

The Auto Industry: “We Make Cars, Everyone Else Makes Money”

(Or, how the downstream portion of the automotive industry spawns value-creating opportunities)

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- “Downstream” Segment Outperforms

Why Do OEMs Capture So Little of This Value?

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Some Examples of Downstream Value Creation

- The Niches are Small but Very Rewarding

The Automotive Value Chain: Overview

Calculated on a per car basis

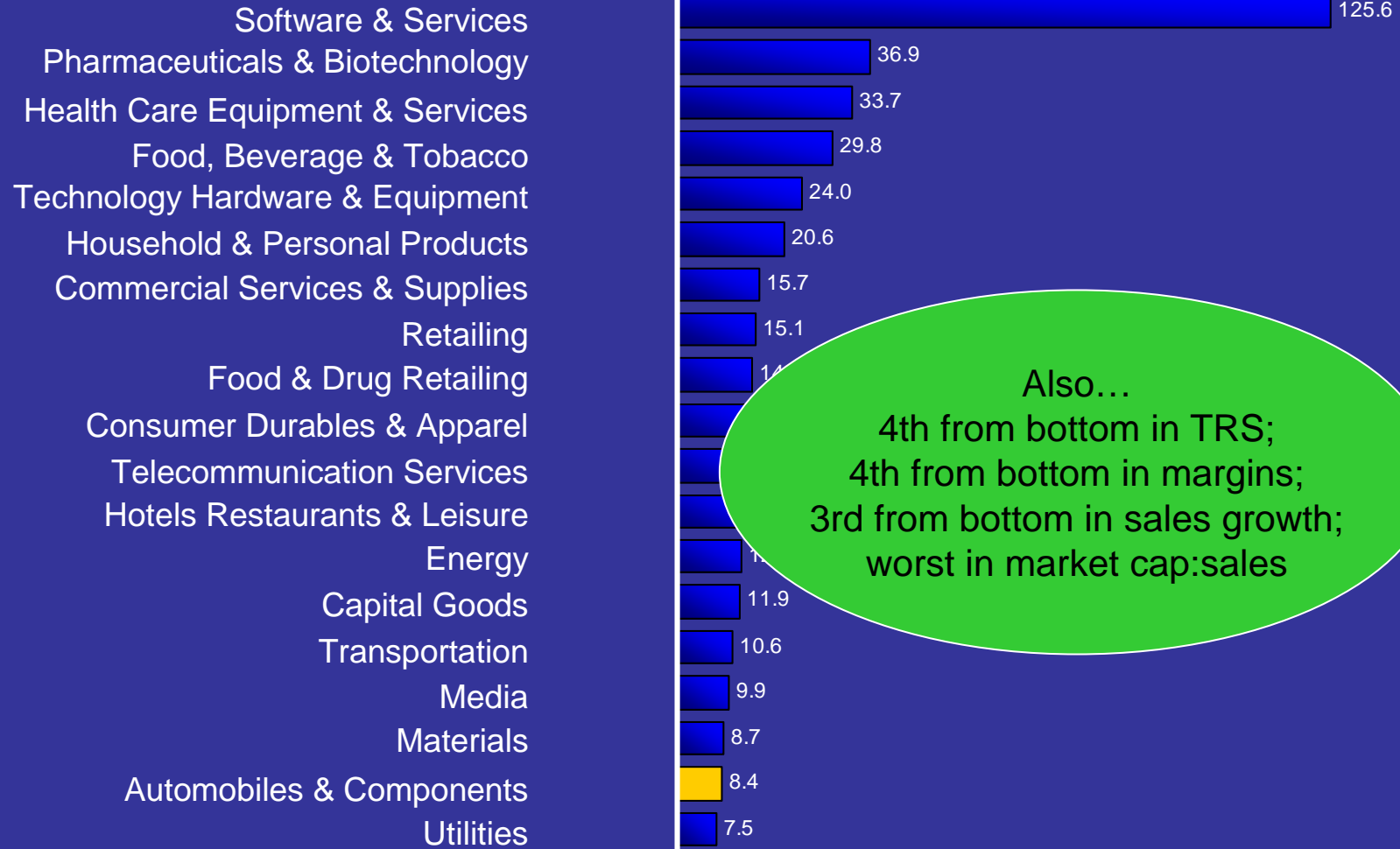
“downstream”



	Design	Source	Build	Distribute	Service
Cost	\$1,000	\$12,000	\$3,000	\$4,000	~\$2,000 to ???
Drivers	Engineering hours Tooling (e.g. dies)	Purchased parts Internal supply	Labor Tooling investment	Dealer margin Marketing costs	Financing revenue Parts sales
Purpose	Design (styling) of new car; development (engineering) of all parts and systems.	Selection of suppliers (sourcing), negotiation, management of actual delivery, development.	Collection of all needed parts; stamping steel, painting it, welding it, assembling all parts.	Shipment of cars, retailing of cars, launch of new models, all marketing	Financing car sales (lease and loan) Parts sales for repair Any other “downstream”
Activities	Market research Brand analysis Platform strategy Design-to-cost Technology usage	Technology choice Modularization strategy Sourcing strategy Supplier development Market testing	Factory flexibility Speed Build quality Continuous improvement Process control	Channel management Pricing Marketing Selling Launch	Service penetration Financing share and terms Relationship management
Leaders	High: BMW Low: Honda	High: ??? Low: Toyota	High: Lexus Low: Toyota, Honda	No consistent stand-outs anywhere	High: high-line OEMs Low: none consistently
Metrics	Time to market, car cost, program cost, market success	Low cost, high quality of parts, low warranty costs	Hours per car of labor, factory flexibility measures, build quality	Varies, but: Incentive cost per car, dealer coverage, exclusivity	Finance margin (if any); parts revenue; open-ended

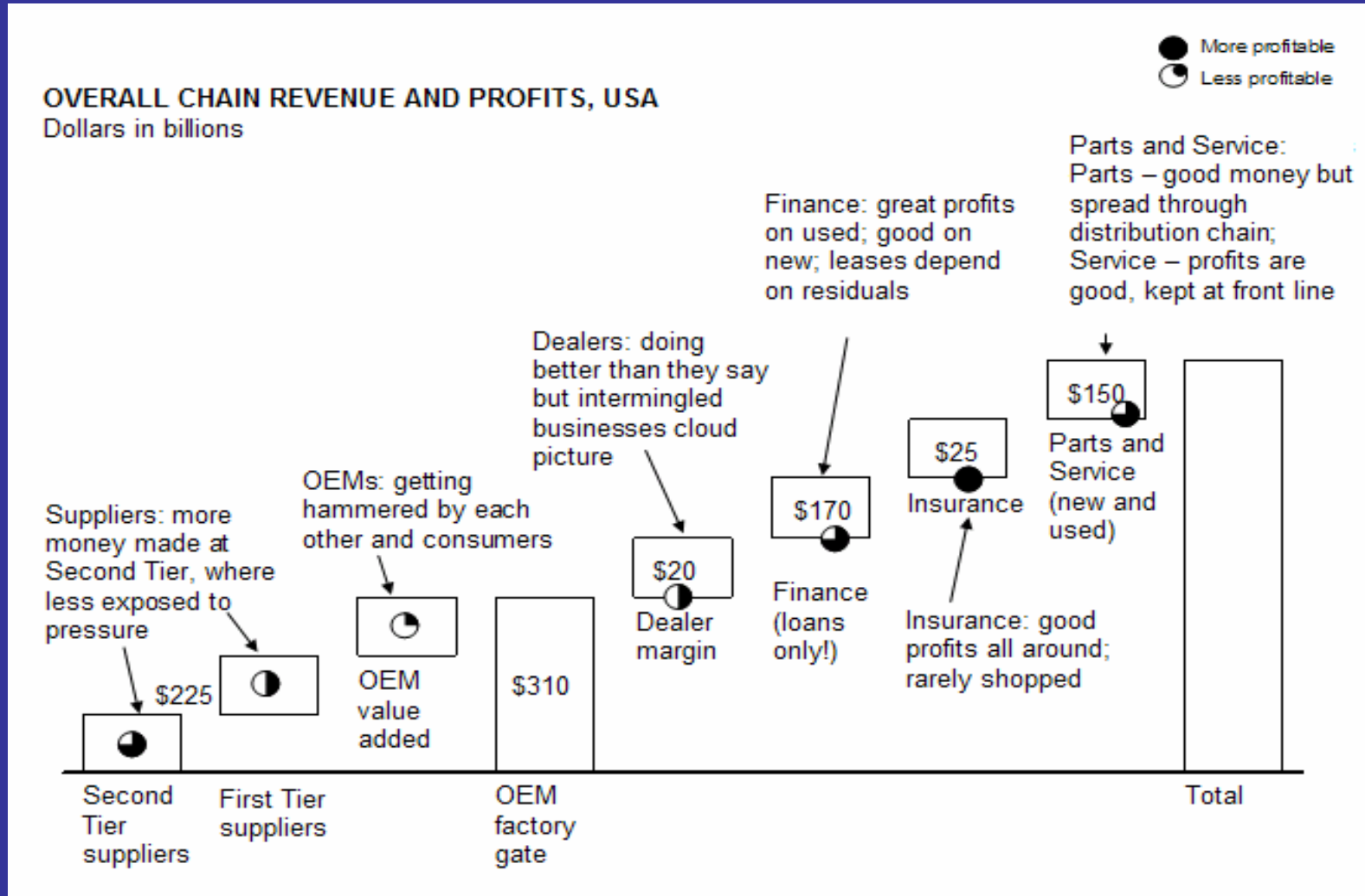
The upstream industry doesn't perform well

AVG. MARKET CAP WTD. ROIC OF U.S. FIRMS IN S&P 500, 1997-2001, %



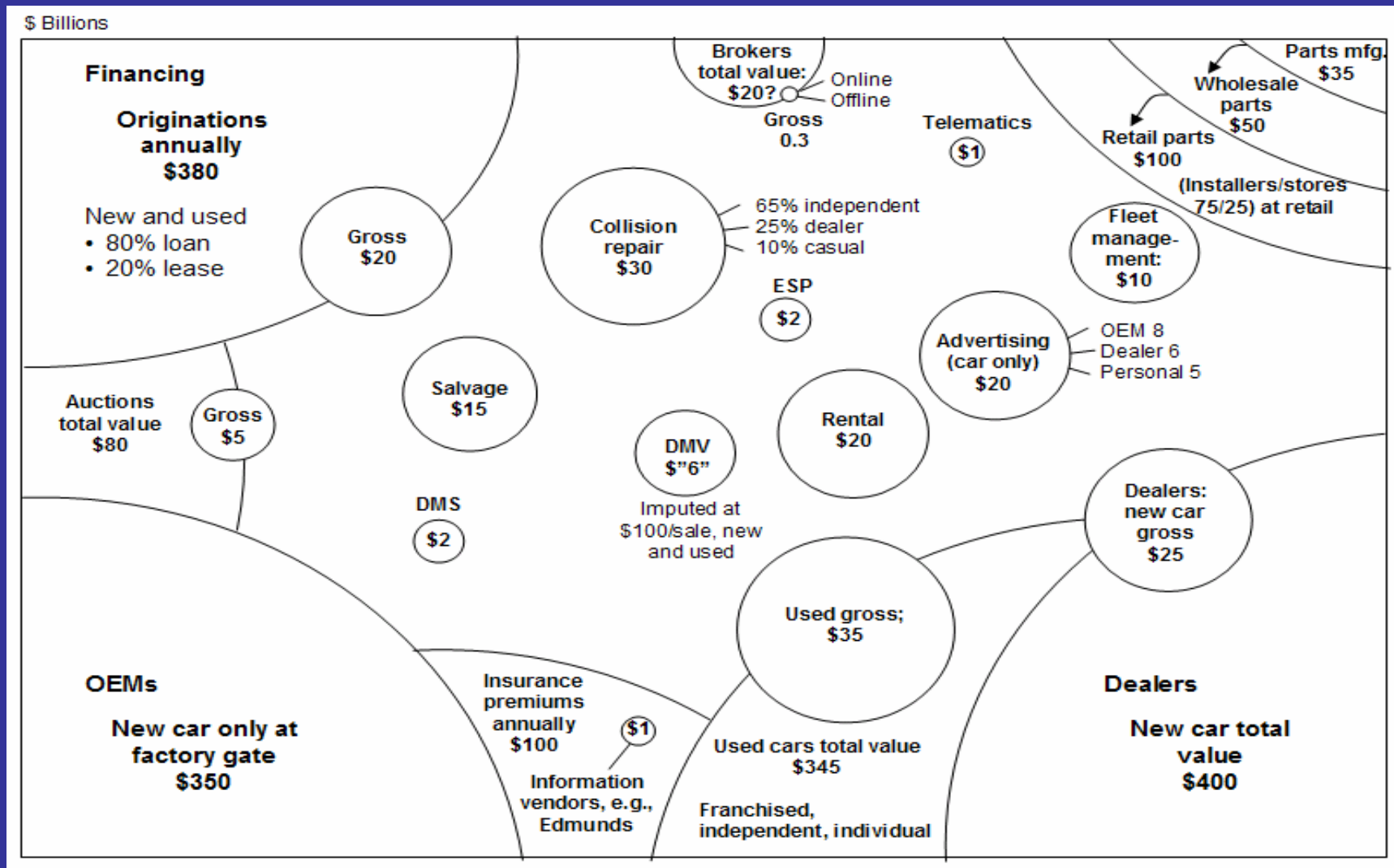
Source: McKinsey & Company from public securities data

Downstream tends to outdo upstream



Source: Authors' experience over time; contact author for additional estimates from Bain, investment banks, etc.

And downstream is *not* small!



Source: Authors' experience over time; Reynolds + Reynolds; USA data only

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Most OEMs Do Participate, if Modestly

Typical downstream participants

- Parts sales
 - Financial
 - Car rental
 - Accessories
 - Used cars
- Although OEMs may be reluctant to admit it, the downstream market (in this case primarily maintenance and repair parts) provides an enormous portion of their total earnings: “perhaps 10% of OEM revenues but 50% or more of their earnings” (Goldman Sachs, 2002)
- Car repair
 - Accessories
 - Used cars

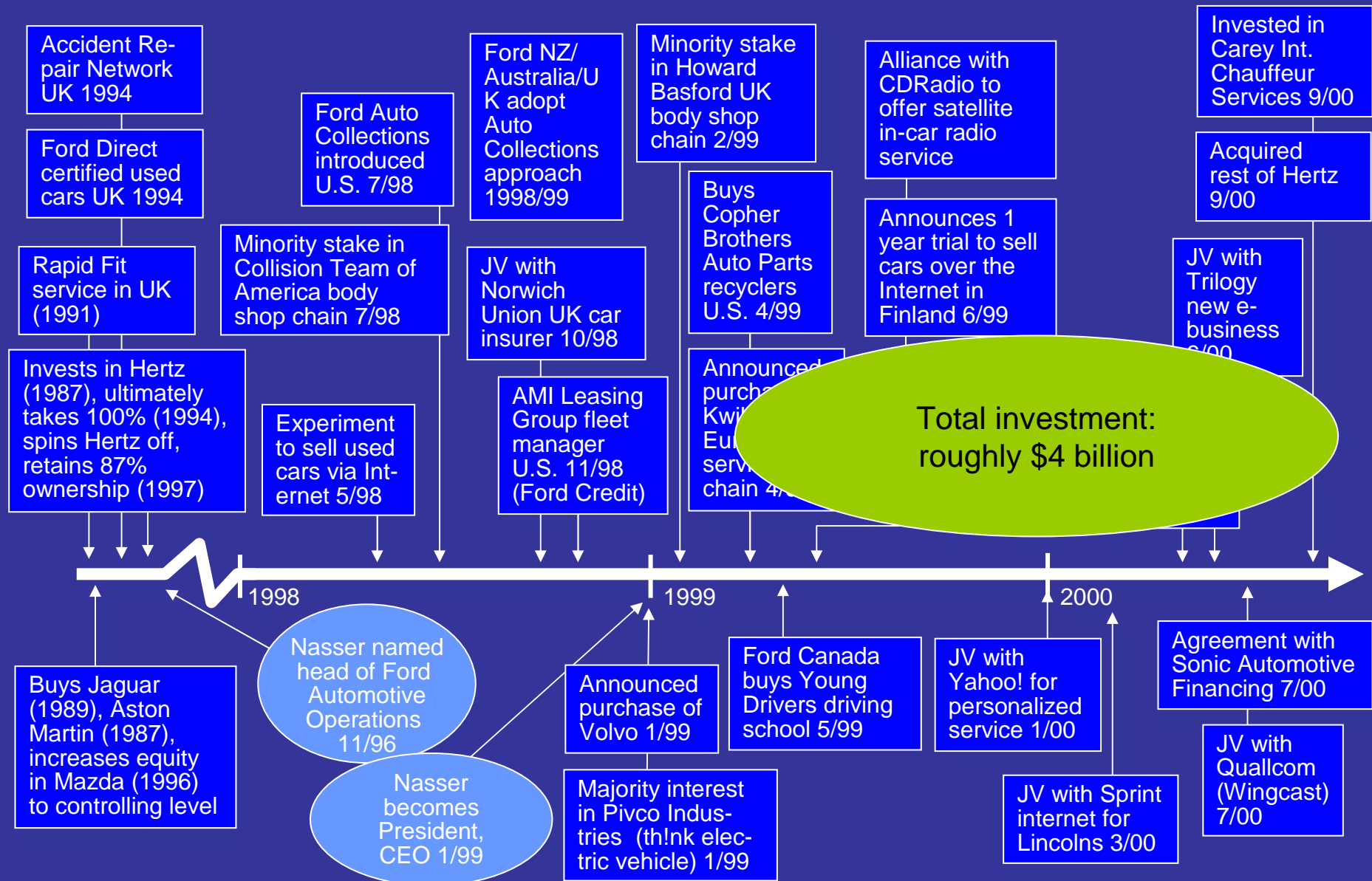
Why not do more?

- As adjunct to upstream business (e.g., one must support repair of cars or no one will buy new cars; one can offer financing to make purchase feasible) +++
- To provide support to the dealer network (i.e., service work provides a source of revenue supplemental to new car sales) ++
- To obtain sources of revenue and profit as core business profits erode +
- To stabilize revenues (e.g., if new car sales are cyclical, downstream revenues tend to be less so) . . . the lure of “subscription” revenue +
- To intervene and support used car “residual” values (e.g., through certified used car programs) ++
- To build customer loyalty through “cradle-to-grave” provision of services, along the lines of CRM (Customer Relationship Management) ++

But there are reasons *not* to do more, too.

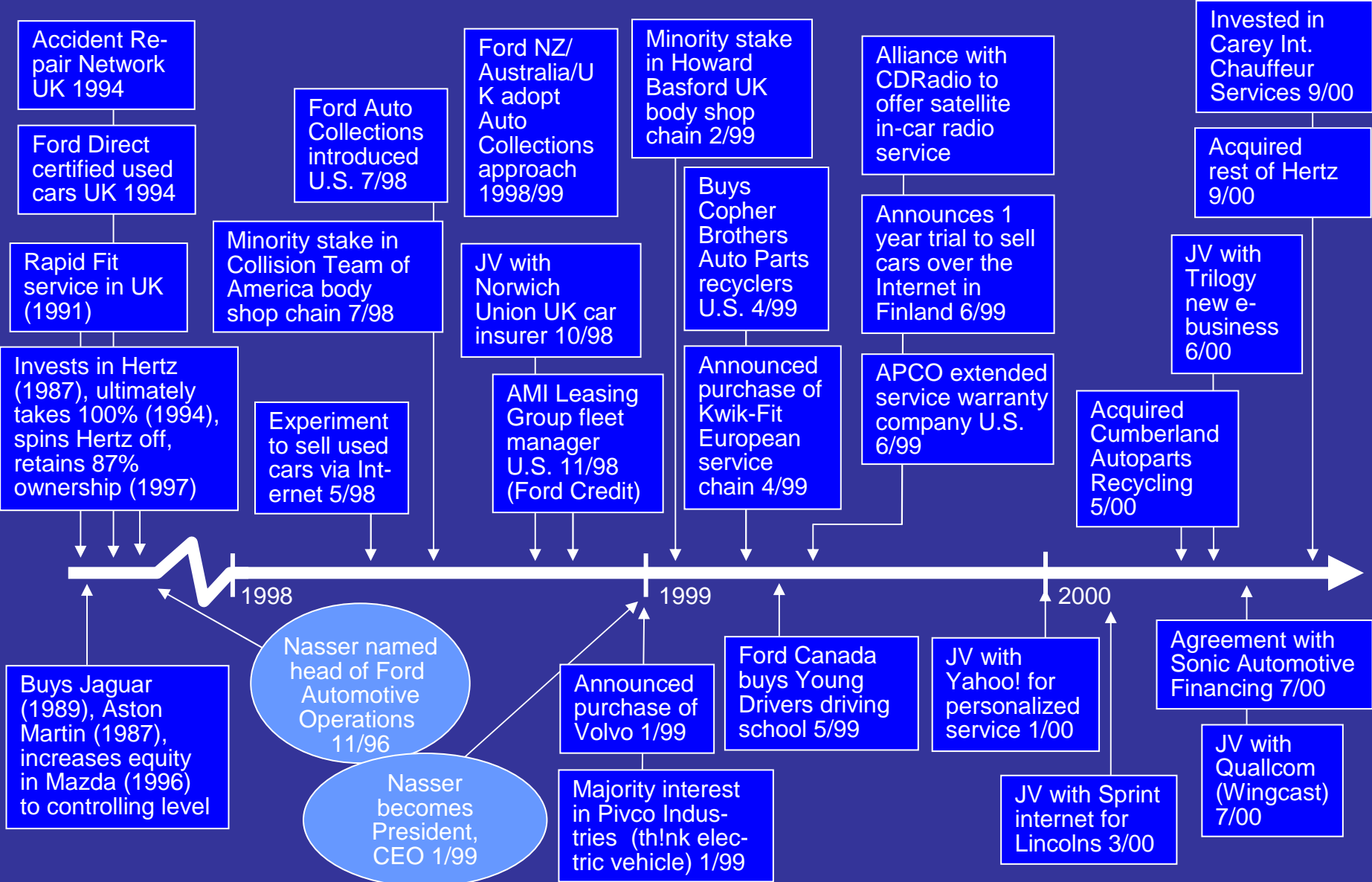
- Diversion of management focus: It is difficult enough to make money making cars; can car companies afford to devote key talent to these other areas?
- The multibrand issue: Most downstream businesses serve all makes of cars, so how can we leverage one to build **our** brand preferentially?
- Skill mismatch: Car companies are good at managing thousands of people in a few big factories . . . but most downstream businesses involve managing a few people in each of thousands of locations, which is a very different task
- Negative synergy: If a customer is dissatisfied with a **\$25** downstream service we sold him (e.g., a car wash), will he then be less likely to purchase his next **\$25,000** car from us?
- Market share impact: A car company might have a 25% new car market share. But the downstream world is so large that such a share is almost impossible to attain. How does a company synchronize 2 unequal positions?

The Ford Case: 1990s Move Downstream



Note: Nasser was released as CEO of Ford in October 2001

The Ford Case: Retreat from Downstream



The Ford Case: Learnings

1. The cost of establishing a significant presence in the downstream market, given its great size, can be enormous.
2. Ownership by Ford in many cases *increased* the costs and *decreased* the effectiveness of these downstream businesses, as Ford's overhead structure and corporate standards were applied (e.g. loss of entrepreneurial drive, added reporting requirements).
3. The complexity and independence of these businesses were so great that Ford never achieved the CRM-driven integration they sought.
4. The company did not have the human resources necessary to divert to running these operations.
5. Downstream businesses most often are multi-brand, such that leveraging them exclusively to Ford's advantage did not work.
6. Ignoring the further-out ventures (e.g. drivers' schools), Ford's *traditional* downstream businesses (e.g. Ford Credit, parts sales) continued as major profit generators for Ford throughout this era.

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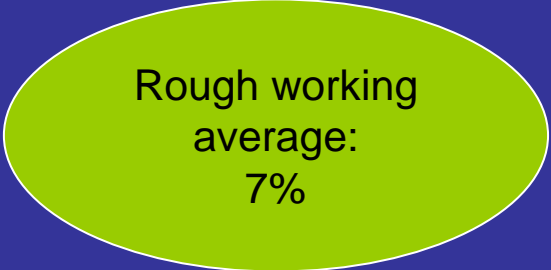
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Upstream Profit Standard

First, to set the stage: actual OEM EBITDA* numbers

Average results, 1997-2007:

Nissan	10%
BMW	7.5%
Renault	3.0%
Honda	8.0%
PSA	4.0%
Toyota	9.5%



Rough working
average:
7%

US “Big 3:” n/a, due to losses

* Earnings before interest, tax, depreciation, and amortization

Source: Company financial statements

Examples of Downstream Value Creation

Five downstream mini case studies

1. Portside vehicle handling
2. Recycled collision repair parts
3. Aftermarket accessories for motorcycles
4. Dealership electronic parts catalogs
5. Salvage auto auctions

1. Portside vehicle handling

- Such companies handle vehicle export and import, loading and unloading cars from and to ships and railcars, inspecting and storing vehicles, installing accessories, cleaning vehicles, repairing damage incurred in transit, tracking and dispatching cars on their next transport leg.
- Case study firm:
 - \$100 million in revenue
 - EBITDA % 17

2. Recycled collision repair parts

- Such companies acquire wrecked or discarded (end-of-life) vehicles; dismantle them; sell unusable metals for scrap; and then clean, store, catalog, and re-sell viable components (sheet metal and mechanical parts) to collision repair shops and mechanical repair garages.
- Case study firm:
 - \$1 billion in revenue
 - EBITDA % 12

3. Aftermarket accessories for motorcycles

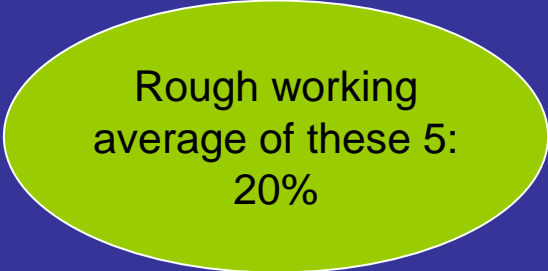
- Such companies make or buy a range of accessories for sale to owners of motorcycles, including both performance parts (e.g. engine components) and appearance products (e.g. seat covers, chromed pieces, decorative lighting).
- Case study firm:
 - \$300 million in revenue
 - EBITDA % 16

4. Dealership electronic parts catalogs

- Such companies provide dealers (primarily in cars, but also in boats, powersports equipment, etc.) with electronic catalogs that assist the dealers' parts and service departments to find, identify, cross-reference, source, and install correctly any of the many hundreds of thousands of parts which the dealership might require from time to time.
- Case study firm:
 - \$175 million in revenue
 - EBITDA % 32

5. Salvage auto auctions

- Such companies acquire wrecked or end-of-life vehicles from insurance companies, car dealers, brokers, and other sources, and auction them off (electronically or in a physical setting) to buyers such as recyclers, rebuilders, “shredders” (who reduce the lowest-value vehicles to saleable metal scrap), and exporters.
- Case study firm:
 - \$800 million in revenue
 - EBITDA % 35



Rough working
average of these 5:
20%

Conclusions

- While most attention is focused on the upstream OEMs and Tier One suppliers, there is an enormous downstream auto industry as well – one that works on stocks of cars (e.g. USA 250 mm) vs. flows (e.g. USA new car sales of 15 mm annually)
- Historically, OEMs find it difficult to conquer this market, leaving it to independent players to exploit
- Despite its lack of “status” in the automotive world, the downstream industry is arguably much better at value creation than the upstream side. This is in part due to its ability to discover and exploit market niches flexibly and quickly, and in part due to much greater pricing freedom.
- In a time of unprecedented financial stress on OEMs and suppliers alike, the performance advantage of the downstream industry may become even more pronounced.