

New captive finance – Optimizing customer lifetime value

White paper



Management summary

Major **European car markets** are forecast to experience **only moderate growth** after the European crisis and **remain extremely competitive**

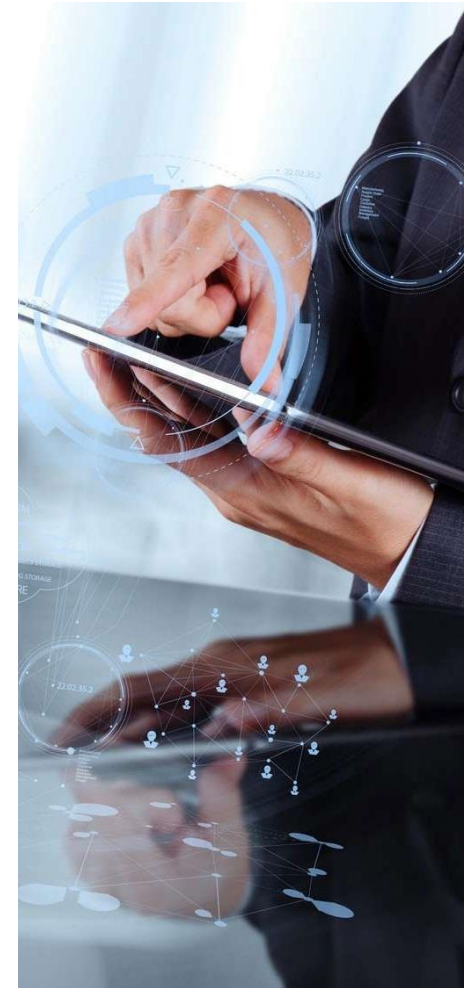
Offering **finance products is a must** to create additional **sales momentum** and defend current **market shares**. In **Germany**, car sales are mainly **driven by corporate sales** using **leasing products**

Providing **finance products** to customers also is a key means for OEMs to **maximize customer lifetime value systematically** – Most OEMs use their **own captive units** once they've reached a critical size in total sales

In the past, the offering of **finance products by OEMs** has evolved **from a pure sales support function to the pursuit of profit contribution objectives** while following a **characteristic path** related to sales volumes

Recently, mature **captive units increasingly shifted focus** away from pure sales support by broadening the product offering to **mobility** or **retail banking services** with ultimate aim of **maximizing customer lifetime value** for OEM

Roland Berger has identified **three strategic moves** to successfully develop captives and **optimize the customer lifetime value**



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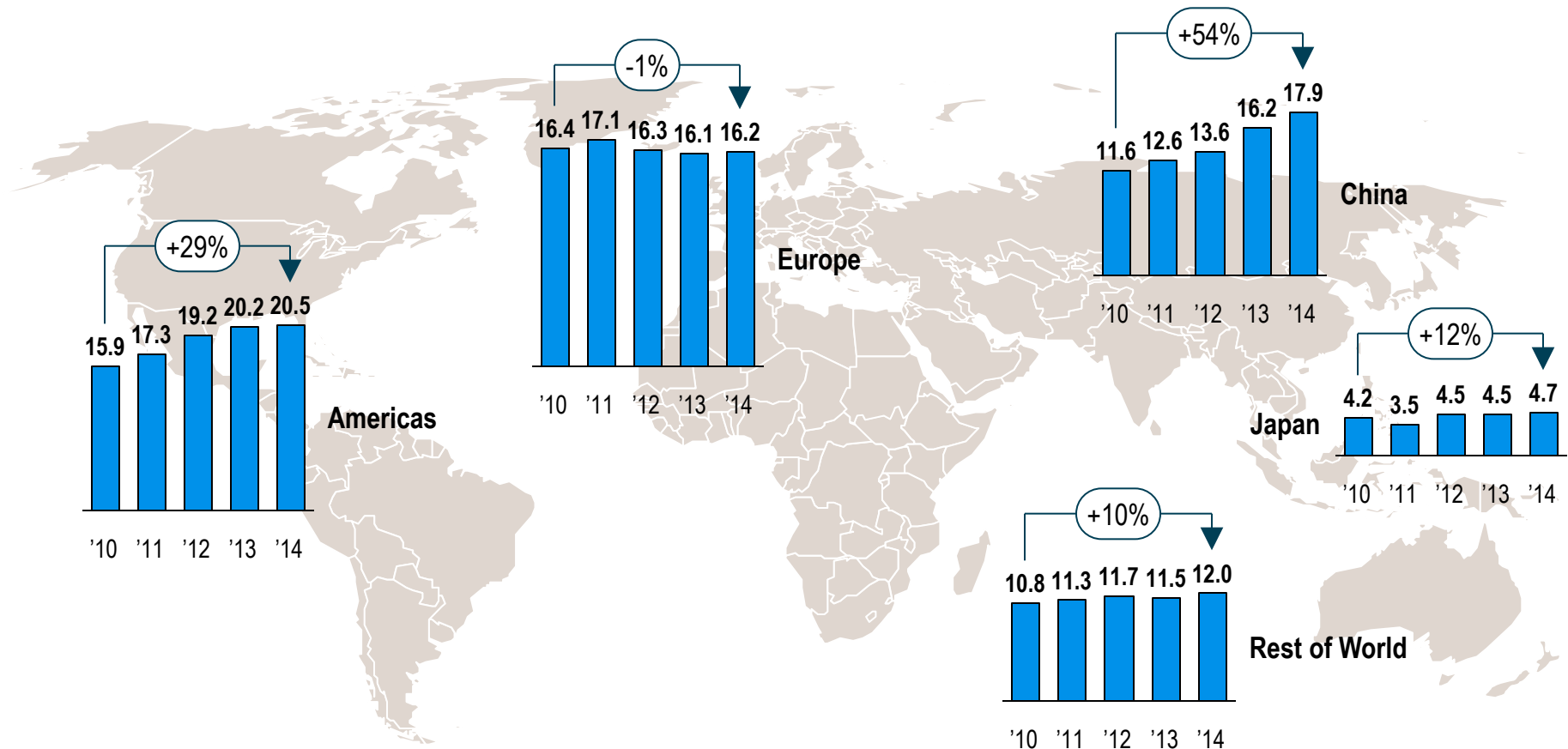
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A. Current market overview



Passenger car sales volumes have increased globally – Especially strong growth in China, but Europe has been stagnating recently

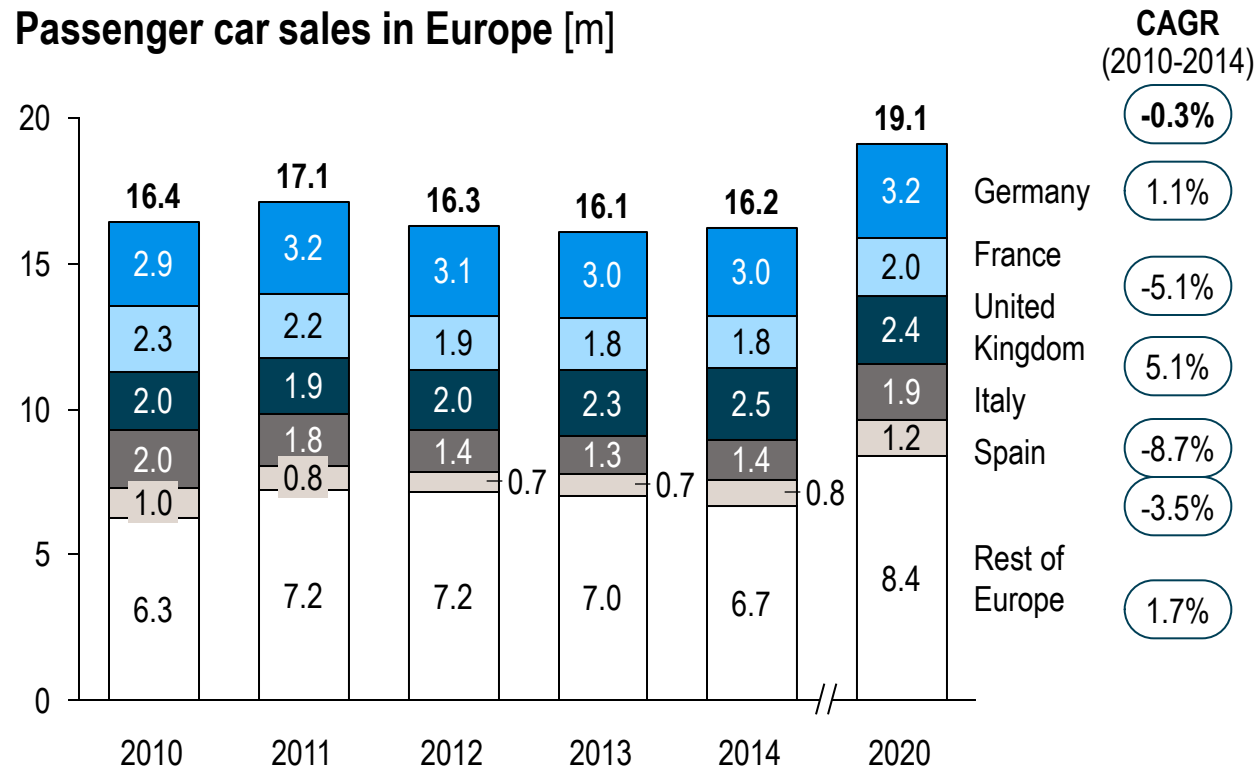
Passenger car sales per region [m]



Italy, France and Spain saw the strongest decline – But future overall growth expected and first signs already visible

A closer look at EU-5 automotive markets plus rest of Europe

Passenger car sales in Europe [m]

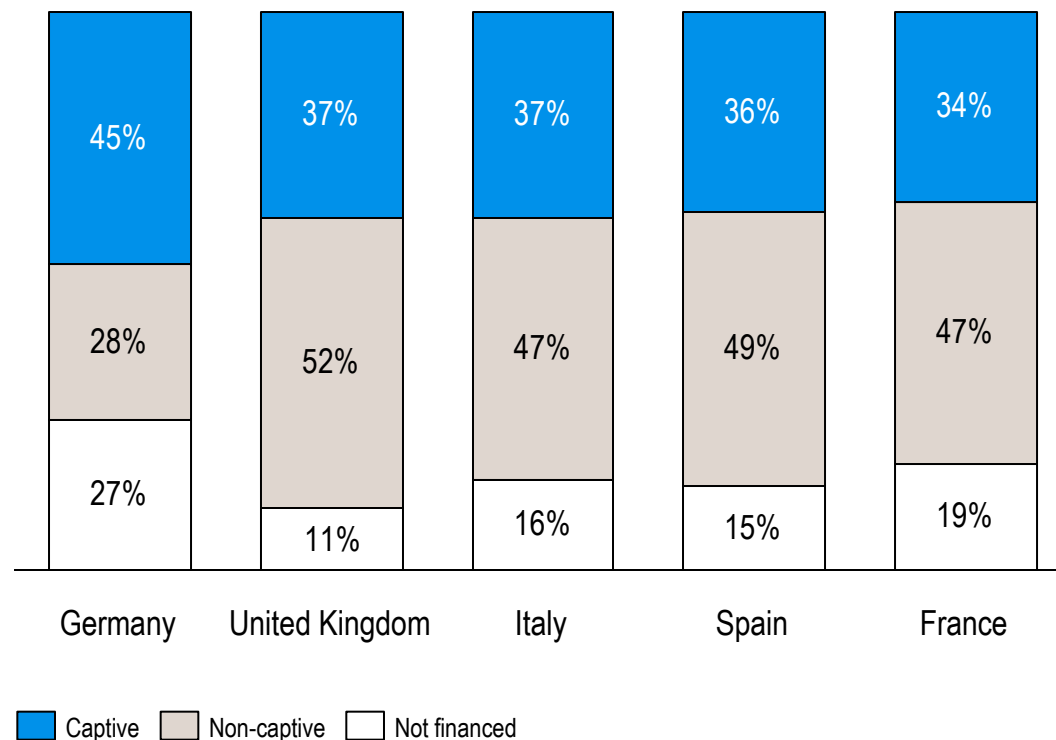


- > Most important and stable car market: Germany
- > Most positive development in UK with a rise of more than 20% from 2012 to 2014
- > In contrast, Southern European markets hit hard in aftermath of financial crisis
- > Signs of recovery observable in Italian and French markets in 2014
- > Spain's economic recovery also visible in car sales, which rose by almost 20% in 2014

More than 70% of cars are financed at point of sale – Market share of captives is typically slightly below 40%, except in Germany

Market structure of car financing in EU-5

New car financing in selected European markets

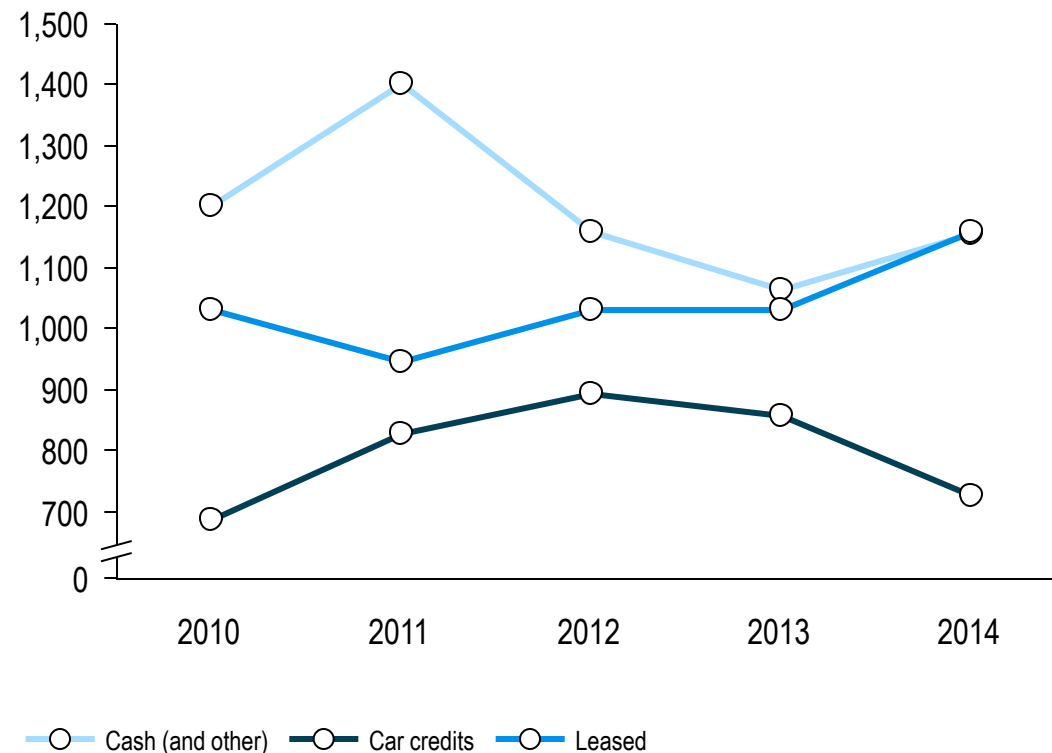


- > Captive banks have the strongest position in Germany – Possible driver: Strong German OEMs with broad FS offering
- > Also, Germany has the highest share of cars not financed at the POS – Two possible drivers:
 - High proportion of cash payers
 - Strong position of local banks in Germany, i.e. banks providing salary accounts
- > From OEM perspective, providing financing via a captive also provides a significant upside in terms of customer ownership
 - Customer data available centrally
 - Master data (e.g. address) can be maintained better

German car market development relatively flat, but leasing products are becoming ever more important driven by corporate sales

The largest European market in close-up

New car sales in Germany, 2010-2014 ['000]



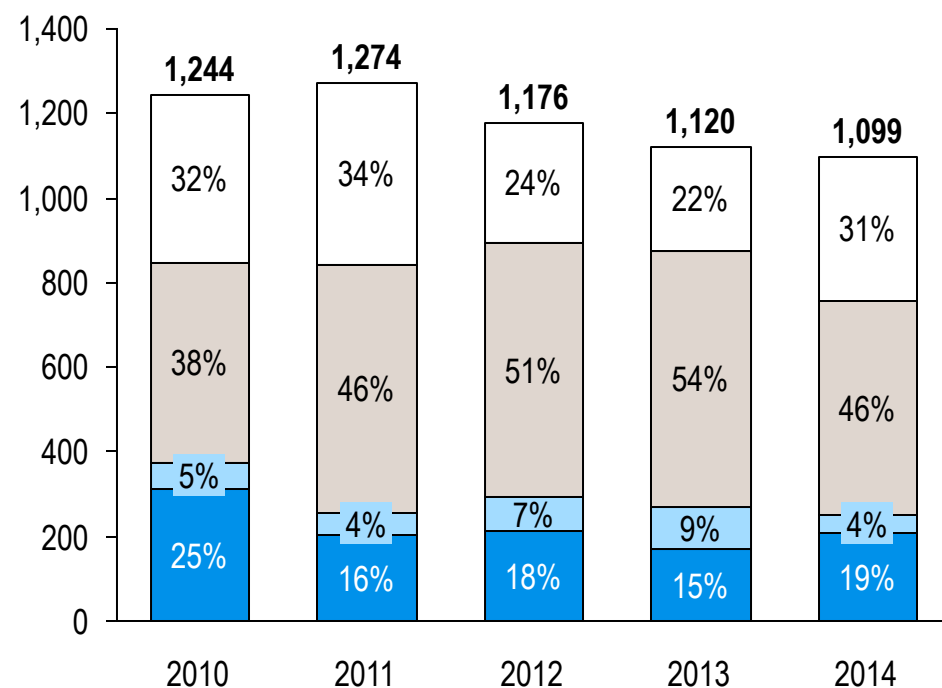
- > **Car sales tumbled by some 3 million cars p.a. since 2008 – Exception: 2009 with 3.8 m cars due to government subsidies**
- > **Cash payments** peaked in 2011 due to the euro crisis and now on a **declining trend**
- > **Leasing** expected to become **dominant form of car financing**, mainly driven by corporate customers¹⁾
- > **Share of financed or leased new cars is also rising** with size of cars and engine capacity
- > Besides new cars, **share of financed used cars increased** from 28% (2010) to 35% (2014)

1) In particular, whether leasing can be structured as operating lease

~800k new private cars are at least partly financed annually –
 Financing focus is on classic products; leasing share below 20%

New car sales in Germany – Non-corporates

New car sales to private customers, 2010-2014 ['000]



Cash payment
 Partly financed
 Fully financed
 Leased

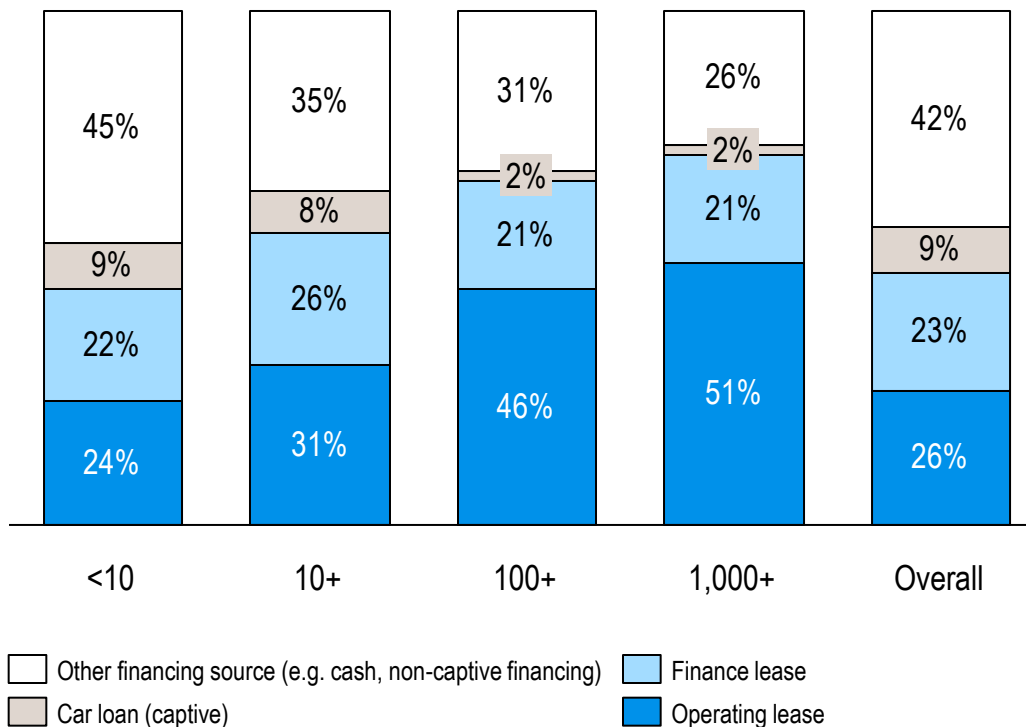
1) In particular, whether leasing can be structured as operating lease

- > New car sales to private customers **declining since 2011**
- > **Cash payments** jumped **back to 31%** after two years at relatively low level
- > **Partly financed** cars in particular include so-called **triple way finance**
 - **Lump-sum** payments at contract initiation and end
 - (Rather low) **monthly rates** during contract lifetime
- > However, likelihood of **choosing finance products** also **differs** between **customer groups**. (e.g. 2/3 of car replacements are financed, while only 1/3 of first time buyers choose finance products)
- > While **for used cars**, the **share** of financed or leased cars is **considerably lower (~30%)**, a **trend toward non-cash payment can also be observed**

Fleet customers use lease options more frequently – High share of non-captive options indicates untapped potential for captives

New car sales in Germany – Corporates

Fleet sales in Germany by company size [# employees]



- > For **corporate customers** overall, **leasing** is the dominant form of car financing (49%), driven by accounting rules
- > However, significant differences can be observed **depending on company size**:
 - Share of **operating leases increases** with company size from **24% to 51%**
 - **Self-purchases decrease** at the same time from **45% to 26%**
- > **Finance leasing** and **car loans** account for 23%-34% and are **relatively equal for all company sizes**
- > Disregarding crisis effects, the **choice of financing** has been relevantly **stable since 2008**
- > **Customer and data ownership** typically lies with car **dealers** and **leasing/finance providers**

Automotive finance players are characterized by two large groups: OEM-owned captive banks and traditional, non-captive banks

Market participants in automotive finance

Captive banks/OEM-owned financial service providers (not exhaustive)



- > Most OEMs are active in financial services, but not necessarily under a banking license – Decision dependent on target products and national regulation
- > For smaller markets, OEMs are also using white label products from local banks, e.g. Volvo, Infiniti, Kia, Mazda, Suzuki in Germany









Non-captive banks in automotive finance (not exhaustive)



- > Some non-captives are active as white-label providers for financial services activities of OEMs, e.g. Santander runs service centers for several OEMs
- > Non-captive players can be further grouped into "Consumer finance banks" (e.g. Santander) and "Specialized banks" (e.g. Bank Deutsches Kraftfahrzeuggewerbe)

In revenue terms, BMW Financial Services is biggest OEM captive – Penetration rates differ between premium and volume captives

Captive finance companies (selection)

	Total operating assets 2013 [EUR m]	Financed volume 2013 [EUR m]	EBT 2013 [EUR m] (share of total group profit)	Return on equity	Number of current contracts [#]	Penetration rate ⁶⁾ [%]	Share dealer financing/ total operating assets	Rating ⁷⁾	Funding from deposits
	126,600	...	1,315 (11%)	12.3%	10,700,000 ²⁾	43.0%	~13%	A-/A3	21%
	84,347	...	1,639 (21%)	16.5%	4,130,002	44.0%	~5.4%	A+/A2	37%
	83,539	40,500	1,268 ³⁾ (~12%)	18.8%	'''	'''	'''	A-/A3	'''
	21,312	7,256	368 (n/a)	'''	731,003	29.1%	25.8%	BB+/Ba1	4%
	14,577	7,810	247 (8%)	'''	'''	40.0%	25.5%	BB+/Baa3	0%
	25,894	11,393	744 (60.9%)	5.6%	1,160,612 ¹⁾	34.6%	34.6%	BBB/Baa3	14%
	14,481	...	273 (n/a)	'''	'''	35.3%	40%	BBB/Baa3	0%
	127,756	'''	2,352 (24%)	'''	'''	'''	'''	BB+/Ba1	'''

1) New contracts 2013, plus 1.7 m service contracts

2) New contracts (non-service) 2013 2.8; total contracts 10.7 m

3) EBIT

4) EUR/pound 1.18

5) EUR/USD 0.76

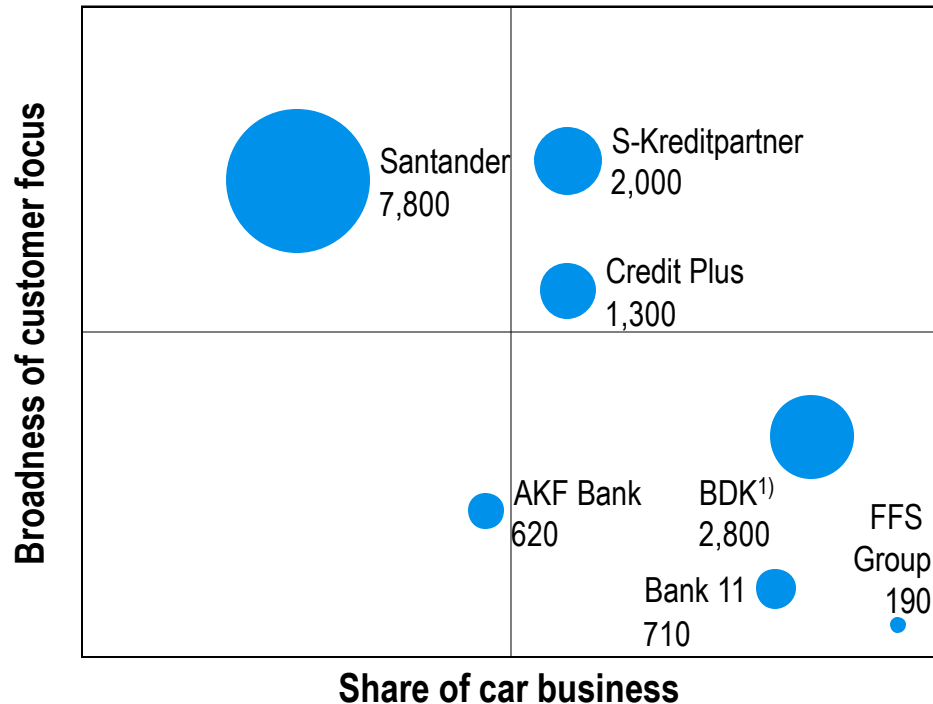
6) As reported by OEMs and excl. off-balance sheet business

7) Of parent company, i.e. OEM

Several non-captive players are also active in car finance, but actual business models and size of players vary widely

Competitive landscape in commercial finance in Germany

Non-captive players' car business in Germany



- > Several players (Santander, Credit Plus, FFS Group) are also **acting as preferred finance provider** esp. for Japanese **OEMs**
- > Besides this, some players also have **activities in financing other durable goods** (caravans, furniture, electronic goods)
- > All players **rely heavily on cooperation networks** with independent car dealers
- > The majority of players are aiming at **aggressive growth** in the near future
- > Three players (S-Kreditpartner, Credit Plus, BDK) are strongly **integrated into bigger organizations** with possible leverage effects
- > Players are typically **also active in the leasing and insurance business**

xx = Financed volume [m], only automotive, figures partly estimated

1) Bank Deutsches Kraftfahrzeuggewerbe

Offering all car related products allows OEM to increase and better steer their total profit with the customer

Initial view on steering profit generation

Break-even calculation: Credit rates vs. direct discount

From a total cost of ownership point of view, a 5.7% discount on car sales price is needed to make a 4.9% bank loan cheaper than a 0.9% loan from a captive on an undiscounted car

Offer from other bank for 36-month loan

	3.9%	4.9%	5.9%	6.9%	7.9%	8.9%	9.9%
0.0%	5.7%	7.0%	8.4%	9.6%	10.9%	12.1%	13.3%
0.9%	4.4%	5.7%	7.1%	8.4%	9.6%	10.9%	12.1%
1.9%	2.9%	4.3%	5.7%	7.0%	8.3%	9.5%	10.7%
2.9%	1.5%	2.9%	4.3%	5.6%	6.9%	8.1%	9.4%
3.9%	0.0%	1.4%	2.8%	4.2%	5.5%	6.8%	8.0%
4.9%	0.0%	0.0%	1.4%	2.8%	4.1%	5.4%	6.7%
5.9%	0.0%	0.0%	0.0%	1.4%	2.8%	4.1%	5.4%

Offer from captive for 36-month loan

Implications

- > Captives can offer **low rates** on car finance as a marketing tool, but OEMs have levers to **compensate** for this by generating profits in **other steps of the value chain**
 - Realizing **higher sales prices/giving less discount** on financed cars – Increased profit in sales
 - Realizing profits by directing financed cars into **own garages** – Increased profit in after-market
- > From a **customer perspective**, it is rather **difficult** to analyze the **total cost of ownership** – But if a customer does so, using alternatives to a captive can be a reasonable proposition

B. Business model of automotive captives – Attractive, but also necessary at the same time



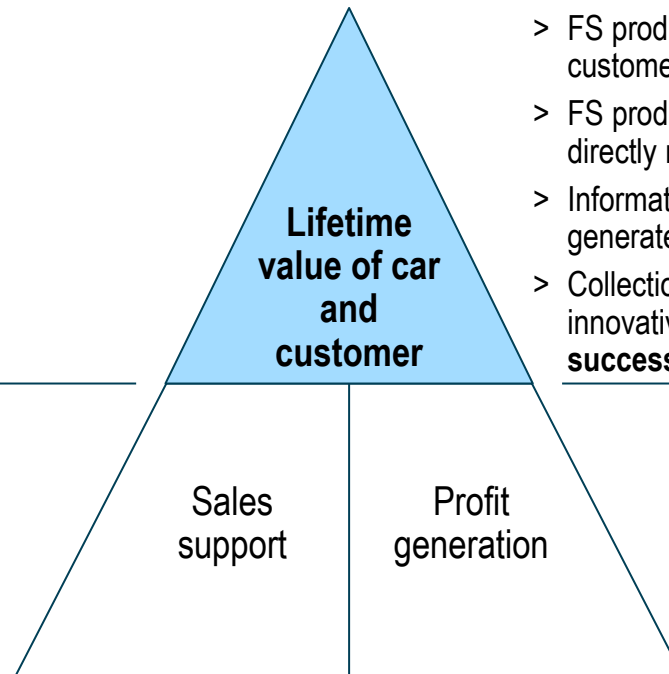
Focus of captives is extended by also taking into account customer lifetime value aside from the traditional elements of sales and profit

Objectives for captives

Advanced focus

Traditional focus

- > Sales support for an OEM has **two basic dimensions**:
 - Increasing **total number of cars** delivered to customers
 - Increasing **average value per car** delivered to customers
- > Most OEMs also offer **finance products for their dealers** (e.g. to finance inventory)
- > Stabilization and management of **residual values**

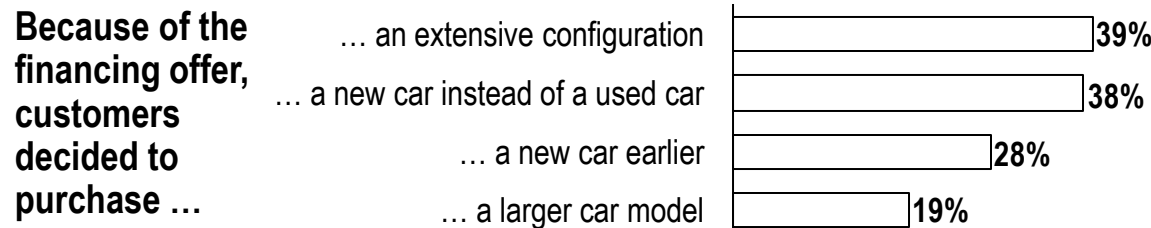


- > FS products play an important role in creating customer **loyalty**
- > FS products can also be used to generate revenues directly related to car, e.g. garages and spare parts
- > Information gathered through financial products can generate important **customer insights**
- > Collection and use of **smart data** to offer tailored innovative products for customers becomes a **key success factor**

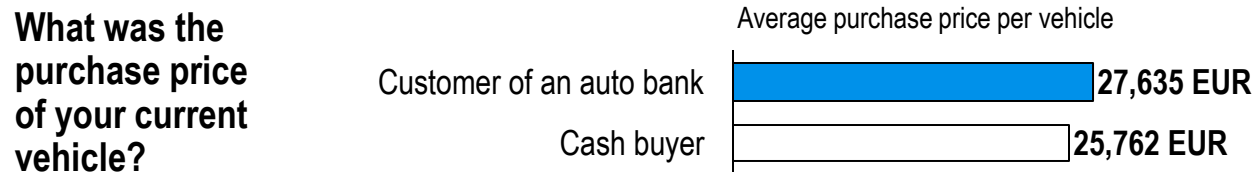
- > Provisioning of financial services offers an opportunity for **profitable expansion** of product offering **close to core business**
- > Car financing is a **rather low-risk business** for OEMs compared to normal banking
 - Financed **cars** can be used as **collateral**
 - **Large scale** of business makes it **well predictable**

Empirical data confirms benefit of financial services provisioning: More cars in total are sold as well as more expensive cars

Effects of providing financial services on car sales (1/2)





- > **Vehicles of the customers of captives are on average 4.5 years old vs. 6.2 years in the case of cash buyers**
- > Financial services also generate a positive **P&L effect in the traditional car business**
 - By **increasing** the sale of **new** instead of used **cars**
 - By selling **more expensive cars** (larger cars or more add-ons)



- > So far, OEMs are typically **not able to assess marginal effect** of financial services offering on total P&L
 - How **sensitive** are sales to **financial service offers**?
 - What is the **P&L effect** beyond FS of offering **better rates**?

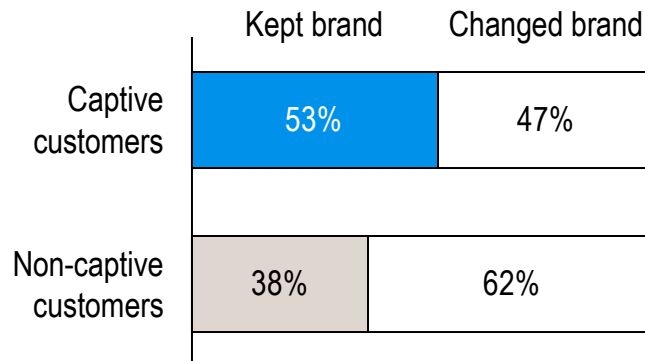


 Autobank customers: avg. 4.5 years
 Cash buyers: avg. 6.2 years

In addition, data shows that offering FS products via an own captive can also contribute to higher customer loyalty



Effects of providing financial services on car sales (2/2)

Did you decide on buying a car of the same brand as your previous car or did you change brand?



If you had to replace your current car, how likely would you be to ...¹⁾



 Captive customers
 Non-captive customers

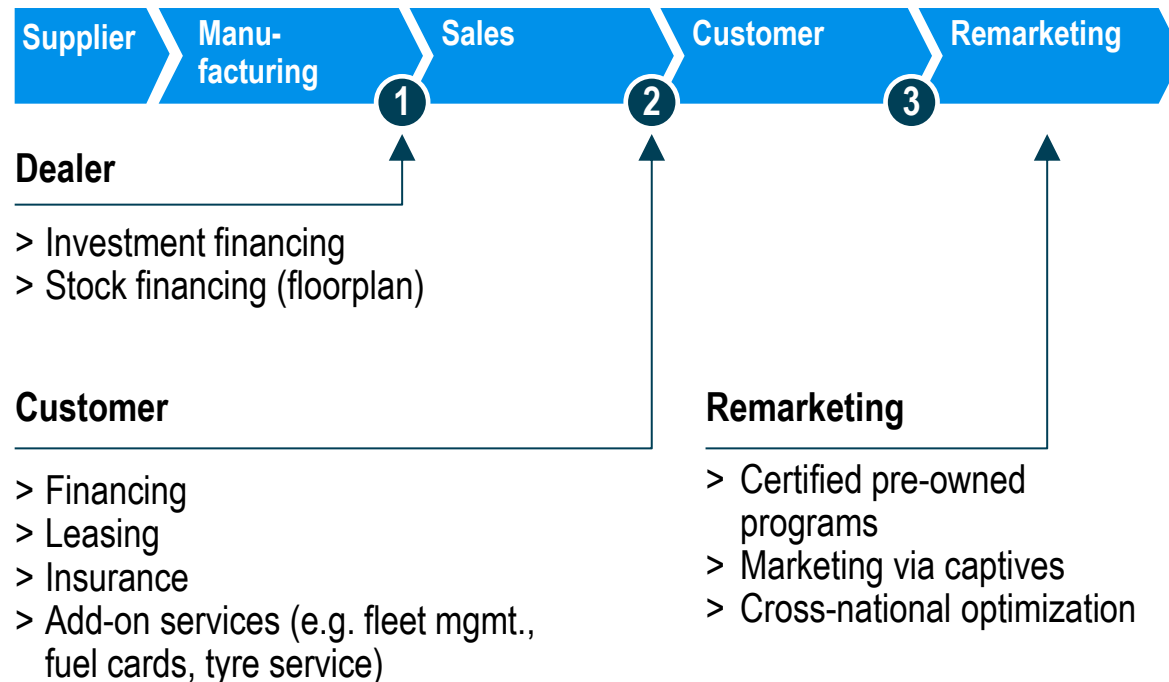
1) Only answers "likely/very likely" considered

- > Increasing **customer loyalty is of great significance** in developed markets
 - **Overall sales figures growing only marginally or not at all**
 - **Most car sales are replacements**
- > From a dealer perspective, offering **captive products** also considerably **more attractive** than working together with non-captive partners
 - **Higher return rate** of existing customers
 - **Higher recommendation rate** to new customers
- > More effective **data collection** as captive can store data, while **ownership** is typically with the dealer/lease provider

Automotive captives usually address the automotive value chain in three business areas: Dealers, end customers and remarketing

Impact of financial services in value chain of car manufacturers

Value chain of financial services for an OEM – Outline

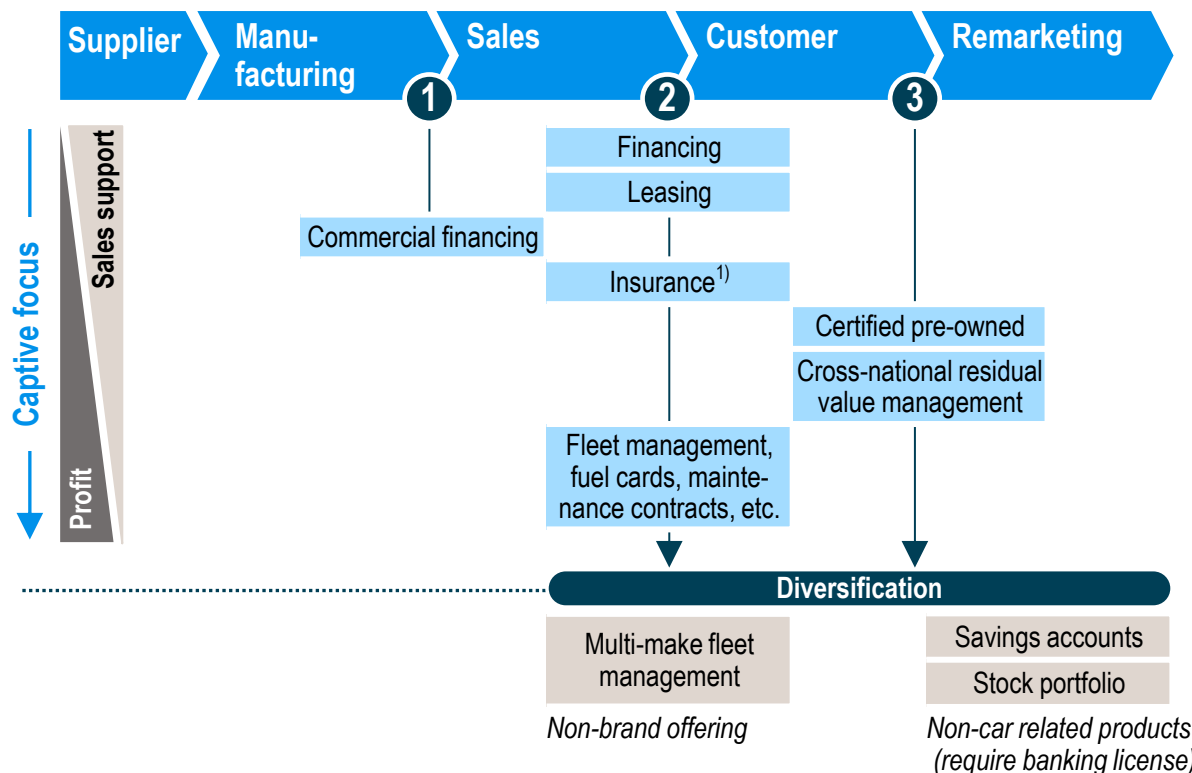


- > **Provisioning** of financial services makes a **high contribution** to car manufacturers' sales and earnings due to
 - High **impact on purchase decision** of customers itself
 - Facilitation for customers to buy **larger car and/or more services**
 - Support to maintain large sales network by providing **financing to dealers**
- > Empirical data also shows **higher loyalty among customers** that are provided with financial services

Captive financing usually follows an evolutionary path that ultimately leads into banking and/or enhanced mobility services

Evolution of captive finance entities – Outline

Different product offerings per development stage

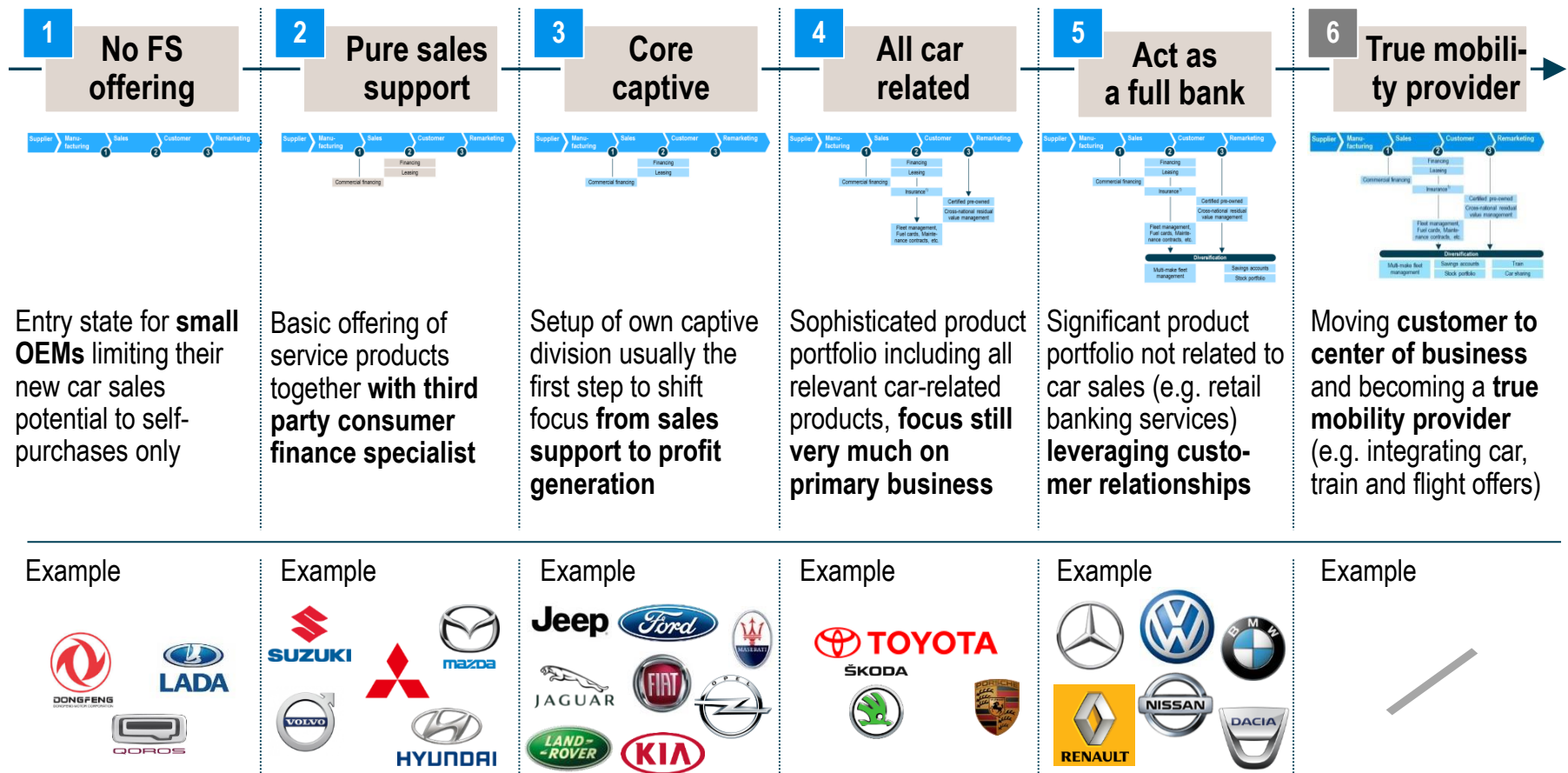


- > Captives usually starts with the sole purpose of supporting **new car sales** and usually expand first to **insurance products**, followed by **remarketing initiatives**
- > These "basic" offerings are often provided by or **together with external partners**. Further-developed captives tend to be **OEM owned**
- > **Brand** strength and **volume** influence the **tipping point of ownership structure**
- > **After offering fleet management**, captives have two options to further diversify from their core focus: Either **banking services** or brand independent offerings (**multi-make**)

1) Typically as white label offering from a cooperating insurance company

There are five different maturity stages that define unique captive archetypes of OEM financial services offerings

Overview of different models of financial services – Selection

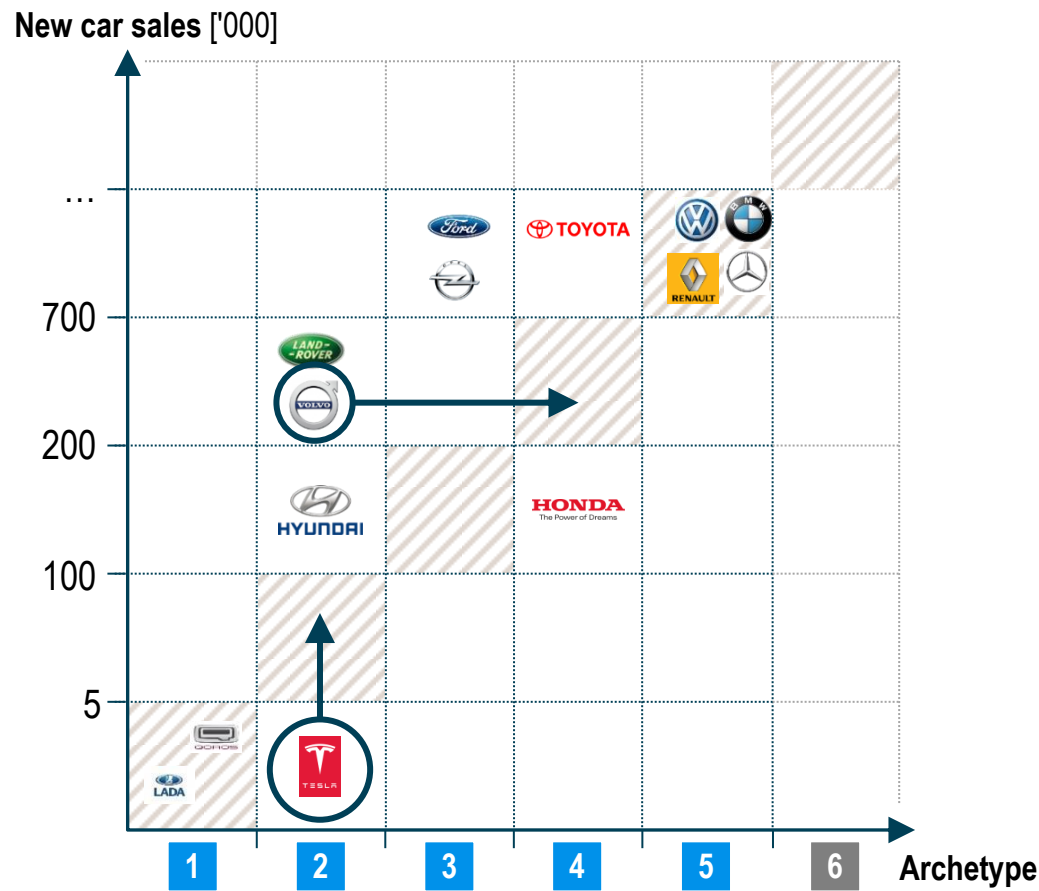


C. Captive maturity stages



The main driver of the automotive captive maturity stage is the volume of new car sales, but deviations show development potential

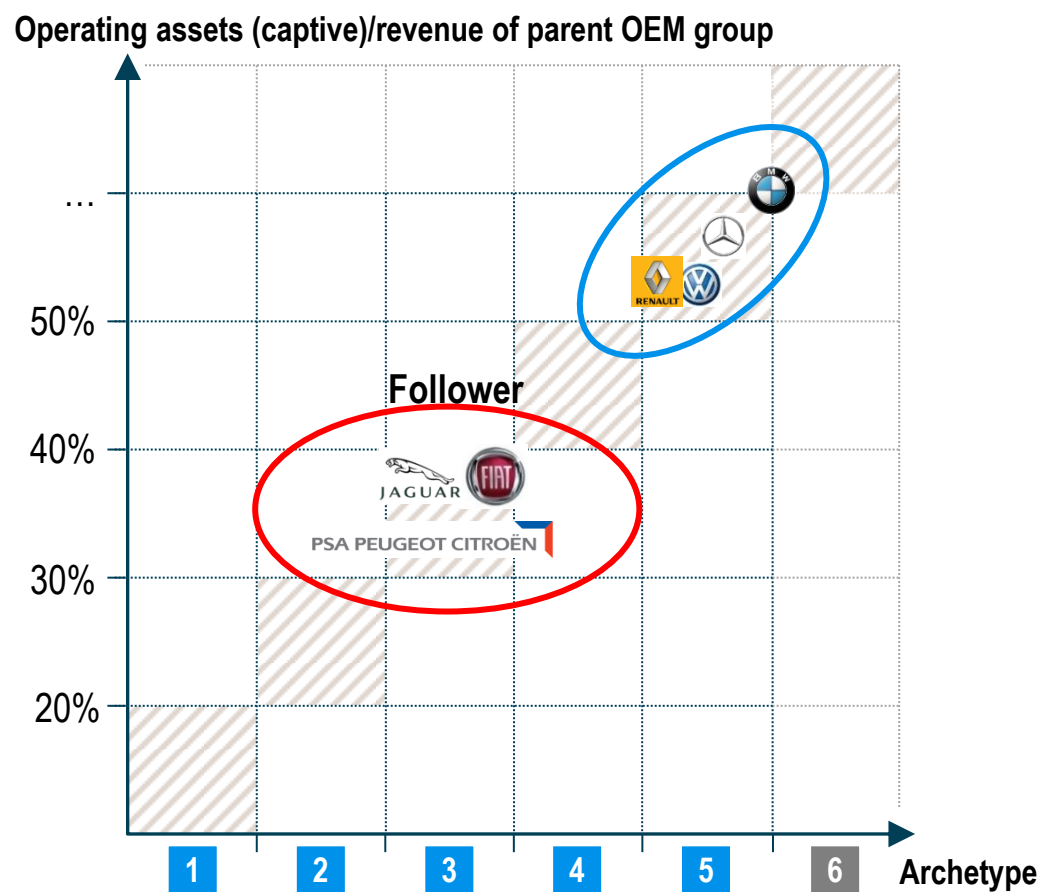
Maturity matrix (illustrative)



- > **Volume of new car sales** is the **main trigger** for the development state of captives
- > Archetype deviations to the left indicate **development potential** for captive units (e.g. Volvo Passenger Cars)
- > Deviations to the right indicate readiness of captive units to **support an increase in new car sales** volume (e.g. Tesla Motors)
- > Within large companies, a **multi-brand strategy**, e.g. for premium brands, can be pursued for captive business (e.g. VW with VW Financial Services and Porsche Bank)
- > Depending on the **strategic direction** of the parent OEM, captives can prepare the **ground for future success**

Some captives have improvement potential compared to their peers, highlighting opportunities for further growth

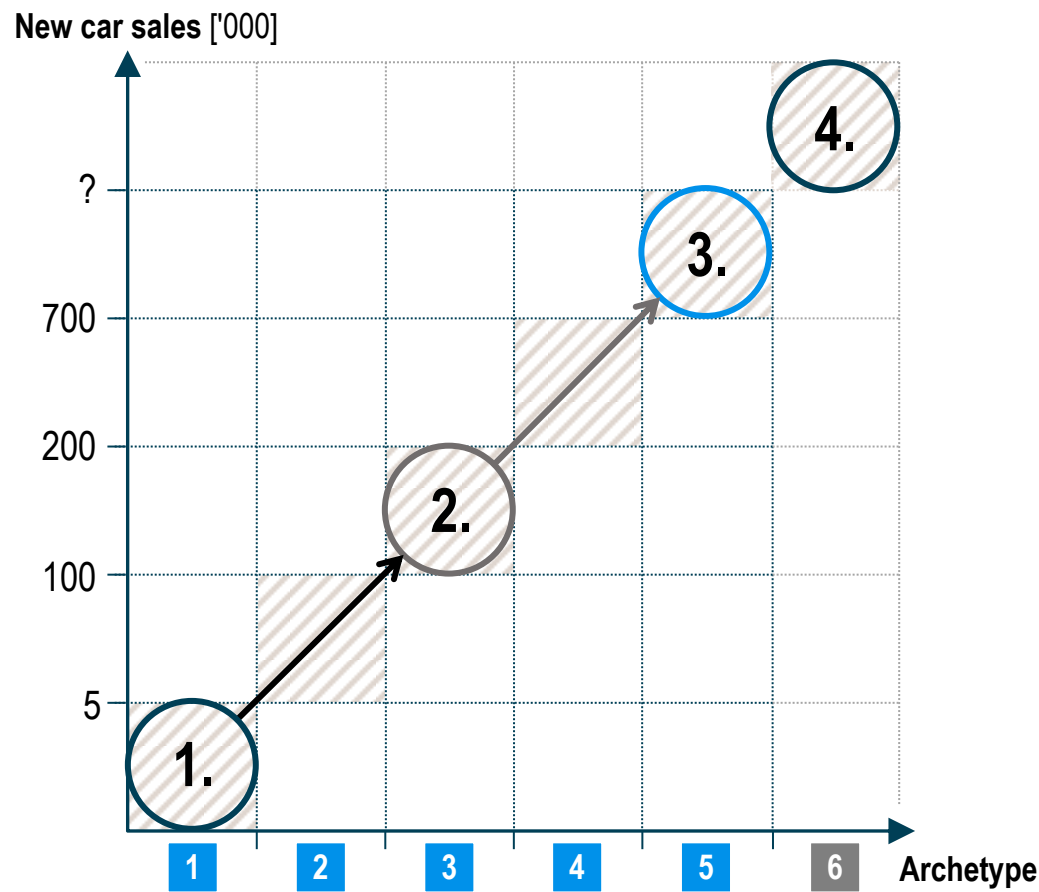
Maturity matrix (illustrative)



- > Amount of **operating assets** is mostly **driven by**:
 - **Car sales** (new and used)
 - **Penetration rate** on sales
 - **Average duration of finance provided**
 - **Finance provided to dealerships**
- > **Relation of captive assets to total turnover**, ratio gives an indication of how well the **captive is able to capture its full business potential**
- > **BMW Financial Services is the clear benchmark**, with a current ratio above 100%
- > Ability to generate **sufficient funding is a key prerequisite** to increase the ratio

Depending on the maturity of captive units, we identified four winning strategies to secure future success

Maturity matrix (illustrative)



Winning strategies

- 1. Fight and grow market share**
 Move out of niche markets, clear strategy to grow and reach significant size. Captive can be an enabler to realize future growth potential

- 2. Expand the captive**
 Once captive is set up, reaching archetype 4 and 5 is the crucial task, turning the focus from sales support to profit generation

- 3. Maximizing car lifetime value**
 The strategic challenge is the full exploitation of the car-/OEM-related revenue and profit potential with synchronized and personalized offerings

- 4. Maximizing customer lifetime value**
 Even beyond archetype 5 there is potential to maximize profit by going beyond pure OEM sales support and becoming a true mobility provider – One lever could be to use the data available to the captive

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