

MANAGEMENT SUMMARY

Oliver Wyman Study on Future of Automotive Profit Pools: Automakers' System Profits Threatened

- **Manufacturers now earn money only from their financing and spare parts**
- **Independent financing and aftermarket companies now capturing increasing market share in all segments**
- **One-third of automakers' system profits are threatened – forward-looking strategies are needed to protect profits**
- **Turnaround must extend to new car sales as well**

The sale of new cars has become a zero-sum game for global Automotive OEMs. Automakers and their brand partners earn their money primarily from financial services and spare parts. However, this long-standing lifecycle business has come under increasing pressure in recent years: independent specialists in auto sales, financing, repair and service, fleet management, and parts sales are wrenching more and more of the market away from the old-line players. At the same time, auto sales are being liberalized across Europe, greatly weakening the manufacturers' hold on the dealers in the process. Automakers who cannot defend the profits they make in financing and parts sales and drag their new car sales business back into the black may be forced out of business. These are the conclusions drawn by the study "Automotive Sales: System Profit 2015" by Oliver Wyman. The study proposes a scenario for the future of sales, financing and aftersales and derives action plans for the brands. The final result is a comprehensive agenda for the refinement and rebuilding of automobile sales.

The automotive industry is a low margin business. In Germany for example the sector generates end-customer sales of about 160 billion euros annually. However, the automakers, banks, importers, and parts shops and auto dealers make only 4.1 billion euros in profit. This corresponds to a profit margin of approximately 2.5 percent. In particular, the new car business is under a great deal of pressure: Globally, there is about 20 percent excess capacity in the industry, leading to expensive rebate wars. During the first six months of 2005 in Europe, the average list price discount was almost 16 percent, matching US discount levels for the first time ever. The result? Most manufacturers barely break even on new car sales, or even lose money. And in 2004, auto dealers managed only a paltry 0.6 per cent profit margin; that figure currently appears to be falling as well.

However, the embattled new-car business is necessary to be able to gain the lucrative follow-up business: financing and replacement part sales account for less than 20 per cent of the industry's sales, but they are responsible for 95 per cent of the profits. Today, the manufacturers' business model works a lot like those for razors and inkjet printers. The product can no longer be sold at a profit, requiring all of the profits to be made in the after-sales service and support.

One-third of automakers' system profits are threatened

The Oliver Wyman market scenario forecasts only one percent market growth in key markets by the year 2015. Competition in the automotive industry is growing fiercer along the entire value chain. For manufacturers, about 20 percent of their sales volume and one-third of their profits are on the line – by 2015, they must either successfully defend those profits or lose them to independent players. In the worst-case scenario, automakers and their partners could watch their sales volume and profits fall to about 40 percent of current levels, which would weaken their influence on the market just when they need it most.

The most important strategic goal of all manufacturers will be to create long-term customer and dealer loyalty to their brands and their lifecycle business. However, this will be even more difficult to do ten years from now, because by then, large, highly professional dealerships will control at least a quarter of the market. Most of these are multi-brand dealerships with considerable market power. They threaten to tear lifecycle business away from the manufacturers and destroy brand loyalty and replace it with dealer loyalty. But by 2015, independent leasing providers and auto rental companies will also be on the way to building their own sales channels that will threaten manufacturers' sales strategies. The next ten years will see brands battling for the best dealers. Because over the long term, good dealers create successful brands, and good brands create successful dealers.

The commercial and fleet business is an important growth market. In Germany for example, half of all new cars today are sold to commercial customers, and this business will continue to grow by three percent a year across Europe. The largest portion of the commercial customer business will be handled by manufacturer direct sales, but they will face stiff competition from leasing companies and fleet management firms.

Manufacturers must act to defend their system profits

Financing services and replacement parts sales will continue to dominate earnings for the automobile manufacturers in the year 2015 as well. Manufacturers still control three quarters of all car sales in Germany, accounting for 117 billion euros of the 160 billion euro market. Therefore, they earn just about 80 percent of auto profits over the life of the vehicle. But the independents are gaining ground. They are getting a boost from the European liberalization of the auto market, driven primarily by the gradual repeal of the European block exemption regulation (BER). The repeal of the BER will permit independent parts manufacturers and shops to penetrate the previously protected brand business and allows manufacturers' dealerships to purchase services from sources outside the brand.

In recent years, independent providers have grabbed an increasing share of the most profitable business segments. In particular, independent car financing banks like the Santander CC-Bank, chain repair shops like pit stop, and parts dealers like Wessels + Müller are putting pressure on the manufacturers' offerings. The United States and Great Britain show all too clearly the future scenario that the European automakers must avoid in their home market: there, independent providers already dominate non-subsidized financing and the replacement parts market, which is not protected from imitators. The tremendous success that the independent financing companies, repair shops, and parts dealers enjoy here only proves that the manufacturers' system profits are not sufficiently protected from a strategic standpoint.

Financing services and replacement parts sales will still provide the lion's share of the profits in 2015. According to the Oliver Wyman market scenario, only those manufacturers who can make both their new car sales business and their used car marketing profitable will be able to maintain or grow their share of lifecycle business. The Oliver Wyman study "Automotive Sales: System profits in 2015" develops action plans to help make lifecycle business more competitive: make the sales

system leaner and more effective; network and professionalize the four business segments of new cars, financing, parts, and used cars; and finally, redesign all activities and offerings to maximize their contribution to customer satisfaction as a basis for creating customer loyalty and long-term lifecycle business.

Sales needs a more efficient division of responsibilities

The division of responsibilities between manufacturers, importers/wholesalers and car dealers is currently inefficient and has many areas of duplication that must be eliminated in the future. A new division of responsibilities will improve the system as a whole, ensure more precise sales direction, and increase margins for both dealers and manufacturers. Above all, the import and wholesale level must be thinned out, and some of their functions should be re-assigned to the manufacturers and large dealerships.

Despite rising numbers of direct sales, car dealers will remain the most important customer interface. Manufacturers and wholesalers must put dealers in a position to be able to handle their increasingly complex responsibilities with respect to brand loyalty. These responsibilities include the ability to sell comprehensive system products, handle rebates properly, and implement measures specified by manufacturers and wholesalers. Only profitable dealers are successful over the long term – and average rebates that are one percentage point lower immediately raise the dealer's profit by one percentage point.

The increasing success of large multi-brand dealerships has weakened top-down control of the dealers and contact with customers. Buying stakes in important dealerships and the careful cultivation of the manufacturer's own dealerships can keep this effect within certain limits. The manufacturers can't risk losing their access to the customer. Only direct customer contact via the branded sales channels allows the manufacturer to control prices, market rollouts, and follow-on business.

New car sales must become a profitable foundation

To strengthen system profit over the long term, all business areas must be profitable. This is particularly true of new car sales – on both the manufacturers' and dealers' ends. Prices must stabilize, rebates must shrink, and cost structures for sales must become more efficient. Furthermore, the share of customers loyal to the brand must increase.

The road to this goal leads through appropriate and lean sales channels for all customers in all regions and effective revenue and sales control tools. Key account management and graduated service packages extending all the way through fleet management will enable more attentive service to be provided to commercial customers.

Financial services provide profit and promote sales

The manufacturers' banks must first make an effort to secure their existing financing business through dealer loyalty programs. Then these efforts should be expanded to dealers of other vehicles and the Internet, possibly using a second brand. Strict cost control is a must for manufacturers' banks if they wish to compete with independent competitors over the long term.

Financing conditions must be coordinated even more closely with manufacturers sales incentive programs in the future. Also, the manufacturers' banks should be more closely aligned with the satisfaction of customers and dealers. The basic financing business must be complemented with insurance and other offers.

A functioning service business model keeps customers with your brand

The auto brands need to increase their market share in the repair and replacement part business, for older cars as well. To accomplish this, they must ensure service quality using a qualification program. Differing shop formats and specializations will ensure optimal availability of services to various customer groups at acceptable prices. It is important to concentrate the service business on central customer satisfaction factors so that the customers will become more loyal again.

Following the example of Renault's Motrio quick-service shops, or ACDelco, GM's parts brand, the manufacturers should follow aftermarket strategies for parts, wholesale parts, and repair shops that will allow them to offer parts for brands other than their own. An alternative to this would be to buy a majority stake in an independent parts wholesaler to participate in the success of independent repair shops.

Used cars bridge the gap in system profit

Currently, the used car market is abused by the automakers as a release valve for their excess capacity, especially for the cars with one-day registrations. As an independent and profitable business segment, the used car business can achieve an attractive sales volume with margins of over three percent, opening the door to additional system profit potential. It also serves to win price-sensitive customers, improve new car sales, and stabilize residual values.

Leasing customers are sold configurations that are hot on the used car market to sweeten the used car inventory later. Prepping the car in a way that boosts its value, offering additional services, and differentiating sales channels make the used car inventory more valuable and differentiate the brand, even in the used car market. An international marketing pool will guide used cars to their most appropriate markets and channels.

Long-term customer loyalty and brand loyalty

To build long-term customer loyalty, there should be an appropriate product and service mix available for customers at all stages of their lives. Sold as a cohesive, brand-determining product bundle, it would contain appropriate mobility, convenience, lifestyle, service, and safety components. The result would be "starter packages" for a person's first car, "enjoyment packages" for the well-heeled over-50 set, or "total cost of ownership" packages for commercial customers. The highest goal of this phase-of-life approach is long-term customer satisfaction and brand loyalty.

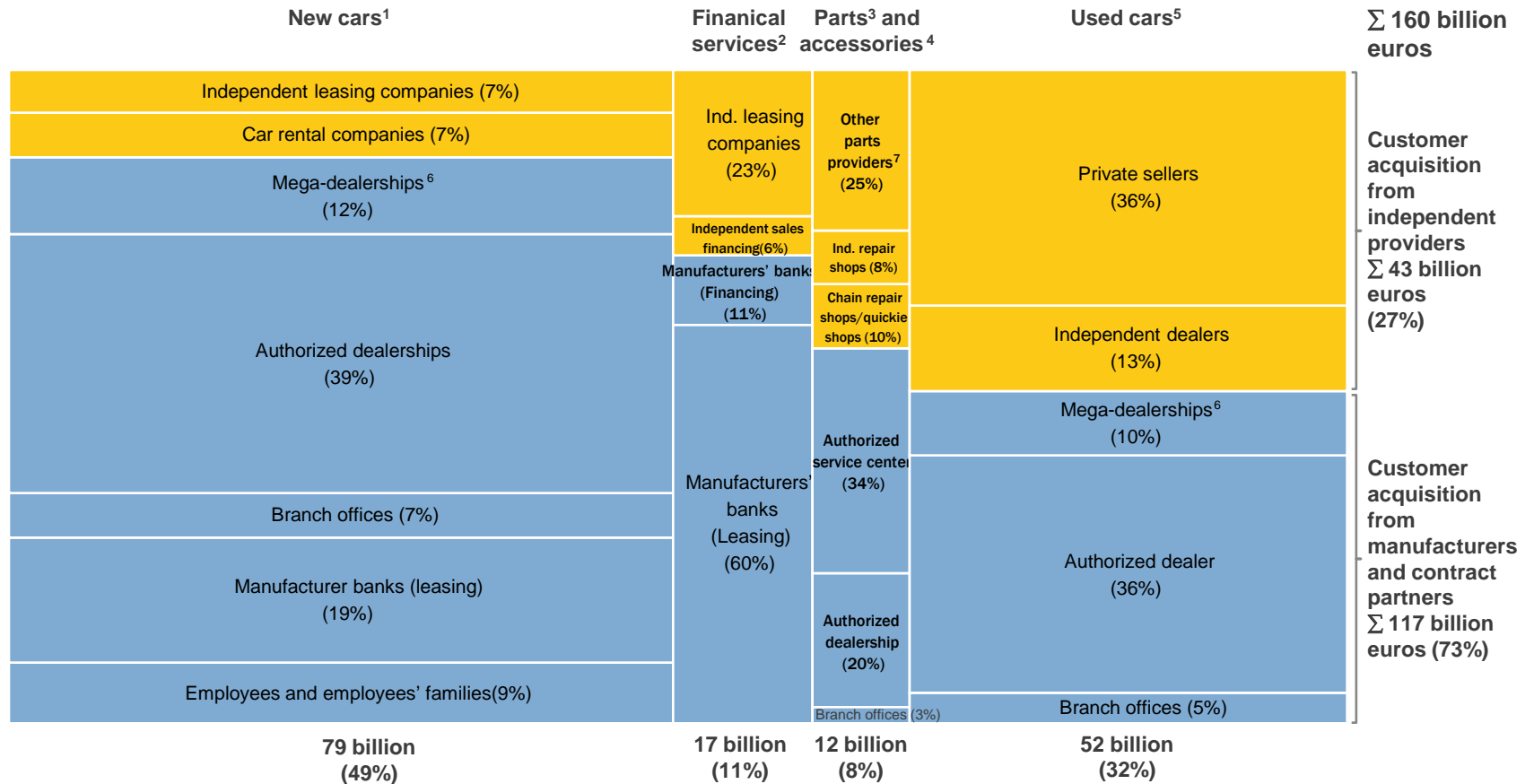
System profit means comprehensive optimization of profits for the brand – not per sale, but rather per vehicle, per customer, and per dealer. Tomorrow's winners will be the brands that develop a deep understanding of the needs of their target customer segments and achieve above-average loyalty.

Six Action Points for Brand Sales

1. A new division of responsibility between the manufacturer, wholesale and retail segments will boost effectiveness, improve efficiency, and make the sales system more marketable.
2. Greater dealer professionalism and transactions with higher margins will turn the new car business around and make it profitable again.
3. A stronger sales orientation at the manufacturer's finance captives will ensure targeted sales incentives and profits in a more liberal sales landscape.
4. Better integration of services into the overall system will support the profitable replacement parts business and keep customers and dealers with the brand.
5. The used car business must be expanded from an unprofitable sales valve into a fourth independent pillar of profit.
6. Customer-specific service packages over the entire lifecycle increase brand loyalty and open up additional sources of profitable growth.

Manufacturers still dominate the market – for now

2004 system profits in Germany

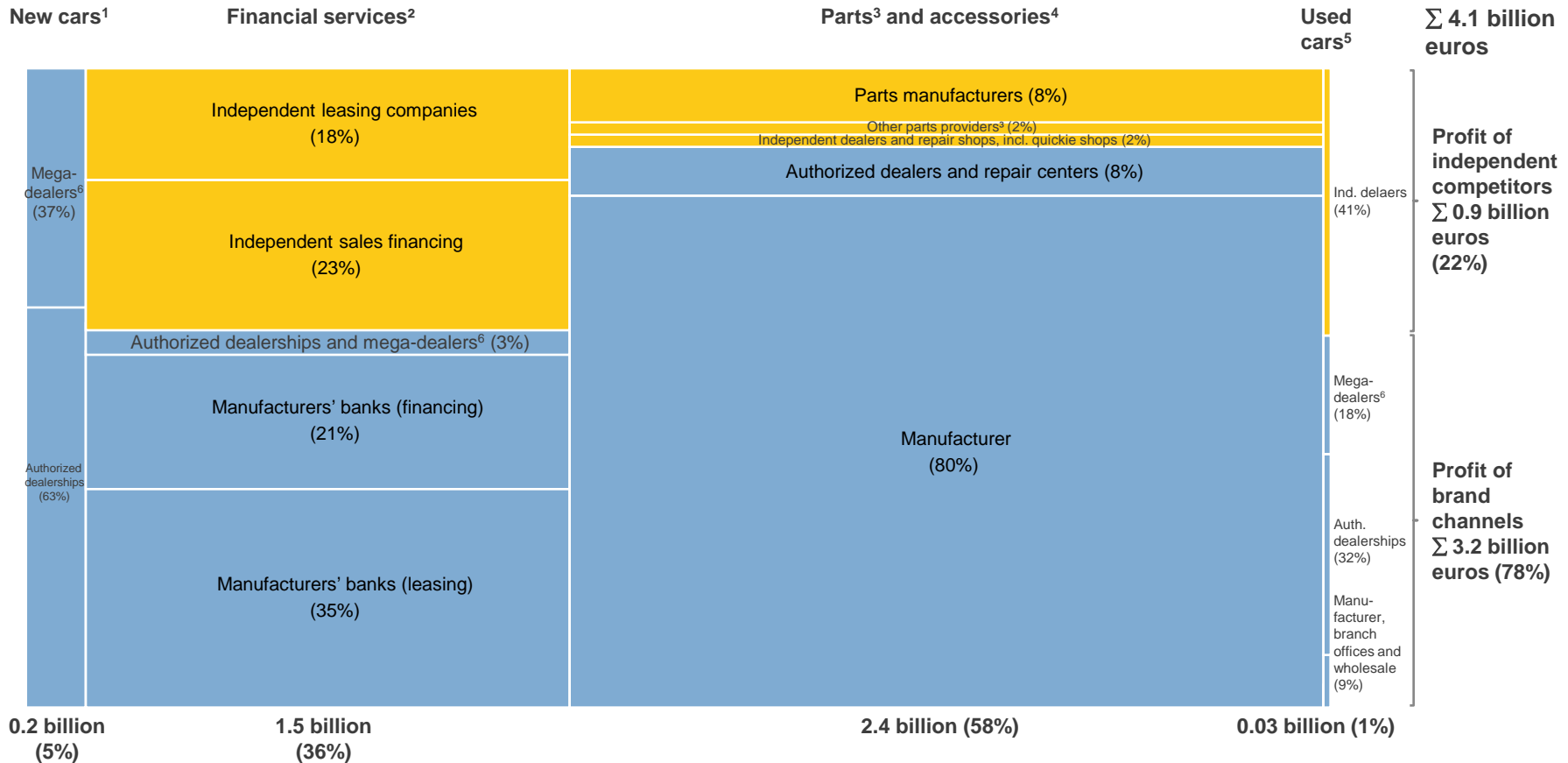


1 Manufacturer sales by channel, incl. one-day registrations and re-imports
 2 Leasing rates and interest revenue from new car and inventory business
 3 Includes paint and auto glass, excludes fluids and lubricants, tires and wages
 4 Not including tuning and wages

5 Not including dealer business
 6 Dealers with annual sales of > 3,000 vehicles
 7 i.a. specialized stores and parts specialists

Profit lies in financial services and parts

2004 system profits in Germany



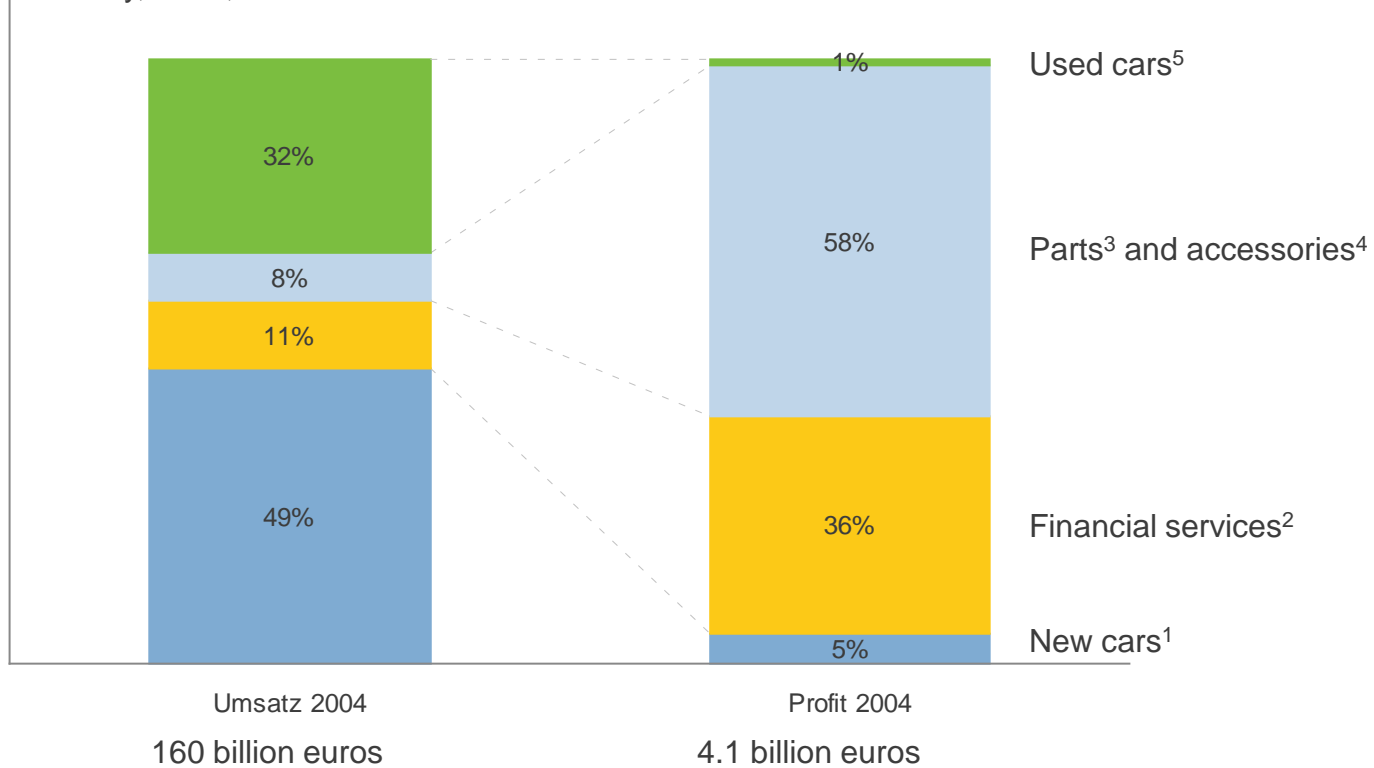
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Money is earned almost exclusively downstream

Sales and profits by business segment

Germany, 2004; in %

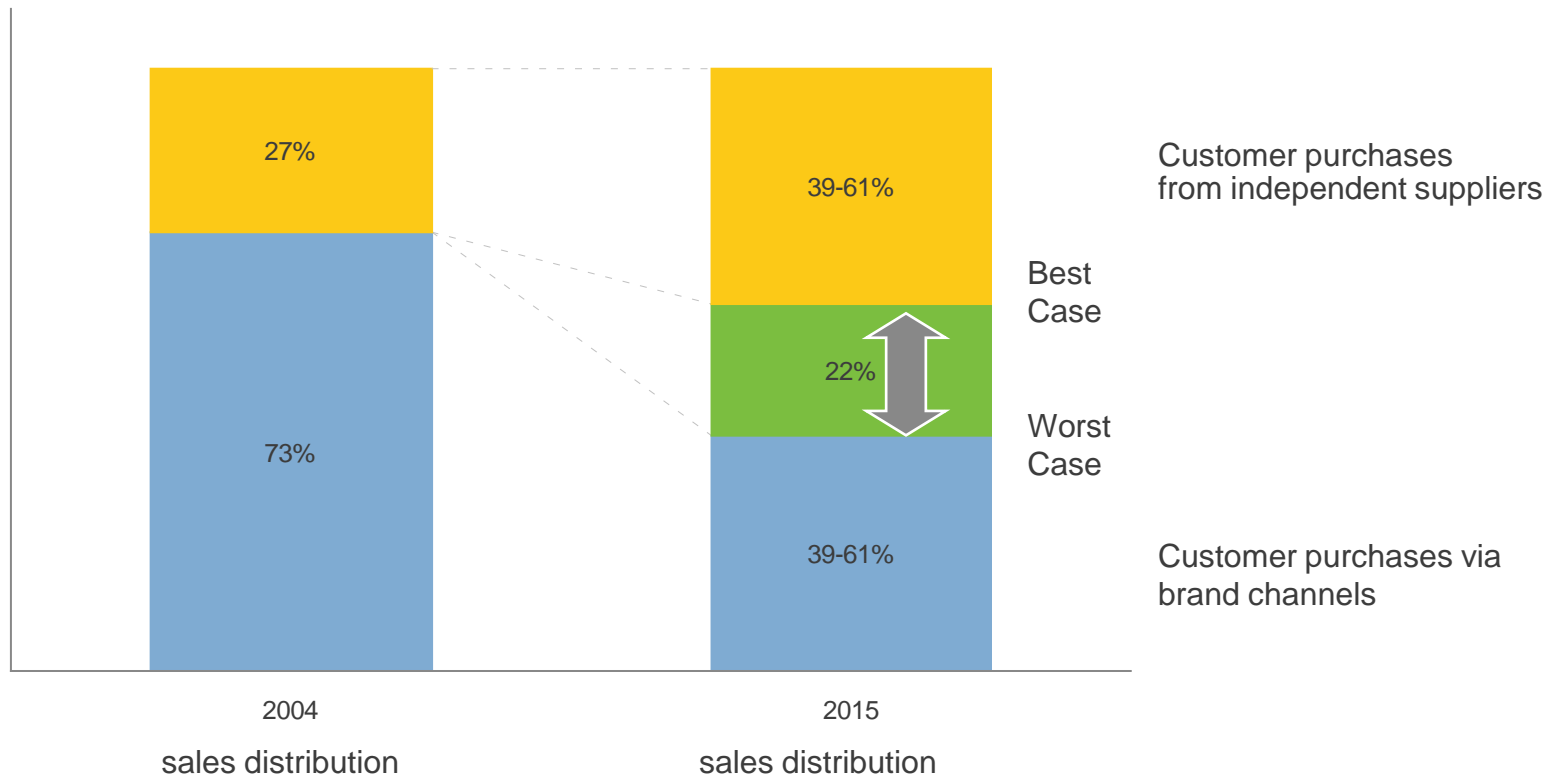


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22 per cent of end-customer sales in 2015 are up for grabs. Brand channels may see their share shrink to as little as 40 per cent

Sales by channel

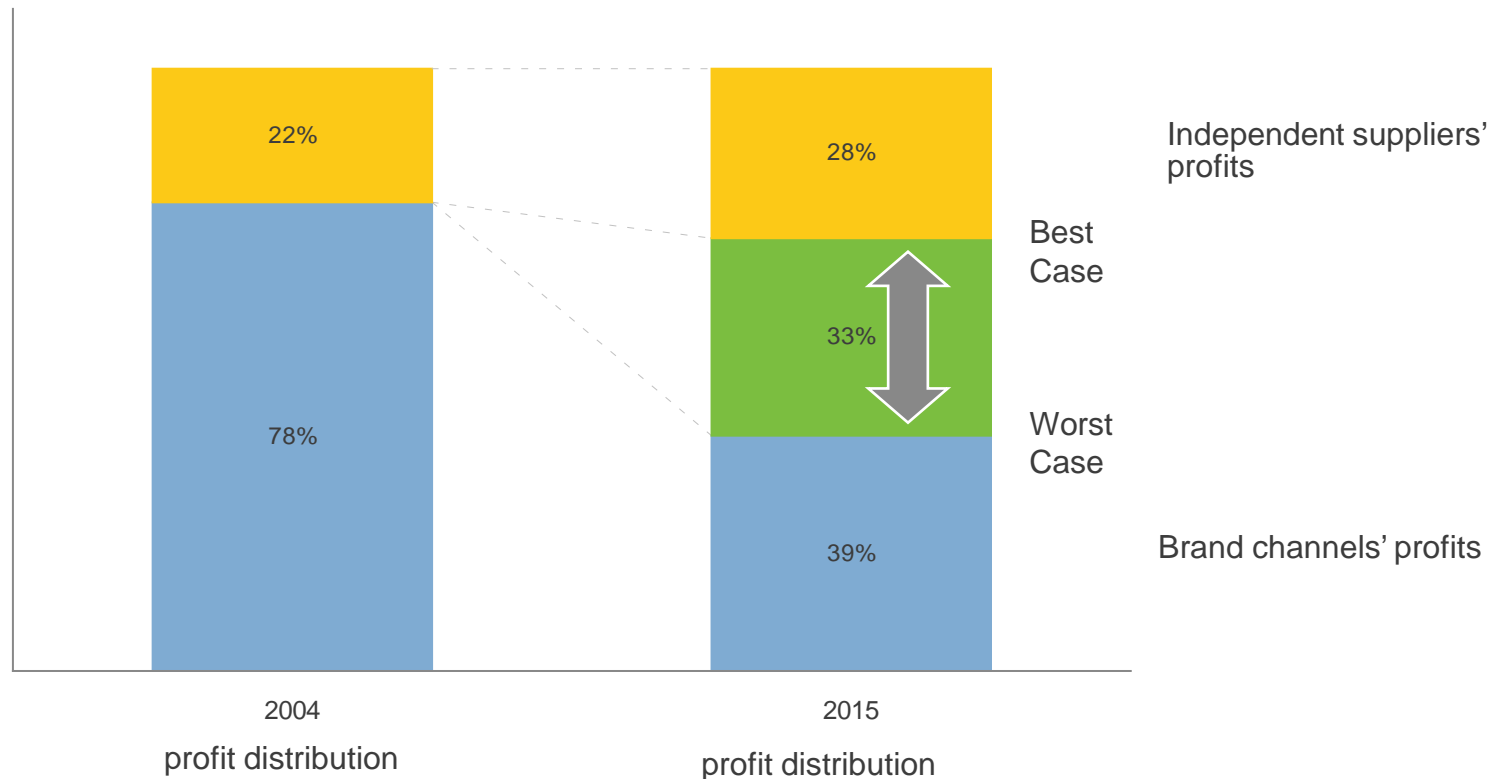
Germany, 2004 vs. 2015; in %



33 per cent of profits in 2015 are up for grabs. Brand channels may see their share shrink to as little as 40 per cent

Profits by channel

Germany, 2004 vs. 2015; in %



Six action areas for brand sales

