Finding the automotive distribution model of tomorrow
2018
Car dealers, importers and manufacturers form a distribution network where each player has traditionally made money from a set of activities in sales and after market. A number of trends are likely to force changes to the setup, in this publication we will look at how and what can be done about it.

The automotive distribution industry as we know it is mature in its nature and has continuously refined its processes and structure over many decades. The system featuring Original Equipment Manufacturers (OEMs), National Sales Companies (NSCs) and Dealers is robust and the rules of engagements are clear and understood.

There have been a few significant challenges in modern days, such as the shift from product- to customer-centric sales and the first steps towards digital capabilities. The last few years have also seen a wave of consolidation in our Nordic markets where OEMs, NSCs and dealers strive to find critical mass to sustain profitability, enable investment and increase professionalization in an ever more demanding world.

We are now, however, standing before a new set of challenges which are more profound than those we have mastered in the past. Yesterday’s changes could be addressed within the existing structures and business models of the day. The challenges we face today will fundamentally challenge the logic of the existing activity-based remuneration model.

Direct selling of cars from OEMs to the end customer, increasing volumes of electric vehicles, connected cars, as well as the uprising of mobility services are likely to have significant impact.

Digitalization disrupts customer interaction and sales process but also opens up for new revenue streams. Electrification is a potential game changer and an increasing share of cars are sold to fleet operators.

From this, it is clear that the logic of the current activity and remuneration structure is being challenged. If left unattended, it is likely to result in unsustainable profitability balances in the distribution channel that can victimize both OEMs, NSCs and dealers.

So what can be done to navigate this new landscape and find the answers to how we construct a robust distribution model for the future? In this publication, we take a look at the situation for NSCs and dealers across the activities in car sales and aftermarket.
What does the current model really look like?

In our experience, it is not uncommon to find that OEMs/NSCs and dealers have misaligned understandings about what their activity scope actually looks like. This leads to difficulty understanding the true operational and financial situation for the participants. A number of activities and cost/revenue sources must be considered:

- **Pre-sales**
  - Marketing
  - Car type analysis
  - Test drive
  - Options & pricing

- **Sales**
  - Order management
  - Bonus admin.

- **Financing**
  - Lending
  - Leasing

- **Delivery**
  - PDI
  - Paperwork
  - Handover

- **Maintenance & Repair**
  - Scheduling
  - Receipt & Return
  - Service work
  - Repair work

- **Add-on Services**
  - Tire handling
  - Connected car

The figure below visualizes the operating revenues and costs across the customer journey, expressed as proportional distribution of costs and revenues for key activity areas*.

For the industry as a whole, half of the profits come from the aftermarket. Car sales account for the other half, split roughly equal between dealers and NSCs, with the vast majority coming from new cars rather than used. Financing is starting to matter, contributing up to 10% of industry profits. Aftermarket is, to no surprise, a vital source of profits, without which the business of selling cars would be hard-pressed to survive.

It is also clear that NSCs and dealers bear a share of marketing, pre-sales and delivery cost. As vehicle gross margins are slim, it can be argued that those activities are financed by the aftermarket service business and would not be sustainable otherwise.

Let’s look at how some new trends of our industry will change this landscape.

*) Source: EY analysis 2017-2018
What trends will have an impact?

In some of our recent engagements we have looked closer at the impact of the key trends that face our industry have on operations in our Nordic market. We can already now see evidence of the ripple effect that these trends have on the business logic of the current distribution model.

Electric cars
Sales of electric cars have increased remarkably during the last couple of years. Forecasts indicate that Swedish sales will continue to grow to 60,000 cars, or a market share of 13%, by 2021.

This trend has massive consequences for society, the energy sector and infrastructure, but it also impacts the traditional aftermarket business as electric cars need less maintenance, typically up to 30% less parts and 10-20% less labour, but require new investments and competence to service compared to combustion-engine cars. This will squeeze aftermarket profits from two directions.

New ownership models
Traditional car ownership is being challenged by various ways of selling mobility, seeing car usage as an experience rather than a product. Many major OEMs are setting up ventures for car sharing, subscription models etc. This will impact multiple activities in the traditional car distribution.

The service cost of an electric car is about 20% lower than that of a combustion-engine car.

The number of members of cars sharing pools in Stockholm has increased by 100% since 2016.

The average private car has a utilization of less than 5%. For car sharing operators, that number is rather 10-40%. This should translate to fewer cars sold, though the impact is not yet dramatic. Also, when the buyer is no longer a consumer, but rather a fleet manager, the traditional sales channel will be less relevant, leading to less sales for the dealers.

On the plus side, fleet cars require more service and that service can be easier to schedule, which is good business for those able to get a piece of it.
How will profitability be impacted?

New sales channels
Just as bricks and mortar retail is being challenged by online sales, the car buyer is looking in the same direction.

In the used car segment, online platforms and auction sites are well established competitors to the traditional dealers. The same trend now follows for new cars.

New sales channels and touch-points are being introduced, e.g. Peugeot sells online directly to the customer and Volvo Cars is testing sales combined with a factory delivery experience.

This is likely to change the way OEMs, NSCs and dealers collaborate and some of the traditional steps in the value chain might be reduced or changed.

Players who have direct contact with automotive users will also face new types of capability requirements, as customers are highly informed when interacting physically with a brand and demand technical experts rather than a sales pitch.

Almost 50% of consumers are likely to purchase their next car online through an online car dealer or manufacturer internet site.

Connected cars & analytics
New enabling technologies are available at relatively low cost and the technology inside the car gets more advanced.

Connected cars use car telematics solutions enabling both vehicle monitoring and internet connection of in-vehicle systems and sensors. This opens up for new types of offerings and services.

Predictive maintenance – car sensors sending data to the manufacturer, predicting needs for maintenance and repair.

Driving behaviour analysis – lowering costs for e.g. insurance and fleet operators.

Consumer services – e.g. in-car delivery, in-car sales, accessories on demand, in-car entertainment

New forms of collaboration between OEMs, NSCs, dealers and other parties are likely needed in order to consolidate car and customer data and use these insights to create new revenue streams.

All new cars are predicted to be connected to the Internet by 2025
How will profitability be impacted?

As we have seen, the current activity scope in automotive distribution is made up of a number of under-profitable activities and a number of over-profitable activities that balance out the equation to a sustainable level. This is all well and good in the system that we know. However, the new trends and realities of our industry impacting this set-up at the core.

Let's look at the potential impact to profitability of some major trends.

1. **Directs sales and new ownership models** such as car sharing are expected to reduce the number of cars sold in the traditional NSC/dealer channel. Given large fixed/semi-fixed costs and typical net profits of ~1% for dealers and even less for NSCs, a small reduction is enough to make this unsustainable.

2. **Electrification** is likely to reduce maintenance and parts revenue by ~20% per car, while costs for equipment and training increase. Given net profits of ~3-10%, the impact will be significant.

3. **Connected cars and telematics platforms** enable new revenue streams from analytics (e.g. insurance tailoring) and add-on services (in-car delivery etc). This could counter some of the lost service revenue and also help reduce cost of service by e.g. sensor-based predictive maintenance. It is, however, uncertain if new revenue streams will benefit the dealers.

If these impacts do materialize, and there is lots to suggest that they will, the automotive distribution networks of today will not survive. This means we need to reconsider what they should look like tomorrow…

*) Source: EY analysis 2017-2018
What are the ways forward?

So, what can be done to create a robust distribution model that is able to face challenges of today and navigate in the new landscape? By taking a closer look at the current remuneration model, it is clear that it does not allow us to simply take out an activity in the customer journey scope as this can easily lead to unsustainable levels of over or under-profitability for the distribution system. Rather, we need to re-examine the impact of new business models in depth to understand how we can re-construct a new balanced system.

As discussed in the beginning of this publication, OEMs, NSCs and dealers need to understand the current and future allocation of costs and revenues to find a healthy balance.

As OEMs and dealers alike experiment with new business model approaches, often in isolation of each other, they risk missing out on understanding in depth how their respective capabilities can be remodeled to build a new robust role based automotive distribution system.

Some of the more successful approaches we have been involved in have focused on establishing a clear and fact-based understanding of the current business model and activities, including the profitability on activity level for each participant. From there, we can quantify the impact of new remuneration models, loss or gain of activity scope or revenue distribution. This insight will enable us to understand what decisions for changes are needed to establish a distribution model fit for the needs tomorrow.

It is important that OEMs initiate and carry the torch of collaboration between themselves, their dealers and other participants as the new distribution landscape with its new roles emerges.

There are a few major questions to address:

**Who does what in tomorrow’s distribution network?**
OEMs need to understand what parties should carry out what activities to serve the end-users. What should the network of tomorrow look like and who are the relevant partners?

**What is the critical mass needed to sustain healthy profitability?**
As volumes decline for traditional dealers, and investments are needed for new technology, what share of the pie can fall on what partners and who will survive? What new revenue streams can be used to finance under-profitable activities that still need to be performed?

It is clear that the challenges of today and tomorrow are not solved in isolation by any stand alone party. But rather in close and transparent collaboration between OEMs, dealers and other stakeholders where the new rules of engagement are understood, analyzed and agreed.
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Contact

Martin Cardell
Partner
Automotive Leader EMEIA
martin.cardell@se.ey.com
0046 703 517733

Per Holmblad
Director
Automotive Retail Leader
Nordicsper.Holmblad@se.ey.com
0046 725 762611

Contributors:

Per Holmblad, Johan Haldén, Alexander Sundin, Emma Axelsson, Isabell Hultén och Åsa Söderlund