Operational Excellence as a No-Regret Move

Driving Operational Excellence at Automotive Captives – Issue 1

Deloitte.

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Preface

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"The economic conditions are becoming significantly more difficult."

Lars-Henner Santelmann
CEO VWFS[1]

The rapid transformation of the automotive and mobility sector is a regular feature of today's headlines. Stagnant new car sales in mature markets, new players entering the mobility market and innovative business models emerging for the digital age are just some of the topics shaking up the auto finance industry. The future of OEM-related auto finance companies – known as Automotive Captives – is uncertain. As a business model, OEM sales support through auto financing has been successful for decades. However, new trends in the automotive industry and mobility sector represent a threat for Captives, compelling them to consider substantial changes in their business and operating models. Even though we may not see direct evidence of a market shift in the balance sheets of many Captives, the vast majority of their CEOs are well aware that the storm is yet to come.

In our study *Future of Captives*[2], we took a glimpse into the future and analyzed the sector's most important trends and challenges. Together with numerous Captive executives and Deloitte industry experts, we evaluated the qualitative and quantitative implications of those disrupting forces and identified six strategic fields of action that will be crucial for a successful transformation.

There is one strategic field that most Captives have recognized as a key success factor for the future and one that we see as a major driver in our day-to-day work with clients: Operational Excellence (OPEX). OPEX strives to achieve efficiency through the elimination, optimization, automation and outsourcing of company processes and structures.

This is the first edition of a new Point of View (PoV) series designed to raise awareness about OPEX, highlighting the need for action as well as future potential based on selected showcases from the Captive industry. Once we have outlined the importance and the advantages of OPEX, the focus will shift to OPEX implementation. We will show you how to set up a successful OPEX program, highlight typical pitfalls and offer guidance on how to avoid them. And finally, we will cover various best practice concepts from OPEX-related initiatives, such as process automation, workload management, digital self-service and artificial intelligence.

Join us in our PoV series to see how OPEX can support Captives in today's business environment and, even more importantly, prepare them for the future!

"Innovative disruptors are redefining the traditional business models and creating new markets."

Peter Zieringer
Member of the Board of Management of Daimler Mobility AG[3]

Fig. 1 – Six strategic fields of action (*Future of Captives* study)[4]

Flexibilisation of core business
In future, Captives will need to modify their existing core business to become more flexible. Direct sales and on-demand services will gradually replace the current fixed-term credit and leasing products.

(Urban) mobility solutions
Cities will play an even more important role in 2030 than today. Urbanization rates throughout the globe will further increase, putting more pressure on city authorities to develop efficient urban mobility ecosystems.

(Multi-brand) fleet management
Decreasing private ownership of vehicles based on leasing contracts as well as bans of personal driving in inner cities will fuel the demand for large fleets. The funding and management of this fleets becomes one of the key capabilities in the future to provide mobility services.

Captive payment services
The service-based business models, especially in connection with autonomous fleets, will significantly increase the required number of payment transactions. Own payment infrastructures can become a key competitive advantage for Captives and OEMs to secure the value creation in and around their vehicle platforms.

Operational excellence
Both existing and new core businesses will be under great pressure towards operational excellence due to the competitive environment. The ability to build and run highly scalable (international) operating platforms will become a key challenge in the future.

Data monetization
Service-based businesses in particular will generate large quantities of vehicle, mobility, and customer data. Captives need to find ways to generate and use this data while staying compliant with ever-increasing regulation.

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Market conditions for traditional business become less favorable

Captives as a success story

Captives have a long and successful track record. Over the last few decades, they have seen their revenues and profits steadily increase and a solid business model evolve. Captives contribute up to 55%[5] of profits[6] in overall group results and hold up to 69%[7] of the group's assets. OEMs are facing challenges on several fronts, from stagnating car sales in established markets to emission scandals and fleet electrification. Despite those challenges, the Captives of Volkswagen, BMW, Daimler, Toyota and Ford, for example, have seen their average pre-tax profits rise with a CAGR[8] of 8% from 2010 to 2019.

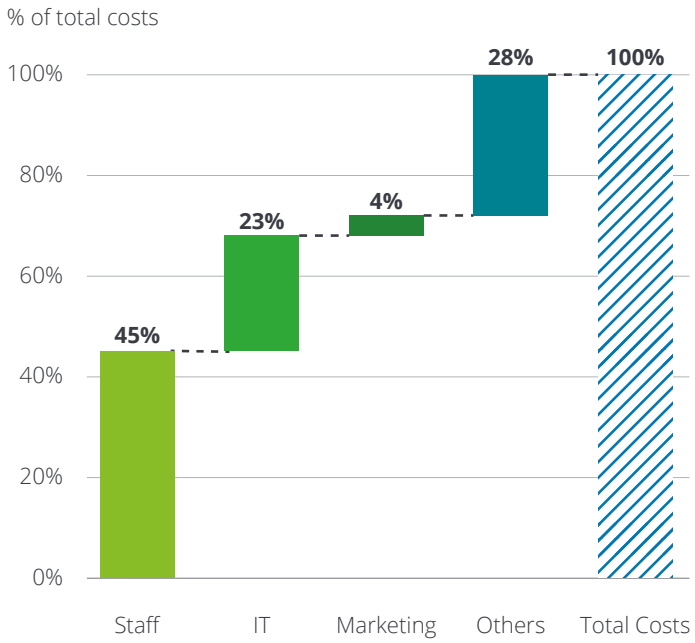
Fig. 2 – Average profits before taxes and CIR[9] of Top Captives[10]

Neglecting the cost side

One striking observation on the cost side is the relatively stable cost-income ratio (CIR) for all the above-mentioned Captives in recent years. The CIR did in fact increase from 2011 to 2019, since total cost CAGR at 10% slightly outperformed profit growth during that same period.[11] In its original role as sales support for OEMs, Captives had a more sales-driven mindset and focused less on costs and processes. The fact that CIR is now flat after a sharp initial increase combined with growing profits and revenues demonstrates that Captives have not yet managed to fully leverage economies of scale.

One reason for this, particularly in certain markets, could be increased labour costs. The annual growth rate for labour costs in Captives has been fluctuating between 3% and 5%[12], while overall price levels had a lower growth rate during the same time horizon in most major markets (e.g., Germany: 0.5%-1.8%, China: 1.4%-2.6% and USA: 0.1%-2.1% per year[13]). Most Captives' operations are extremely labour-intense, with labour representing the largest cost component (see figure 3). Many processes are still manual and the automation potiential, whether it is self-service portals and online banking platforms for customers and dealerships or process automation, is lagging behind other industries. The second largest cost component are IT costs. Instead of leveraging standard systems, most Captives are still operating complex and highly customized legacy systems. These systems not only account for the high maintenance costs but also offer only limited flexibility for updates and adjustments (e.g., integration of new services). In a current cost-cutting initiative at Volkswagen Financial Services, more than 70% of the total cost savings potential comes from IT operating costs[14]. Last but not least, Captives have already started to diversify their product portfolio, which has made their operating model more complex and further increased overall costs.

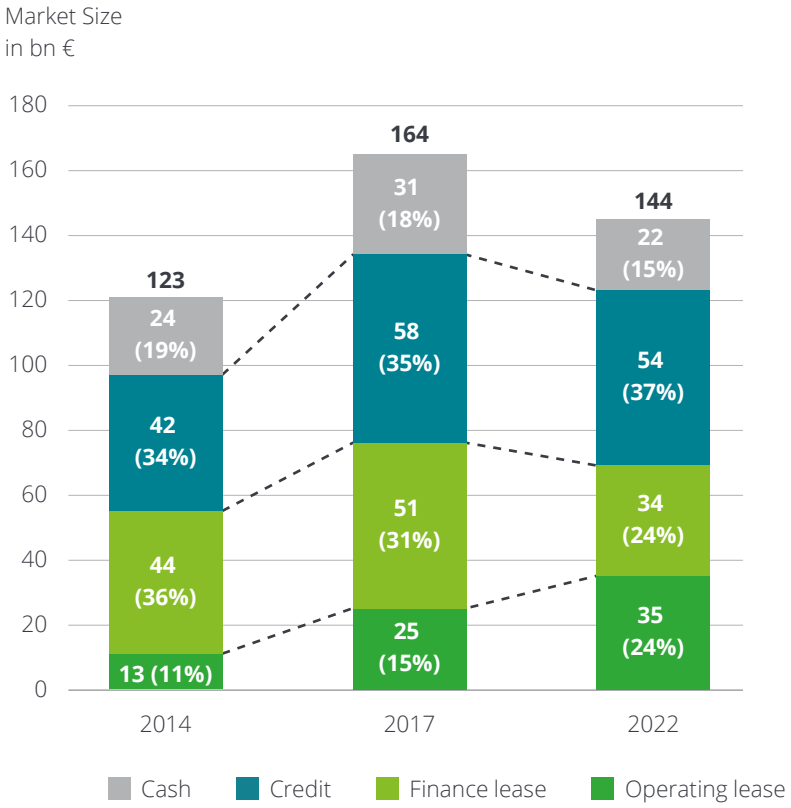
Fig. 3 – Average cost structure of Captives across regions[15]



Declining sales forecasts in mature markets

Even though Captives have not been as strongly affected by current market trends as most of their parent OEMs in recent years, the outlook isn't necessarily positive for the vehicle leasing and loan business in various markets. No one can precisely predict the exact impact of the current COVID-19 crisis at this time, so when we refer to our recent pre-COVID-19 forecasts, bear in mind that the current situation further supports our prediction that sales and revenues will decline in these markets. A closer look at the revenue side reveals that the majority of revenues in the Captive industry at present (both leasing and loan business) are directly in line with global automotive vehicle sales.

Fig. 4 – Market size/share (sales volume, pre-COVID-19) forecast of individual/ private vehicles in EU 5 (France, Germany, Italy, Spain and the United Kingdom)[16]

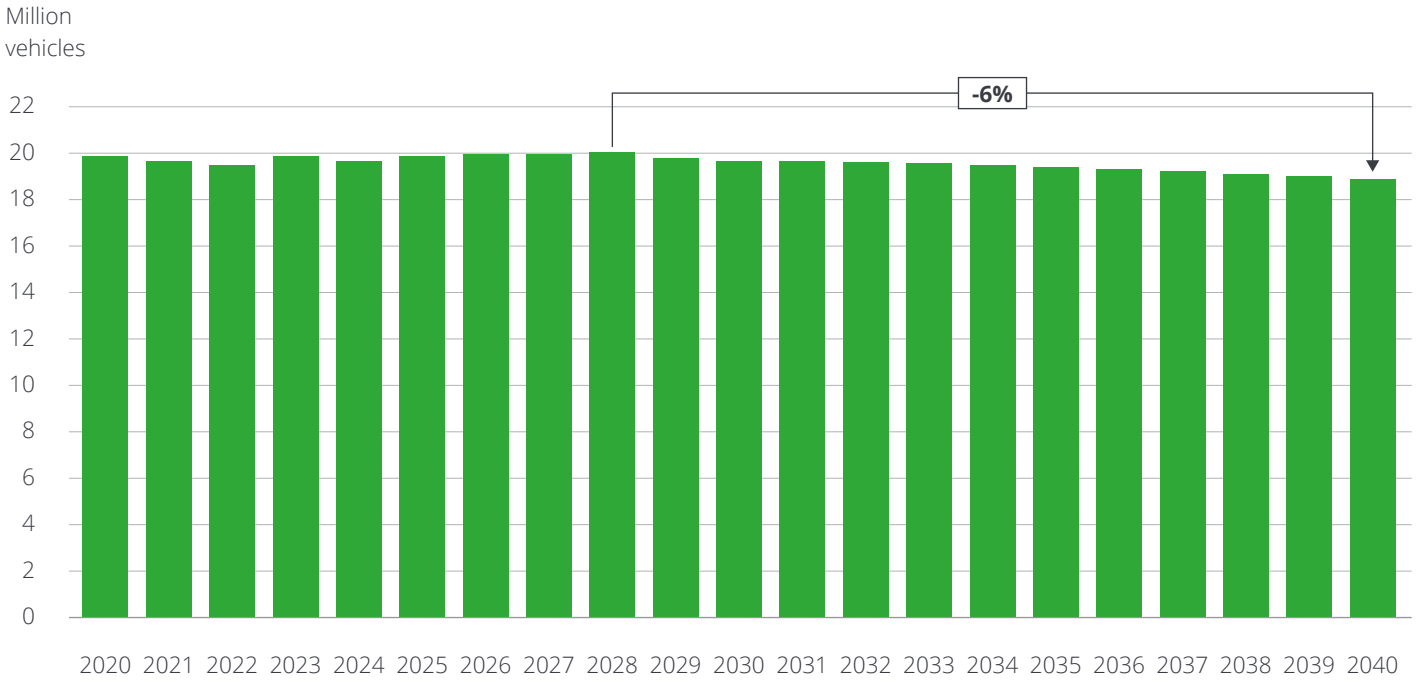


While growth figures are positive in emerging markets, more mature markets show stagnation or even a decline in vehicle sales. Germany, for example, is expecting the sales slump to continue from 2024 to 2030 (-9%) and 2040 (-25%, see figure 5), according to Deloitte's predictions. This is in part due to the decreasing population from 2025 onwards (short-term) as well as new trends in the automotive industry such as shared mobility and autonomous vehicles (long-term).

Fig. 5 – Vehicle sales forecast (pre-COVID-19) for Germany (in million vehicles)[17]

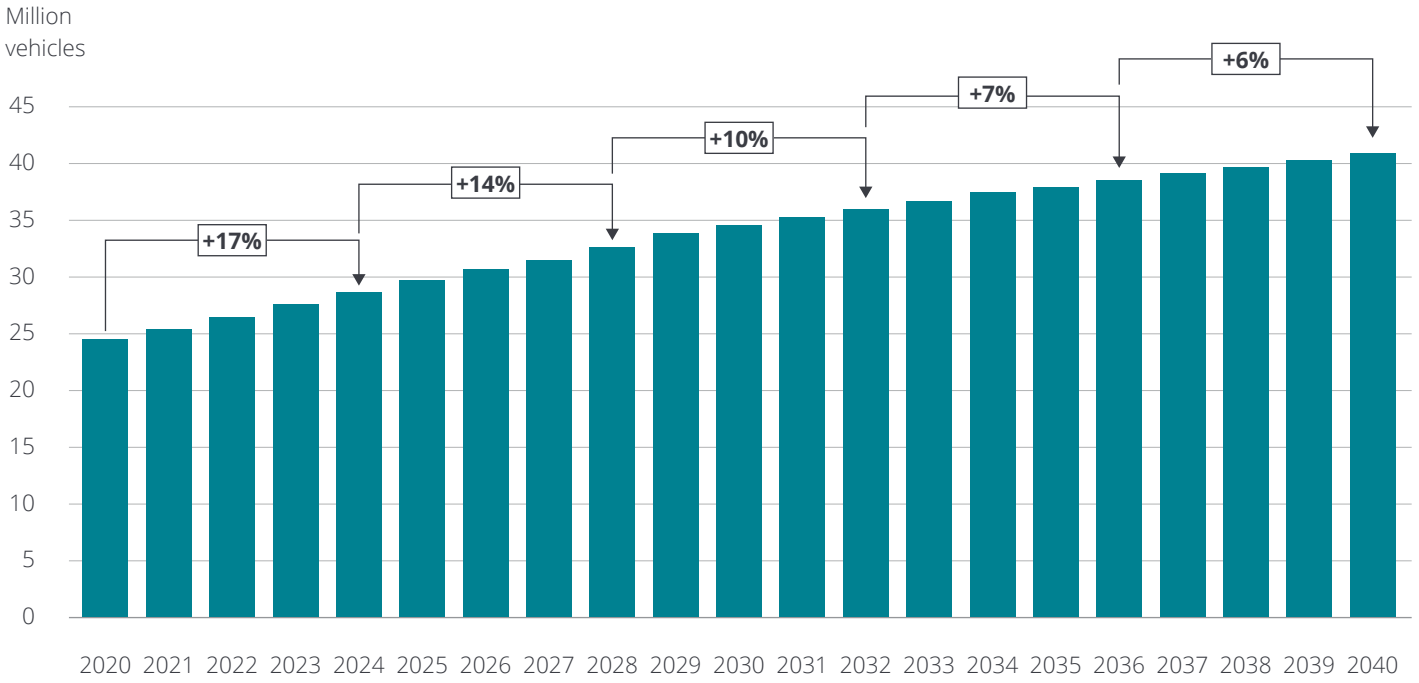
The NAFTA vehicle markets show a similar trend, even though the decreases are smaller and have a lag of about four years (6% from 2028 to 2040, see figure 6).

Fig. 6 – Vehicle sales forecast (pre-COVID-19) for NAFTA (in million vehicles)[18]



Though the potential of the Chinese market is considered massive (less than 15% of the population currently owns a vehicle), it is not likely to be leveraged in full over the coming years. Future vehicle sales are expected to grow as both the population and its purchasing power increase, but the rate of growth will likely taper off from 17% (2020 to 2024) to 6% (2036 to 2040, see figure 7).

Fig. 7 – Vehicle sales forecast (pre-COVID-19) for China (in million vehicles)[19]



New competition on the rise

In addition to a shrinking market for the automotive leasing and loan business, Captives are facing additional competition by new players within this declining segment. Independent leasing and fleet management companies, traditionally focused on corporate customers, are beginning to target private customers. Two examples of this phenomenon are LeasePlan and ALD Automotive, which have announced ambitious expansion plans up to 2025. LeasePlan aims to have 200,000 vehicles under management from private customers, while ALD has announced plans to double its current fleet size from 1.5 to 3 million vehicles, of which one-third will belong to the private customer segment (see figure 8 and 9).

Fig. 8 – ALD Automotive's announced growth strategy (pre-COVID-19)[20]

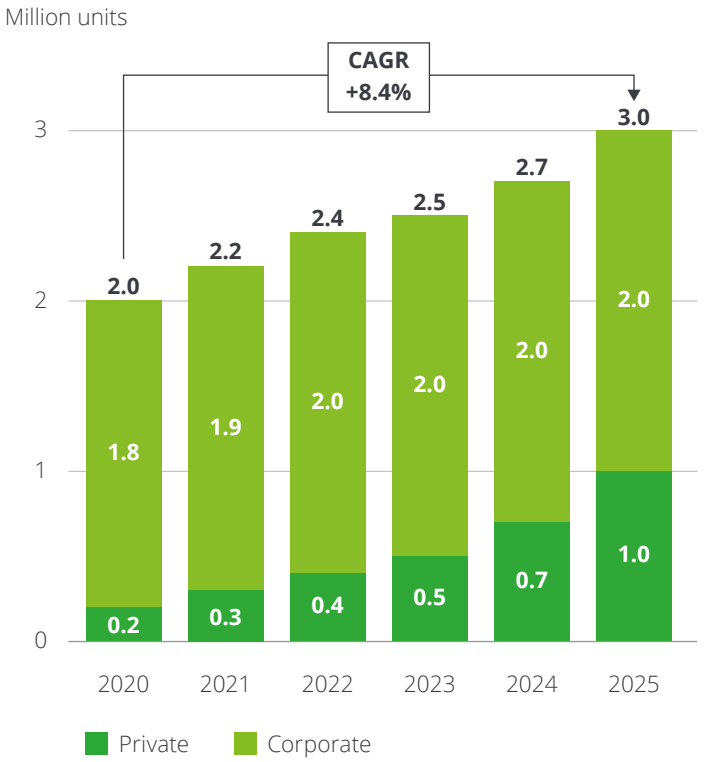
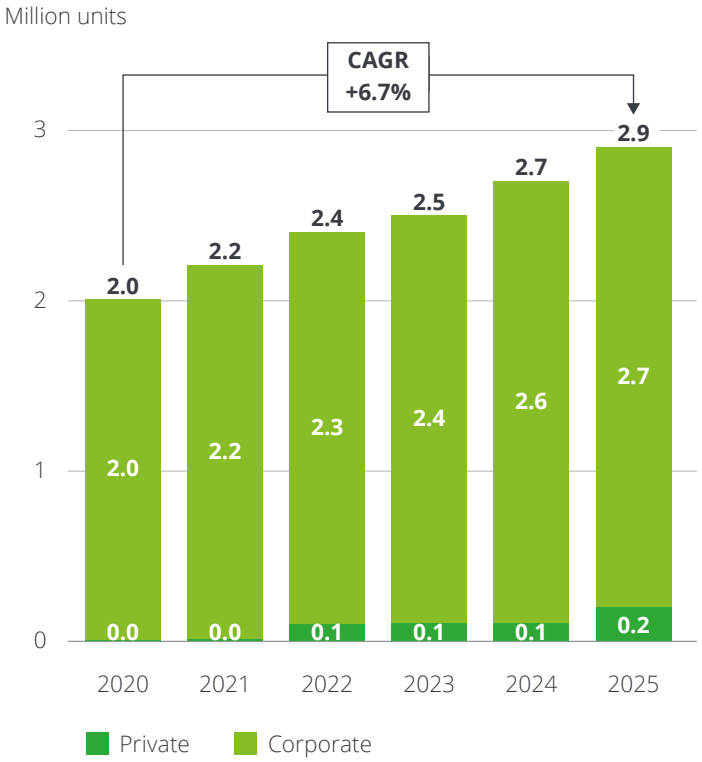
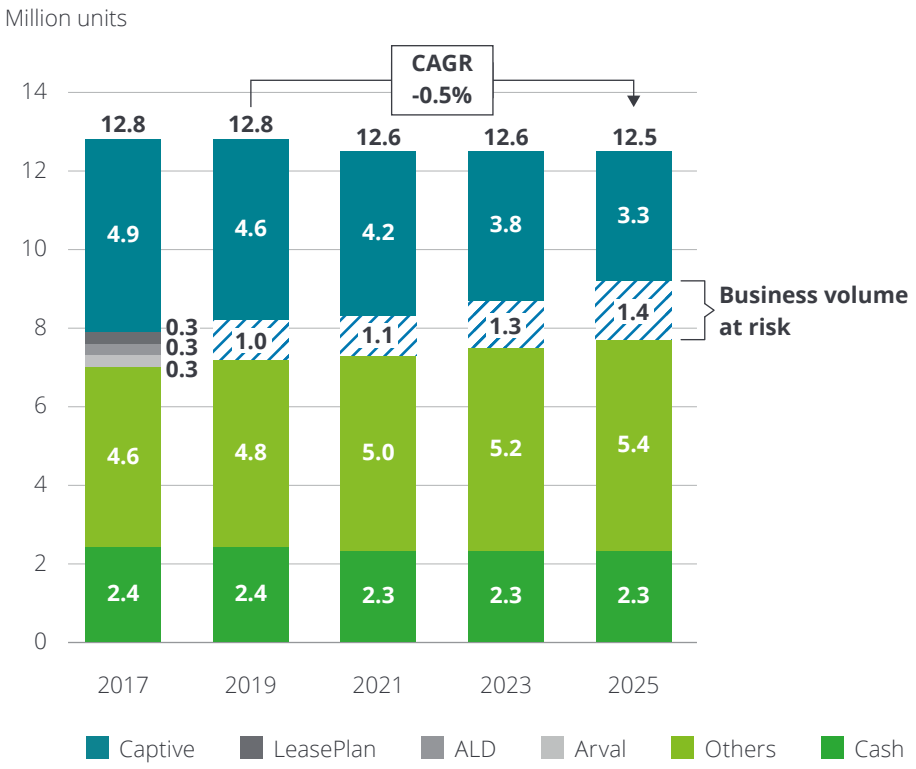


Fig. 9 – Lease Plan's growth forecast (pre-COVID-19)[21]



Provided they succeed, these growth plans would enable ALD and LeasePlan to double their current market share in the EU5 countries.[22] Independent leasing companies could account for up to 25% of the overall Captives business volume by 2025, as much as €42bn p.a.[23] (see figure 10). In addition to independent leasing companies, large private consumer banks, fin-tech companies such as Cluno and rental-car companies have extended or are planning to extend their portfolio in an attempt to disrupt, at least in part, the Captives' current market segments.

Fig. 10 – European market share forecast for direct sales of automotive vehicles[24]



03

Operational Excellence as a no-regret move for the future

03 | Operational Excellence as a no-regret move for the future

In our Deloitte study *Future of Captives*, we elaborated four possible scenarios for the future of Captives as well as the no-regret moves to overcome the specific challenges of each scenario. All four scenarios identified OPEX as an essential element along the way to successful transformation.

In the following chapters, we will introduce the three main goals of OPEX to help Captives overcome near-term challenges and leverage future opportunities.

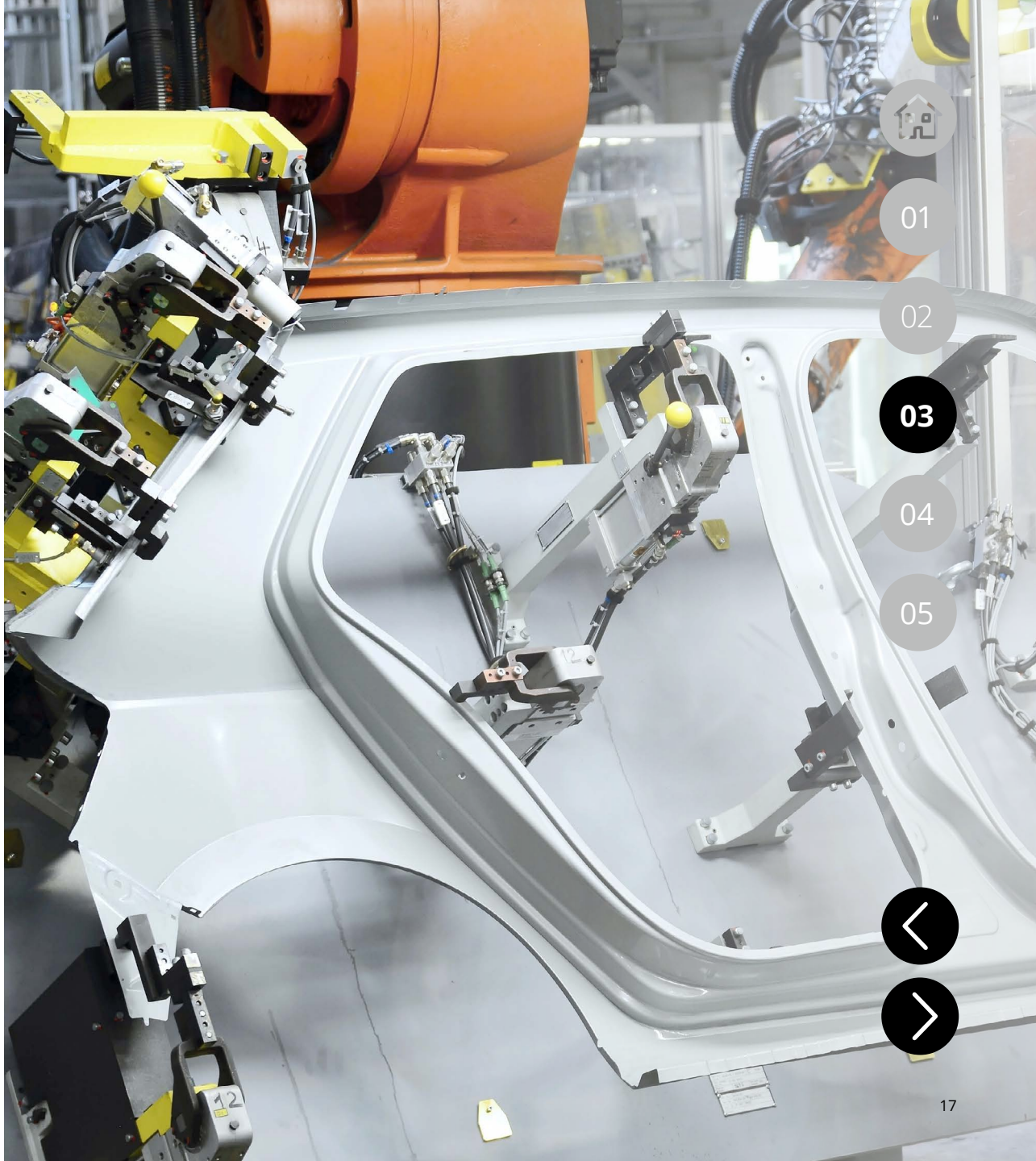


Fig. 11 – Four scenarios for the Captive industry in 2030[25]

Vehicles owned by OEMs/Captives

Ownership

Incremental evolution
Major differences in urban mobility regulations and differing global technological adaption rates prohibited the emergence of globally dominant mobility providers. Captives have focused on incrementally optimizing their asset-based business model, for example with AI-based residual value forecasting, and also their infrastructure.

Owner of the mobility ecosystem
Captives are the dominant players in the finance as well as mobility service market, offering full-service lease and multi-brand fleet portfolios. They are the powerhouse of the group, contributing themajority of revenues. Captives run asset- as well as service-based infrastructures efficiently at the same time.

Fragmented — Structure of mobility provider landscape — Concentrated

Vehicle

Empty shell
Captives have moved to a substantially different business model as financial regulation tightened and new players entered the market, specializing on single parts of the traditional value chain. Captives aggregate best-in-class service providers and manage them on behalf of OEMs as well as mobility providers.

Mobility platform orchestrator
Captives are the OEMs' key customer relationship manager and are true digital champions. They orchestrate various mobility services. By reducing their balance sheets they were able to invest in new service-based businesses built on a flexible and scalable infrastructure.

Vehicles owned by 3rd parties

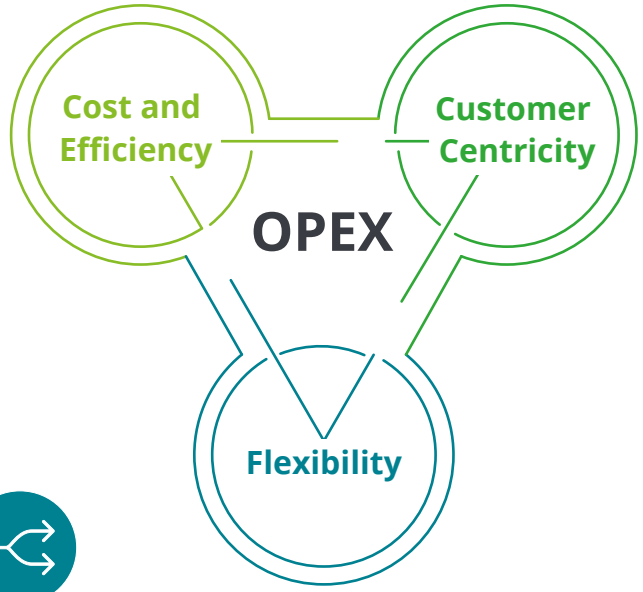
Reduce cost and improve efficiency

More and more traditional financing products, including fixed-term leasing and loan products, will become commodities in the future. This threatens the incumbent position of Captives, as customers tend to opt for the best price in a more homogenous market environment. If competition increases and Captives can no longer rely on their unique selling points, we expect prices to drop and cost advantage to become a more significant factor. Maintaining revenues will also be a huge challenge for Captives due to the shrinking market and increasing competition eating up their market share. As long as they are dependent on OEM vehicle sales, the levers on the revenue side will be limited. Captives would therefore be well advised to further optimize their cost base if they want to sustain their historically high profits.

OPEX supports this goal with short-term and longer-term cost saving initiatives to optimize the core business model and enable Captives to compensate in part for declining revenues.

Aside from the challenges and changes in the traditional core business model, various other trends are shaping the Captive industry as well. Some of these offer great opportunities for Captives to extend their portfolio volume and customer base but come with high investment costs. That is why it is so vital to reduce costs in the traditional business model and free-up additional capital to invest in new service offerings. In our Deloitte study *Future of Captives*, we identified four trends as central findings, because of their special significance for Captives moving towards transformation. All of those central findings require additional investments that Captives will have to self-fund.

Fig. 12 – "Magical Triangle" of OPEX goals



Reduced cost/improved efficiency

- Significant cost savings through more efficient processes and organization
- Improved competitive position due to lower cost/better prices
- Freed up funds for investments in new business models

Increased flexibility

- More flexible organization and utilization of sourcing allow for swift adoption to changes in demand
- High level of digitalization and customer/dealer self services make the operating model less dependent on personnel
- BPO and functions as a service help to source skills externally that are not available in-house
- Faster time-to-market through lean products and processes

Improved customer centricity

- Optimized processes allow for
  - more focus on customer/dealer needs and value-add
  - seamless and convenient customer/dealer experience (CX)
  - Fast and efficient processes and response to customer/dealer inquiries
- Online origination helps provide more direct interactions with customers
- Simplicity in products, processes and interactions (e.g., less variations, fewer information requirements)

Fig. 13 – Highlighted trends with high significance on the Captive's transformation path[26]

Shifting center of gravity

Business volumes will be moving away from traditional markets (EU & NAFTA) towards emerging markets (China & RoW)

This implies new customer segments with specific needs and new competitors

Switch from indirect to direct sales model

Declining relevance of traditional dealer sales channels over the next decades

Increasing intensity of customer interactions demand for new sales channels

On-demand services will gradually replace current fixed-term products

Evolving product portfolio

Asset-based financing business (credit, leasing and wholesale) will decline substantially in relevance

Demand for (new) mobility services based on flexible leasing offerings will increase substantially

Customer centricity becomes key

Customer centricity to become a key concern for Captive executives

Seamless customer experience (CX) along the whole ecosystem becomes inevitable

Innovative offerings, new sales channels and the rising number of customer interactions pose significant challenges

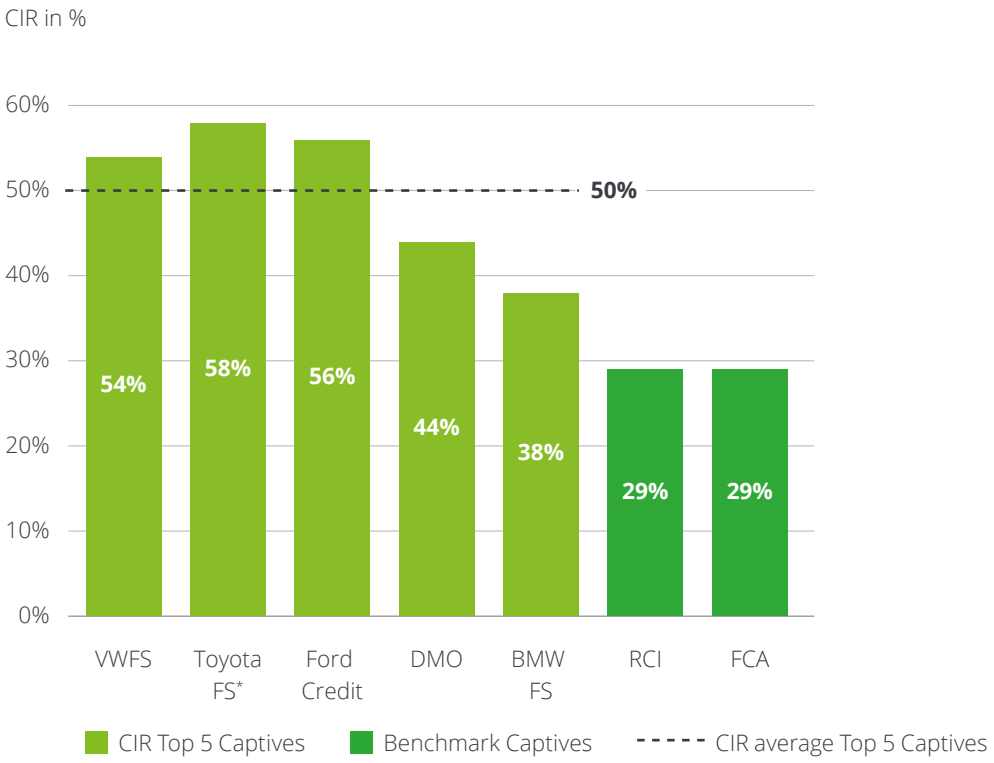
As vehicle sales and demand for financing shift to new markets, bound capital in mature markets will become less profitable in comparison. OEMs will instead focus investments on setting up – or improving – business operations in the emerging markets. This includes office facilities, talent and IT systems, but also dealer development or brand building/marketing activities. In addition, Captives will need to invest heavily in setting up or acquiring new business models in an effort to cater to the growing need for flexible mobility offerings. Car sharing, for example, requires large investments in physical assets, as customers expect a sufficient availability of vehicles in their respective geographic area. For other service offerings, such as charging and parking services, a stronger customer-centric focus across all services or switching from indirect to direct sales models, Captives need to invest in advanced IT systems and retain skilled employees to ensure they remain competitive against new market players.

Some of those new business models will require additional backup funding as well as cost-efficient operations to survive the initial post-launch phase. Many mobility services, such as car sharing, are still not profitable due to low margins and fierce competition. With so many new players in the game, we expect consolidation to narrow the market to only a handful of players in the near future. Captives tend to have more staying power in terms of funding than some of their competitors, usually early-stage startups. But without sufficient funding, a lean business model and a competitive cost structure, Captives will not be able to compete in the long-run. They may even be forced to exit the race before the business turns a profit, which means that all of the heavy initial investments would be lost.

Potential investments are not limited to changes and opportunities within Captives, but necessary for the OEM group as a whole. Captives have a huge impact on OEM balance sheets with their asset-focused business model and contribute a large part of overall profits, which makes them a potential source for additional investment funding throughout the OEM group. And significant investment will be required for the radical changes the automotive industry is facing in the near future. Over the next 5 to 10 years, the world's 29 largest automotive manufacturers are planning to invest more than $300bn in the development of electric vehicles and battery cells (or their purchase) alone.[27] To launch autonomous vehicles, OEMs will need to invest further in digitalization and the development of those vehicles. OEMs may expect Captives to free up capital from their balance sheets to fund the investment priorities within the group.

Many Captives have already announced cost saving targets and launched dedicated initiatives. Volkswagen Financial Services, for example, announced an annual savings target of €850m by 2025 and recently increased the target to €1.3bn (~25%–30% of total estimated costs).[28] In order to remain competitive in the market, Captives need to set mandatory targets with suitable KPIs such as CIR. Based on the Volkswagen Financial Services example and our own Deloitte research, we believe the cost-saving potential for Captives could be upwards of 30%. With comparatively high CIR rates at around 50%, the top 5 Captives need to leverage this cost-saving potential to close the gap towards the industry benchmark of around 30%. Achieving a CIR close to this benchmark will help to retain profits, to keep Captives competitive with new asset-financing players that have more cost-efficient operations and to free-up additional capital to fund new business models.[29]

Fig. 14 – Cost-income-ratio comparison in 2019[30]



*CIR from 2018

Create more flexibility

In addition to lower costs and improved efficiency, flexible processes and product offerings are a key goal of OPEX. The world is changing at break-neck speed and in order to survive the future, Captives need to quickly react to changing customer needs and market conditions. We are seeing first-hand just how important flexibility is in the current COVID-19 crisis, which has posed multidimensional challenges for Captives. The drop in demand for auto finance and leasing products is threatening revenue and profit streams and Captives must respond decisively with alternative, more flexible product offerings. The temporary shutdown and potential bankruptcy of part of the Captives' dealer network further jeopardizes the Captives' dominant sales channel, which underscores the need to bolster alternative customer touchpoints such as direct online sales. Last but not least, the sudden shift towards remote work has disrupted operations among most of the Captives, where their IT landscape lacks the flexibility and scalability to deal with the increased remote access.

The importance of flexibility for the traditional auto finance business described here is even more relevant for new business models, which are more prone to fast-paced change. Services around mobility as well as charging and parking solutions are relatively new offerings that are still undergoing development and facing frequently changing market dynamics due to volatile customer demand and innovations from competitors. Captives need a high degree of flexibility to respond to sudden changes in the market and customer demand, which – in turn – requires flexible, scalable processes and IT systems to cope with the increasing number of customers shifting to new offerings. Standardized systems aligned with lean processes and a suitable organizational structure can offer additional benefits for Captives looking to scale their business through process automation and increase their flexibility in other areas (e.g., third-party integration).

Many Captives have yet to reach their desired state and continue to struggle with replacing inflexible legacy systems and automating or digitizing manual processes. Captives need to critically assess their level of flexibility within the organization. Offering new business models in particular will give Captives the opportunity to rethink processes and organizational structures, giving them a "blank canvas" on which to create their desired state. In its DNA, OPEX is designed to give Captives the functionalities they need to achieve the flexibility they require in order to build a lean, scalable operating model and ensure competitiveness in the long-run.

Improve customer centricity

Along with cost-savings, efficiency gains and increased flexibility, OPEX also aims to improve the overall customer experience by placing the customer needs at the center of all its initiatives. Captives will be offering a more diversified, intertwined product portfolio around asset financing and multiple mobility service offerings in the future. As Captives embrace digitalization and work towards expanding vehicle sales and financing through direct channels, the role of managing the direct customer touchpoint will become even more relevant. Customers will interact with Captives mainly online, demanding faster purchasing processes as well a single log-in for all services. The current offering of Captives often seems fragmented with several contracts and customer IDs needed to access the full product range. In order to assume control of customer touchpoint from dealerships, it will not be sufficient to simply digitalize existing processes. Captives need to fully transform their operating models to establish digital sales channels and links between new platform-based business models. This will require efficient back office operations with streamlined and automated processes as well as a harmonized IT landscape across all offerings to facilitate a seamless customer experience.

In addition to the measures described here, Captives need to collect better customer insights in real-time. This requires technological competence in the area of data management and analytics. Competitors for new business models are often established tech companies such as Google or Apple as well as tech start-ups in the automotive and mobility environment such as Uber, Lyft or Gett. Those companies typically know how to operate and leverage technology, offering business models that rely heavily on the utilization of customer data. Captives are under pressure to catch up rapidly by replacing existing legacy IT systems with state-of-the-art systems fit for the purpose of utilizing and monetizing customer data.

With Captives taking over the customer touchpoint from dealerships and startups setting new standards, Captives need to react quickly and become more customer centric.

OPEX helps Captives transform their operating model and stay competitive in a new market environment with changing customer demands and additional business models.

OPEX programs as a holistic approach

Excelling in efficient business operations will be the foundation of any future Captive business model and a crucial element of any successful transformation. In order to succeed, Captives will need to implement OPEX on the basis of company-wide initiatives. A holistic approach to rolling out the OPEX program across the entire organization has a much higher likelihood for success than single source initiatives in various departments. Many Captives are aware that they need to act in this changing market and have already started OPEX programs. While Volkswagen Financial Services is continuously promoting its own OPEX program, several other OEMs such as Daimler, BMW, Ford and Toyota have included their Captive OPEX activities in their group-wide cost-savings initiatives.[31,32,33,34,35,36] The requirements of the business and operating model of Captives, however, are specific to their mission and we recommend developing a tailored OPEX program for Captives rather than handing over the lead to the OEM group and introducing one-size-fits-all measures and activities. Our structured approach and extensive experience with OPEX programs offer proven solutions to Captives that are striving to realize their full potential. In our next PoV, we will provide a glimpse into this approach and showcase best practice examples in setting up a successful OPEX program.

04

Summary and outlook

Captives have had a history of success with their traditional business model, but the era of above-average growth and record sales is expected to vanish over the coming years. In order to sustain past profit margins, Captives will be under pressure to reduce costs in their traditional business and look for additional profit pools in new areas. OPEX is an integral step along the path to transformation in multiple ways. By revealing hidden cost potential and improving efficiency as well as competitiveness against other Captives and new competitors, OPEX will help Captives defend their market share in the traditional business, improve overall profitability and collect the funds needed to develop new business models. Increased financial power and cost-efficient operations are just the beginning, OPEX can also make an organization flexible enough to adapt quickly to changes in the market and to shift its focus towards customer centricity.

This PoV is the introduction to a larger series of publications that introduces approaches and best practices Captives will need to become efficiency leaders. The series provides a deeper understanding of OPEX as an enabler for a sustainable cost basis, a cost-conscious mindset and efficient processes within an organization. We will be sharing our expertise of proven first-hand insights, from building the strategy and scoping to the initiation of the program, combining our practical experience with comprehensive OPEX programs and our methodological expertise to create a valuable knowledge base for OPEX.

The upcoming issue of the PoV series entitled "A Playbook for Operational Excellence" will provide insight and guidance on the OPEX project itself. The PoV will explain the best practice approach to setting up and executing an OPEX program as well as supporting elements like the OPEX playbook and OPEX story. The subsequent PoVs in the series offer a deep dive into the four main areas ("Elimination", "Improvement", "Outsourcing" and "Automation") that may be included in an OPEX program, also using examples from other industries to showcase best practices. The series will close with a PoV addressing the question "Vision of the future: How to reach the next level?".

We invite you to join us on this journey to learn more about OPEX levers and best practices and gain insight into achieving the right setup for your organization.

For further information on our PoV series, please visit www.deloitte.com/de/automotive-captives-opex

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06 | Endnotes

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05. Data Source: Daimler AG, *Annual Report 2019*, 2020, https://www.daimler.com/documents/investors/reports/annual-report/daimler/daimler-ir-annual-report-2019-incl-combined-management-report-daimler-ag.pdf.

06. Profits before income and taxes (in order to ensure comparability)

07. Data Source: Bayerische Motoren Werke AG, *Annual Report 2019*, 2020, https://www.press.bmwgroup.com/global/article/detail/T0306824EN/bmw-group-annual-report-2019?language=en.

08. CAGR: Compound annual growth rate

09. CIR: Cost-income rate; Calculation: Selling and administrative expenses + other operating expenses / Revenues adjusted by cost of sales and other net operating results

10. Data Source: Annual Reports 2010-2019 Volkswagen Financial Services, BMW Financial Services, Daimler Financial Services (Now: Daimler Mobility) and Ford Credit

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