Automotive Industry Marketing Channels: Conflicts and Solutions

By

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ABSTRACT

In the dynamic market, manufacturers constantly seek for optimal channel alignment for maximizing the channel benefits, which needs joint efforts by both manufacturer and channel partners. Driven by their own interests, dealers act very differently in the marketing channel cooperation. To motivate dealers to behave in a more cooperative way, the marketing channel incentive system is commonly used as the most effective tool. However, aiming at maintaining a high marketing channel efficiency in the dynamic market, OEMs need to develop good internal controls and a more scientific approach in adjusting dealer marketing target. In this paper, current channel marketing status in automotive industry will be introduced, conflicts in the marketing channel cooperation will be identified, channel stakeholders will be analyzed to identify the key influencing factors and build a more reasonable MERT adjusting methodology, and finally, recommendations will be provided for manufacturer's in-house executives.

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Chapter 1: Auto Manufacturer and Dealer Channel Introduction

The automotive industry is a wide range of companies and organizations involved in the design, development, manufacturing, marketing, and selling of motor vehicles. It is one of the world’s most important economic sectors, and also one of the supporting pillar industries for many countries, such as the United States, Japan, Germany, and China, etc.

The automotive industry has a history of more than one century, and it has experienced exponentially growth globally in the past two decades. According to OICA Production Statistics, 95 million vehicles were produced globally in 2016, increased by 4.5% year-on-year. In the industrial development, China is playing an increasingly important role, representing 29.6% of the global production volume and 14.5% annual increase rate in 2016.

There are many stakeholders in automotive industry, and the most important two stakeholders are Auto Original Equipment Manufacturer (hereinafter referred to as “Auto OEM”) and franchised dealers. The Auto OEMs are responsible for designing, developing and manufacturing vehicles, and then wholesaling the vehicles to the distribution channels for retailing. The franchised dealers, working as distribution channel, are responsible for selling the vehicles to end customers, with a series of functions that bring sales, service, spare parts and surveys together.

In this chapter, the importance of the channel collaboration will be analyzed, the partnership and cooperation model between Auto OEMs and dealers will be introduced, and the development of their relationship based on different interests regarding the market changes will be elaborated.

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1.1 Auto OEM's Channel Choice - Franchised Dealer Model

There are several channel options for manufacturers to choose to distribute the products to the end customers conveniently.\(^3\) The first is direct channel, which requires the manufacturers to do direct marketing or use their own direct sales force to sell products to customers. The direct channel is usually quite costly that mainly the products with high unit value or high profitability are fit for justification, for example, airplane engine under GE Aviation. The second is indirect channel with two layers of distributors and dealers, which in cooperation can weave a huge network penetrating every corner of the market, and the fast-moving consumer goods company is a good example under this indirect channel. The third is indirect channel with one layer of dealers, which is usually brand franchised dealers – also known as franchisee, such as IKEA furniture franchised dealers.

"How do customers want to buy" is the first thing to consider when deciding on the channel options.\(^4\) For Auto OEM, the direct selling channel is impossible regarding the high demanding customer needs for touch and feel, shopping convenience, and services such as test drive, maintenance and warranty, and the transportation fee for each order is also too high to be realistic. The indirect two-layers channel is not an ideal option since the increasing layers of channel partners are also accompanied with decreasing control by Auto OEMs. With the indirect one-layer channel – franchised dealer, Auto OEMs can allocate more operation cost to be undertaken by dealers, get more cooperation benefits on better local marketing and services to acquire and retain more customers, and get better guaranteed cash flows from dealers.

Auto OEM’s channel choice on collaborating with franchised dealers is a great channel model which create a win-win-win situation among the stakeholders. As the


franchised dealers are distributed in many cities, customers are happy since they can shop the vehicles conveniently without travelling outside the city, as well as when they need the aftersales services. The franchised dealers are happy, since they can get the brand authorization which makes them differentiated directly with other dealers, and also gain plenty of resources in staff training, store performance guidance, OEM sponsored marketing, different kinds of incentives, etc. Besides all the benefits gained by OEMs stated above, OEMs also saved large amounts of capital in building the dealerships by themselves, and they can invest and focus better on paving the path to a better competitive position.

Risk comes with benefits. In the channel cooperation model, there are also many potential risks for OEMs to undertake and manage. As the franchised dealers run by themselves, OEMs have very little control over the dealer operations, therefore they are not able to ensure that the brand image and product values will be conveyed to potential customers accurately. All the benefits and risks work together to motivate OEMs to invest in designing reasonable incentives to dealer partners, thus building a robust and productive channel relationship.

1.2 Current Auto OEM and Dealer Collaboration Process

In the channel collaboration, Auto OEM is running the B-to-B business, and dealers are running the B-to-C business. Auto OEMs usually cooperate with hundreds to thousands of dealers globally based on their business scale.

To better manage the dealerships and monitor their business performance, Auto OEMs adopt different kinds of Dealer Management Systems (hereinafter referred to as “DMS”), in which they can track dealers’ performance regarding business functions of sales, after-sales service, spare parts and finance\(^5\). Each dealer has a separate account to access the dealer-end DMS to update the data, and dealer’s data

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and information are organized thoroughly, including vehicle pipelines, wholesales numbers, declared sales to end customers, vehicle and spare parts stock status, used car flow in and out, after-sales service items, customer file and transaction history, etc. With DMS centralized managing system, Auto OEM is able to track dealer performance and provide guidance and resources support accordingly.

![Dealer Management System Functions](image)

Figure 1: Dealer Management System Functions

In the DMS, all data and information are recorded for tracking two most important flows - vehicle flow and capital flow.

1.2.1 Vehicle Flow in Distribution Channel

Vehicle flow shows all related information regarding certain vehicle, including basic Vehicle Identification Number (VIN), model and configuration, wholesale information, customs clearance, transportation status, in-stock status with certain dealer, sold to certain customer, etc. In the chart below, stakeholders in the sales process and vehicle flow are elaborated.
Firstly, the dealer orders certain number and models of vehicles from Auto OEM in the DMS, and the OEM will arrange shipping them from vehicle plants in and/or outside the country to the dealership. If the vehicles ordered are only manufactured by factories abroad, customs clearance process will be needed. When these vehicles are shipped to the dealer side, the titles of the vehicles will be transferred to the dealer in the DMS as dealer stock. And this is the wholesale process.

When dealers have vehicles in stock, they usually sell them in two channels. The first is to sell to the end customers, which is the traditional B-to-C business. The second is to sell to non-franchised dealers, and non-franchised dealers then sell the vehicles to end customers, which is a B-to-B-to-C business. The second option is usually adopted by dealers who want to get rid of their high stock as soon as possible, and they are sold to the non-franchised dealers with a relatively lower price. This option is also not encouraged by Auto OEM, because non-franchised dealers usually carry many vehicle brands, and they attract customers by low price and no after-sales service instead of providing premium service and conveying brand message. In the long-term perspective, though solving a portion of the sales problem, non-franchised dealers are weakening the brand image by unqualified customer sales process and store layout design.

When dealers retail the vehicles to local customers, they do local marketing to
attract potential customers, including above the line (ATL) advertisements and below the line (BTL) activities. Salespeople in the dealership performs a whole set of sales processes from welcoming to test drive, until they get the sale and hand over the car to the customer, which is required by Auto OEM to provide standardized excellent service conveying brand image. And this is the retail process.

1.2.2 Capital Flow in Distribution Channel

Capital flow shows how do stakeholders exchange the capital for vehicles, and how does each business partner make money in the sales process. The dealership usually deals with four main stakeholders (see the figure below), including Auto OEM, Non-authorized Dealer, Customer, and Investor Group. And all four main stakeholders cast indispensable influences on the collaborative relationship between the Auto OEM and dealers.

![Capital Flow in Distribution Channel](image)

Figure 3: Capital Flow in Distribution Channel

i. Dealer and Auto OEM.

When vehicle models are launched by the OEM, they are ticketed with a Manufacturer Suggested Retail Price (hereinafter referred as to “MSRP”). However, this price is just a suggested price for customer’s information, with no compulsive

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influence on dealer’s retail pricing decision. Dealers have their sole discretion to
decide the final retail price in each sales case, and any pricing hint or pressure from
Auto OEM is strictly regulated by the Anti-Trust Law, and huge amount of fine could
be charged as penalty.

When dealers order vehicles from the OEM, wholesale price is calculated with a
discount off the MSRP. The wholesale discount amount (ρ%) is usually ranging from
5% to 10%. This is the capital paid by dealers to purchase vehicles from the OEM.

To motivate dealers’ enthusiasm in achieving higher sales volume and investing
more in local marketing activities, dealer targets in sales and marketing are usually
set by Auto OEMs as the minimum in the way that whoever achieves this target will
be rewarded with substantial incentives. Setting the dealer incentive policy is usually
the most important method that Auto OEMs adopt to negotiate with dealers and
invest in their channel partnership. The incentive system will be elaborated more in
detail in the following chapters.

Dealer holdback is another kind of sales commission provided by the OEM to
supplement dealer’s cash flow. The holdback is also a percentage of MSRP, usually
ranging from 1% to 3%8. Not all OEMs adopt this method to support dealers, but this
is a substantial amount of capital to dealers.

Summarizing the three main kinds of capital flow between Auto OEM and
dealers, the balance of capital flow can be formulated as:

\[ C_{\text{Dealer-OEM}} = - \sum_{i=1}^{N} \text{MSRP}_i * (1 - \rho\%) + \text{Incentives} + \text{Holdback} \]

\[ N \text{ – The number of vehicles ordered by dealer from the OEM annually} \]
\[ \rho\% \text{ – The wholesale discount amount set by the OEM} \]

ii. Franchised Dealer and Non-Franchised Dealer.

As is stated in Chapter 1.2.1, non-franchised dealers purchase vehicles from franchised dealers, and then sell them to end customers. The profit model of non-franchised dealers is to make profit from the price difference between the final retail price and the resale price from franchised dealers, without caring about anything regarding brand franchised fee, premium sales service, customer satisfaction and after-sales service. In this process, the capital flow of franchised dealer and non-franchised dealer can be formulated as:

\[
C_{\text{Dealer}} - C_{\text{Non-authorized Dealer}} = \sum_{i=1}^{i=n_1} P_{D-\text{resale},i} - \sum_{i=1}^{i=n_1} P_{ND-R,i} - \sum_{i=1}^{i=n_1} P_{D-\text{resale},i}
\]

- \( n_1 \) – The number of vehicles sold through non-franchised dealers
- \( P_{ND-R} \) – The retail price by non-franchised dealers
- \( P_{D-\text{resale}} \) – The resale price set by franchised dealers to non-franchised dealers

iii. Dealer and Customer.

Most vehicles are sold from franchised dealer to end customers in this way directly. The normal process that a car is sold by salespeople to customer starts from collecting prospects contact information from ATL and BTL marketing activities. Then the salespeople will invite the prospects to visit and shop in their 4S store through email, texting or phone calls. Besides invitation, there are also many walk-in prospects who visit the dealer showroom directly. When potential customers show up in the showroom, salespeople will ask about their needs, preferences, and recommend proper models. After test drive of certain models, if the customer is satisfied with the vehicle performance, model configuration and final price, contracts will be signed, and payments will be conducted. In the car hand-over process, salespeople will help the customer test the stock car together, coach him on necessary
car basics, and provide guidance on how to register car plate. After one week, the salespeople will follow up with a phone call to see if the customer has any problems with the car and how satisfied the customer is.

![Diagram of Normal Sales Process]

Figure 4: Normal Sales Process by Dealer’s Salespeople

As the models, configuration, selected accessories and applicable discount options are different, the final retail price of each car is likely to be different. For customer’s convenience and its own profitable benefit, dealers also provide insurance service to customers, where they can make an extra commission from insurance companies. In this process, the capital flow from customers to the dealer can be formulated as:

\[ C_{Dealer-Customer} = \sum_{i=1}^{n_2} P_{retail,i} + \sum_{i=1}^{m} P_{Insurance Commision,i} \]

- \( n_2 \) – The number of vehicles sold from franchised dealers to customers directly
- \( P_{retail} \) – The retail price of vehicle sold from franchised dealers to customers directly
- \( m \) – The number of vehicle insurance handled by dealer

iv. Dealer and Investor Group.

The Investor Group is the parent company of the dealer. The investor group

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evaluates and makes the decision on which OEM brand to join, and it invests capital and human resources to build the dealership. The purpose of the investor group is to make profit, and each year, dealer will divide the annual profit into two parts – one part is to be kept in the dealer side for investing in next-year growth, the other part (\(a\%\)) is delivered to the investor group. In this process, the capital flow from dealer to the investor group can be formulated as:

\[
C_{\text{Dealer-investor Group}} = - \text{Annual Profit}_{\text{Dealer}} \times a\%
\]

\(a\%\) – The portion of dealer profit that is delivered to the investor group

To sum up, all four stakeholders in this process have indispensable influences on the partner relationship between the Auto OEM and dealers. To build a better incentive system for Auto OEMs to motivate dealers, more analysis and suggestions will be elaborated in Chapter 4 regarding different stakeholder’s role, interest, behavior and the influence on dealer.

1.3 Different Interests of Auto Manufacturer and Dealers

Chapter 1.2 elaborates that dealer’s profit is flowing to the investor group, and the only transactions between Auto OEM and dealers are vehicles wholesale and incentives as commission by dealer’s performance. Therefore, the Auto OEM and dealers are independent organizations with different interests from each other.

The Auto OEM devotes a lot of efforts to build brand image, invest in marketing, drive market share, enhance dealer network sales, and emphasize on customer satisfaction, and these results cannot be achieved by the OEM alone without the cooperation of dealers in the local markets. Eventually, all the efforts are served to achieve the OEM’s ultimate goal – maximize the long-term overall sales.

However, there are more aspects to be balanced and taken care of to drive the healthy growth of long-term overall sales. For example, developing more dealers into the brand franchised network will bring more wholesales, but too many dealerships with certain market capacity will create fierce competition which drives the network
business to an unhealthy price war.

The dealer's interest is to maximize profitability and meet certain KPIs required by its investor group. Usually, a 4S dealership operates four to five business functions, including new car sales, after-sales service, spare parts, used car, and finance & Insurance. Among them, the after-sales service and spare parts business generate the greatest profits to support the dealer running the whole business. Specially, the service and parts absorption rate is to evaluate how much percentage of dealer's cost and expenses can be absorbed by the after-sales service and parts profitability. The new car sales do bring a portion of the profit, but it serves more as adding into the large quantity base to the after-sales and parts business for more profits. The dealer is more likely to focus on the synergies created by the cooperation of five business functions to generate more profits. And the sales, which is valued most by the OEM, is only one part of the whole business.

![Figure 5: The Business Functions of Auto Dealership](image)

The different interests of the OEM and dealers creates interesting dynamic relationships. When the automotive market capacity is growing rapidly, all channel partners make lots of profits easily. In this environment, dealers collaborate very actively to sign and hit every sales and marketing investment targets set by the OEM just to get more of the most popular vehicle models. However, when the market is tough, dealers' profitability is weak, anymore wholesale targets adds the pressure on
their stock, and they are not willing to invest in local marketing, which poses the brand exposure and long-term sales into risks.

1.4 Relationship Development with the Market Saturation

Chapter 1.3 elaborates that the different interests of the OEM and dealers creates dealer's dynamic cooperative altitude through the channel collaboration.

In the past decades, the global automotive market has experienced tremendous expansion with the growth of global economy, especially in developing countries where vehicles for normal families are becoming more and more approachable. In the past 10 years, China is playing an increasingly important role in global vehicle consumption, taking over the percentage from 10% to 30%.

Table 1: Vehicles Global Sales Volume from 1990 to 2017¹⁰

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<td>TOTAL SALES</td>
<td>39.2</td>
<td>53.74</td>
<td>71.18</td>
<td>72.61</td>
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<td></td>
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<td>Canada</td>
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<tr>
<td>Germany</td>
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<td>3.21</td>
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<td>Eastern Europe</td>
<td>1.18</td>
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<td>32.29</td>
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<td>China</td>
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<td>South America</td>
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<td>2.5</td>
<td>1.82</td>
<td>1.39</td>
<td>1.53</td>
</tr>
</tbody>
</table>

Sources: Scotiabank Economics, Ward's Automotive Reports, Bloomberg.

In the meantime, the number of auto dealers are also expanding rapidly. Investor groups paid high franchise fee to develop new brand franchised dealers and broke even quickly in a few years. With a fast-expanding pie, all stakeholders were happy in those years with few conflicts in the collaboration.

However, with the market saturation in recent years, restrictive policies and slower year-on-year growth of automotive market are leading to growing pressure in dealer’s profitability, and some dealership quit the network due to bankruptcy. Many dealers are suffering from sales growth downturn and weaker profitability. Dealers have less enthusiasm in their local marketing, which poses a major threat to both Auto-OEM branding and retail performance in the long run. Increasing complaints and resistance from dealers have risen and put the partnership into risk.
Chapter 2: Current Marketing Incentive System

In last chapter, the cooperation model, different interests and relationship between Auto OEM and dealers are elaborated, and the different interests of Auto OEM and dealers are posing more conflicts in the channel collaboration in difficult market conditions.

For Auto OEM’s interest to ensure the long-term sales, marketing investment inAutomotive industry plays an extremely important role in branding enhancement and sales promotion. Besides brand central marketing, the OEM needs more collaboration from dealers to invest in the local marketing. To stimulate dealers’ enthusiasm in marketing, a marketing incentive policy is usually introduced by the OEM to achieve the co-investment in marketing activities. The Marketing Expense Rate Target (hereinafter referred to as “MERT”) based on dealers’ sales target is usually set by Auto-OEMs as the minimum in the way that whoever achieve this target will be rewarded with substantial incentives.

In this chapter, the current OEM and dealer co-investment facts in marketing will be introduced, the problem in the current incentive system will be identified, and the methodology to develop a more scientific approach to adjust the next-year dealer marketing expense target based on the dealer’s performance of current year will be discussed.

2.1 Marketing Co-investment Facts

Marketing co-investments by both Auto OEM and dealers are essential to achieve the short-term and long-term sales goal. Auto OEM’s central marketing works to build the brand image, brand awareness and convey the right brand message to all existing and potential customers. Dealer’s local marketing works to engage the customer relationship and drives the retail sales.

In the joint efforts of marketing, Auto OEM is responsible for the central marketing, which aims to enhance the brand overall image, maintain brand digital
marketing, and provide support and instructions to dealer’s local marketing activities. Auto OEM’s central marketing usually invests in mass customer facing online advertisements, publish brand digital media contents continuously, designs brand national campaigns, monitors dealer’s marketing performance, and provides sufficient supports to dealer marketing (Mage Wang, personal communication, January 2018).

In the joint efforts of marketing, dealers are responsible for the local marketing. The local marketing is categorized into ATL and BTL marketing. Dealer’s ATL marketing is targeting at a wider spectrum of audience through television, digital media, print media, outdoor display advertisements. Dealer’s BTL marketing is targeting at a more focused customer group, who has a higher willingness to make a sales deal. The BTL marketing usually includes roadshow, new car launch, holiday activities, showroom activities, special test drive day, co-branding activities, direct mail and other promotion activities. The dealer local marketing plays an extremely important role in driving the dealer showroom or activity traffic and converting more new car sales.

Figure 6: An Example of ATL and BTL Marketing Activities by Dealer

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To realize a better collaboration in marketing, Auto OEM usually designs the dealer marketing incentive policy to motivate dealers to invest in local marketing in the way that OEM prefers. The main part of the incentive policy is about to set an annual marketing expense target for each dealer, and dealers whoever achieves the annual target will be rewarded with substantial incentive bonus after year-end evaluation. Sometimes, if there is a special national campaign lead by the OEM, such as the new car launch or special model promotion, additional policy on co-marketing the national campaign will be released right before the event. Dealers who participate in promoting the national campaigns designed by the central marketing might get their marketing expense reimbursed or get additional subsidies.

2.2 Dealer's Annual Marketing Expense Target

Dealer's annual marketing expense target is usually calculated based on the product of dealer's annual sales volume target, the average MSRP of certain model, and the MERT rate. In terms of an individual car, it indicates the lowest amount of marketing budget should be allocated to the car which is suggested to be sold at the price of its MSRP.

\[
Dealers\ Annual\ MET = \sum_{i=1}^{n} MSRP_i \times Sales\ Target_i \times MERT(\%)\n\]

\[n \text{ – The number of vehicle models sold in the market}\]

For example, an Auto OEM has 4 vehicle models (A to D) selling in the market. The dealer's annual sales volume target and the average MSRP of each model with different configuration is displayed in the following table. Assume the MERT of the OEM is 0.5%.

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Table 2: Dealer's Annual Marketing Expense Target Calculating Example

<table>
<thead>
<tr>
<th>Car Model</th>
<th>Avg. MSRP</th>
<th>Annual Sales Target</th>
<th>Marketing Expense Target for Each Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model A</td>
<td>$30,000</td>
<td>100</td>
<td>$30,000<em>100</em>0.5% = $15,000</td>
</tr>
<tr>
<td>Model B</td>
<td>$40,000</td>
<td>80</td>
<td>$40,000<em>80</em>0.5% = $16,000</td>
</tr>
<tr>
<td>Model C</td>
<td>$50,000</td>
<td>50</td>
<td>$50,000<em>50</em>0.5% = $12,500</td>
</tr>
<tr>
<td>Model D</td>
<td>$60,000</td>
<td>20</td>
<td>$60,000<em>20</em>0.5% = $6,000</td>
</tr>
</tbody>
</table>

Dealer's Annual Marketing Expense Target = $15,000 + $16,000 + $12,500 + $6,000 = $49,500

In this example, the dealer’s annual marketing expense target is 49,500 dollars, which means in the minimum requirement by the OEM, 49,500 dollars need to be invested in the local marketing to ensure a healthy environment to enhance brand image and generate local sales.

2.3 Problem in Current Marketing Incentive System

With different market positioning, the Marketing Expense Rate Target (MERT) of Auto OEMs is usually segmented differently. For premium automotive brands, such as BMW, Mercedes Benz, Volkswagen Imported, and Jaguar and Land Rover, the MERT is usually set higher than the low-end brands, because they need to invest more in marketing to communicate the brand value, educate the customers, and enhance the premium brand awareness.

Besides market positioning, factors such as Auto OEM’s product and market strategy, market competition, dealer’s feedback, are also influencing in adjusting the Auto OEM’s MERT decision. The figure below shows some MERT data extracted from annual dealer policy of premium brands in China, and the trend shows that the MERT level have changed greatly with market dynamics for the past several years.
From the figure above, huge adjustments in the MERT level were made by OEMs during the past several years, and it is interpreted as attempts to cope with the market changes, and sometimes with hypercorrection indicating loss of marketing efficiency.

For Mercedes Benz in China, the average MSRP of vehicle models ranges from 236,000 to more than 1 million RMB (37,000 to more than 150,000 US dollars), a slight drop of 0.1% in MERT will result in a marketing budget difference dropping by 236 to 1,000 RMB (37 to 156 US dollars) for an individual vehicle. While from 2012

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4. MERT of BMW Group China is significant lower than VGIC and Mercedes-Benz because BMW adopts a different marketing incentive methodology – marketing central funds.

to 2016, the MERT of Mercedes Benz and VGIC declined significantly, with nearly 50% marketing expense investment cut off.

Every adjustment in MERT by Auto OEMs casts a tremendous influence in allocating dealer’s resources differently and relieving dealer’s financial pressure. Therefore, adjusting the MERT is a very critical task to deal with. Lowering the MERT as the minimum required marketing expense target is always welcomed by dealers, but increasing the MERT after the hypercorrection last year will meet with more resistance from dealers to implement.

The huge fluctuations in MERT levels also reveals that Auto OEMs are attempting to find the right MERT for the current market. However, the market situation changes quickly in these years, and any wrong moves in adjusting the MERT will result in the incapability of adapting to the current market changes in a flexible and rational way. Therefore, how to determine a reasonable MERT by a more scientific approach to improve marketing efficiency is an essential marketing management problem.

2.4 Determine A More Scientific Approach to Channel Marketing

As is elaborated in Chapter 1, besides Auto OEM and dealers, there are more stakeholders in the distributing channel that cast influence on the OEM-dealer relationships simultaneously. Understanding how the other stakeholders influence the dealer’s behavior in achieving its own interests is significant to find out the critical variables lying behind.

In Chapter 3, the framework of optimal channel alignment will be introduced, and the most important elements regarding relationship building between Auto OEMs and dealers will be identified. After that, marketing tools will be utilized to identify whether it is the right economic valued decision to invest more in maintaining the partnership. Finally, dealers’ collaborating patterns under the current marketing pressure will be categorized into four sections, and the more
reasonable MERT is their common demand to move dealers towards the most desired section.

In Chapter 4, how and why the stakeholders are influencing dealer's behavior and enthusiasm in marketing will be analyzed. By researching the OEM channel policy, Balanced Scorecards, dealer's value map, benefits and drawbacks, etc., the critical variables lying behind each stakeholder's influence will be identified.

In Chapter 5, all influencing variables identified in Chapter 4 will be evaluated to see the difficulty in collecting the data, the reliability and accuracy of the collected data, the data collection level (national level or dealer level) and in what way (positively or negatively) the variable should influence the MERT adjusting model to determine the next-year MERT.

In Chapter 6, a brief qualitative model will be built with the identified variables, and recommendations will be provided to high level management to better the design of channel incentive policies for safeguarding the channel activities in similar channel models.

2.5 Research Significance and Business Value

The purpose of this method design is to optimize the target setting approach, capable of improving marketing management efficiency in the presence of market changes, as well as benefiting both Auto OEMs and franchised dealers.

The method design is very important because the interaction between central policy and dealer marketing affects marketing efficiency directly. Either too high or too low marketing target will result in certain kinds of efficiency loss. By setting a more reasonable MERT, dealers are more easily to be motivated in their local marketing investment.

Despite automotive industry has developed for over one hundred years, there still exist many dilemmas in management that need to be addressed with more scientific approaches instead of an empirical manner. Henceforth, this research topic
will assist to standardize the way in improving management practice, which is highly valued by companies and organizations, and is widely applicable to many other groups to manage and motivate their own dealer network in other industries.
Chapter 3: OEM-Dealer Channel Relationship Analysis

In last chapter, the co-investment in marketing by Auto OEM and dealers is introduced, the current sales-based dealer marketing target is shown step by step, the problem in current marketing incentive system is identified, and the proposal to develop a more scientific approach to adjust the next-year dealer marketing expense target is raised with significance and business value.

Before digging into the basics of building model directly, a closer look into the type of channel relationship and the necessity to applying the more accurate adjusting model is necessary to ensure the model’s business practicability.

In this chapter, the framework of optimal channel alignment will be introduced, and the most important elements regarding relationship building between Auto OEMs and dealers will be identified. After that, marketing tools will be used to identify what type of channel collaboration should Auto OEMs adopt, and whether it is worthwhile to invest more in designing the incentives to better serve the channel relationship. Finally, the current collaborating patterns of dealers will be categorized into four sections by dimensions of collaborating level and quality of the marketing activities. The suggested solutions to move dealers towards the desired section will be given, and besides all suggested solutions, a more reasonable MERT will be identified to be most important in building a sustainable and healthy channel relationship.

3.1 Optimal Channel Alignment

The optimal channel alignment is the for all channel partners. To achieve optimal channel alignment, four key aspects – channel benefits, channel functions, relationships and incentives – should be considered carefully in deciding the channel cooperation.

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In the four key aspects, channel benefit is to solve the problem of how customers want to buy, and channel functions is to decide what channel activities are needed to enhance channel benefits. And in Auto OEM-dealer channel relationship, the above two factors depend more on the dealer side in implementing and providing the channel benefits to customers, although with Auto OEM’s requirements and guidance.

For the other two key aspects in the framework, the relationship mainly emphasizes on reviewing the channel partnership to see what type of channel relationship the Auto OEMs should have with their channel partners, and the incentives is to help ensure their channel partners do the right activity at the right price. A closer look into the relationship and incentives in Auto OEM’s perspective is essential to achieve its the optimal channel alignment. In Chapter 3.2 and 3.3, the type of the relationship between Auto OEM and dealers will be identified, and dealers’ behavior patterns under current marketing incentive system will be discussed with proposed solutions.

3.2 Identify the Type of Channel Relationship

A high level of channel cooperation is not always efficient for partners in all business collaboration. According to Anne T. Coughlan and Sandy D. Jap (2016), developing and maintaining a channel relationship requires plenty of investments in
time, efforts and willingness to coordinate activities and share information. To
determine the efficient level of channel cooperation, the economic value of the
partnership needs to be evaluated to decide whether to keep the relationship more
transactional or more collaborative. There are six dimensions – transaction frequency,
key outcomes, competitive orientation, information exchange, operational linkages,
specific adaptations and shared risks – to measure the continuum of cooperation
types from one-off transactional exchanges to high cooperative strategic exchanges.19

Table 3: Identify Type of Relationship Between Auto OEM and Dealers

<table>
<thead>
<tr>
<th>More Transactional</th>
<th>Continuum Dimensions</th>
<th>More Collaborative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrequent/one-shot</td>
<td>Transaction Frequency</td>
<td>Regular and repeated</td>
</tr>
<tr>
<td>Price is king</td>
<td>Key Outcomes</td>
<td>Intangible value</td>
</tr>
<tr>
<td>Self-maximization</td>
<td>Competitive Orientation</td>
<td>Joint maximization</td>
</tr>
<tr>
<td>Minimal</td>
<td>Information Exchange</td>
<td>Open sharing of useful info</td>
</tr>
<tr>
<td>None</td>
<td>Operational Linkage</td>
<td>Shared and connected</td>
</tr>
<tr>
<td>None</td>
<td>Specific Adaptations and</td>
<td>Greater than average</td>
</tr>
<tr>
<td></td>
<td>Shared Risk</td>
<td></td>
</tr>
</tbody>
</table>

With huge investment in building a franchisee dealer 4S shop by investor group
and great efforts in training the dealership by Auto OEM, both Auto OEM and dealers
are intended to build a long-term beneficial relationship. The transactions between
two sides are frequent and complex, and they are working together to build the brand
image for a higher premium retail price. They share many information regarding
market, product, competition, policy and business performance, and their goal of
sharing information is to achieve the joint benefits maximization by expanding the
total pie. They share the operational information and some risks. Measured by the six
dimensions, the partnership between Auto OEM and dealers should be highly cooperative.

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Especially for the current dynamic market with frequent policy changes, increasing competition, and new emerging market for electric vehicles, huge investments should be devoted to make the relationship more efficient, quicker response to the market change and more long-term benefits for both sides.

3.3 Dealers' Behavior Patterns under Current Marketing Incentives

Channel temptation to misbehave is activated when three conditions – pressure, opportunity, rationalization – exist simultaneously, especially for dealers who are highly self-interested. The imperfection of channel marketing incentives provides the opportunity, the market saturation and thin profit margin poses pressures on dealers, and dealers who do not recognize the channel cooperation benefits would easily rationalize the misbehavior for their own goods. In this condition, some dealers misbehave in the way that weakens the channel cooperation.

Figure 9: A Dangerous Triad of Temptation to Misbehave


Among all kinds of channel opportunistic misbehaviors, (1) dealer marketing manipulation, (2) giving up dealer marketing target totally, and (3) free-riding problems are the most common ones that reduce the overall channel marketing effectiveness and efficiency.

(1) Marketing Manipulation.

For every dollar saved in marketing investment, it becomes part of the dealer profit in the short run. For a better profitability outcome, especially in a harder market environment, some dealers tend to invest much less than the dealer marketing expense target required by Auto OEM, as well as getting as much incentive bonus as possible. How can it be done without actually investing in local marketing? Some opportunistic dealers give the answer by manipulation.

Dealers declare to the Auto OEM that they have planned and implemented certain marketing activities with manipulated supporting documents, such as photoshopped activity photos, old photos from other activities, fake invoices from non-existing service providers, manipulated customer information, and marketing expense per activity way much higher than what it should be. Some Auto OEMs will hire an external agency to review the validity of the declared marketing activities, but chances still exist that some dealers might survive the review, and get the marketing bonus which in real cases they should not have obtained. But the high output/input opportunism lures many dealers to follow, in which way harms both the OEM’s benefits and dealer’s long-term local sales.

(2) Giving Up Dealer Marketing Target Totally.

Dealer’s annual marketing expense target is set based on its annual sales target and the average MSRP of the vehicles ordered, regardless of dealer’s special reasons for incapability to fulfill the target, such as dealer’s financial pressure, or investor group’s instruction on marketing strategy. When the marketing target is too high to be achieved in dealer’s perspective, the dealer will usually give up the OEM required target totally, in a negative way that some of them just don’t do marketing at all. In other words, some dealers either achieve 100% of the OEM required dealer marketing target, or in the other way do 0%~20%, never choose to fall in the middle of the positive investment interval 50%~90% (Cloud Bai, personal communication, January 2018). This also indicates that an unreasonably high marketing target set by the Auto
OEM will have more negative influence than no marketing target does.

(3) Free-riding Problems.

Free-riding problem more common to see in dealers, especially dealers located in the same city. One dealer who does radio advertisements for the brand and vehicles is creating the pre-sale valued externalities for the other dealers located in the same city. Without doing any marketing, they can also get more showroom visits and converted sales. However, if not managed well, the enthusiasm of the dealer who is actively investing in local marketing is likely to wane.

Take a real-life example for totally giving up marketing expense target and free-riding (Cloud Bai, personal communication, January 2018). There were two dealers under the same OEM brand located in Nanking, and one of them (dealer A) gave up the required marketing target directly because it was too difficult for dealer A to achieve. Besides taking advantage on the external benefits of dealer B’s online advertisements, dealer A even took advantage in dealer B’s BTL activities intentionally. When dealer B was doing a car road show in shopping mall or public square, which involves a substantial amount of expense invested in renting the location space and decorating the exhibition stand. On the day of the road show, dealer A sent several sales people to dealer B’s road show, distributing flyers of their own dealership’s better retail price to take the customers away. Dealer A used the marketing budget saved to lower the vehicle’s retail price, steal away the customer traffic gathered by dealer B and sell their own cars by a malicious price competition. Without timely intervention from the Auto OEM, dealer A’s enthusiasm declined quickly, and the two dealers ended up in a negative way that no one investing in marketing or making it more secretly while on the other hand also attracted less traffic than it would otherwise have done. Under unreasonable marketing target, the free-riding problem without timely intervention wakens both dealer’s long-term sales, as well as OEM’s benefits.

With both dealers’ positive and negative cooperation behaviors, dimensions of
“Dealer Marketing Quality” and “Collaboration Level in Fulfilling Marketing Target” are selected to categorize dealers’ behavior patterns. The dimension of “Dealer Marketing Quality” measures ATL/BTL activity quality under similar marketing budget. In other words, with similar marketing expense declared, dealers who try to manipulate with some non-existing activities, or use unfair valued service providers, or hold activities that cannot match the brand image will be perceived as low in “Dealer Marketing Quality”. The dimension of “Collaboration Level in Fulfilling Marketing Target” measures dealer’s altitude towards fulfilling the assigned marketing expense target. In other words, dealers who invest actively in local marketing with the goal of achieving assigned targets will be perceived as high in “Collaboration Level in Fulfilling Marketing Target”. In this way, four sections with different patterns of dealer behavior are shown in figure 10.

![Figure 10: Dealers’ Behavior Patterns under Current Marketing Incentives](image)

(1) **L-L Dealers in Section A**

For dealers in section A, they have low enthusiasm in local marketing and low quality in marketing activities. The root causes of this kind of negative behavior are usually imbedded in negative mindset and lack of competency. They might:

- Have a stronger mindset in “price is king” over marketing, and/or
- Haven’t realized the value of marketing, and have no confidence in the output effect of local marketing, and/or
- Lack the capability and enough guidance to implement qualified marketing activities, and/or
- Disheartened by unreasonable marketing expense target, that they give up the target totally without the basic attempts to improve their marketing.

When dealers are discouraged by either of the root causes above, it casts negative influence on both the dealer and Auto OEM’s central marketing management. Without active local marketing, dealer’s local brand awareness is low, for which it is difficult to drive showroom traffic and generate sales. With the continuous negative influence on dealer’s short-term and long-term sales, market share will be lost to local competitors gradually with an increasing difficulty in dealer’s operation and profitability. For Auto OEM, there is also a loss of efficiency from central marketing management in rolling off the incentive system to motivate dealers investing in local marketing.

To influence the mindset and behaviors of dealers in section A in a positive way, the following proposed action plans could be taken by Auto OEM for a better channel marketing cooperation:

- Spend more efforts on educating the dealers about the value of marketing and try to change their mindset from low price to active marketing (Sharmila C. Chatterjee, personal communication, October 2017).
- Provide more targeted coaching and guidance to dealers who are not competent to implement marketing activities as is required by the OEM.
- Give more flexibility in adjusting the conditional marketing target policy for special dealers.

(2) H-L Dealers in Section B

For dealers in section B, they have high enthusiasm in local marketing and low quality in marketing activities, and this case is usually covered by the illusion of high enthusiasm from declared high marketing expense by dealer. The root causes of this
kind of negative behavior are usually imbedded in opportunism and fraud. They might have the motivations to:

- Be totally self-interest focused, and seek the loophole in management systems as opportunity to take benefits, and/or

- Manipulate the fulfillment of marketing requirements, and fraud to take the marketing incentives that in reality do not belong to them.

When dealers are instigated by either of motivations above, it casts very negative influence on Auto OEM's franchised dealer network. The moral hazard exposes the OEM's dealer network under unfairness and huge risk of opportunistic imitation.

If dealer's manipulation behavior was not detected timely by the OEM, and the dealer is awarded with substantial incentives, it is very unfair to those dealers who actively invest in marketing but just earn as much the incentive bonus as the fraud dealers do. Unfairness in the incentive system will undermine the enthusiasm of good performers and foster the spread of moral hazard. More dealers in the network will notice or figure out what is happening gradually, and start to imitate the marketing manipulation, in which case the OEM invests large amount of support to the channel partnership but seeing much lower returns than what it would otherwise bring.

Not only the OEM suffers great loss in the channel support, but also the dealers who manipulate to get the incentives spend less than enough in local marketing, which in the long run will weaken the local brand awareness and sales performance.

To prevent this problem from going worse, a governance strategy must be adopted to regulate dealer’s behavior and enhance the fair and equitable marketing incentive system. Essential elements of a governance strategy are defined by the establishment, communication, monitoring, and enforcement of appropriate rules of conduct and associated consequences. Using this framework, Auto OEM should

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protect the healthy channel cooperation by:

- Establish the compliance in rules of conduct under the incentive system, clearly communicate the requirements and boundaries of marketing behaviors with all network dealers.\(^{22}\)

- Communicate the consequence of violating the compliance rules clearly.\(^{23}\) When there is any dealer violating the pre-agreed compliance, penalties could be applied to punish the dealer and warn other network dealers.

- Set a monitor system to review the dealer’s marketing behaviors regularly. Some OEMs hire a third-party company to monitor dealer’s marketing regularly, and some other OEMs randomly pick dealers to do onsite check quarterly or annually with less expense compared to hiring an agency.

- If certain dealer is found to manipulate in marketing investments, penalty should be applied to make the dealer pay the price for non-compliance behavior, such as canceling the dealer’s bonus and its qualification in participating other kinds of reward ranking for a reasonable period of time. The non-compliance behavior and penalty should also be announced in the network to show to other dealers.

(3) L-H Dealers in Section C

For dealers in section C, they have low enthusiasm in local marketing and high quality in marketing activities. Dealers in this section usually have developed their own methodology in local marketing based on the past experience:

- They learned from experience about what kinds of marketing activities are most cost-effective in generating sales in their local markets. Therefore, they


spend efforts designing marketing plans, hold high quality events, and ensure every dollar invested in the marketing will worth it.

- They are not easily moved by the target and incentives, and only invest the amount they think is the best for generating desirable sales outcomes. Any more investment in marketing in their calculation means a waste of money, thus resulting the gap between OEM assigned marketing expense target and dealer’s actual investment.

Generally speaking, dealers who fall into this section have very high potential in expanding the total pie for channel cooperation, but they are just too cautious in calculating the input-output benefits for themselves. If they can be more active in channel marketing cooperation, less efficiency loss and more value will be generated from the OEM’s incentive system. Proposed solutions for Auto OEM to encourage these dealers moving towards a more collaborative altitude are as follows:

- Communicate the value of marketing in long-term benefits with short-term trade-offs and move dealer’s mindset towards a long-term view.

- If there is an attention-getting number of dealers who fall into this section, a serious review of the current incentive mechanism needs to be conducted, because the possibility is high that the MERT might be set unreasonably high for dealers under that situation.

(4) H-H Dealers in Section D

For dealers in section D, they have high enthusiasm in local marketing and high quality in marketing activities, and these dealers are the best cooperating partners in the channel relationship. If the channel marketing incentive system is reasonably designed, most of the network dealers should fall into this section, which means that the incentive is designed very attractive to dealers, as well as approachable with good plans and efforts. The most desired outcome is to encourage dealers from section A, B and C moving towards section D, and together make a bigger total pie for the channel cooperation outcome.
In summary, dealers' behaviors are influenced by both internal factors and external incentives. To achieve the optimal channel alignment, incentive policy and channel communication should be carefully designed and adjusted with changes. Whichever patterns of marketing behavior that the dealers are distributed in, their common demand for the marketing incentive system to safeguard a better channel cooperation is a reasonably designed marketing expense target. In the next chapter, a further step will be taken into each stakeholder to analyze their influence on the patterns of dealer marketing behaviors.
Chapter 4: Stakeholders’ Influence on Dealer Marketing Behaviors

In the previous three chapters, the OEM-dealer channel relationship and conflicts in the channel alignment are introduced. Under current channel marketing incentive system, dealers’ behaviors are driven towards different patterns by the misalignment between the different interests of OEM and dealers. Besides proposing tailored solutions for dealers in each behavior pattern in Chapter 3, a common demand by all network dealers for a more reasonable annual marketing expense target is urgently required.

In this chapter, the premium segment of automotive market will be taken as an example in analyzing the channel policy, important stakeholders and critical variables influencing dealer marketing behaviors. Mercedes Bez, BMW, Volkswagen Imported China (hereinafter referred to as “VGIC”) will be taken as OEMs in this premium segment.

By listing all important channel stakeholders in this chapter, what aspects does each stakeholder care about, what is expected by stakeholder from the dealers, and how is the stakeholder influencing dealer’s decision in marketing behaviors will be analyzed systematically. Dealer policies by OEMs, annual balanced scorecards, and dealer value map by investors in recent years are selected to be the most important information resources to study the causation in this area. After an in-depth analysis of each part, the key influencing variables will be picked out for further study in Chapter 5.

4.1 Auto OEM

In Chapter 1.1 and 1.2, the vehicle flow and capital flow inside the distribution channel are elaborated clearly, where we can see dealers are the payers to Auto OEM, and Auto OEM uses dealers as the unique channel to distribute vehicles to the market end use customers. If well built, distribution channels can serve as a very distinctive differentiator and create a huge advantage over the competitors.
Though dealers are the payers to OEM, the primary customers of OEM are still the end use customers. As the payer and primary customer are not the same stakeholder, besides educating primary customers generally through online marketing, OEMs are also investing huge amount of resources in managing the channel partners to provide better services to the end use customers.

The relationship between OEM and dealers is the most important and most complex among all channel stakeholders. In this sub chapter, the major influencing factors will be analyzed through four main aspects:

1) **OEM’s interests in channel**, which is best reflected in the Annual Dealer Balanced Scorecard.

2) **OEM’s dealer incentive policy**, which reveals the level of central incentive and support by the OEM.

3) **Hidden stock**, which is resulted from dealer’s manipulated declaration of achieving sales target.

4) **Overall dealer marketing target completion status of the past year**, which helps examine the healthy status of channel marketing management.

### 4.1.1 OEM’s Interest in Channel (BSC)

What factors does OEM care most when managing dealer channels are best reflected in the dealer annual balanced scorecard, which is designed by OEM to motivate dealer’s behavior in the way that OEM values most.

In this part, the 2015 Annual Dealer Balanced Scorecard by BMW will be taken as the example to examine the critical variables OEM cares about and cast influence in deciding the dealer marketing expense target. Dealers are grouped into ABC by sales size, and dealers in each group whoever achieve the top 20 to 30 will be awarded with substantial incentives as is shown in the figure below.
BMW Dealer Excellence Award

<table>
<thead>
<tr>
<th>BMW Dealer Excellence Award</th>
<th>Nominated by region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 1</td>
<td>Top 2-10</td>
</tr>
<tr>
<td>Top 11-20</td>
<td>Top 1 Top 2-10 Top 11-30</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Group A</th>
<th>Group B</th>
<th>Group C</th>
<th>Best Improvement Award</th>
<th>Best New Dealer Award</th>
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</thead>
<tbody>
<tr>
<td>Dealer Excellence Award</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 1</td>
<td>Top 2-10</td>
<td>Top 11-30</td>
<td>Top 1 Top 2-10 Top 11-30</td>
<td>1 dealer region 2 dealers region</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Support amount for each BMW China wholesale (RMB, incl. VAT)</th>
<th>Support amount for each BMW Brilliance wholesale (RMB, incl. VAT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>50,000</td>
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<table>
<thead>
<tr>
<th>BMW China (RMB)</th>
<th>BMW Brilliance (RMB)</th>
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<table>
<thead>
<tr>
<th>Total BMW China support (RMB, incl. VAT)</th>
<th>Total BMW Brilliance support (RMB, incl. VAT)</th>
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<tbody>
<tr>
<td>1,750,000</td>
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</tr>
</tbody>
</table>

* Top 3 dealers in Group A/B/C respectively in each quarter will be additionally provided with first option for certain amounts of hot cars.

Figure 11: BMW 2015 Dealer Excellence Ranking Award (in RMB)

In the methodology of designing the dealer balanced scorecard (see table 4), BMW emphasized on three major areas – Target Achievement (take up 52% of total scores), Joy in Retail (take up 45% of total scores), and Business Sustainability (take up 3% of total scores). The first two areas – target achievement and joy in retail – in total take up 97% of balance scorecard, emphasizing the OEM’s interests in achieving high sales volume and enhancing customer satisfaction and BMW brand image by standardized excellent process, which is also served for the goal of long-term sales. Detailed key performance indicators under each area are listed to evaluate dealer’s performance in these dimensions.

Table 4: Methodology - 2015 BMW Dealer Performance Ranking

<table>
<thead>
<tr>
<th>Area</th>
<th>KPIs</th>
<th>Full Year Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Achievement</td>
<td>BMW Retail Target Achievement %</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>7er Retail Target Achievement %</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>Parts Retail Target Achievement %</td>
<td>60</td>
</tr>
</tbody>
</table>

---


<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Finance Penetration Rate %</td>
<td>16</td>
</tr>
<tr>
<td>Sales Process Quality (SPQ)</td>
<td>44</td>
</tr>
<tr>
<td>Aftersales Process Quality (APQ)</td>
<td>44</td>
</tr>
<tr>
<td>Net Promoter Score (NPS)</td>
<td>44</td>
</tr>
<tr>
<td>Wholesale &amp; Retail Leads Follow-up %</td>
<td>32</td>
</tr>
<tr>
<td>Actively Offer Test Drive</td>
<td>5</td>
</tr>
<tr>
<td>New Car Handover</td>
<td>2</td>
</tr>
<tr>
<td>National Sales Competition</td>
<td>1</td>
</tr>
<tr>
<td>DMS Financial Module Usage</td>
<td>4</td>
</tr>
<tr>
<td>Business Plan Submission</td>
<td>2</td>
</tr>
<tr>
<td>Used Car Contribution to RoS</td>
<td>2</td>
</tr>
<tr>
<td>Total Score of Balanced Scorecard (BSC)</td>
<td>376</td>
</tr>
</tbody>
</table>

There are also preconditions that dealers should all achieve before anyone can be qualified in participating the BSC dealer ranking. The most important preconditions include:26


2) Market Share: achieve at least No.1 & No.2 position in dealer local city in terms of BMW market share in premium segment.

3) Marketing: marketing expense is no less than 0.15% of new car sales turnover, and subject to 3rd party auditing review; plus 100% fulfillment of mandatory marketing items required by BMW.

Summarizing from the OEM designed dealer balanced scorecard and its rewarding system, it is obvious to tell that factors of retail sales target, market share, customer satisfaction and incentive support are highlighted by OEM in managing the channel cooperation. In perspectives of dealer marketing, retail sales target, market share and incentive support should be picked out for further analysis, because considering Auto OEM’s next-year plan:

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- **Retail Sales Target**: By expanding the dealer network and pushing a higher sales target on each existing dealer, OEM has an increasing overall retail sales target year by year. To support and safeguard the higher sales target, larger marketing investments are needed by both central marketing and dealer local marketing.

- **National Market Share**: Market share is measured by vehicle registration number, and it is compared between competitors in a well-defined market segment. Take BMW China subsidiary as an example. As of May 2015, BMW took up 25.8% market share in the premium segment, ranking the 2nd following Audi whose market share is 33.2%. With the company mission of "We are Number ONE" 27, BMW always seeks to be in the first place. By the target of increasing market share, continuous investments in marketing are needed to safeguard the market share expansion.

![Market Share Chart]

Figure 12: BMW 2015 YTD May Registration and Market Share 28

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Local Market Share: OEM's national market share is accumulated by dealer's local market share, and that is the reason why OEM puts dealer's local market share as the pre-condition for them to participate in annual BSC dealer ranking. The local market share is an important indicator of dealer's competitiveness and long-term sales performance in the city level. More benefits of leading local market share will be specified in Chapter 4.4.3. If dealers want to pursue the first two positions in the same market segment in local city, a higher marketing investment is needed for driving the brand awareness and larger customer traffic to convert more retail sales compared to local competitors.

4.1.2 OEM's Dealer Incentive Policy

Dealers are motivated to fulfill the requirements by OEM due to the attractive amount of incentive bonus, which put in other words is a direct add-on in their profits. There are generally two kinds of dealer incentive policy that are influencing dealer's behavior in local marketing investments.

The first one which is also the largest one is linked with Dealer Balanced Scorecard (as in Chapter 4.1.1), evaluating dealer's performance with OEM's ruler. In the example of BMW BSC, dealer marketing target fulfillment is the pre-condition to participate the annual best dealer ranking. Dealers who are performing great in every criterion but fail to fulfill the pre-condition of marketing target are not eligible for getting the bonus which he could have won otherwise. In this condition, dealers are likely to take more initiatives in fulfilling the marketing requirements when the incentive bonus are very attractive, or the dealers are already performing great in fulfilling BSC criterions to receive a substantial bonus.

Besides the incentive bonus by BSC dealer ranking, there are also many kinds of marketing incentives that are designed solely for compensating or supporting dealer marketing activities. Take BMW 2018 Marketing Cooperation Policy as an example.
Table 5: 2018 BMW Dealer Policy – Local Marketing Incentive

<table>
<thead>
<tr>
<th>Group Dealer</th>
<th>Marketing Requirements</th>
</tr>
</thead>
</table>
| ATL (60%)    | 100% fulfillment of product communication in line with BMW headquarter requirements. The Marketing Incentive on ATL should be equal to 60% of total:  
  - New Product + Tactical Campaign.  
  - The marketing incentive on long-term OOH cannot exceed 15% of total marketing investment. |
| BTL (40%)    | 100% fulfillment of dealer local events in line with BMW regional requirements, The Marketing Incentive on BTL should be equal to 40% of total:  
  - New Product Launch + Local Motor Show + G12 Activity.  
  - "4+X"dealer local event. |
| CI           | 100% Strictly comply with CI guideline for marketing activities:  
  - 4 times system check by BMW 3rd party and;  
  - No CI issue or received no more than 2 times written warning letter of CI issue by region. |

Incentive Ratio | Up to **0.3%** of Gross Retail Revenue **

In this marketing cooperation policy, dealers whoever achieve marketing expense target and also fulfilling all requirements made in table 5 can receive marketing special fund by OEM as high as 0.3% of dealer’s gross retail revenue, which is defined as the aggregate MSRP of all the vehicles actually purchased by a dealer from OEM.

4.1.3 Hidden Stock Level

Dealer’s wholesale and retail targets are set quarterly by the OEM, and dealer’s sales target completion rate decides whether they can get the substantial sales incentives. However, with intrinsic operation capability and extrinsic market

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dynamics, dealers might have difficulty in failing to achieve the sales target on time. Motivated by the substantial sales incentives, some dealers choose to take opportunism moves to make the illusion that they have achieved the sales targets.

In my past working experience in Sales Incentive Application Review projects, dealers who declared fake sales in the DMS system would issue invoices and sealed vehicle maintenance book for vehicles that were not sold, and hide the stock somewhere that cannot be found by third party reviewers. Among the manipulated declared sales to OEM, most of them can be detected with carefully designed review methods, but there still exists some vehicles with a narrow escape. As a statistic reference, there was nearly 10% manipulated declared sales founded for one OEM.

The hidden stock are also vehicles that need marketing investment to safeguard the sales in the next year. Therefore, besides designing the marketing expense target based on the next-year “nominal sales target”, an extra amount of target should be taken into consideration regarding the left hidden stock from last year. If there is a significant level of hidden stock from last year, the marketing expense target should be raised in order to accelerate the higher “actual sales target” in the next year.

**4.1.4 Dealer Marketing Target Completion Status of Last Year**

A very direct index to evaluate the OEM’s central marketing management effectiveness is dealer’s marketing completion rate of the past year. If the marketing incentives are well designed and dealers are well motivated, the overall marketing expense target completion rate should be relatively high. But if the overall completion rate turns to be low (below 80%), that is an indicator that dealers have difficulty in fulfilling the targets. If the targets of this year are still set in the same methodology as the last year, the marketing expense targets will still be too high for many dealers to achieve, thus resulting a less efficient channel marketing management outcome.

In this case, if the dealer’s marketing expense target competition rate of last year is significantly lower than expected, a slight decrease in setting the next year dealer marketing expense target should be taken into consideration.
As a summary of Chapter 4.1 in OEM’s influence on dealer’s marketing behavior, six critical variables – Retail sales target, national market share, local market share, incentive & support, hidden stock level by manipulated declared sales, and dealer marketing target competition rate of last year – under four main aspects are selected as influencing factor representatives, of which the influence will be further evaluated in Chapter 5.

4.2 Investor Group and Franchised Dealer

In Chapter 1.2 and 1.3, we know that investor group is the parent company of franchised dealer, and they share the same interests of growth and profitability. Different from the OEM whose major interest is in the long-term sales, dealers also value businesses of aftersales service, used car trade, finance and insurance penetration, because the profit generated by these businesses are more than the new car sales does, but the new car sales is very important because it serves as the basis in driving the other business functions.

To evaluate investor group’s satisfaction with dealer’s performance, the Return on Equity (hereinafter referred to as “RoE”) is the best KPI. The current and future RoE determines dealer’s operational success in investor group’s view. The current RoE is defined by three dimensions – Profitability, Operation Efficiency and Risk:

- **Profitability**: Dealer’s profitability is mainly determined by Return on Sales (hereinafter referred to as “RoS”), of which the performance can be calculated through the formula below:

\[
    \text{RoS} = \text{Contribution}_{i} - \text{SG&A Expenses} - \text{Financial Expenses} + \text{Other Income}
\]

\[
    \text{Overall Contribution} = \sum_{i=1}^{4} (\text{Net Revenue After Discount}_i - \text{COGS}_i)
\]

In the variables listed above, SG&A and financial expenses are related with dealer's internal management capability, and other income is less predictable and non-operational based. The Overall Contribution I is the most important attribute. Among the 4 main business functions, the revenue of new car sales usually takes up more than 90% of the total dealer revenue, since the retail price of vehicles in premium segment is significantly higher than the revenue from other businesses. Therefore, the New Car Sales Contribution I is the most important variable in determining the Overall Contribution I. The COGS of certain vehicle is fixed since that is the wholesale price determined by the OEM. Thus, the retail transaction price of vehicles should be picked out as the most significant critical variable in determining dealer's profitability.

- **Operation Efficiency:** Dealer’s operation efficiency is mainly defined by Asset Turnover, which is determined by dealer’s vehicle stock depth and stock turnover rate. Less stock turnover days indicate that the dealer is more efficient in planning the stock and sales, as well as using the capital with less financial costs per vehicle. The benchmark for a healthy stock turnover in dealers is 30 to 45 days, of which less than 30 days might cast a higher risk in short supply due to seasonal high demand and stock transportation behind time.

For dealers who are under pressure of unable to achieve the annual sales target, they sometimes intend to declare false sales in DMS, manipulating the illusion of target achievement for OEM. Dealers who prepared very well for the fake documents have lower risk to be found manipulated by the OEM or agency review, and they will have a higher possibility to get the substantial incentive bonus as if they achieve the sales target. In this situation, there exists a higher national-wide stock depth than the stock number appears in the OEM’s DMS system. In this dimension, stock depth should be picked out as a critical variable.
- **Risk**: Dealer's operation risk is mainly measured by the equity ratio, which is mainly influenced by investor group and dealer's equity management. No critical factors related with dealer marketing will be picked here.

The figure below is an example of value map from BMW dealers. Dealers are more active in participating in channel cooperation of wholesale and local marketing when they have a better profitability. Therefore, Auto OEM is also paying a close attention to dealer's RoE structure. After collecting business and financial data from network dealers, OEM can generate the value maps for all dealers, and indicate the performance level of each variable by comparing with network dealers. In the figure below, the green, red and yellow lights indicate the dealer's KPI performance is in the top 25%, bottom 25%, or in between.

![Value Map Example](image)

**Figure 13: An Example of Dealer’s Value Map**

Besides the influencing factors in current RoE, the future RoE also comes from the future market sales trend. If the market capacity is still in high growth trend, the expectation of future RoE will be higher than a saturated market. In this dimension,

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the market sales trend should be picked as the critical factor, in which a growing sales trend demands a higher marketing investment.

In summary of this section, by analyzing dealer’s value map in perspectives of investor group and dealer's interests, retail transaction prices, stock depth and market sales trend are critical variables which should be taken into account when deciding a reasonable dealer marketing expense target.

4.3 Non-franchised Dealer

Non-franchised dealers are independent dealers who neither have agreements with any OEMs in distributing vehicles, nor feature any manufacturer brand name in their own names.\textsuperscript{32} They carry vehicles from different brands and have a wide selection of vehicle models. As non-franchised dealers don’t provide aftersales and other services, their sales business is more like a one-shot deal. And customers who want to purchase vehicles from non-franchised dealers are more sensitive towards price, and always get a much lower price compared to the same vehicle model sold in a franchised dealer store.

4.3.1 Benefits in Non-franchised Distribution

Rather than competitors, the relationship between franchised dealer and non-franchised dealer are more like partners. In the premium segment of automotive market, most of customers care more about the experience and aftersales service over the difference of prices. In this situation, non-franchised dealers have much less business threats on franchised dealers. On the opposite, non-franchised dealers are providing more benefits when needed by franchised dealers:

- **Help franchised dealers clear out vehicle stock:** Franchised dealers might get a high stock depth due to many reasons, for example, they might

encounter stagnant sales by competitor’s launch of new models or sales promotions, they might want to fulfill the wholesale target but have less capability in digesting them. When franchised dealer’s stock depth is high, the operation efficiency drops quickly with slower turnover and the financial cost of capital turnover is also very high. To fulfill the next-round target and get the business run efficiently again, franchised dealers have a higher intention to clear the stock to a normal level.

Non-franchised dealers can help to deal with the situation more quickly than franchised dealers doing sales promotion by themselves. Usually in this situation, franchised dealers will resell the stock vehicles to non-franchised dealers in a very low price, and let the non-franchised dealer distribute them to more remote areas where the franchised dealers might not be able to reach, or distribute them to more price sensitive customers who don’t want to maintain their vehicles in a franchised dealer store.

- **No commission in reselling stock vehicles:** As is elaborated in Chapter 1.2, franchised dealers will resell the stock vehicles to non-franchised dealers with a price that both sides think is appropriate. Then the non-franchised dealers can sell the stock vehicles to end use customers at whatever prices they think is profitable. Therefore, the non-franchised dealers make profit by the difference of selling price and purchasing price, and no commission exists for encouraging and rewarding the non-franchised dealers in helping clear the stock vehicles, which costs less in both franchised dealer's sales cost and management efficiency (Dealer Used Car Manager, personal communication, April 2015).

- **No marketing investments are needed for reselling vehicles:** In Chapter 2.2, we know that dealer’s marketing expense target is calculated on certain percentage of dealer’s annual sales volume target, and the methodology is designed so because it defines that certain amount of marketing expense should be invested to get a successful sales deal. If
dealers resell some stock vehicles directly to non-franchised dealers, there are no marketing investments needed for these vehicles because the title of the vehicles are transferred to non-franchised dealers, and it is their responsibility to get the sales done.

- **Non-franchised dealers have complementary channels with franchised dealers:** Franchised dealers and non-franchised dealers usually have very different channel networks. Franchised dealer’s location picking is well planned considering the city capacity, local competition and the nation/state coverage. Franchised dealers are mostly located in the first to third tier of cities, capturing most of potential customers. On the opposite, non-franchised dealers who are positioned as lower price product providers have a broader network in third to fifth tier of cities. They can operate a store with much lower cost regardless of store decoration, thus running more small showrooms in remote areas. Potential customers who can easily approach the non-franchised dealers instead of franchised dealers might be converted into customers, and potential customers who live in remote cities are more likely to be price sensitive, for which they might prefer to purchase vehicles from non-franchised dealers. In this cooperation, the non-franchised dealers are helping the franchised dealers to reach to more customers in other areas, expanding the total pie for their joint benefits.

### 4.3.2 Drawbacks in Non-Franchised Distribution

As elaborated in Chapter 4.3.1, there are many benefits for franchised dealers to distribute stock vehicles through non-franchised dealer’s network. However, the benefits are only contributing to dealer’s short-term performance – clearing out redundant stock vehicles in a less costly and more quickly way. There are more long-term negative influences that will take time to be seen:

- **Cannibalization:** By reallocating vehicles from franchised dealers to non-franchised dealers, the cannibalization in the time dimension is
inevitable. The more vehicles sold by non-franchised dealers, the larger influence do they gain on customers in local cities. The tendency of customers to purchase the vehicles is likely to move from enjoying full services and experience to enjoying the lower price. This kind of customer tendency introduces the competition between franchised dealers and non-franchised dealers for the same segment of customers, accelerating the phenomenon of cannibalization.

The cannibalization also brings the problem of free-riding. With similar accessibility of franchised dealers and non-franchised dealers, potential customers might enjoy the shopping experience in a franchised dealer, and then make the final purchase with a non-franchised dealer to pay less for the same product. The professional services before making a final deal include vehicle introduction by product genius, model comparison, configuration confirmation, test drive, and suggestions on maintenance, and these services provide substantial values to customers when they are choosing a model. These professional services are costly in developing and are only featured in franchised dealers.

With the problem of free-riding, franchised dealers are not only wasting more time and investments in providing services with less sales conversion rate, but also losing more customers to non-franchised dealers. In the long-term view, to maintain a solid position in certain market segment, franchised dealers must control their reselling behavior, and assessing the risk level of cannibalization in a regular time basis.

- **Price War:** Non-franchised dealers are positioned as no service and low price in competition. With an increasing number of vehicles distributed by non-franchised dealers in nearby cities, potential customers as well as existing customers are potentially educated in a way emphasizing the lower price for same products. When potential customers are shopping in the franchised dealer’s store, they are less easily to compromise for price and
more likely to post pressure comparing with the price provided by non-franchised dealers.

- **Brand Image Damage:** Franchised dealer’s store decoration and layouts are well designed with OEM’s global standards aligning with the brand image and premium market segmentation. The OEM wants to ensure customer’s experience with the brand in every customer facing process. Showroom and trained staff is the first-hand message that the brand is conveying to customers.

![BMW Franchised Dealer Showroom in Premium Segment](image1)

**Figure 14: BMW Franchised Dealer Showroom in Premium Segment**

![Non-franchised Dealer Showroom with Multiple Brands](image2)

**Figure 15: Non-franchised Dealer Showroom with Multiple Brands**
When purchasing the same branded cars in franchised and non-franchised dealers, customers are experiencing totally different shopping environments, and the premium brand image is likely to be damaged in view of customers who make the purchase from non-franchised dealers.

- **Less Customer Satisfaction:** With more vehicles distributed through non-franchised dealers to end use customers, more customers are left unattended after the non-shot deals. These customers cannot join car club held by franchised dealers, are not invited to regular maintenance activities, and are not attended for the aftersales and warranty. Their overall customer satisfaction with the brand will be much less than customers who purchase from franchised dealers directly.

- **After-sales Revenue Lost to Street Shops:** Unable to build relationships between the franchised dealer and customers due to the lost sales to non-franchised dealers, the customers who might be more sensitive towards price are more likely to turn to street shops for aftersales and maintenance. As is introduced in Chapter 1.3 and 4.2, dealer’s aftersales business generates substantial profits compared to other business units, and it is evaluated in the degree that can cover and support the whole dealership’s expense in running the store. Without getting customer information and building relationship in the beginning, not only the new car sales profit is lost, but also the customer lifetime value generated by aftersales and other services are not captured and lost to street shops. The loss of customer’s lifetime value in aftersales services, future used car trade-in business, future re-purchase, and future segment upgrading is a huge loss to franchised dealers in a long-term view.

In summary, franchised dealer’s reselling strategy to non-franchised dealers is a double-edged sword. In one hand, it helps dealer deal with the headache of indigestible stock vehicles quickly, on the other hand, it poses huge negative influence in dealer’s long-term business. If managed appropriately, the reselling strategy can
save the franchised dealer in difficulty and assist it to go back into the normal business operation. If used as a daily operation method to digest stock, the dealer’s future business will likely to be put into question.

The scale of reselling amount should be monitored by franchised dealers regularly, to balance trade-offs in a way that avoids negative influence in dealer’s long-term business. The OEM should also pay a close attention on the reselling scale, to adjust the dealer policy in a way that can guide dealer’s behavior in reducing the distribution through non-franchised dealers network.

4.4 Competitors (Local Competition)

For purpose of analyzing competitor’s influence on dealer’s behavior more comprehensively, the concept of competitors in this chapter needs to be expanded into local competition. Under this concept, local competitors, which includes the number of local competitors under the same brand and different brands, local price war, and local market share ranking in the same market segment will be taken into discussion in this chapter.

4.4.1 Local Competitors

Considering the difference in competitor’s nature, local competitors are categorized into two groups – competitors under the same brand and competitors under different brands in the same market segment.

For competitors under the same brand, store locations are planned carefully by the OEM to avoid the cannibalization among same branded dealers. Each dealership has a relatively separate geography territory. In this situation, there also exists same brand synergy other than sales competition. When dealers are marketing the brand and vehicle models for themselves, they are also creating external marketing benefits for other dealers under the same brand. With only one dealer doing marketing activities, the other dealers might also observe increase in customer traffic and sales conversion in their own stores.
This same brand synergy is also a double-edged sword. If the dealers are all very enthusiastic in investing in local marketing activities, the overall effects of marketing will far exceed the simple add ups of all dealers. But this synergy also creates opportunities for free-riding – dealers who are doing less marketing investments but riding on the external value created by other dealers might still get better results than it deserves from its actual investment. As a result, keeping other factors constant, with the number of competitors under the same brand increasing, individual dealer’s tendency in investing in local marketing is likely to decrease.

For competitors under different brands in the same market segment, dealers under the same brand are seeing as a whole representing the brand and competing against other brand dealers. When the number of dealers under other brands are increasing, their marketing efficiency is rising exponentially, as well as the local influence and sales volume as a whole. Under this situation, potential customers and market share are lost to competitor brands gradually. To defend the position and market share, dealers under the same brand are more likely to enhance their local marketing investments. As a result, keeping other factors constant, with the number of competitors under different brands increasing, individual dealer’s tendency in investing in local marketing is likely to increase.

4.4.2 Local Price War

Price war is commonly seen as one of the worst results of competition. When competitive products are similar to each other in customer’s view, or when some dealers are driven by short term revenue increase, or when some dealers are maliciously lowering price to grab market share intending to drive other dealers out of business, price war happens.

Price war is creating a vicious cycle for dealers. Once the price war starts, customers are attracted more by lower price and care less about the difference between competitive products, the business pressure of other dealers will increase due to the loss of sales to competitors who are offering lower price. When more
dealers are joining the price war, increasingly higher discounts are urged by the market. Every dollar saved from marketing expense can be converted to a dollar off the retail price, creating a lower price advantage against other competitors. By keeping educating customers on the low price, marketing activities will also be less effective in sales conversion rate than it could have been otherwise. The more severe the price war is, the less confidence and enthusiasm dealers will have in investing in local marketing, leaving dealers struggling with very thin profit margins.

Besides, the price war is also creating a false expectation for customers. Existing customers’ experience will be hurt, and potential customers will get used to price drop and be increasingly sensitive to price increase. Once dealers are starting the price war and others are joining it gradually, it is far more difficult to bring it back to the healthy and sustainable development.

To sum up, the increasing level of price war is undermining dealer’s enthusiasm in local marketing investments. Concerning the negative influence of different levels of local price war, dealers’ past transactional prices should be tracked regularly. With a benchmark in comparison, dealers whose transactional prices are reaching the warning line of price war should be reminded and coached with more education on marketing value creation over short-term benefits by price war.

4.4.3 Local Market Share Ranking

Dealer’s local market share ranking in city level is a very important indicator for long-term sales potential that OEM pays close attention to. The OEM cares about the market share because it is a key indicator of market competitiveness, as well as the most important metric to judge the effectiveness of implemented strategies and support future marketing decisions, such as national campaigns, central marketing investments, and branding initiatives33.

To address its importance to dealers, some OEMs require dealers to maintain their local market share ranking within the first two places, of which fulfilling the requirements serve as pre-conditions in participating annual ranking and being qualified for incentive bonus.

For dealers themselves, achieving a high local market share is also important for their own businesses. According to Robert D. Buzzell, Bradley T. Gale, and Ralph G.M. Sultan, there exists a positive correlation between market share and ROI, which means dealers who are maintaining a higher market share are more likely to be profitable. And the economies of scale, market power, and quality of management are all possible explanations for the positive correlation. Therefore, for dealers who are ranking behind in local market share, they have the initiatives in striving for a higher market share. As a result, dealers will attach more importance to local marketing investments to drive the market share up persistently.

In a summary of Chapter 4.3, by analyzing the influence of local competition on dealer's marketing behavior, four critical variables – number of local competitors under the same brand, number of local competitors under different brands, dealer’s past transactional prices, and dealer’s local market share ranking – are picked out for further analysis in designing a reasonable marketing expense target in Chapter 5.

4.4 Consumer

What matters most to dealers about the consumers is that how consumers are making the purchase decisions. Consumers’ different mindsets are influencing their shopping behavior and purchase decision. Mindset, by definition in social psychology, is a set of cognitive processes and judgmental criteria that assist in decision making.


Put in another way in retail industry, a customer’s mindset can influence his or her shopping decision. If dealer’s behavior is educating customers in a way that can influence their purchasing mindsets, customers’ purchasing behaviors will also be influenced towards certain direction. That is also how marketing is working on setting the brand image among customers.

In automobile retailing business, in certain dimension of customer mindset, customer’s behavior patterns mostly fall into two groups – value oriented and price oriented, which can be easily observed by dealers in customer’s shopping journey and reflected in the final transaction prices.

**Value Oriented Mindset.** Customers whose mindsets are more value oriented can better recognize the value provided by certain brands on products and services, and they are willing to pay an extra fee for that part of value added. The value-oriented mindsets are decided by many factors, such as consumer’s past shopping experience, income level, preference on product and service, etc. And it can be largely influenced by customer education continuously. Through constant marketing efforts revealing values provided, customers will gradually recognize the value, try to capture it, and finally willing to pay for it.

Dealers prefer customers with more value-oriented mindsets, because they help dealers generate larger profit margins and also bring stronger relationship between dealers and customers. When customers are more value oriented, dealers are more motivated in continuous investments in local marketing, aiming at maintaining a long-term sustainable profitability.

**Price Oriented Mindset.** Customers whose mindsets are more price oriented are difficult for dealers to develop loyal relationship and close deals with an acceptable profit margin. Price-oriented dealers do not see the disparity among competitive products as a big difference. Within the similar product segment, they are more driven by the low price regardless of additional values attached. The price-oriented customers are also less committed to loyalty, in which case whichever
dealer drops the price, they will switch to them directly, resulting a much lower customer lifetime value to dealers.

Similar with the price war concerns in Chapter 4.4.3, once the consumer’s price-oriented mindsets are cultivated and activated, dealers’ business are exposed under great pressure from consumers who ignore the added value but only bargaining on the prices. Dealer’s profitability and sustainability will be put into question, and if without realizing the importance of marketing, they will just be less and less enthusiastic on local marketing investments.

As a summary of the whole chapter, through analyzing the stakeholders’ influences on dealer’s marketing behavior, 11 critical factors – retail sales target, national market share, local market share, incentive & support, hidden stock level by manipulated declared sales, dealer marketing target competition rate of last year, retail transaction prices, stock depth, sales trend, scale of reselling, and number of local competitors under same and different brands (duplicated variables are removed) – are selected for further analysis in Chapter 5 for designing a reasonable marketing expense target.
Chapter 5: Critical Variables and Influences on Model

In the last chapter, the influence of channel stakeholders – OEM, investor group, franchised dealer, non-franchised dealer, competitors and consumers – on dealer’s marketing behaviors are elaborated specifically. By selecting the best analyzing mechanisms – dealer policy, balanced scorecards, dealer value map, benefits and drawbacks analysis – 11 critical variables are identified as influencing factors for further analysis.

The measurability and practicality of the variables in building a uniformed network-dealer applicable model are evaluated briefly in the table below.

Table 6: Dealer Marketing Behavior Influencing Factors Evaluation

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<thead>
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<th>Variables Identified</th>
<th>Measurable?</th>
<th>Practical?</th>
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<td>OEM’s Interest (BSC)</td>
<td>OEM’s Retail Sales Target</td>
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<td>✓</td>
</tr>
<tr>
<td>2</td>
<td>OEM’s Interest (BSC)</td>
<td>OEM’s National Market Share</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>3</td>
<td>OEM’s Interest (BSC)</td>
<td>Dealer’s Local Market Share</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>4</td>
<td>OEM’s Dealer Policy</td>
<td>Incentive &amp; Support Level</td>
<td>✓</td>
<td>×</td>
</tr>
<tr>
<td>5</td>
<td>Incentive Manipulation</td>
<td>Hidden Stock Level</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>6</td>
<td>Marketing Management</td>
<td>Marketing Status of Last Year</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>7</td>
<td>RoE – Profitability</td>
<td>Retail Transaction Price</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>8</td>
<td>RoE – Operation Efficiency</td>
<td>Stock Depth (Stock Turnover)</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>9</td>
<td>Future RoE</td>
<td>Sales Trend</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>10</td>
<td>Non-franchised Reselling</td>
<td>Scale of Reselling</td>
<td>✓</td>
<td>×</td>
</tr>
<tr>
<td>11</td>
<td>Competitors</td>
<td>Number of Competitors</td>
<td>✓</td>
<td>×</td>
</tr>
<tr>
<td>12</td>
<td>Price War</td>
<td>Retail Transaction Price</td>
<td>(duplicate)</td>
<td>(duplicate)</td>
</tr>
<tr>
<td>13</td>
<td>Local Competition</td>
<td>Local Market Share Ranking</td>
<td>(duplicate)</td>
<td>(duplicate)</td>
</tr>
<tr>
<td>14</td>
<td>Customer’s Mindset</td>
<td>Retail Transaction Price</td>
<td>(duplicate)</td>
<td>(duplicate)</td>
</tr>
</tbody>
</table>

30 “Practical” in the table is to measure whether the variable is highly representable of national dealers and significant in influencing the optimal marketing expense target, without generating too much complexity dealing with individual level issues in the model.
The **Incentive & Support Level** under dealer policy can be measured by the total amount of incentives every year, but it is not practical for taken into account in adjusting the dealer marketing expense target. The nature of the incentive is to motivate and award dealers who achieve the targets, and it is not shared equally among all dealers. In this case, if dealer's marketing expense target is set higher due to the larger incentive and support level, the bonus is less rewarding for dealers who are able to achieve the marketing targets, and the target becomes even higher for dealers who cannot achieve the marketing targets. The inventive & support level should not be taken to adjust the marketing expense target, avoiding the polarization of dealer marketing.

The **Scale of Reselling** through non-franchised dealers can be measured by the resell VAT invoices issued by dealers, but it should be used as an alert for business sustainable development rather than a marketing target adjusting factor. First, the frequent reselling business happens more on dealers with worse operations, and it is not a representable variable for all franchised dealers. Second, the scale of reselling is costly to get by collecting all dealers' invoice system data and other supporting documents. Third, the data can be easily manipulated by dealers, resulting the data less accurate and dependable. Considering the cost and benefits, the scale of reselling is not a practical variable to adjust the marketing expense target.

The **Number of Competitors** under same and/or different brands is also a less dependable variable in measuring the influence of competition. Business competition is better reflected in dealers' operation performance rather than the number of competitors. In this case, the number of competitors and local competition can be reflected in dealer's local market share, which is listed in table.

As a summary of the first step of variable measurability and practicality in adjusting marketing expense target, 3 variables are taken out. In the next step, the data accessibility, data reliability/accuracy, data extraction level, and influencing direction on MERT are going to be evaluated among the left 8 variables. Then a qualitative model will be set up in Chapter 5.9 using the variables identified.
5.1 OEM's Retail Sales Target

Quarterly and annual retail sales targets are negotiated between OEM and dealers and written in documents each time. With higher negotiation power in OEM, the retail sales targets are usually set more stretched for dealers, which is increasing year by year. If used to adjust the marketing expense target, an increase in sales target should result in an increase in total marketing expense target. In this paper, the target is to adjust the marketing expense rate target (MERT), which is not influence by the volume (see dealer marketing expense target calculation in table 2 in Chapter 2.2). Therefore, for the variable of OEM's Retail Sales Target:

- Data Accessibility: Easy
- Data Reliability/Accuracy: High
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: No Influence

5.2 OEM's National Market Share

The national market share data is calculated based on the vehicle registration number, which is obtained through Government Department of Transportation monthly. As illustrated in figure 12, OEMs are monitoring the market share fluctuations among competitors closely every month. Both the brand market share ranking and absolute value matter to the OEM. If OEM's strategy for next-year national market share is to increase rather than maintain, an increase in MERT should be adjusted for safeguard. Therefore, for the variable of OEM's National Market Share Target:

- Data Accessibility: Easy
- Data Reliability/Accuracy: High
- Data Extraction Level: National Level

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5.3 Dealer’s Local Market Share Ranking

Similar with national market share, dealer’s local market share ranking is also calculated based on the vehicle registration number from Government Department of Transportation. Instead of the absolute benchmark number of market share in the same segment, the OEM cares more about dealer’s market share ranking in city levels, which can be read from the dealer policy example. The pre-condition of dealer market share ranking for dealers to participate in BSC ranking is to rank in the first or second positions in local city. Dealers who are currently out of the first two positions in city level should be picked out attaching a higher percentage of MERT. Therefore, for the variable of Dealer’s Local Market Share Target:

- Data Accessibility: Easy
- Data Reliability/Accuracy: High
- Data Extraction Level: City Level
- Variable in Adjusting MERT Direction: Same Direction

5.4 Hidden Stock Level

The hidden stock exists in every OEM’s channel if there is a sales incentive on dealers. As is stated in Chapter 4.1.3, the hidden stock level is a result of dealer’s manipulated declared sales in order to get more sales incentive bonus.

OEMs’ altitudes toward the hidden stock are also different. The VGIC employees 3rd party agency to conduct dealer stocktaking and review sales documents quarterly to evaluate the actual level of sales volume, and distribute the sales incentives based on the actual sales volume, which is dealer declared sales minus hidden stock. But BMW chooses to ignore the hidden stock, on one hand saving millions of RMB in hiring 3rd party agency review cost, on the other hand easing the channel relationship
in the tough market.

To get dealer's hidden stock level, extra efforts and expenses should be made, indicating a more difficult accessibility to the data compared to the previous variables. But once obtained, the data will be very meaningful and full of insights in helping the OEM adjusting business strategies. As is discussed in Chapter 4.1.3, though the 3rd party agency can find out most of the hidden stock vehicles, there are still some stock vehicles hidden and documents manipulated too well to be found by reviewers. From the perspective of data reliability/accuracy, the hidden stock level is also lower compared to the previous variables.

If there is a significant level of hidden stock exists, a higher MERT should be adjusted to digest the next-year retail sales target as well as the left over hidden stock from last year. Therefore, for the variable of Hidden Stock Level:

- Data Accessibility: Hard
- Data Reliability/Accuracy: Medium
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: Same Direction

5.5 Marketing Underperformance Level of Last Year

OEMs have the first-hand information on dealer's annual marketing target completion status, which is usually reviewed and provided by 3rd party agency. A much lower overall target completion rate usually indicates that the marketing targets are set to high for dealers to achieve considering the dynamic market environment. The benchmark for the overall target completion rate should be identified by the OEM and compared with dealer's actual performance. If the overall marketing underperformance level of last year is much higher than acceptable

37 The Marketing Underperformance Level of Last Year is easier to formulate the influence, mapping with the 6th variable – Marketing Status of Last Year in figure 6.
interval, the MERT of next-year should be decreased significantly to save the channel marketing management efficiency. Therefore, for the variable of Marketing Underperformance Level of Last Year:

- Data Accessibility: Easy
- Data Reliability/Accuracy: High
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: Opposite Direction

### 5.6 Sales Discount Level\(^{38}\) (Retail Transaction Price)

The retail transaction price is directly recorded in dealer's invoice system. The invoice information is very confidential to dealers because there are both customer information and price strategy embedded in it. The invoice information can be exported from the invoice system and modified easily. Therefore, to ensure the accuracy of the invoice information, the OEM usually employs a 3rd party agency to export the invoice information onsite directly, leaving no chance for dealers to play tricks. The process and cost to get the data is somewhat costly, but the reliability of the data is very high.

By comparing the national transaction price with the MSRP, the national sales discount level is easy to be identified. Usually, a benchmark for sales discount level should be developed by the OEM to evaluate dealer's retail situation. If dealer's sales discount level is increasing continuously surpassing the benchmark, the decision on adjusting the MERT should be two-fold. On one hand, a higher marketing investment provides a more effective way for dealers to educate customers to change from price oriented to value oriented. On the other hand, with price war, dealer's profit margin is very thin, which is making it more difficult for them to invest in local marketing.

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\(^{38}\) The Sales Discount Level is easier to formulate the influence, mapping with the 7th variable – Retail Transaction Price in figure 6.
Quantitative analysis should be done with the two-fold concerns under this variable. Therefore, for the variable of Sales Discount Level in reflecting transaction price:

- Data Accessibility: Medium
- Data Reliability/Accuracy: High
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: Partly Same + Partly Opposite Direction

5.7 Stock Depth

Dealers’ stock depth can be accessed by OEM through centrally managed DMS system, of which the data is in alignment with dealer’s wholesale, pipeline, declared sales status. Regardless of the hidden stock, which is discussed in Chapter 5.4, the nominal stock depth should also be compared with the healthy benchmark for stock depth. For dealers in premium segment, the healthy benchmark for stock turnover is about 30~45 days, which converted to stock depth is the product of dealer’s monthly sales and a coefficient of 1.0~1.5 (Joseph Zhao, personal communication, January 2016).

If the stock depth in the DMS shows a higher level than the benchmark, an extra sales volume is needed to be digested to achieve a healthy stock level for next year, and an extra marketing expense is needed to safeguard the larger actual sales target. Translating into MERT on the nominal retail sales target, the MERT should be increased to compensate the higher level of national stock depth. Therefore, for the variable of Stock Depth:

- Data Accessibility: Easy
- Data Reliability/Accuracy: Low
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: Same Direction
5.8 Market Sales Trend

The market sales trend is to forecast the future market capacity and growth for OEM and dealer’s business. The forecast is usually based on the past years’ performance and upcoming opportunities and challenges. The strategy department insides OEMs and consulting firms such as McKinsey are developing forecasts for the market sales trend. However, as the government policy is influencing the industry directly, and the policy is less forecastable, the reliability and accuracy of the forecasted sales trend is lower than the previous variables.

During the past two decades in automotive industry in China, there was a great expansion of the market capacity year by year, and OEMs were investing aggressively to grab as much market as possible. In recent years, the growth rate of the industry tends to slow down, leaving the competition more intense for maintaining the existing market share and grab more from others. Therefore, for the variable of Market Sales Trend:

- Data Accessibility: Medium
- Data Reliability/Accuracy: Low
- Data Extraction Level: National Level
- Variable in Adjusting MERT Direction: Same Direction

5.9 Summary of Variables Selected

Regardless of OEM’s retail sales target, which is influencing the marketing expense target on the volume level not the rate level, 7 variables are selected to be taken into consideration when building a qualitative MERT adjusting model.

As a summary of all variables, data accessibility, data reliability/accuracy, final adjusted variables and the corresponding influence on adjusting the MERT are all reflected in the figure below.
Figure 16: Summary of Variables Selected

In the next chapter, a qualitative model on MERT adjusting methodology will be built with the identified variables, and recommendations on business insights will be provided for advancing the automotive industry channel marketing management effectiveness and efficiency.
Chapter 6: Qualitative Model and Recommendations

Chapter 1, 2 and 3 introduced the channel relationship in automotive industry, the current marketing incentive system and existing conflicts in channel management. Aiming to find out a working solution to solve the conflicts, Chapter 4 and 5 discussed the stakeholders and their influences on dealer marketing behaviors, identified 7 key variables which influence the reasonable MERT for dealers in the dynamic market environment.

In this chapter, a brief qualitative MERT adjusting model will be built with the identified variables, aiming to provide insights and recommendations to in-house high-level management team in deciding the channel incentive policy.

6.1 Qualitative MERT Adjusting Model

As is introduced in Chapter 2.2, dealer’s annual Marketing Expense Target (MET) is calculated on the sum of product of Manufacturer Suggested Retail Price (MSRP), sales target of different vehicle models and the OEM decided MERT.

\[
\text{Dealer's Annual MET} = \sum_{i=1}^{n} MSRP_i \times \text{Sales Target}_i \times \text{MERT(\%)}
\]

\[n - \text{The number of vehicle models sold in the market}\]

As dealer’s annual marketing expense target is sales target volume based, the key variable to optimize the marketing target for dealers is to adjust the MERT with the market changes. By deciding the MERT adjusting model, the F(x) in the formula below is what should be built for a more reasonable methodology for MERT adjustment.

\[
\text{MERT}_{\text{previous year}} = F(x) \times \text{MERT}_{\text{next year}}
\]

In the last chapter, 7 influencing variables are identified for building the MERT adjusting model. The variables are listed in table 7, with names from X₁ to X₇, the corresponding weight in the model from β₁ to β₇, and the summarized influencing
direction.

Table 7: Adjusted Variables and Influences on MERT

<table>
<thead>
<tr>
<th>#</th>
<th>Adjusted Variables in Chapter 5</th>
<th>Variable</th>
<th>Weight</th>
<th>If the variable is increasing, the MERT should be</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>OEM’s National Market Share Target</td>
<td>X&lt;sub&gt;1&lt;/sub&gt;</td>
<td>β&lt;sub&gt;1&lt;/sub&gt;</td>
<td>↑</td>
</tr>
<tr>
<td>2</td>
<td>Dealer’s Local Market Share Target</td>
<td>X&lt;sub&gt;2&lt;/sub&gt;</td>
<td>β&lt;sub&gt;2&lt;/sub&gt;</td>
<td>↑</td>
</tr>
<tr>
<td>3</td>
<td>Hidden Stock Level</td>
<td>X&lt;sub&gt;3&lt;/sub&gt;</td>
<td>β&lt;sub&gt;3&lt;/sub&gt;</td>
<td>↑</td>
</tr>
<tr>
<td>4</td>
<td>Marketing Underperformance Level of Last Year</td>
<td>X&lt;sub&gt;4&lt;/sub&gt;</td>
<td>β&lt;sub&gt;4&lt;/sub&gt;</td>
<td>↓</td>
</tr>
<tr>
<td>5</td>
<td>Sales Discount Level</td>
<td>X&lt;sub&gt;5&lt;/sub&gt;</td>
<td>β&lt;sub&gt;5&lt;/sub&gt;</td>
<td>↑ + ↓&lt;sup&gt;39&lt;/sup&gt;</td>
</tr>
<tr>
<td>6</td>
<td>Stock Depth</td>
<td>X&lt;sub&gt;6&lt;/sub&gt;</td>
<td>β&lt;sub&gt;6&lt;/sub&gt;</td>
<td>↑</td>
</tr>
<tr>
<td>7</td>
<td>Sales Trend</td>
<td>X&lt;sub&gt;7&lt;/sub&gt;</td>
<td>β&lt;sub&gt;7&lt;/sub&gt;</td>
<td>↑</td>
</tr>
</tbody>
</table>

The qualitative model \( F(x) \) is to aggregate the influences of variables in the formula below:

\[
F(X) = \prod_{i=1}^{i=7} \beta_i * X_i
\]

\[
MERT_{previous year} = MERT_{next year} * \prod_{i=1}^{i=7} \beta_i * X_i
\]

The variables \((X_1 \text{ to } X_7)\) and weights \((\beta_1 \text{ to } \beta_7)\) require to be designed specifically through more quantitative research. This qualitative model is to provide a overall suggestion on what stakeholders and variables to consider while deciding the channel marketing incentives. The dynamics of dealer’s condition and business environment is important to be taken into consideration when expecting dealers to behave in the way that OEM prefers.

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<sup>39</sup> According to Chapter 5.6, quantitative analysis should be conducted to analyze the two-fold influence of sales discount level on designing the MERT.
6.2 Recommendations for Executives

In the dynamic market, constant strategic review on the channel alignment is a must for OEM executives to identify channel conflicts and act timely to solve them.

Driven by pressure, opportunity, and behavior rationalization, dealers have the temptation to misbehave and override the systems. Stronger internal controls are recommended to safeguard the functioning of channel marketing incentives:

- More dealer education on the value of marketing and channel cooperation.
- Establishment of a monitor system on reviewing dealer marketing behaviors.
- Clear communication of rules of conduct, boundaries, and consequences of violating the compliance.
- Scientific adjustment on dealer marketing target with market dynamics.

The last one is the most important and fundamental in controlling the overall channel marketing management efficiency. When adjusting the channel marketing incentives, OEM should be careful with the conventional “top-down” management approach and develop more “bottom-up” solutions by listening to the “voice” of dealers and thinking about the root causes of dealer behaviors. Recommendations below are made for designing a more reasonable dealer marketing target:

- Besides OEM, other stakeholders are also influencing dealer’s behaviors significantly, which demands an enhanced stakeholder management.
- Keep track on the 7 key influencing variables identified in chapter 4&5. If any of the 7 variables is displaying abnormal movements, actions should be made on how to adjust the MERT to cope with the dynamic situation.
- Dealer’s overall financial and business performance should be taken into account when designing the MERT annually.

40 Detailed action plans under each strategy can be referred in Chapter 3.
41 Stakeholders and key variables analysis can be referred in Chapter 4 and Chapter 5.
Bibliography


