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Chris Angevine,
Manish Chopra,
Parmeet Grover

A VIRTUOUS CYCLE FOR GROWTH: FINDING PROFIT OPPORTUNITIES AFTER THE INITIAL SALE

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Advanced analytics can extend the profit lifecycle for carmakers who know how to use it.

A life-cycle approach to sales can give companies that make high-cost, long-lived equipment a new lease on life. By expanding the focus beyond the initial sale, makers of products meant to last years—from heavy construction equipment and aircraft to medical-imaging devices and IT equipment—can open up new profit opportunities across the entire life of the product. (For more on this life-cycle concept, see “A virtuous cycle for top-line growth” on McKinsey.com.)

Nowhere is this virtuous cycle for growth more welcome than in the auto sector, where new competitors, business models, and exacting customer demands have tamped down growth and exerted massive pressures on the industry.

While automakers have long embraced various revenue streams such as financing and servicing, the focus still tends to be predominantly on a single transaction at the dealership. What’s needed instead is a mind-set that seeks to monetize a vehicle-identification number (VIN) across the entire life of the vehicle, creating a virtuous cycle powered by advanced analytics whenever possible. This becomes a self-reinforcing strategy; as each stage of the product lifecycle is optimized, it compounds the benefits of each of the other stages.

Advanced analytics is powering this shift from selling cars to maximizing the profitability of each vehicle for as long as it’s on the road. When executed correctly, we have seen a strategy based on the virtuous cycle add up to 12 to 15 percent to margin growth while also growing revenue. In addition, companies experience faster sales of their most profitable products, enhance brand equity, and build a stronger bond with their customers.

Six elements for driving profitable growth

There are six elements of the virtuous cycle that can contribute to profitable growth for automakers (see Exhibit 1). It is critical to keep in mind that the elements are all interconnected; a failure to manage any single element correctly can trigger risk—and destroy value—in the others. Carmakers can guard against this by adopting a life-cycle approach and using advanced data and analytical techniques.

Exhibit 1

Successful OEMs focus on six phases of automotive lifecycle pricing

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1. Packaging the options: Use customer analytics to optimize trim offerings

The overall goal of trim-mix strategy is to drive as much consideration as possible for each model. This requires a thorough assessment of how to position the trim and options packaging for each model. By analyzing data on customer preferences as well as the packages offered by competitors, carmakers can identify gaps in the market, such as inadequate coverage at its top or bottom ends.

Analytics allows carmakers to take the analysis even further. For example, a comparison of content (i.e., car features) in each trim package by VIN, using conjoint analysis could help determine the features that are most often included at each trim level, as well as the features most highly valued, allowing carmakers to profitably fill holes in the industry lineup. Ultimately, by using detailed customer data to set their content strategy, carmakers can address underserved market subsegments that have the highest consumer demand—and profit potential—while minimizing complexity.

2. MSRP and incentives: Reduce incentive spend by setting the right price points

Manufacturer's suggested retail price (MSRP) is the most powerful lever carmakers have for driving profit growth. It is essential to overall success to get the initial sticker price right. The first step, once the market-coverage strategy is set, is to determine the price customers are willing to pay for each type of transaction, including lease, financing, and cash sales. The next decision is to determine the optimal split between MSRP and incentives. This can vary significantly among market segments.

With increasing data transparency and advanced analytics, carmakers can take pricing to new levels of granularity, providing customized pricing by region, trim level, or VIN. And they can analyze historical data to get a detailed understanding of the elasticity curve, looking for opportunities to decrease incentive spend (thereby increasing margins) without losing significant volume (see Exhibit 2). By using advanced analytics, carmakers can vary the balance between MSRP and incentives to hit precise volume- or margin-growth rates.

3. Dealer margin: Optimize margin levels to more precisely align dealer and manufacturer goals

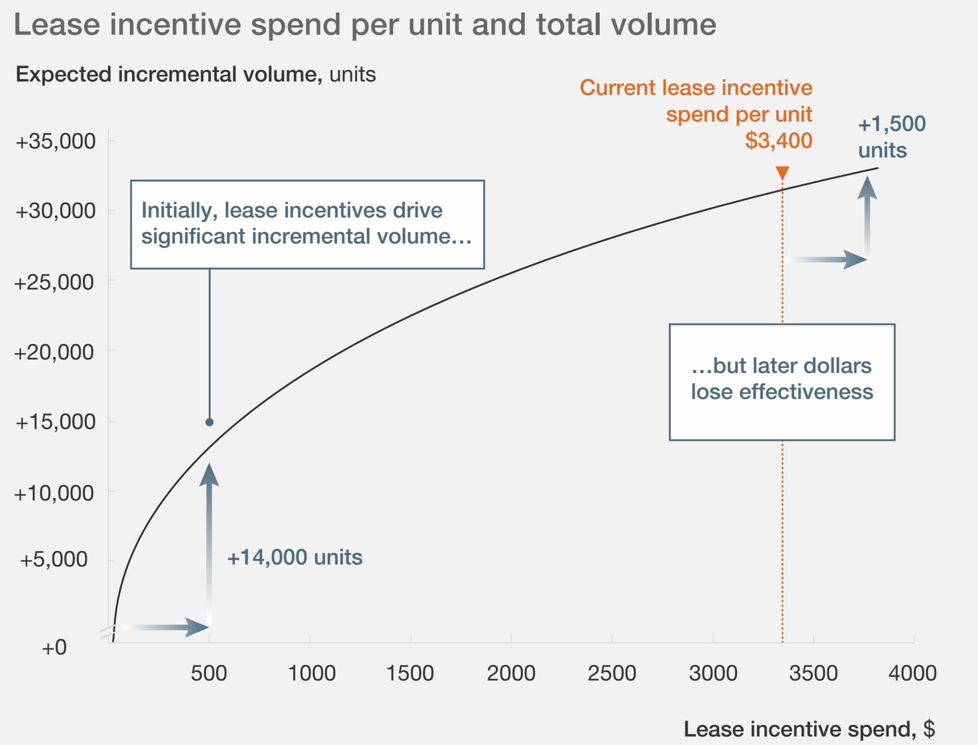
Setting the dealer-margin percentage should be an opportunity to position products in a way that drives a carmaker's overall strategy. Instead, in many cases, dealer margin becomes almost an afterthought, just a flat percentage regardless of trim level.

Using advanced analytics, carmakers can find the optimal combination and weighting of different types of dealer margin, enabling them to increase profitability while also improving relationships with dealers. The first step is to determine the overall percentage of dealer margin they want to assign to each trim level. Using linear programming, they can determine the optimal margin allocation based on profitability for each trim and service and dynamically predict how this will affect dealer balance sheets. By differentiating margins based on the actual profitability of products, carmakers provide greater incentives for dealers to push for the highest-profit sales.

In this way, dealer margin becomes a powerful tool for driving desired dealer behavior and outcomes. A premium carmaker focused on delivering a high-end, luxury experience, for example, could allocate a higher percentage of margin to customer-service metrics, incentivizing the dealer to meet those premium-brand standards.

Carmakers can find the optimal margin mix by using a test-and-learn approach to margin allocation. By trading off different levels of dealer support for various initiatives—for example floor-plan support versus local marketing—and tracking the corresponding shifts in sales, they can continuously adjust their margin allocations, improving channel profitability and effectiveness.

Exhibit 2



SOURCE: Elasticity analysis

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4. Financing: Offer competitive consumer-financing options by improving the efficiency of captive-finance arms

A high-performing captive-finance arm can be a key tool in helping carmakers drive sales, noncyclical profits, and consumer loyalty. The key here is “high performing.” A finance arm that uses robust analytics to design competitive financing options can also create additional revenue streams from well-thought-out insurance and warranty programs. A prime example of this is the use of analytics for advanced customer segmentation—similar to that offered by credit-card companies. Advanced segmentation enables the automaker to target a greater number of specific segments, creating tailored financing/leasing offers that can help close the sale and increase revenues.

To reap the full value of a finance arm, carmakers should focus on improving the unit’s efficiency. They can start by asking a few basic questions:

- Does the finance arm have a low internal cost of funds that it can pass on to the carmaker? If it hasn’t done so already, the finance arm should explore low-cost funding sources such as consumer deposits, which could include Demand Deposit Accounts (DDA) or consumer floating-interest notes.

- Does it achieve operational excellence? Today, operational excellence must include digitization, including digital loan applications. It should also include lean organizational structures to help minimize operating costs.

- Does it offer a full suite of nonloan revenue streams? Insurance coverage for tire and wheel, windshield, and others, as well as extended warranties can maximize revenue per vehicle.

5. Aftersales and services: Generate additional revenue and loyalty by targeting offerings throughout the product lifecycle

Carmakers may be missing an opportunity to increase aftersales revenues if they are not offering a service format for price-conscious consumers and those with older models. Some carmakers, for example, offer lower-cost service formats in stand-alone locations, targeting owners who would be unlikely to pay the higher prices for service at the dealership.

To design an additional-service format, carmakers should gather and run advanced analytics algorithms against offerings from competitors, feasibility assessments, and granular regional differences in demand at different price levels. Despite prices that are 20 to 30 percent lower than those at the dealership, these service formats can achieve profitability by using lower-cost labor and a warranty. on parts that may be remanufactured. Handled correctly, these lower costs offset the lower prices.

6. Remarketing: Increase the lifetime value of products by analyzing remarketing channels, pricing, and volume

The quest to maximize profitability throughout the entire life of the vehicle must include the period after the first trade-in or lease return. Besides driving additional profitability, focusing on this stage of the product life cycle gives carmakers greater control over their brand.

Just as they do with new cars, automakers should have a robust sales organization devoted to “remarketing,” with capabilities similar to the new-product sales team’s. By using robust modeling of the value at stake once a vehicle is purchased by a second owner, for example, and developing a deep understanding of customer demand, the team can analyze the relative value of both dealer and auction channels and determine pricing strategies for each.

Teams can also use advanced analytics to significantly improve auction strategy by guiding release times, prices, and locations and optimizing investments in reconditioning. For example, the carmaker’s analysis may show that all-wheel-drive (AWD) cars sell at higher prices in the Northeast in the winter. To improve margins, the carmaker can ship additional AWD cars from the South to the Northeast in January and February, using analytics to optimize by price, by time of year, and by channel.

A strong remarketing program also gives carmakers more control over their brand image. They can maximize the number of used vehicles dealers take by using linear programming to optimize the incentive packages associated with these vehicles. A strong remarketing program can also contribute to improved residual values by maintaining a robust market—and thus higher prices—for used vehicles. This contributes to the overall virtuous cycle. The higher residuals enable the carmaker to command a premium on new vehicles as purchasers take into account the higher value to come at trade-in time and lessees enjoy lower monthly lease payments.

Change the culture to foster collaboration

The virtuous cycle is predicated on a strategy focused on the entire product life cycle. It requires collaboration across organizational silos, new performance metrics and incentives, and possibly new kinds of talent. At times it may also require a surrender of the primacy of traditional metrics, such as new-car revenue, in favor of supporting overall profitability for carmakers and dealers.

How one carmaker regained its place in the virtuous cycle

When one carmaker set MSRPs 5 to 15 percent above the competition, sales consistently fell below plan and margins eroded. Consumers gave the brand the worst value ranking in the segment, 20 percent below the leader, while consideration rates fell to 40 percent below competitors'. To cope, the carmaker hiked incentives to as much as 70 percent above the competition's. That, in turn, drove residual values 16 percentage points below competitors'.

To dig its way out, the carmaker conducted a comprehensive review of its pricing and channel strategy, compiling a robust data set that included detailed competitive data on MSRP, incentive levels, payment type, dealer-margin structure, and more. By lowering list prices while decreasing incentive spending, the carmaker was able to increase both margins and demand. In addition, by reducing its dependence on sales incentives, the carmaker was able to improve residual values, improving its performance in the leasing market and driving higher margins when cars returned to the lot for remarketing to a second or third owner. By improving its pricing strategy, the company was able to once again return to a virtuous cycle of positive growth.

This new approach may require some fundamental cultural changes. For one thing, carmakers will need to look beyond their immediate organization and form closer relationships with their ecosystem partners to ensure access to data:

- Dealers are traditionally reluctant to share information in dealer management systems with carmakers; carmakers must provide financial incentives tied specifically to data sharing to ensure access.

- Captive-finance partners can continue to serve as a source of cash flow that is somewhat disconnected from the cycle of new-car volume. Still, carmakers should view them not as a profit center but as a support function for the core business.

- Carmakers can improve their access to data by working with third-party data providers, such as JD Power. For example, they can provide incentives for dealers to participate in reporting, which improves the quality of the JD Power data, and work to create integrated data systems that improve the usability of JD Power data, compared to interfaces that show only specific categories of information.

Using advanced analytics to continually find new sources of value

As cars become even more technology enabled, they will transmit ever-greater quantities of data on operating health and how the vehicle is being used. Carmakers able to take advantage of this data will find new opportunities to create value:

- By mining data to predict maintenance needs and parts failure, carmakers can alert customers to problems before they arise. Besides building customer loyalty, this could reduce warranty costs by performing maintenance that avoids a larger failure in the future.

- As customers' interactions with automobiles shift over the next several decades through ride sharing, autonomous vehicles, and the "connected car," massive new streams of data will become available. Carmakers must begin to use advanced analytics now, both to compete successfully in the current environment and to be prepared to utilize the big data to come.

- Create programs to test offers, and adapt based on feedback. Continually evaluate offer performance on a granular level (e.g. geography, customer segment) to create more impactful offers.

Shifting an organization to focus on creating a virtuous cycle is a lot of work. It requires a shift in mind-set and buy-in from leadership as well as from stakeholders inside and outside of the sales organization. Done properly, however, the journey can lift the fortunes of all involved.

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Chris Angevine is an associate partner in McKinsey's Atlanta office, where **Parmeet Grover** is a partner; **Manish Chopra** is a senior partner in the New York office.