers Association (NFDA) represents franchised car and commercial vehicle retailers in the UK. Our role is to lobby, represent and support our members. We currently represent over 85% of the UK's franchise vehicle retailer network. NFDA deals with a number of issues that impact retailers on a day to day basis, including relationships with manufacturers, advising on legislation and various aspects of retailers' businesses such as used cars, aftersales and finance and insurance.

For more information, see www.nfda-uk.co.uk

About ICDP

ICDP is an international research-based organisation focused on automotive distribution, including the supply and retailing of new and used vehicles, after sales, network structures and operations. Through our research activities, data services, education, events and consulting, we work with vehicle makers, retailers, suppliers, and related organisations to improve the quality and effectiveness of the distribution model. We believe that changing behaviours, new technologies and market pressures will combine to drive new ways of doing business. We welcome the opportunity to work with like-minded individuals and organisations in pursuit of this goal. ICDP does not represent any of its clients or their individual policy views.

For more information, see www.icdp.net

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