KPMG Enterprise

Automotive industry enters 'perfect storm' of change and uncertainty

By Steven Bragg, National Lead, Motor Industry Services, KPMG Enterprise

In Australia, this year is likely to see lower new car sales, higher interest rates (barring a recession), decreasing vehicle affordability, and continued margin pressure, forcing original equipment manufacturers (OEMs) to make radical changes in their product lines and business models, as evidenced recently by General Motors, Jaguar Land Rover and Ford.

These changes are also impacting the behaviors of their dealers, who are sharpening their focus on expenses, reducing both new and used inventory, honing in on back end gross opportunites and even considering selling their businesses. Then, there are also the potential impacts of strategic investments, such as mobility startups, personal vehicle ownership alternatives, and autonomous or electric vehicles, which are all expensive gambles for automakers and potentially major disruptors for car dealers.

Recognising these adjustments, investors have been relatively bearish on the auto sector throughout much of the bull stock market over the last couple of years. In the past six months alone, the stock prices of major automakers, retailers, and almost any company with close ties to the industry, have underperformed the broader market averages significantly. Nevertheless, despite shifting industry conditions and the poor stock performance of the entire sector, there are opportunities for OEMs and dealers alike.

Global Outlook

Global Automotive Industry entering a 'perfect storm' of change and uncertainty and not all CEOs are prepared for the impact.

The global automotive industry is entering a phase of adjustment to respond to market conditions, this will mean as an industry we will all need to reassess our position and operating models to remain relevant. Globally we've already seen restructuring, global auto executives name connectivity and digitization the number one automotive trend for 2019 in the 20th KPMG Global Automotive Executive Survey (GAES).

The survey overwhelmingly shows that executives believe a shift in the industry is imminent and players need to build on core competencies, while defining a new role for themselves beyond traditional expertise. However, the results demonstrate most executives have little fear that their company's profitability will suffer. KPMG believes though, that profitability will decrease as OEMs and dealers are faced with tough market conditions and shrinking markets if they don't act now to prepare for the industry of tomorrow.

Other key global insights identified in the annual KPMG GAES (a survey of 1,000 executives in the automotive and technology industry and approximately 2,000 consumers around the world), include:

- Auto industry is likely to be **driven by policies and regulations**
- **Countries are likely to match powertrain technology to their raw materials:** expect the US to focus on internal combustion engines (ICEs) and fuel cell electric vehicles (FCEVs) while China rules the e-mobility market
- **Retail landscape is undergoing dramatic transformation** – number of retail outlets will be reduced or transformed by 30-50 percent by 2025
- **No one player will master the value chain alon**e – more companies may be willing to cooperate in the future
- Majority of consumers want to buy a **hybrid as their next vehicle**
- **Battery electric vehicles (BEVs)** reclaim spot over fuel cell electric vehicles (FCEVs) as the year's **number one manufacturing trend**
- **Toyota** named by executives as the brand positioned for best future success, followed by **BMW** and **Tesla**.

Key Survey findings:

Regulators acting as the driving force

More than three out of four (77 percent) of executives are convinced that while OEMs declared themselves responsible for the technological agenda in the past decades, this role is being taken over by the regulator who will set the primary agenda defined by industry policies.

Multiple drivetrain technologies will co-exist

Execs globally believe in a fairly even split of BEVs (30 percent), hybrids (25 percent), FCEVs (23 percent) and ICEs (23 percent) by 2040 – with BEVs taking the lead. And consumers say "no" to fully alternative drivetrain technologies, with hybrids the number one choice for a consumer's next car choice and ICEs closely following.

Mobility and logistics will merge

The expectations for a mobility and logistics ecosystem are increasing: more than ever before, executives agree (60 percent) that in future we will no longer differentiate between the transportation of humans and goods. What have you done in your business to adapt to this model in the future?

Australian Automotive impacts:

Alongside the shifts of the Global Automotive environment, the Australian Automotive Industry is leaning into headwinds of their own. Shifting trends of reduced volumes, economic uncertainty led by house price declines and tightened lending by the financiers have already provided significant change within the Australian market. These continued trends, combined with a Federal election in May 2019 and the evolving preferences of consumers, will impact 2019 and beyond forcing the industry to adjust and adapt to these changes.

Australian perspective

The Australian Automotive Industry is leaning into headwinds of reduced volumes, economic uncertainty led by house price declines, tightened lending policies by the financiers, a May 2019 Federal election and the evolving preferences of consumers.

Australian Automotive Industry volumes - December 2018

The recently released December 2018 **FCAI VFacts motor industry new vehicle sales volumes** showed significant falls in December monthly volumes, with the total market down 14.9 percent year on year. This was led by drops in NSW (down 19.7 percent), Victoria (down 17.9 percent) and Tasmania (down 20.6 percent) for the month. For the 12 months to December 2018, the Australian market was down 3.0 percent to 1,153,111 new units, breaking the three year trend of record volumes.

Coinciding with the geographic performance, sales of all vehicle types were lower in December YoY, led by a sharp decline in passenger vehicles of 26.3 percent continuing the trend of consumer preference shifting to SUVs.

Bucking the December sales decline was BMW, which was up 15.6 percent for the month showing the benefits of its refreshed line-up. Lexus, LDV, Isuzu Ute and Volvo also showed improvement in December on the back of new or refreshed models.

Heavy commercial vehicles sales volumes have continued to improve, up 13.3 percent for the 2018 year to a record 41,628 units. The previous record was 38,131 new truck sales, set way back in 2007, during the pre-GFC market peak. Despite the record, volumes were restricted in the 4th quarter due to signs of the 'credit squeeze' imposed by financiers in response to the banking sector royal commission.

Key trends developing from the December 2018 sales data:

NSW is still the largest market in Australia, with almost 1 in 3 vehicles sold. However, there has been a shift to the other states with the housing market downturn having a particular impact on NSW and Sydney.

	YTD Market Share by State	
	2018	**2017**
Australian Capital Territory	1.58%	1.56%
New South Wales	32.17%	33.41%
Northern Territory	0.89%	0.90%
Queensland	20.08%	19.60%
South Australia	6.16%	6.09%
Tasmania	1.78%	1.67%
Victoria	28.91%	28.54%
Western Australia	8.43%	8.22%
Total	**100.00%**	**100.00%**

Source: VFacts

Another key trend in the past three years is the exit of the private buyer. From the analysis below, private buyer volumes have declined 17.7 percent or 91,298 units from their peak in 2015 shifting to business and rental. This shift reflects the buyers' preferences in financing towards novated leases and rental. More broadly, this may indicate a shift in consumer preference to buy vehicles through channels outside of the physical dealership buying

	2014	2015	2016	2017	2018	Movement from Peak year		Peak Year
Sub Total	**1,081,899**	**1,123,224**	**1,145,024**	**1,152,267**	**1,111,685**	**-40,582**	**-3.7%**	**2017**
Private	585,346	606,770	571,544	557,365	515,472	-91,298	-17.7%	2015
Business	398,332	417,939	472,156	484,440	480,696	-3,744	-0.8%	2017
Gov't	42,149	41,577	40,989	39,055	38,322	-3,827	-9.1%	2014
Rental	56,072	56,938	60,335	71,407	77,195	-	-	2018
Heavy Commercial	31,325	32,184	33,109	36,849	41,426	-	-	2018
Total Market	**1,113,224**	**1,155,408**	**1,178,133**	**1,189,116**	**1,153,111**	**-36,005**	**-3.1%**	**2017**

YoY Movement (Units)					
Sub Total	-22,632	41,325	21,800	7,243	-40,582
Private	2,864	21,424	-35,226	-14,179	-41,893
Business	-28,157	19,607	54,217	12,284	-3,744
Gov't	1,402	-572	-588	-1,934	-733
Rental	1,259	866	3,397	11,072	5,788
Heavy Commercial	-371	859	925	3,740	4,577
Total Market	**-23,003**	**42,184**	**22,725**	**10,983**	**-36,005**

YoY Movement (%)					
Sub Total	-2.1%	3.7%	1.9%	0.6%	-3.7%
Private	0.5%	3.5%	-6.2%	-2.5%	-8.1%
Business	-7.1%	4.7%	11.5%	2.5%	-0.8%
Gov't	3.3%	-1.4%	-1.4%	-5.0%	-1.9%
Rental	2.2%	1.5%	5.6%	15.5%	7.5%
Heavy Commercial	-1.2%	2.7%	2.8%	10.1%	11.0%
Total Market	**-2.1%**	**3.7%**	**1.9%**	**0.9%**	**-3.1%**

Source: VFacts

Economic uncertainty led by house price declines will apply pressure the Australian new vehicle market volumes in 2019

While new car sales were down 3.1 percent in 2018, cumulative sales were either higher or the same as 2017 until the middle of last year. That trend reversed in the second half of the year, coinciding with a slide in home prices in Sydney and Melbourne.

Corelogic recently reported Australia's median home price decline by 4.8 percent in 2018, a result reflecting declines in Sydney and Melbourne of 8.9 percent and 7.0 percent respectively. The nationwide price falls were the steepest as a percentage since the GFC with the deterioration accelerating in the final month of the year, slipping 1.1 percent as valuations tumbled in Sydney (1.8 percent) and Melbourne (1.5 percent) in December.

Prima face, a declining wealth effect from weaker property prices is deterring consumers from buying new cars. Following weak household consumption in Australia's September quarter GDP report, the aforementioned signals from new car sales in Q4 2018 and the broader weakness in the Christmas retail trading period points to a continuation of weak household consumption in Q4 2018.

The trend looks to continue into Q1 2019 with house prices trending similar to what we experienced in 2018.

Tightening lending by Financiers in response to the royal commission into the banking sector

Adding to the shift in the Australian market, the automotive industry financiers have increased scrutiny on consumers when obtaining credit in response to the royal commission into the banking sector. While unethical practices needed to be cleared out of the industry, there will be a period of uncertainty while the financiers and the dealers navigate their way through the new regulatory pressures. Anecdotally, some dealers have expressed concern on getting their customers settled where previously it was relatively painless. This 'credit squeeze' has also coincided with the ASIC regulatory changes that came into effect on 1 November 2018 which has also created additional requirements for dealers to navigate.

The introduction of comprehensive credit reporting (CCR) scoring in 2019 will level the playing field for the dealer as the consumer, like the dealer, will be better informed to ensure the best rate possible is offered to the consumer. This means financing the vehicle purchase at the Point of Sale (PoS) is the easiest and best option for the customer.

When fully established (which I estimate will take 2-3 years) CCR will provide full transparency when financing a vehicle purchase and will make the dealer the path of least resistance for the consumer. This will see the Australian dealers operating with penetration rates similar to the US and the UK at 90+ per cent.

To increase penetration, dealers will need to invert their process: where financing the car used to be a post-sale decision, it is now a pre-sale decision. The mindset has to focus on 'lost contracts', rather than 'won contracts'.

We can't forget with all these changes in our market that at the core customer experience is what sells cars and sustains our industry. In the US, CCR allows a customer to purchase a vehicles and drive away on the same day. Imagine the efficiencies a dealership could achieve if it's end to end sales model was less than a day.

The good news is that the finance market is helping you.

A projected Federal election in May 2019 (or earlier) will have implications on the economy and car sales

There is anecdotal evidence that uncertainty that surrounds federal elections can cause households and businesses to put off spending decisions and the longer the campaign period the more likely it is. However, actual evidence of the effect of elections on the economy is hard to come by and mixed at best.

The best place to look is how the share market reacts in order to get an overall view on the sentiment of the consumer. In the lead up to a federal election, the Australian share market typically trends sideways in the lead up to the election followed by a rally soon afterward. On the presumption that consumer and business sentiment will follow the share market's typical patterns, we can expect car sales to be reduced until the Federal election with some form of a rally in the June month, despite what looks to be a fait accompli in terms of a Labor party victory.

Retails sales by Country of Origin

Rank	Country	2018 Total Market Volume	% Total Market
1	Japan	356,230	30.9%
2	Thailand	300,274	26.0%
3	Korea	169,315	14.7%
4	Germany	91,411	7.9%
5	USA	44,492	3.9%
6	England	33,011	2.9%
7	Spain	14,818	1.3%
8	Mexico	11,859	1.0%
9	Other	127,476	11.1%
10	Locally Manufactured	4,225	0.4%
	Total	**1,153,111**	**100.0%**

Source: VFacts

Despite the preferences of consumers, the shift in powertrain from internal combustion engines (ICE) will be primarily driven by the vehicles country of origin for the Australian market

With local production officially ceasing in Australia in October 2018, the Australian automotive market will experience its first year being fully imported for the first time in 2019. The importance of this is that despite consumer preferences the choice of powertrain in the future will be guided by the vehicles country of origin.

As countries are likely to match powertrain technology to their raw materials: KPMG expects the US and North America to focus on internal combustion engines (ICEs) and fuel cell electric vehicles (FCEVs) while China and Asia will rule the battery electric vehicle (BEV) market.

As represented below, Japan, Thailand and Korea imports constitute 70+percent of the vehicles sold in Australia during 2018. While the OEMs will be driven by regulation in Australia (Australian Design Rules – ADR), there will be a very strong influence from the regulatory bodies in the OEMs domiciled country and their access to raw materials for BEVs or FCEVs resulting in a mix of powertrain technologies in the future. There will not be one dominate powertrain tech for our market, however these trends will need to be closely watched and monitored to ensure Australian based dealers are stocking vehicles to match consumer needs.

Our KPMG GAES noted Toyota as the brand positioned for best future success in an EV and autonomous vehicle (AV) future. This bodes well for Australia as Toyota is the dominate market player in the Australian market with 18.8 percent market share. Toyota has a clear plan for the AV/EV and a diverse line of hybrid drive models to bridge the gap.

Hybrid EV are having a more immediate impact as the bridge powertrain on the journey to fully BEV/ FCEV technology.

Australian consumers, while lagging behind China and other European nations, is slowly shifting its uptake of electric and hybrid drive vehicles. As evidenced below, there is a noticeable shift from diesel to hybrid/EV. Particularly in passenger vehicles but also in SUVs.

Our KPMG GAES indicated that a majority of buyers are looking to buy a hybrid as their next vehicle, which will only accelerate the shift from petrol and diesel vehicles.

	Market Volume		% of total Market		
	2018	2017	2018	2017	Var%
Total Passenger	**378,413**	**449,949**	**100.0%**	**100.0%**	**0.0%**
Diesel	13,982	18,189	3.7%	4.0%	-8.6%
Electric	646	512	0.2%	0.1%	50.0%
Hybrid	12,728	9,793	3.4%	2.2%	54.5%
LPG	0	1	0.0%	0.0%	-100.0%
Petrol	351,057	421,454	92.8%	93.7%	-1.0%

	Market Volume		% of total Market		
	2018	2017	2018	2017	Var%
Total SUV	**495,300**	**465,709**	**100.0%**	**100.0%**	**0.0%**
Diesel	132,331	141,276	26.7%	30.3%	-11.9%
Electric	690	611	0.1%	0.1%	6.2%
Hybrid	1,600	1,416	0.3%	0.3%	6.2%
LPG	0	0	0.0%	0.0%	n/a
Petrol	360,679	322,406	72.8%	69.2%	5.2%

Total Market Ex. Light & Heavy Commercial	100.0%	100.0%	0.0%
Diesel	16.7%	17.4%	-3.8%
Electric	0.2%	0.1%	24.7%
Hybrid	1.6%	1.2%	34.0%
LPG	0.0%	0.0%	-100.0%
Petrol	81.5%	81.2%	0.3%

Source: VFacts

Preparing for 2019 and beyond

How can dealers position themselves to face into what seems to be nothing but ambiguity in the Australian market for 2019?

Dealer groups have been forced to evolve their operations to adapt to the new landscape and those that aren't agile will face being forced out of the market. Success in the new automotive ecosystem will not be attained by a single entity dominating the entire process. Each player must identify their role and define their field of play to create their own point of difference. In the new normal, consolidating with industry peers may be a way for the industry players to survive and keep up with the non-product based players (Google and Facebook.) Finding the right balance between where to compete, cooperate and co-integrate will be the key. There are exciting times in the future, so let's embrace the change and find our place in the new customer focused ecosystem

Short term strategies:

Re-Focus the dealership's efforts

KPMG Motor Industry Services would recommend Dealerships maintain focus in the changing and challenging market - recognising the strengths and weaknesses in the business; and building a plan to optimise your opportunities and operations.

- Don't waste your customer opportunities
- Don't be scared of trade-ins. Used vehicles need to be the focus in a declining new vehicle market as they are your best opportunity to maintain gross
- Utilise your CRM database to mine your current customers that are coming out of warranty, in for 30,000 klm service or driving the previous model.
- Get the finance locked away well and truly upfront and get your F&I team proactively pre approving customers.
- Start all F&I commission schemes at 100% penetration and disincentivise for lost business, which will refocus the team on the new normal.

Value Leadership

Dealer groups need to monitor and where possible reduce costs in every day operating activities to align with the drop in overall gross margins. Getting your business lean and right-sized will allow you to maintain profitability in a down market and really soar when the market improves.

Conduct a 'Two Types of People' analysis and work out how to remove or restructure non-gross generating people out of the business through technology, offshoring or job sharing.

Become easier to do business with (the biggest threat to the traditional dealer model)

Car dealers need to offer a sales process similar to the way people want to buy cars and have been trained to shop by the likes of Google and Amazon.

Dealers will need to have complete transparency in vehicle pricing and financing upfront. Consumers no longer want to haggle and negotiate a deal at the dealership. The price is the price…when was the last time you negotiated the price of a loaf of bread at Coles or Woolworths?

Consumers want to shop 24/7 for cars online, transact online and have their vehicle delivered when and where it's most convenient to them, or click and collect from a delivery centre. Can you shift your operating model to a click and collect offering?

Lastly, consumers will need to have the option to return the vehicle (typically within 7 days and limited by 100 kilometres), similar to the way they currently interact with other online retailers.

Dealers need to take these steps themselves or must be open to the type of disruption seen in other traditional retail sectors by Amazon or similar businesses. You would be remiss to think the OEMs aren't already looking at this as a new distribution model.

Become the lender

Dealerships need to consider changing their business model in order to participate in the profit from car loan financing after the new ASIC changes are put in place. One alternative is for dealer groups to become the lender and provide car loans directly to customers. Becoming the financier (usually in a joint venture with an established financier) will allow dealers some flexibility to set rates to their customer risk profiles and participate in the gross margins through the value chain. Becoming a full service provider to your customer will reduce the chances of them being romanced by another dealer.

Long term strategies:

Pivot

Position the dealer group to take advantage of the forthcoming changes in the industry and be an active participant. Align with a brand in a region to become the retail representative for that brand or be a mobility service provider for a region or a particular segment of the market.

Exit or Grow

Small to medium dealer groups are at a cross roads where they decide whether to remain in the market and fight an uphill battle. If the small players stay in the market, they will need to have strong growth plans in order to compete with bigger dealer groups in the future.

I'm excited to see where the next 12 months takes us, for additional information on the future of automotive, or for a 'future ready' assessment on your business, contact Steven Bragg or the KPMG Motor Industry Services Team.

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