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Automotive sales to corporations

From growth engine to risk trap

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Executive summary

The European automotive industry faces its worst crisis in many years. After a long period of steady growth, vehicle sales plunged in 2008, and the outlook for 2009 is worse. Sales to corporate fleets have traditionally stabilized revenues and profits, helping OEMs through rough patches in the economy by making up for declining private sales. However, the current worldwide crisis is now cutting into fleet sales and leasing as well, putting pressure on what was once a steady growth engine in Europe. Not only will OEMs be hit hard, but all the players along the automotive fleet and leasing value chain will be significantly affected: captive finance arms, independent leasing companies, dealers, insurance companies, and brokers. In light of recent developments, general market trends, increased risks, and new government interventions, most players are rethinking their tactics and strategies to prepare for the difficult times ahead, while laying a foundation for success once the economy recovers. Strategy& recently interviewed more than 50 key stakeholders across the automotive fleet and leasing industry in Europe. This report presents their reactions and expected responses to current market dynamics.

The role of the corporate leasing market

Corporate fleet sales and leasing in Western Europe have been growing for years, stabilizing overall automotive sales and making these businesses attractive for original equipment manufacturers (OEMs) and financial-services providers. This growth is now under threat by a deteriorating economy that is both depressing customer demand and choking off financing for even the strongest players in the market. “Owning the customer” is the ultimate mark of success in the corporate fleet sales and leasing industry. Difficult times mean that the individual players are battling one another more fiercely than ever — to at least retain, if not gain, market share.

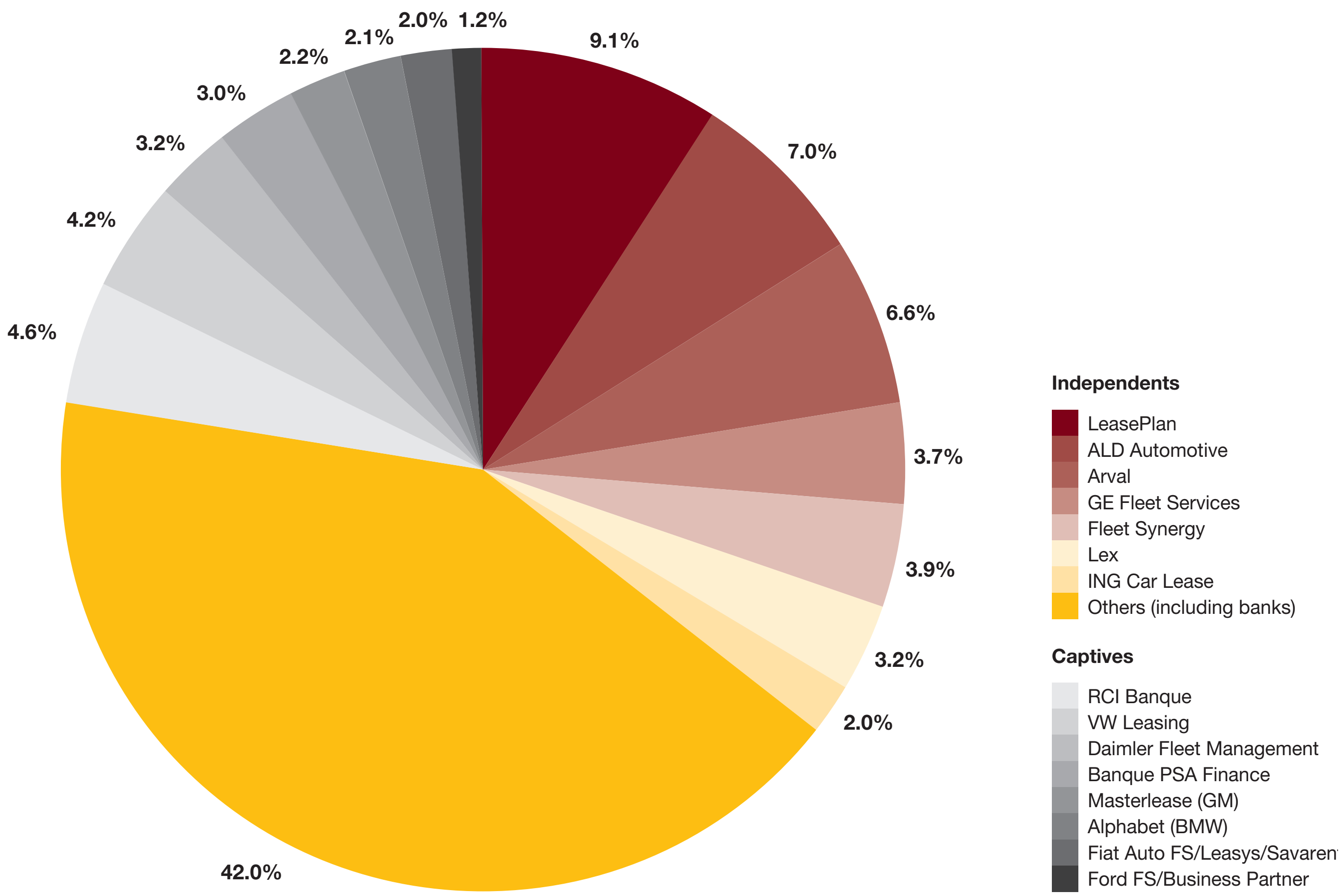
In a depressed business environment, vehicle manufacturers are reenergizing their commitment to downstream activities such as leasing, financing, or after-sales service.

In a depressed business environment where profits on new car sales range from low to none, vehicle manufacturers are reenergizing their commitment to downstream activities such as leasing or financing and after-sales service, with the aim of strengthening these strategic pillars.

The triumvirate of manufacturer, captive finance arm, and franchised dealer continues to jointly address customers in the manufacturer-branded environment, while some OEMs have diversified into multi-brand offerings and fleet management services to serve customers more holistically. Meanwhile, independent leasing companies — the main alternative to captive leasing arms — have successfully positioned themselves with multi-brand offerings, international coverage, and competitive leasing rates. Like their captive competition, they are expanding fleet management and service offerings while constantly seeking greater efficiency.

Although fierce competitors, the OEMs/captives and the independent leasing companies also depend on each other. The independents, which source vehicles from the manufacturers, have long provided an essential high-volume sales channel for the OEMs, and the current crisis only increases the importance of that relationship. Today, independents hold most of the European market, but that share is fragmented: No single firm boasts more than a 10 percent market share (*see Exhibit 1, next page*).

Exhibit 1
Corporate leasing market in Western Europe



Source: Fleet Europe; Datamonitor; Strategy& analysis

Pan-European players and OEMs, seeking new routes to growth, have driven industry consolidation. Merger and acquisition activity, however, has diminished significantly during the past two years; the high prices of previous transactions and the unwillingness or inability of lenders to finance large deals have slowed deal making to a crawl.

Local competition is strong in most countries, either from captives that are well positioned in their home base or from large local leasing companies like Lex in the U.K. or Bansalease in Spain. Yet, some Pan-European leasing companies — LeasePlan, ALD Automotive, and Arval — eschewed a single-country focus and have built considerable volume across Europe (*see Exhibit 2, next page*).

Overall, the fleet and leasing industry has evolved smoothly over the years. There have been no major disruptions, as everyone concentrated on improving operations and growing their product and service portfolio to capture incremental business. The road ahead will be much rougher.

Exhibit 2
Corporate fleet size of leasing companies in Western Europe

Source: Fleet Europe; Datamonitor; Strategy& analysis

Supply-side dynamics: The financial and economic crisis

The speed and depth of the economic crisis have shocked the fleet and leasing industry. The crisis now dominates all factors that will drive market evolution for years to come. That reality, in turn, is forcing all players to thoroughly review individual strategies and reappraise preexisting trends.

To varying degrees, the industry's profit picture has been altered by these developments:

- Difficult access to funds and increased refinancing costs
- Increased remarketing and residual value risks
- Selected government intervention

Difficult access to funds and increased refinancing costs: Until mid-2007, refinancing costs differed only slightly among players, depending on the underlying risk rating. As the interbank market broke down and risk spreads increased, however, poorly rated players began experiencing severe refinancing disadvantages. The corporate bond market practically dried up, while opportunities to place asset-backed securities — previously a source of cheap funds for leasing companies — evaporated.

Many lenders, already overexposed to automotive risks, now fear that one failing link might unleash a cascade of damage to their portfolios. The resultant scarcity of funding now requires leasing companies and captives to limit their focus. This is particularly true for captives tied to struggling OEMs, which are unable to secure funds at competitive rates and thus are at risk of pricing themselves out of the leasing markets. Captives will therefore require considerable cross-subsidization from their OEMs, which are likely to concentrate scarce funds on core markets. The trend toward withdrawal from noncore and subscale markets will be magnified. Furthermore, OEMs and banks that own leasing businesses will reconsider their involvement, as even in good times it is difficult to attain an acceptable risk-adjusted rate of return

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(*see "Risk Management Role of Independent Leasing Companies," page 19*). In tough times, those businesses will be the first to retrench.

Increased remarketing and residual value risks: Residual values continue to plunge, which could radically transform the competitive landscape. Topping the list of likely trends are the following:

- Demand volatility will continue to increase, with no end in sight.
- Customer preferences for petrol or diesel engines will continue to shift, based on fuel price volatility and tax rules.
- Larger cars will become less attractive in the used-car market due to ever-tightening CO_2 regulations and consumer reaction to peaks in fuel prices such as the dramatic increases of mid-2008.
- Historic growth in corporate fleets will run head-on into an oversupplied market. Off-fleet vehicles two to four years old will enter the market between now and 2012 in a potentially depressed economy.
- Demand in Eastern Europe, a traditional outlet for older vehicles, will likely decline.

Dealers and smaller leasing companies that lack efficient remarketing capabilities are expected to face severe exposure on their current portfolios. They might also face pressure to sell vehicles at a loss to avoid share erosion in the price-competitive new vehicle market. Moreover, the financially vulnerable dealer channel could refuse buybacks and push for changes in risk sharing among manufacturers, leasing companies, and dealers.

The changing landscape could take on alarming new dimensions, depending on the soundness of the dealer body throughout Europe. Every week the press chronicles yet another series of bankruptcies declared by traditional dealers. If dealers' finances deteriorate further, captives/manufacturers and independent leasing companies will lose the dealers as guarantors of residuals. They will therefore retain the risk — or the cars themselves — with a low probability of successful remarketing, since dealers are often also a prime retail channel for used vehicles.

Overall, these developments could strengthen OEMs and large independents. OEMs, however, must overcome their deficits in remarketing to get control over used-car flows. Large independents may strengthen their remarketing capabilities and positions by leveraging their skills and size.

Historic growth in corporate fleets will run head-on into an oversupplied market. These vehicles will be coming off fleet and onto the market during the next several years in a potentially depressed economy.

Selected government intervention: Throughout Europe, governments have tried to counter the economic crisis by stimulating consumer confidence and demand, whether through state guarantees for consumer savings, state loans for banks, or aid to the endangered automotive industry in the form of loan guarantees or direct subsidies.

Leasing companies with bank licenses, as well as the captives, have reacted and applied for this support as well. Because not all players will have access to subsidies, a wave of leasing portfolios "for sale" can be expected to flood the market. The question remains, Who is able to afford them?

Demand-side dynamics and trends

As demand falls more rapidly than companies are able to reforecast sales, they face unprecedented uncertainty. Industry experts differ significantly on how severely and how long the automotive fleet business will be affected, with some counting on offsetting trends to smooth the downturn.

Major demand-side trends include the following:

Decline in demand through recession: For manufacturers, fleet volumes have gained in importance as new private vehicle sales have declined. All interview respondents believe that fleets will become an even larger portion of the future mix. Private registration volumes fell sharply across Europe in late 2008, while fleet registrations have not yet been similarly affected. This trend is expected to continue, with fleet increasing its share of total volume.

In absolute terms, expectations for future fleet volumes vary. In a best-case scenario, volume remains flat. A trend toward severe downsizing of fleets isn't apparent yet, but it could occur if layoffs continue to reduce the eligible workforce at large corporations.

Downgrading and "greening" of fleet vehicles: Customers' cost-consciousness, particularly their focus on the total cost of ownership, is especially sharp now, leading a trend toward smaller and more economic vehicles. Vehicle downgrading is expected to continue, reinforced by fuel price uncertainty and an ongoing policy debate on environmental issues.

The "greening" of fleets is becoming a commonplace topic at large corporations. An increasing number of companies are setting up programs to use vehicles with low CO_2 emissions as a key part of corporate social responsibility initiatives. Government regulations and pricing schemes, such as the French *bonus-malus* and the London congestion charge, may further reinforce this trend.

Longer holding periods: Two effects are expected to drive a trend toward longer holding periods: First, in times of uncertainty, customers prefer to extend their fleets rather than replace them with new contracts. Second,

"We see growth potential primarily in the small- to medium-fleet market."

— Dealer group

with increasing residual value risks, those risks can be smoothed through longer contract durations, resulting in lower monthly fees.

Smaller effect on functional fleets: Hard economic times will have a smaller effect on fleets that directly support a company's core business. Companies will try to limit downsizing unless an especially deep recession significantly reduces transportation and in-field needs. Nevertheless, some hits to demand can be expected as companies extend the use of existing vehicles or bring in vehicles that are nearly new, rather than brand-new.

Changes to user-chooser fleets: User-chooser fleets, which offer employees some choice in which car they'll be driving, will be hit harder by economic weakness than the business-dedicated category. In an economic downturn, companies will look first to pare user-chooser fleet costs, even if it means some executives will have to settle for a car that may not be fully to their liking. However, two positive trends are expected to stabilize user-chooser demand on a Europe-wide scale: Corporate fleet penetration is still underdeveloped in some markets, such as Spain and Italy, offering future catch-up potential. Meanwhile, corporations will continue to promote company cars as an attractive salary component. Both the company and the employee will benefit from large manufacturer discounts and tax advantages.

Growth in the importance of large (mainly international) fleets: In-country and cross-border M&A activity may slow, but it won't stop. Large domestic and international companies, over time, tend to take an even larger share of the entire company car market in Europe. Hence, although the number of customers is not increasing, the number of cars in that segment may grow through mergers and cross-border arrangements, thus putting downward pressure on pricing.

Emergence of small and medium enterprises (SMEs) as the core growth area for corporate operational leasing: Operational leasing penetration in large fleets has reached its limit. However, the small and medium enterprise market still offers growth potential. Driving this growth are several factors: realization of the total cost-of-ownership savings, the need to clear balance sheets, and the attractiveness of converting salary considerations into a company car program. Given current attractive leasing offers and the increasing interest in small fleets by manufacturers, more small fleets are expected to convert to operational leasing contracts.

Demand for mobility/ownership solutions: "Mobility" has become a buzzword in recent years and is embedded in all competitors' strategies, although nothing revolutionary has yet evolved. Still, our survey revealed that customers increasingly are requesting "mobility" in their car acquisition decisions. Players in the corporate fleet market need to be prepared to offer flexible mobility-oriented services and packages.

"The shift from private demand to corporate fleet through new/innovative HR policies will continue."

— OEM

Expected competitor moves along the value chain

In the face of unpredictable macroeconomic developments, market players are repositioning themselves to maintain their competitive strengths and protect their business, while remaining alert for growth opportunities (*see Exhibit 3, next page*).

OEMs and their captives

For OEMs, the corporate fleet market is an essential volume channel that secures aftermarket revenues both for them and for their dealer networks. A captive leasing company operates as an OEM's extended arm. It will continue to be an important sales outlet for the OEM, and collaboration between the two will remain close. Domestic brands typically occupy a strong fleet position in their home markets, while importer brands typically lag behind (*see Exhibit 4, page 16*).

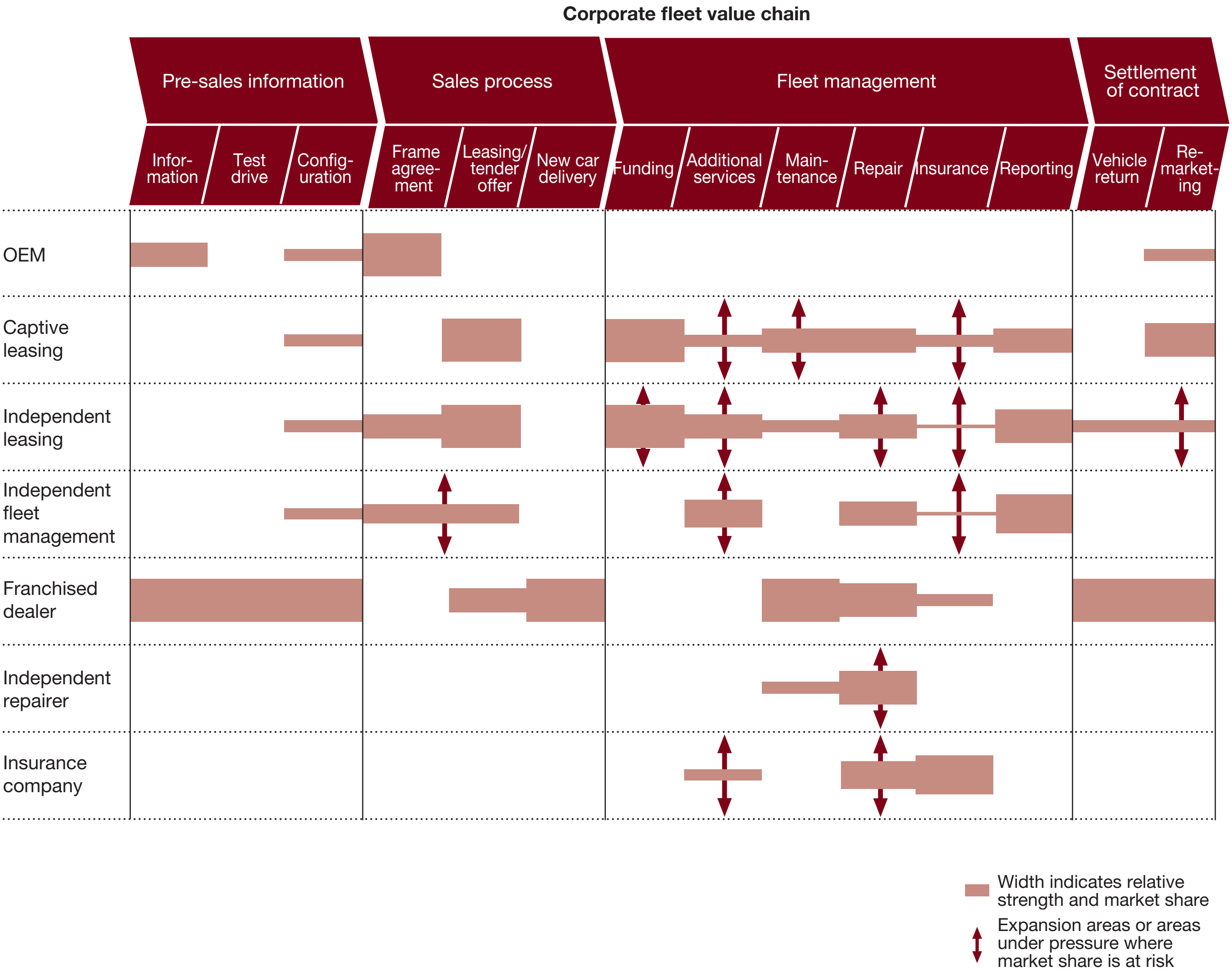
However, importers will attempt further incursions into the fleet market as private sales decrease.

Protection of after-sales business: Some premium and volume manufacturers are recrafting fleet discount policies to steer volume to their captive finance arms and dealer networks. Package deals that combine captive leasing with cross-subsidized service contracts, insurance, and extended warranties strengthen an OEM's hand against the independents.

Competitors, on the other hand, question the sustainability of these packaged offerings, pointing to the often unfavorable cost positions of captives and the franchised network in delivering these services. Nevertheless, the cross-subsidized packages will affect market prices, and independent leasing companies fear price pressure and the loss of the profitable service component. Whether manufacturers can continue this strategy given current liquidity constraints remains questionable.

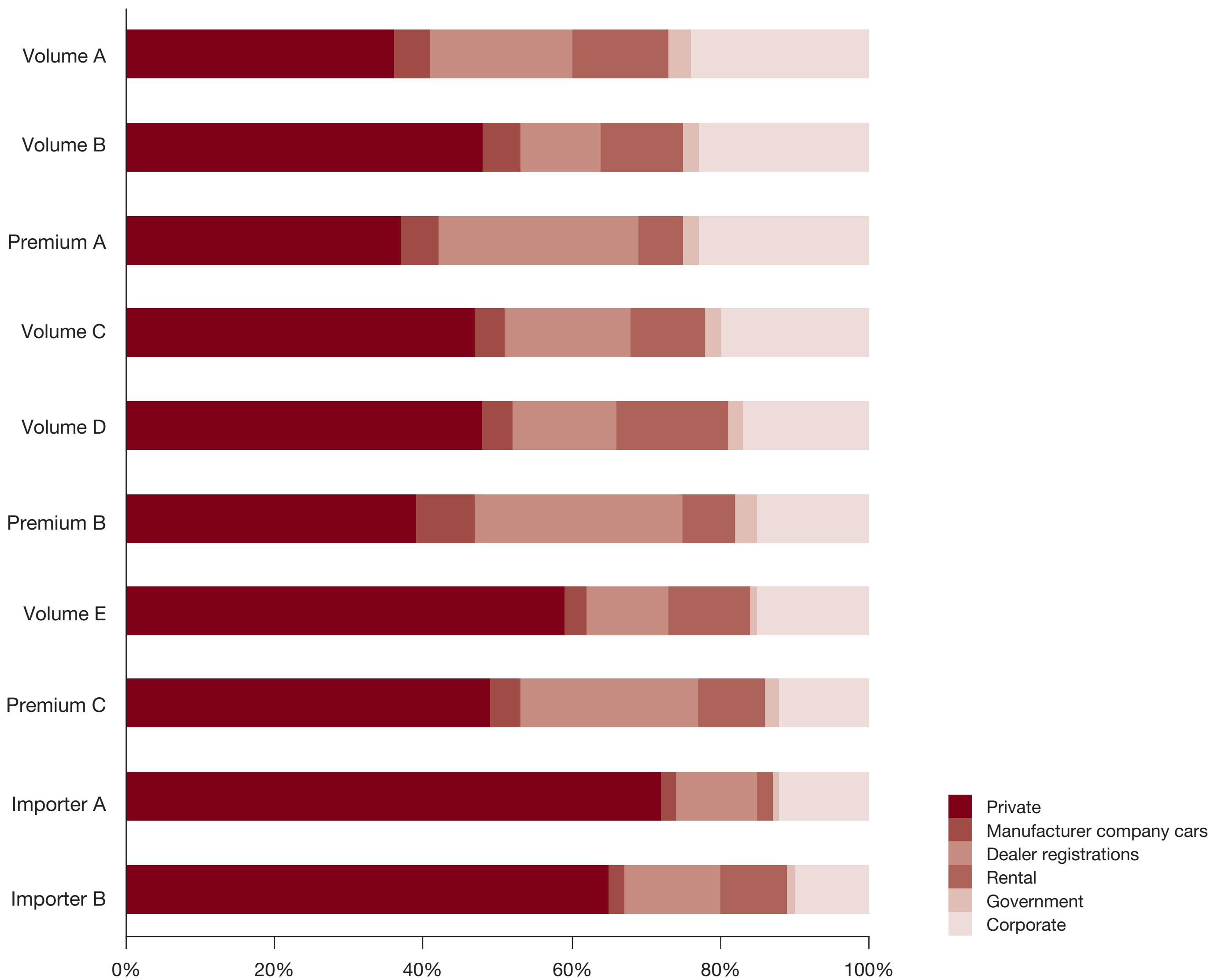
Focus on SME segment: Because SME segment contribution margins are higher than those of large fleets, OEMs are expected to become

Exhibit 3
Focus areas along the corporate fleet value chain



Source: Strategy&

Exhibit 4
OEMs' passenger car sales by channel in major European markets



Source: Strategy& analysis

more aggressive in this market, along with their dealer networks and captives.

Withdrawal from multi-brand initiatives: In recent years, most captives have built up multi-brand fleet capabilities to expand their addressable market, but with mixed success: Many customers did not believe in their brand neutrality.

Given the challenges facing the automotive industry, it is likely that captives will focus their scarce funds on their core business — i.e., their own brands. Recent press statements seem to confirm this.

Focus on home or core markets: Captives typically enjoy a strong market position and economies of scale in their home base, built up over many years. They will continue to try to gain share against the independents in these markets if liquidity is available. However, noncore markets are less attractive as stand-alone businesses in the current environment; achievable leasing volumes within captives' own brand are typically subscale, as shown in Exhibit 1. Therefore, manufacturers will become more open to collaboration with independent leasing companies in the near future, while partially or fully divesting themselves of their own captive operations in noncore markets. The first such moves have already taken place, and the financial crisis will continue to fuel such activity.

"Right now, we refrain from collaborating, but we will need to do so going forward to be successful."

— Volume OEM

Independent leasing companies

Independent leasing companies have built a very strong position, which they will use to push for further growth.

Expansion of fleet management offerings: Pure financing of the asset is increasingly unattractive under current market conditions. Independent leasing companies will likely concentrate on operational leasing contracts with differentiating service elements that offer downstream revenue and profit potential. Already, independents have built productive relationships with franchised and independent repair networks to secure cost-efficient repair and maintenance businesses. Most independents also incorporate an insurance component in their leasing packages, thereby increasingly becoming more a competitor and less a customer of the insurance companies.

Focus on large/medium fleets as a growth objective: Major independent leasing companies primarily address large international fleet customers via direct key account management. However, as operational leasing penetration has reached saturation in large fleets, independents will target increased penetration of the medium-sized fleet segment going forward. They are already designing dedicated full-service offerings or collaborating with large multi-brand dealer groups to secure access to customers.

Strengthened remarketing capabilities: With residual values under pressure and demand increasingly difficult to forecast, state-of-the-art remarketing capabilities are crucial. Large independents with broad product portfolios are particularly well placed, given their ability to reduce brand-specific risk and leverage multiple sales channels, including auctions and multi-brand dealer groups. Professionalizing the remarketing segment will increase its attractiveness to OEMs and dealer groups seeking to limit residual risks.

Many OEMs see residual value management as a systemic brand risk they need to manage. Some independents, however, might be better equipped than the OEMs' own country organizations.

Growth opportunities through collaboration and cooperation: To address new customer segments and efficiently leverage their market know-how, some independents will increase partnerships with OEMs and large dealer groups. With captives potentially withdrawing from subscale markets, independents see further cooperation opportunities with OEMs.

Different models of collaboration or cooperation between OEMs and independent leasing companies could emerge, such as these:

- Outsourcing the entire captive leasing business in subscale markets to independents
- Outsourcing back-office functions to leverage the scale of independent players, providing an upside for both independents and OEMs
- Joint market penetration — the development of dedicated offerings and access to new customer groups — for independents and smaller importers lacking their own strong captive finance arm
- Competitive intelligence and data sharing on residual values, service pricing, total cost of ownership, etc.
- End-customer-related data, currently managed in silos, increasingly shared by independents, dealers, and OEMs

"Dealers, independent leasing companies, and we are collecting information — but none of us is using it efficiently!"

— Volume OEM

Risk management role of independent leasing companies

Today's independent leasing companies are managing risks for fleet customers, dealers, and OEMs. The risks include these:

- Credit risk: Covering the financing/credit risk is the historic core business of the independents. OEMs and dealers are guaranteed to receive the car-financing value from the independents in case of insolvency of the fleet customer.

- Residual value risk: Given their fleet size, large brand portfolio, and extensive automobile industry network, large independents are best qualified to efficiently remarket off-lease returns across multiple brands. Other players often lack these capabilities and therefore face considerable residual value risks. Dealers, in particular, are experiencing both high provisions from losses and losses from leasing returns in the current environment. As active risk managers, independents can further strengthen their role as risk taker by adopting the residual value risk for outstanding cars and leveraging their remarketing capabilities and network.

- Technical risk: At the time of purchase, a car's future service and maintenance costs cannot accurately be known by the customer. By offering operational full-service leasing contracts, independents take over the technical cost risks during the vehicle life cycle and give the customer a transparent up-front view of the total cost of ownership.

Brokers/independent fleet managers

Brokers, also known as independent fleet managers, have tried in recent years to establish themselves in the corporate leasing market. Their business model was based on cost advantages through building scale across various markets and leasing providers. However, to date, only limited volumes can be observed.

The long-term profitability of brokers is questionable for small and medium fleets. Low handling fees are only viable at large volumes without customer-tailored offerings. Furthermore, the kickbacks from market participants have to be passed through to the customer.

Overall, OEMs and independent leasing companies expect brokers to remain active in the market today but see no major threat from them in the long run.

Insurance companies

Large insurance companies are trapped between offering stand-alone insurance solutions and collaborating with captive and independent leasing companies.

The insurance business is still very much national, with the international insurers focused mainly on large fleets that can efficiently be served through key account management. Smaller fleets are mainly in the hands of local insurance companies that cooperate with local dealers or leverage their agent network.

Insurance companies will try to differentiate themselves through attractive stand-alone offerings, attempting to retain direct customer access while refraining from commoditization. Expected moves:

- Clear separation of service and insurance components
- Focus on low repair costs through special agreements with dealers and repair chains

Independent leasing companies may take volume from insurance companies, but they are expected to experience decreasing margins as insurance providers try to leverage their market power in damage claims.

"We do not see a chance for brokers in the market."

— Premium OEM

Summary and potential future industry landscape

Overall, interviewees foresee a challenging time ahead for the fleet leasing industry, although growth and profit opportunities remain for focused performers. Supply and demand conditions affect all players to greater or lesser degrees (*see Exhibit 5, next page*).

The most likely scenario in the fleet and leasing industry can therefore be characterized by these features:

A declining or stagnant market: Driven by the economic downturn and resulting downsizing and downgrading of fleets, fleet sales and profits very likely will continue their decline. As the CO_2 policy debate continues, smaller and more environmentally friendly cars will become more popular; the deterioration of residual values will reinforce a generally negative outlook.

Leasing rate increases due to lower residuals and higher funding costs could drive some customers back to purchasing, while smaller vehicle specifications will also hurt the sold portfolio mix.

Further pressure on residual values: In order to keep their share of the corporate fleet market and reduce overcapacities, OEMs are likely to continue or even deepen their discounting strategy. This will put further pressure on residuals and harm new-sales profits for OEMs and dealers.

Dealers hit first and hard: Dealers are the weakest link in the value chain. Many dealers will fail, accelerating dealer consolidation and strengthening the market power of large dealer groups. Smaller and financially weak dealers will try to avoid exposure to residual value risk or will fail, leaving the risk in the hands of OEMs, independents, or potentially large multi-brand dealer groups.

Independents as crisis winners: Captives and independent leasing companies will try to strengthen their positions by addressing different market and customer segments. However, the recession will give the upper hand to large independents, as captives and smaller independents encounter refinancing problems and negative residual value obligations.

Exhibit 5
Summary of interview statements on industry expectations

	Demand dynamics	Supply dynamics
Strong agreement (>80% of respondents)	Overall corporate fleet market will at best be flat but will increase in importance for OEMs	Financial crisis will affect funding cost and thereby will change competitiveness
	Focus on total cost of ownership will reach SME fleets and thereby spur operational leasing	Pressure on residuals will continue; residual management will be key
	Fleet growth in runner-up markets will drive both fleet and leasing volumes	Economic downturn will accelerate evolutionary M&A activities and market consolidation
	Fuel prices, CO_2 regulation, and the “greening” of fleets will lead to downgrading and will impact brand shift	OEMs will try to protect their downstream business through subsidized service or insurance contracts
		Multi-brand activities of OEMs/captives will be scaled down
		OEMs will further penetrate the SME segment, together with their dealers and captives
	Large and international fleet share will increase	BER 2010 will have a limited impact on the competitive landscape in fleet
Less certain (50%–80% of respondents)	Customers will further professionalize in sourcing and enforce competition	More withdrawals of captives from noncore markets will be seen, opening up collaboration opportunities
	User-chooser fleets will decline in an economic downturn, while functional fleets will only downgrade	Collaborations between leasing companies and OEMs/ captives may increase if adequately priced

Closely connected to economy and financial crisis

Less affected by economy and financial crisis

Source: Strategy&

By professionalizing their remarketing activities, independents can create a new strategic pillar in their business and an attractive value proposition for struggling dealers and OEMs. The biggest single remaining risk would be the failure of a major OEM, triggering major downward adjustments of residuals.

Attractive M&A opportunities: OEMs likely will further expand collaboration with independents outside their home markets, freeing up resources, reducing risks, and securing attractive lease offerings with limited subsidization requirements. At the same time, many banks would like to withdraw from the volatile leasing business to concentrate on core banking.

These potential moves by OEMs and banks, together with the expected financial difficulties of smaller or poorly rated competitors, will force consolidation. Many businesses are for sale already or will be soon, with limited buyers hampered by funding constraints and a weakened ability to manage residual risks.

In summary, well-managed independent leasing companies and selected captives are very likely to shape the corporate leasing market in the long run. However, with a focused strategy, OEMs, insurance companies, and fleet management companies will be able to secure their share of the pie.

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