BAIN & COMPANY

From durables to fast moving consumer goods – what’s changing the face of the automotive industry

by

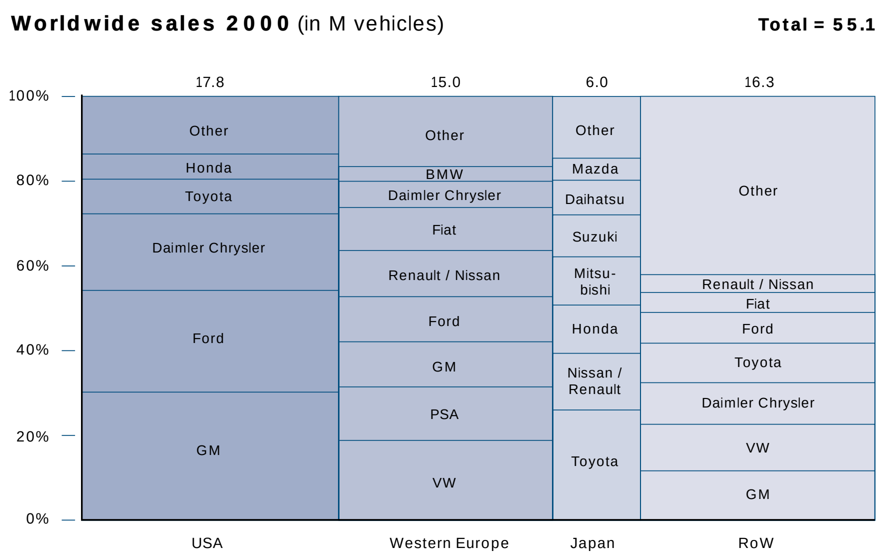
Dr. Gregor Matthies and Dr. Frank Heideloff

Dr. Gregor Matthies is a Partner and Dr. Frank Heideloff is a Manager at Bain & Company´s Munich Office.

A mature industry facing five years of cyclical slowdown

Automotive OEMs have been one of the backbones of economic development in industrialized countries for a long time. Since the early 90’s, the industry has enjoyed solid growth around 5% on a global basis. With the beginning of the 21st century, it seems that the bright days are over. If Asian Tigers don’t bounce back and Japan does not get on its feet quickly, global market growth until 2005 is flat at best – key markets like the US or Germany will shrink in absolute volume terms. Subsequently, an industry that is volume minded and has been dominated by a fix cost perspective ever since its founding, must change direction. While the largest volume segments are contracting, there are some trends that we feel have become visible since the mid 90’s which will prevail until 2005.

Chart 1: Worldwide fragmented market by volume



Automotive Industry

Chart 2

Worldwide fragmented markets by revenues

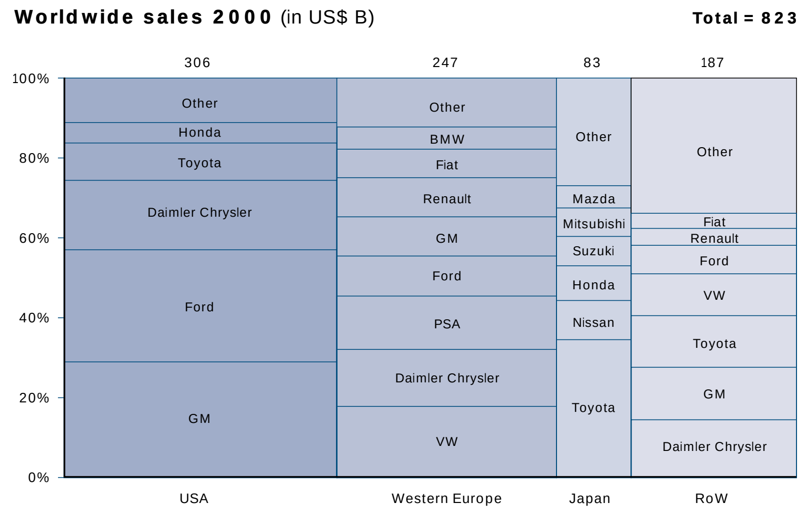


Chart 3:

Premium growth strong in Germany

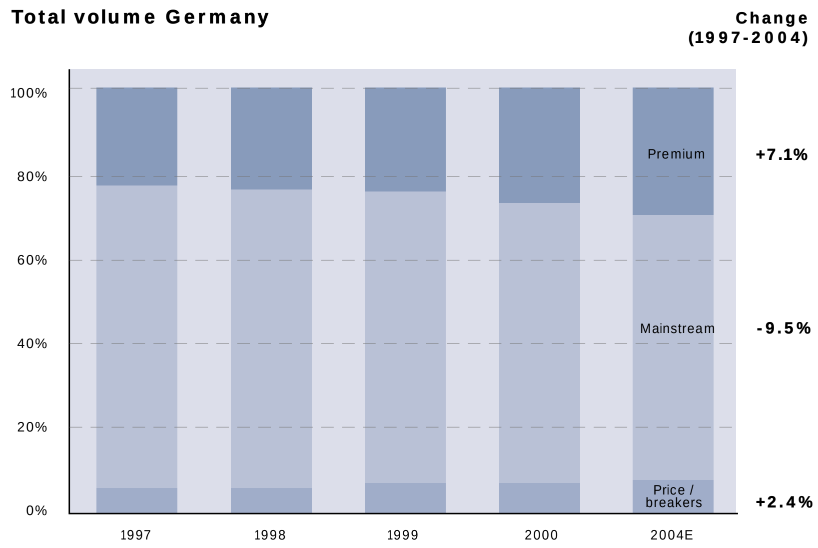
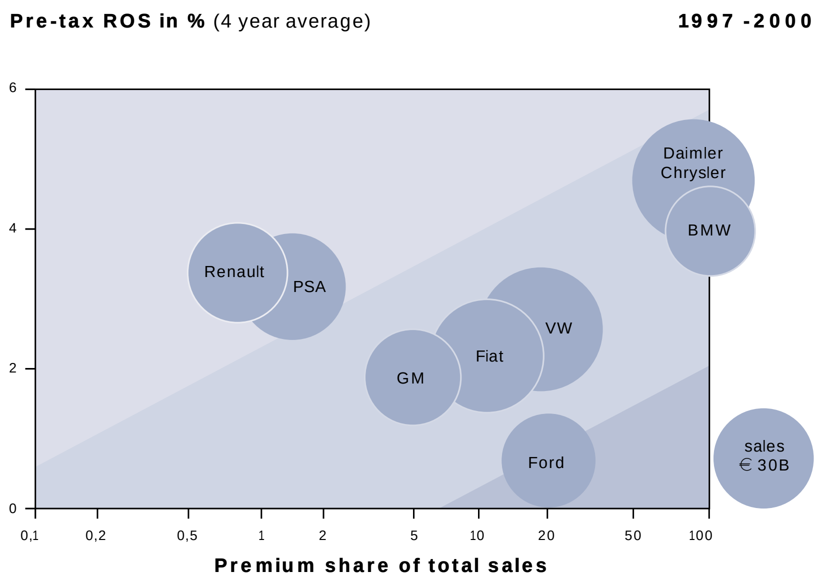


Chart 4:

Premium share of sales key profit driver

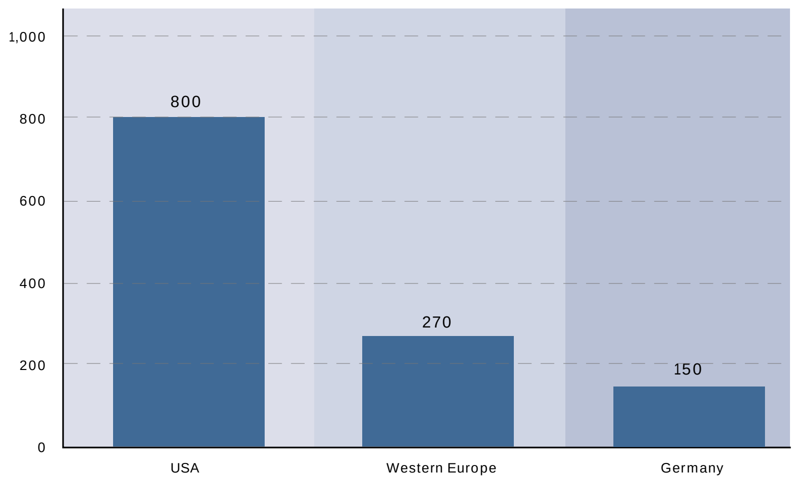


Market fragmentation, which was still high in 2000 (see chart 1 and 2), will decrease further, as global groups drive consolidation and players with only local brand appeal are driven out. Europe will be the world's leading diesel market, because taxation advantages on both vehicles and fuel together with new environmentally friendly diesel technology will continue to link economic advantage and good conscience for the customer. Premium carmakers, the real winners since the early 90's, will gain market share and maintain their profit umbrella, leaving mass market producers with worries as to how to catch up in terms of R&D investment and marketing spending (see chart 3 and 4). The German market is likely to lead this trend in Europe, leading to the competitive position of brands such as BMW, Mercedes-Benz, Audi and Porsche.

Manufacturing and purchasing costs have been the major focus of the industry for too long. Whereas the above mentioned have been hit by waves of reorganizations, process redesigns and efficiency programs on the manufacturing end, as well as value managed relationships, system supplier networks and supplier tier structures on the purchasing end, the cost and revenue potential in marketing, sales and financing has been largely neglected. Marketing, sales and downstream overhead costs are accounting for approximately 35% of total OEM cost today. Small items, such as dealer advertisement campaigns, outbound logistics not paid by the customer, inventory financing support, as well as the core media and sales incentive budgets all add to this bill. Tapping the cost in blue collar parts of the value chain was easy, but going through negotiations with a large number of independently owned dealer franchises or cutting down on white collar activities seemed too painful. For example, if automakers were to adopt a truly customer-driven perspective, they would embrace build-to-order concepts such as Dell's in the PC market. This move could help European OEMs alone to save some 2-3B € per annum in financing vehicles in transit or at the dealerships, by reducing average inventory from 60 to 10 days.

Chart 5: Europe is still dominated by small dealerships

Average sales per dealer in numbers of cars sold (2000)



Automotive Industry

Chart 6: Only UK and Italy with large dealerships

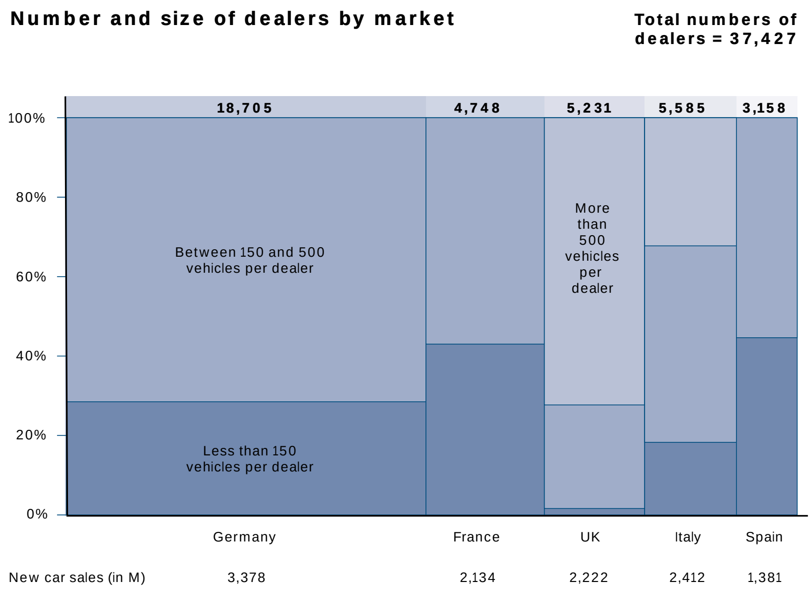


Chart 7: European profit pool in the order of € 45B

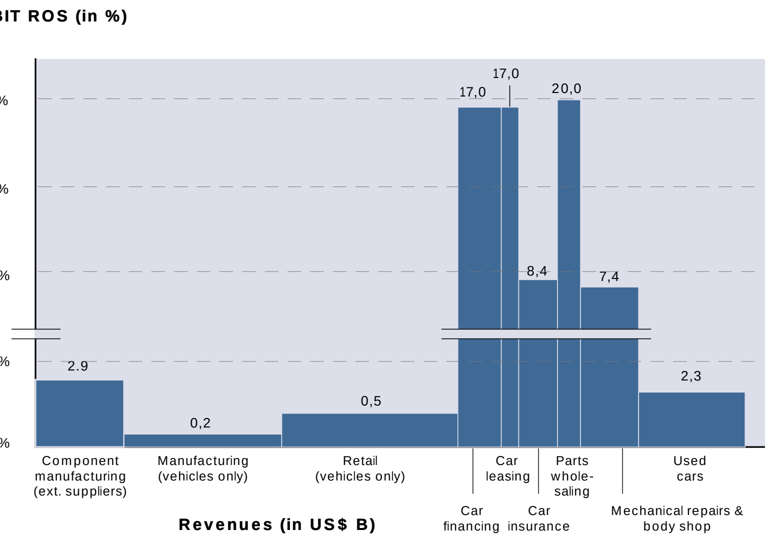
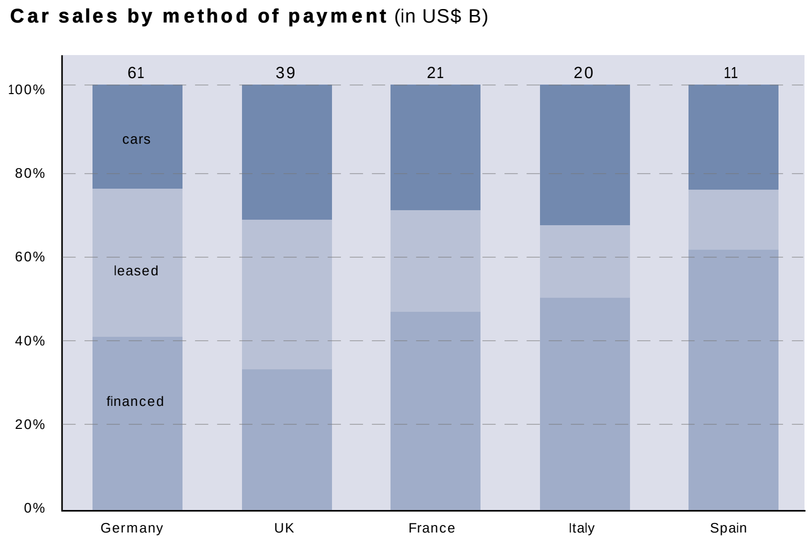


Chart 8: More than 70% of cars are financed or leased



Downstream value chain elements out of direct OEM control tend to be "high hurt" areas

In taking a closer look at the overall downstream activities, it becomes clear that (1) current pricing practices, (2) a profit focus on after sales and service by the dealers, and finally (3) the profit pool shift towards leasing and financing activities and away from manufacturing and selling cars are doing the most damage to OEM's position and financial health. All of these areas are unfortunately not under direct control of the automakers.

In most European markets, cars are sold through independently operated dealerships. Only few manufacturers have driven the concept of OEM sale centers as far as Mercedes and BMW in Germany, so that small family owned outlets are still the norm. Compared to US dealers, who sell 800 new cars on average per year, European dealers are still only about one third of this size (see chart 5). Only in the UK and Italy dealership concentration has reached a significant level (see chart 6). Large networks of dealers lead to intra-brand competition, with the dealers not trying to gain market share from competitors, but playing a zero-sum game among those of their own brand. While customer loyalty in Europe is decreasing in recent years, major OEMs still reach 60% and more return customers, further increasing intra-brand competition and forcing dealers into price cuts in order to keep customers. In Germany, restructuring of dealer networks has been very slow and still many premises look like garages rather than showrooms where 15,000 € items are on sale.

Manufacturers have very limited knowledge – leave alone control - of how the actual price for the vehicle is negotiated and what the actual average transaction for a model is. Research suggests that by the time the customer arrives on premise at a dealership, he or she has gone through a 12 months decision cycle and has by now zoomed in on one to two vehicles/brands to choose from. This should help to close the sale easily based on meeting customer needs in the sales process and offering dealership services. Unsophisticated sales people as well as an array of discounts offered both directly and indirectly lead to inevitable price reductions. Since it is much easier to give up trade-in discounts, end of month registration kickers, additional options at no extra charge or a free first service than to stress the benefits of a vehicle and help the customer connect, sticker prices are loosing relevance. For the OEM, these trends result in a painful loss of control over one of the 4 P's – Price!

Financing and leasing with high profit potential

While profit margins in the new car business at OEM and dealer are dismal, financing and leasing operating profits are usually in the 15-20% bracket (see chart 7). Furthermore, more advanced dealers are not using OEM bank offers to provide the financing, but cut into the OEM profit pool by arranging their own contracts. With now roughly 70% of all vehicle purchases either financed or leased, the profit pool is shifting (see chart 8) to far downstream. The development of financing and leasing in Europe can be characterized in different stages:

1. Until the mid 1980's, leasing was a substitute for bank financing of new car sales. It worked like a consumer credit and the acceptance varied heavily by geographical market. The dominant players were almost exclusively banks, with OEMs entering the segment later.
2. In a second stage, since the late 1980's, the product offer switched from a pure financial arrangement to bundling services, insurance and warranty contracts as well as organizing the exchange of parts after accidents. Operational leasing was born. This bundled offer called for different capabilities, opening the segment to many independent, but often bank-backed, players (e.g. PHH, GE, Lease Plan). Operational leasing was mainly targeting corporate fleets, a steadily growing subsegment of the new car sales market. While OEM leasing firms do well in Germany, the independent players dominate all other large markets in Europe. Banks are withdrawing, because they cannot handle risk aspects of full operational leasing (see chart 9).
3. The next stage is a likely adoption of operational leasing by selected segments of the retail market. By 2005, we assume first substantial influences on retail demand from this trend. Due to tax advantages, some European markets such as the UK and the Netherlands are already quite developed. The pure growth of both operational leasing as a whole, projected to be 10% per annum in Germany for example (see chart 10), as well as the increasing adoption by up-market customers will re-enforce the attractiveness of the segment.

Automotive Industry

Chart 9:

UK and F leading operational leasing markets in Europe due to tax breaks

Operational leasing players 1999 by volume (in US$ M) **Total = 3,76**

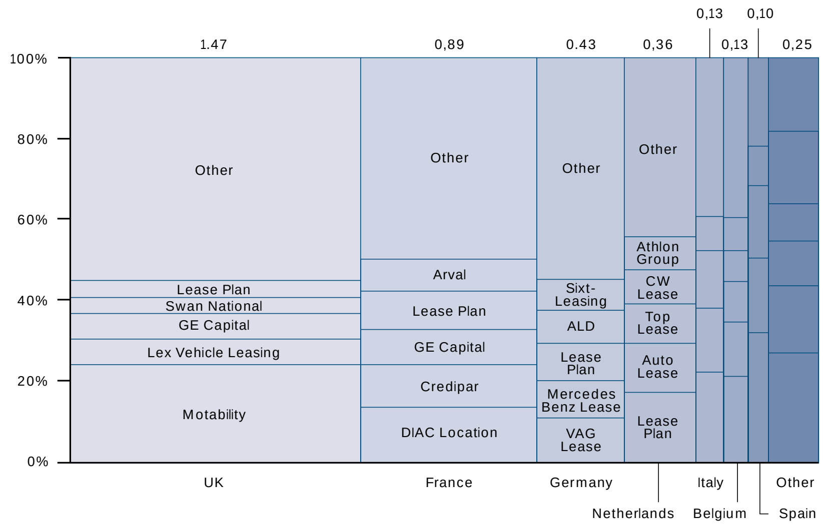


Chart 10:

Strong growth of operational leasing in Germany

Operational leasing fleet size (in K vehicles)

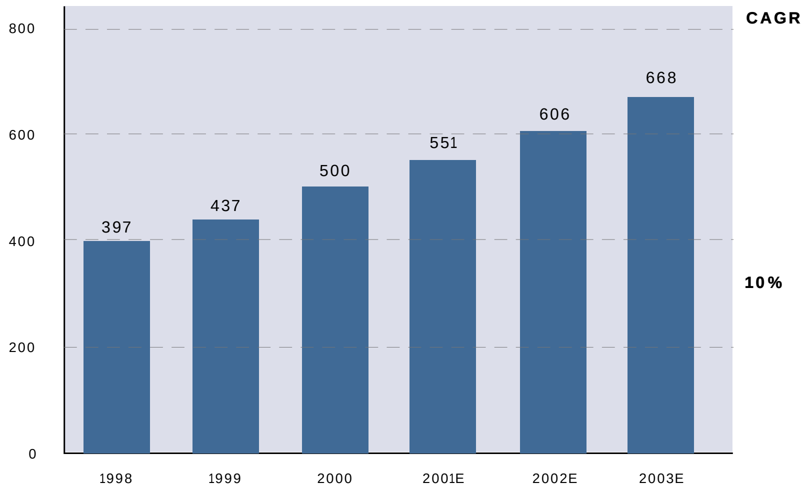
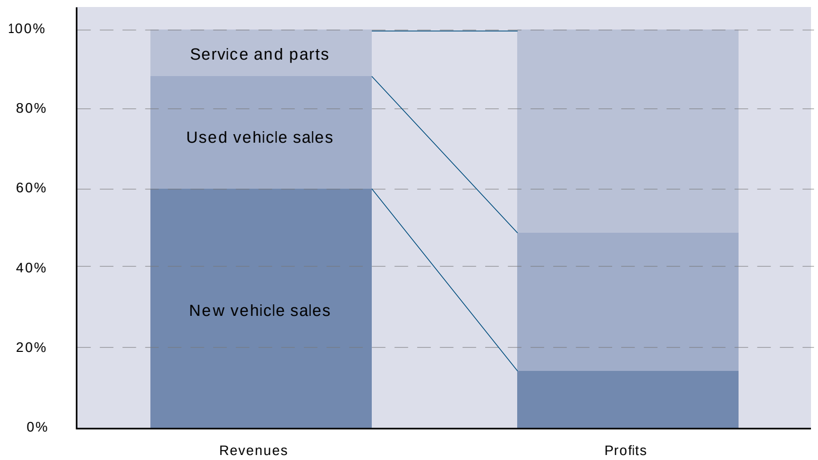


Chart 11:

After-sales is the most profitable dealer business

Dealer revenue and profit mix (in %)



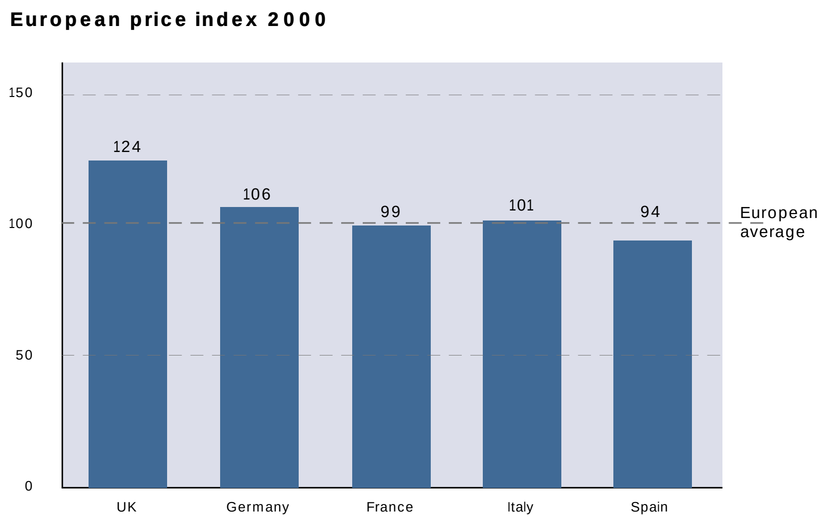
Finally, it is the deteriorating market position of OEM dealers position in the after sales and service segment that hurts the carmakers. OEM dealers are rapidly losing ground to quick service stations and non-franchised service chains such as Pit Stop. After an initial period of 2-3 years of ownership, more and more customers switch to non-OEM service providers. The non-OEM share for standard services such as replacement of tires or oil change is dramatically increasing. But since OEM dealers heavily rely on services and parts for their profits, their capability to invest in the OEM brand locally is diminishing (see chart 11). The substitution of OEM parts is also fully underway, with non-franchised service chains promoting functionally equivalent parts rather than original brand name parts. Some of the lost revenues in parts might kick back through operational leasing agreements with key independents. However, these profits will neither go to dealers nor to automotive OEMs but rather to the leasing company. And even in Germany, where OEM service and parts penetration is still at the high end, the odds are now reversed: 28,000 independent service stations are competing against approximately 20,000 OEM dealerships.

Volume down, profit potential low – and still further negative impacts down the road

As if volume slowdown and profit decrease were not hard hitting enough by themselves, the European car industry is facing further headaches. Likely changes in the block exemption in 2002, increasing price transparency through introduction of the € also in 2002 and emerging new business models will make the market even more competitive.

End of year 2000 price index comparison suggests that prices in the UK and Germany will come down (see chart 12). If British and German prices would drop by 10 and 4 percent respectively, most OEMs in the European market would barely reach break-even. The combined impact would be a loss of more than 4.5B € in revenues and an almost equal loss in profits. This is half of the estimated OEM profit pool in 2001. However, prices are unlikely to flatten out completely, because of different specifications and line-ups for different markets as well as different option take rates on customized vehicles. On the other hand, internet offered configurations are also driving prices down.

Chart 12: Still room for lower list prices



Automotive Industry

In 2002, EU commissioner Mario Monti will change the laws on block exemption. While the three scenarios, (1) abolition, (2) amendment, and (3) prolongation, are evident, the likely consequences are not as easy to anticipate. For each of the scenarios, our experience suggests the following key outcomes:

1. In the case of abolishing block exemption altogether, weak OEM brands will face multiple challenges: deterioration of transaction prices and residual values, increasing loss of control of point of sale communication and product placement, strong purchasing power concentration of classic retailers and potentially emerging multi-brand new car resellers
2. In the case of amendment to the existing block exemption regulation, we see exclusivity in brand and geography dimension fall. Brand strength is then becoming ever so much more important, since a strong product/name plate brand portfolio combined with a healthy new model pipeline is best incentive for dealers to continue to work with OEMs. Nevertheless, dealer network restructuring will become necessary. One option might be the complete separation of new car sales and service point premises
3. In the unlikely case of prolongation, the core inefficiencies of the existing retail network might be veiled for some time longer. However, OEMs would still not be able to afford doing business through unprofitable dealers taking away from their brand. Taking a lesson or two from consumer products companies such as Sony, Gucci, Bang & Olufsen or mass retailers such as Aldi and Walmart, car makers need to be developing a set of value propositions for both their target customer groups and their selected distribution partners: an exclusive up-market, a mainstream retail market, and a wholesale mass market value proposition will be the main categories for doing business in this new environment.

New segment and business models offer growth potential

In the financing and leasing segment, by 2010, the concept of full operational leasing could be enlarged to offer integrated mobility concepts, e.g. flights, rentals, taxi and limo services, different cars by season, type of use and occasion, or just for transportation of guests. This would provide travel agencies and car rental companies with an opportunity to leverage their know-how to enter the market. Given the high importance of risk management capabilities, insurance companies more so than banks might be the natural contenders from the financial services side. AXA for example is testing leasing activities in France ("auto sans soucis"). Another adjacent segment could be in the used car finance segment, where VW group is considering activities to secure residual values and keep used car markets operating smoothly as higher volumes from rental firms are crowding out new car demand.

Finally, it is the potential substitution of business models in the downstream activities that will have a substantial impact on the automotive industry. Currently integrated functions of European dealers will be unbundled and new players such as all-brand high quality service stations, used car supermarkets combining internet catalogue and offline delivery, multibrand new car retailers, alliances of carmakers and high street retailers even for mass market brands etc. All of these will have two effects: (1) the proliferation of existing branding practices, distribution networks and after sales concepts will accelerate and (2) brand and nameplate portfolios, distribution value propositions adopted to the target positioning as well as an innovative channel management will become the key success factors for a commodity product on wheels.

"Sure it's expensive, but look at the quality, honey. And also, they are so nice in the store"

It is the very early and late stages of the automotive value chain (product development, brand position and distribution channel management) that can create competitive advantage over the medium to longer term. Product development has to be based on a deep understanding of current customer values and needs as well as the future development of current customer target groups. The ability to detect and to develop new crossover concepts and segments to fill "white spaces" will become the key driver of carmakers' profitable growth. In an upcoming Bain & Company thought piece, we will explore this area further. While the two other elements, brand and distribution, are more closely linked to marketing activities, studies are indicating that more than 60% (60% in Asia and almost 75% in Europe) of brand strength is driven by product perception. Therefore, product development is the single largest driver of brand position and brand strength.

Gap between strong and weak brand widening

Two aspects of branding and portfolio strategy have dominated the discussion over the last years: (1) group-wide management of manufacturer brands (e.g. VW group with Seat, Skoda, VW and Audi plus niche brands such as Bentley) and (2) manufacturer management of product brands (e.g. Ford Ka, Fiesta, Focus, Mondeo, Cougar, Galaxy). The first is a portfolio approach to managing development costs across product platforms and to reduce purchasing as well as manufacturing costs. The second has to assure that actual product brands match customer targets and provide an opportunity to meet these over the entire life cycle of a customer, trading him or her up to the next vehicle category.

Facing the changes in block exemption, we see the gap between strong and weak OEM and product brands widening. Strong OEM or product brands can be part of relatively weak group brands (e.g. Alfa Romeo or Ferrari/Maserati within Fiat group) and enable manufacturers to approach the customer differently. Strong brands are not only more likely to build a sustainable customer pull and thereby support the viability of exclusive distribution through solid sales volumes. They also allow for a differentiated marketing by events and a co-branded distribution through high price retailers. In a couple of years, the overall marketing approach of Porsche, BMW, Mercedes, and Audi might be more similar to LVMH and Gucci's than to VW, Opel, Renault or PSA. Own showrooms in high street locations will be complemented by catalogue sales through Harvey & Nichols as well as sales in up-market department stores (e.g. Quartier 206, Galleries Lafayette). If this trend materializes, manufacturers still need to build a reseller value proposition and third party concepts to reach their full potential.
Strong brands will also be the driving factor behind individualized communication and true customer relationship management, initiating a virtuous communication circle: strong brands attract affluent customers who provide comments and feedback to develop even more targeted and attractive products thus strengthening the brand further leading to yet even more customer pull and loyalty.

Weaker OEM and product brands will be entrenched in a wholesale and supply push logic and will have to undergo yet a another cruel restructuring once under pressure from low margin retailers. Category management has strengthened the large retail chains to deliver customers (at least) the product they want plus additional choices. Margins for automotive OEMs will shift to retailers. Carmakers' brands in the "cheap and convenient transportation" category will quickly loose remaining brand value and will have to cope with ongoing price point communication at the point of sale. Lessons from fast moving consumer goods suggesting a two-brand-strategy of manufacturer and distributor brand could be applied in this scenario.

Multi-Distribution Channel Management as key success factor

OEMs will also be forced to use and manage a wider range of channels. The Internet is likely to remain a limited source of business in the retail segments of the market. While configurators are already introduced into the market, they still serve information gathering purposes rather than driving sales. At GM in North America, 40% of people are already using the Internet for collecting information. But even very attractive models exclusively offered on the net have reached only limited sales volumes in Europe. We therefore disagree with those studies projecting a massive switch of demand to the Internet. The only major impact is yet another round of decreasing list prices due to increasing transparency. For the internet sales, OEMs will still keep margins through savings in distribution and dealer costs, however the internet price pressure will lead to a solid and not only temporary decline in average retail prices across channels. Having said this for the retail segment, we see differences to approaching fleet and rental customers. As ordering fleet cars is a major procurement process to these customers, web-enabled processes will deliver the same benefits as in other supply chain processes here. Recent research conducted by Bain & Company suggests that only 3-5% of retail sales will actually be made over the Internet by 2004. However, up to 25% of fleet business might shift to online purchasing processes. It is again only strong brands that might walk away with a real benefit by using the Internet as their key enabler for "one-to-one" marketing activities.

Franchise dealerships and OEM-owned dealerships are very likely to remain the single most important channel. Facing the challenges it will be key for OEMs to assure a higher level of professionalism of dealership management in designing local promotions, actively trading retail customers up and in tailoring the product offer to local demand where required. While OEMs have cut down their dealer networks quite a bit already, they will have to accelerate this process to increase the miserable 0.6% ROS that e.g. German dealerships were making in 2000. Recent efforts are visible across Europe:

- VW announced to cut yet another 400 to 500 dealers in Germany
- Opel has announced a similar restructuring in its German network
- Ford has reduced the number of main dealers in France from 300 in 1996 to 160 at the beginning of 2001. The target is 130
- Porsche cut its German network from 350 dealers 15 years ago, when still sharing distribution network with Volkswagen, to only 78 today. While customers are more sophisticated, they don't mind longer distances to the dealership as long as product, service and quality of relationship are doing their job.
- Mercedes has sent 158 UK dealers the pink slip with intentions to replace them with 35 regional dealerships (market area concept) under direct Mercedes influence.

While the rationale for larger dealerships is clear from a profitability point of view, OEMs might interestingly be creating the monsters of their future nightmares today. Too many still don't seem to have a strategy for dealing with these larger and thus more powerful partners in the future. Only few have deeply explored OEM operated dealerships. Besides BMW and Mercedes-Benz, it has been Renault – for a long time the most competitive non-German carmaker in Europe and "import champion" into the German market – that propelled this approach. If retail quality needs to be improved to still deliver the vast majority of volumes sold, OEM operated dealerships make sense to cover the investment in premises, car park for test drives and local brand communication. They also enable OEMs to manage the actual consumer paid price at the point of sale much better and drive the vehicle mix up where possible. In addition, own outlets are probably the easiest way for OEMs to integrate online sales and offline delivery, service, and customer retention.

Potentially new non-exclusive, multi-brand resellers will enter the European market from the US probably using the UK as a European test market. Examples in the US include both a multi-brand and direct approach, e.g. Autonation or sell-by-tel. Also, the classic retailers will not wait for OEMs to develop a value proposition for this channel, but will move ahead using price point teasers such as already seen in the cases of Daewoo in the UK and Fiat Punto in EDEKA promotional sales in Germany. The polarization of retail quality will continue to strengthen car supermarkets, selling based on price and immediate availability, and branded retailers, selling cars as luxury goods in a more sophisticated environment. Commoditized weak brands will be the early pray becoming teaser items in retailers' point of sale communication. Eventually, these OEMs might only be producing the metal boxes for a new sort of theme retailers like the DIY shops in the construction segment. A lot of the accumulated pride of a 100-year-old industry would be erased in this process. So it is definitely time to start moving.

All at once and right away – a lesson or two to learn from luxury brands, consumer electronics and fast moving consumer goods

Luxury brands, consumer electronics manufacturers and consumer goods companies are all focusing on doing a lot of things right in a parallel rather than in a sequential way: customers are driving new product ideas, while multiple channels are used to sell primary and secondary, original and licensed products, this season's and last season's fashion or simply different design styles of the same product with large price spreads to individual target groups. While automotive OEMs have improved their understanding of the customer to some degree, they are still a far cry from moving at the speed of consumer goods companies. Some of this is due to product development cycles of still 36 to 45 months from concept to launch. But what OEMs seem to ignore is the power of working with strong independent retailers to develop a deeper understanding of the customer *and* investing in their own brand strengthening distribution channels at the same time. Building on the key success factors of strong OEM and product brand and delivering cars through a multitude of very different channels will determine winners and losers in an industry facing five tough years. The answers are likely to be found outside the box!

Bain & Company

Bain's business is to make companies more valuable. We convert strategy and action into economic performance. Founded in 1973, on the principle that consultants must measure their success in terms of their clients' financial results, we put ourselves on the line right alongside our clients. We accept equity as part of our fees, and compensate our partners on clients' financial results.

So at Bain, instead of the usual consultants' reports, you get:

- Solutions that matter.
  So you can see the highest returns.
- Strategies that work.
  So you get better results, faster.
- Results that last.
  So momentum keeps building.
- People you can work with.
  So the right things get done - and get done right.

Because of who our clients are and what we do for them, we have been part of some of the most visible breakthroughs and turnarounds in history, outperforming the stock market 3 to 1.

BAIN & COMPANY
Germany, Inc.

Karlsplatz 1 • 80335 Munich
phone: +49-89-5123-0 • fax: +49-89-5123-1113
www.bain.de