

Automotive & Assembly Practice

Reimagining the auto industry's future: It's now or never

Disruptions in the auto industry will result in billions lost, with recovery years away. Yet companies that reimagine their operations will perform best in the next normal.

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Electric mobility, driverless cars, automated factories, and ridesharing—these are just a few of the major disruptions the auto industry faced even before the COVID-19 crisis. Now with travel deeply curtailed by the pandemic, and in the midst of worldwide factory closures, slumping car sales, and massive layoffs, it's natural to wonder what the “next normal” for the auto sector will look like. Over the past few months, we've seen the first indicators of this automotive future becoming visible, with the biggest industry changes yet to come.

Many of the recent developments raise concern. For instance, the COVID-19 crisis has compelled about 95 percent of all German automotive-related companies to put their workforces on short-term work during the shutdown, a scheme whereby employees are temporarily laid off and receive a substantial amount of their pay through the government. Globally, the repercussions of the COVID-19 crisis are immense and unprecedented. In fact, many auto-retail stores have remained closed for a month or more. We estimate that the top 20 OEMs in the global auto sector will see profits decline by approximately \$100 billion in 2020, a roughly six-percentage-point decrease from just two years ago. It might take years to recover from this plunge in profitability.

At the operational level, the pandemic has accelerated developments in the automotive industry that began several years ago. Many of these changes are largely positive, such as the growth of online traffic and the greater willingness of OEMs to cooperate with partners—automotive and otherwise—to address challenges. Others, however, can have negative effects, such as the tendency to focus on core activities, rather than exploring new areas. While OEMs may now be concentrating on the core to keep the lights on, the

failure to investigate other opportunities could hurt them long term.

As they navigate this crisis, automotive leaders may gain an advantage by reimagining their organizational structures and operations. Five moves can help them during this process: radically focusing on digital channels, shifting to recurring revenue streams, optimizing asset deployment, embracing zero-based budgeting, and building a resilient supply chain. One guiding principle—the need to establish a strong decision-making cadence—will also help. We believe that the window of opportunity for making these changes will permanently close in a few months—and that means the time to act is now or never.

This article illustrates winning moves and principles for automotive players, often by drawing parallels to players from other industries that have successfully navigated similar “now or never” moments and emerged stronger.

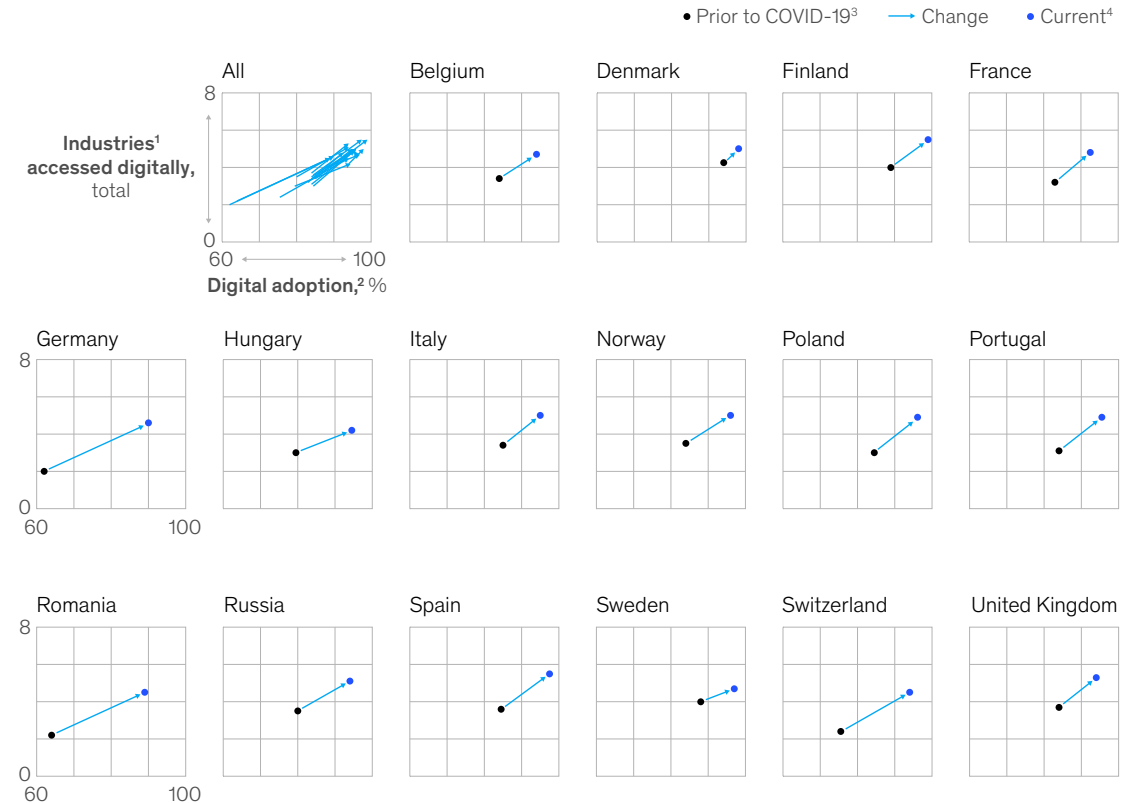
Radically focus online

Right now, more consumers than ever are using online sales channels to engage with businesses in every industry. According to a recent McKinsey digital sentiment analysis, in Europe, the use of digital channels has increased by an average of 13 percentage points (Exhibit 1). Growth in online channels is high for every country surveyed, but the biggest boost has occurred in Germany, which has seen the use of digital channels jump 28 percentage points in response to the COVID-19 crisis. Moreover, 72 percent of first-time users in Germany and 70 percent of regular users are planning to continue engaging online even after the crisis subsides. According to these metrics, having an online presence may be a game changer for businesses.

Exhibit 1

Across Europe, engagement with industries through online channels has increased by an average of 13 percentage points.

More consumers are visiting a growing number of industries online in every country surveyed.



¹Includes banking, insurance, grocery, entertainment, apparel, social media, travel, telco carriers, utilities, and public sector (for most countries).

²Users with at least one digital service in the past 6 months (January–June 2020).

³Includes industries visited digitally in 2020 prior to COVID-19.

⁴Includes industries visited digitally during the past 6 months (as of June 2020).

Source: McKinsey & Company COVID-19 Digital Sentiment Insights, June 2020

Automotive players were uncertain about using digital channels before the COVID-19 crisis hit, while companies in other industries aggressively moved ahead. Consequently, the automotive industry now lags other sectors in this area. A 2019 Digital Quotient analysis, which is a McKinsey method for evaluating an organization's overall digital maturity, revealed that the average automotive business has a clear need to digitize, with the industry earning a below-average score compared with other business-to-business (B2B) players.

Industries in general recognize that remote selling models are becoming the next normal, and some players are already preparing for that in reaction to consumer demand. In fact, according to our analysis, positive customer sentiment for digital sales interactions is now about twice that of traditional models. A recent McKinsey study shows that 96 percent of B2B companies have shifted their go-to-market models in response to the COVID-19 crisis, with 64 percent believing the new digital model is just as effective or more so than before.

One US electric-vehicle maker, with established online sales offerings and contactless test-drives, increased its sales in China by over 10 percent early in the COVID-19 crisis.

Likewise, 32 percent of B2B companies say they are very likely to continue to pursue these sales-model changes for more than a year after the crisis subsides, while another 48 percent are somewhat likely to do so.

Digital laggards in other industries have been able to quickly improve their position, and automotive players can emulate them. One clear success story from another industry involves a traditional German catalog and mail-order retail company. After experiencing increasing pressure and significant competition from online businesses and fast-fashion players, the company created a new platform as an online fashion retailer in 2014. Company leaders executed an internal shift in the business and operating models, focusing on personalized offerings, influencer marketing, and mobile-first offers. In addition, the retailer partnered with Germany's largest digital-marketing agency to guarantee successful implementation, since it realized that it might need assistance.

Traditional companies might be surprised to learn that the retailer's app drives 75 percent of its revenues. By betting on mobile, the company outperformed its former competitors and ultimately became Germany's fifth-largest online fashion retailer. Moreover, the company's digital platform has won a Shop Award from *Internet World Business* (a B2B trade journal) for four consecutive years, reflecting its status as one of Germany's best online stores.

A major US newspaper represents another digital success story. In the second quarter of 2020, it added nearly 700,000 digital subscribers, marking the best subscription growth in its history and outpacing the paid online readership of two of its peers combined. For the first time, the newspaper's second quarter revenues from digital products exceeded print revenues. Its long-term goal of attracting ten million subscribers by 2025 will be primarily driven by growing its digital subscriber base and digital content offerings, including podcasts, lifestyle offerings, and multimedia products.

Within the automotive industry, the benefits of adopting a digital strategy surfaced early in the COVID-19 crisis. In February 2020, China experienced an 80 percent decline in overall automotive sales. One US electric-vehicle (EV) maker increased its sales in China by over 10 percent, however. The company had already established online sales offerings, including a clearly structured online shop, contactless test-drives, and car home deliveries, that proved effective during the nationwide shutdown.

Shift to recurring revenue streams

Between February and March 2020, major stock indexes dropped by almost 40 percent, with the drop affecting nearly all industries and markets. Noncyclical stocks reacted with far less volatility, however, and some even grew in value.

In times when cash is scarce and uncertainty about the future abounds, customers often hesitate to make large up-front purchases. Instead, many people prefer short-term, subscription-based offers that do not tie up significant capital. Within mobility, a preference for subscription-based models is often apparent, even during good economic times, especially among younger consumers. Before the COVID-19 crisis, 34 percent of Generation Y consumers expressed a preference for rental and ridesharing products, whereas 6 percent of baby boomers shared the same sentiment. These preferences show how recurring revenue streams could become very important to automotive players. Other factors to consider when mobility players think about increasing recurring revenues include the following:

- ***On-demand mobility is on the rise.*** The COVID-19 crisis has reinforced the existing trend toward greater flexibility, as customers hesitate to commit to large-scale investments and want flexibility in a fast-changing world. To adapt, many mobility players have already repositioned their offerings to increase customer flexibility. For instance, more rental companies are offering short-term leases as an alternative to car sales, and some OEMs are doing the same.
- ***Recurring revenues create robust income streams.*** One US EV maker's current market capitalization clearly suggests what will drive the value of mobility players in the future. Traditional vehicle sales accounted for roughly \$20 billion of the company's valuation, while software upgrades and over-the-air (OTA) updates contributed more than an estimated \$25 billion. Software subscription services, which enable people to pay for programs that unlock features from heated seating to full self-driving capabilities, allow dealerships to develop an ongoing relationship with consumers while offering them additional flexibility and customization. Driven by higher multiples, low incremental costs, and changing customer behaviors, the EV player's offerings are a great match for today's markets.

Optimize asset deployment through strategic partnerships

Investments in autonomous technologies, connectivity, electrification, and shared mobility (ACES) are a challenge for automotive OEMs and suppliers alike. Given the significant resources required and the need to deliver these solutions now, it makes sense for industry players to work together instead of competing alone. After all, the limited resources of traditional OEMs must stretch even further in the COVID-19 crisis as cash-preserving measures and cost-cutting initiatives leave little room for technology investments.

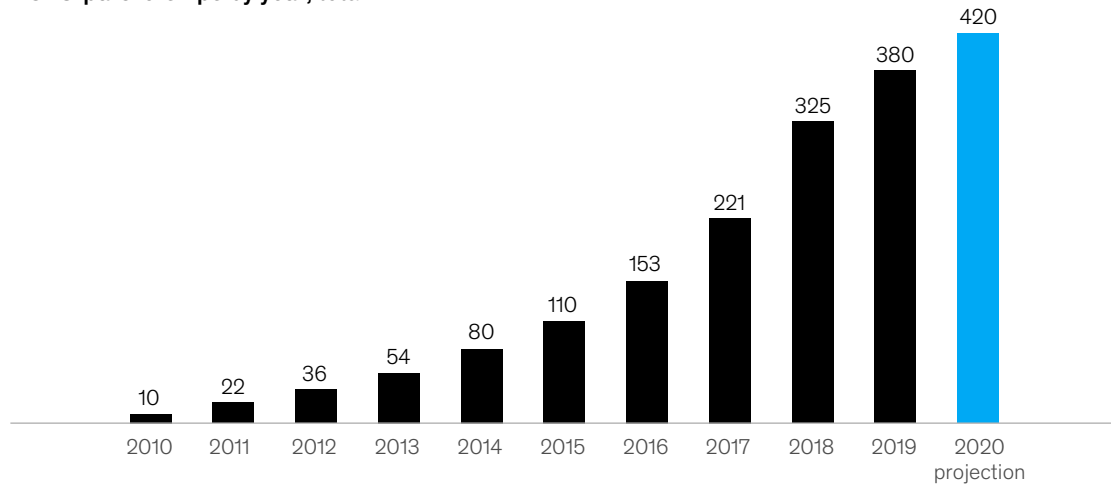
The smartphone industry offers an example of successful cooperation among peers. Beginning in 2019, two tech-giant rivals announced a deal that enabled the music- and TV-streaming services of one player to integrate with the hardware of the other. To do this, one of the companies revisited its former hardware-first approach and cooperated with third parties to boost content and revenue streams from new services. For instance, the player opened its content libraries to a competitor's virtual concierge service and collaborated with yet another company on a contact-tracing tool to combat the global pandemic. Because of these moves, the former tech rivals can now compete more successfully against several new content rivals.

Cooperation in the automotive industry needs to gain the same kind of momentum. Even before the crisis, OEMs and suppliers held long discussions about their focus and technology investments as they attempted to "future proof" their businesses. Auto-industry incumbents face rapidly growing and hugely inventive tech players—from EV makers to autonomous vehicle (AV) innovators—whose leaps and pivots are leaving their slower-moving peers in the digital dust. Their success often results from collaborations with other players, making these arrangements more popular. Over the past decade alone, the number of ACES partnerships have increased by a factor of 40 (Exhibit 2).

Exhibit 2

The past decade has seen a fortyfold increase in the number of ACES partnerships, with a heavy focus on electrification and shared mobility.

ACES¹ partnerships by year, total



¹Autonomous technologies, connectivity, electrification, and shared mobility.
Source: McKinsey Moves Database; press search

Tech players, already serious competitors before COVID-19, are now placing additional pressure on incumbent OEMs due to their strong financial standing during the global pandemic. For example, one e-commerce player set new revenue records in 2020, with top-line increases of up to 40 percent in the second quarter. It used some of those earnings to buy an AV company for nearly \$1.3 billion. Likewise, a videoconferencing player earned a market capitalization greater than those of all the airline companies combined in the first quarter of 2020, showing once again the strong performance of tech players during the crisis—and the potential for fruitful partnerships with cash-strapped OEMs.

The economic outlook for traditional OEMs will likely worsen in the post-COVID-19 world, as cash flows tighten and technology players see continuously strong revenues. Especially in a “winner-takes-all” market, going it alone in terms of investments will be a challenge. If OEMs want to stay ahead of the

innovation curve and maintain a future-oriented business, collaborating with former competitors, tech players, and investors will likely become an inescapable fact of life.

Embrace zero-based income statements

The pandemic has devastated auto-industry growth. According to the latest estimates, global car sales will decline between 20 and 30 percent in 2020. Moreover, depending on the region, it may take up to four years to recover to pre-COVID-19 levels.

While plants remain shut down, many people are in short-term jobs or working from home due to pandemic measures. With so many people working remotely, a window of opportunity has appeared to introduce a fresh way to manage a company's profit-and-loss (P&L) statement, for example through including flexible-work locations and, as a result, operating-expenditure savings through physical workplace reductions. Today's higher

degree of uncertainty calls for a shift away from an annual budget toward dynamic resource allocation. Instead of static budgets that restrict their degrees of freedom, automotive players should embrace a zero-based budgeting approach and reconstruct their income statements from scratch.

Under this plan, each business leader defines their “survival minimum” in terms of services performed and budgets needed, rather than basing needs on last year’s investments.

A zero-based approach can catalyze long-overdue changes in the automotive industry, including the consolidation of production facilities, the elimination of activities that add little value, and the radical reduction of investments in noncritical new assets. Considering the challenges imposed by the pandemic, the airline industry is currently leading the way in applying agile and zero-based budgeting approaches and reconstructing income statements. Automotive OEMs and suppliers should follow suit.

Build resilience into the supply chain

The early weeks of the COVID-19 pandemic revealed how complex yet fragile global supply chains have become. Already in February, before the outbreak arrived in Europe and the United States, a supply-induced shock caused production interruptions at many tier-one suppliers, as critical parts from China went missing.

The increasing dependence on single-country sources of supply, especially China, has grown more visible due to the crisis. If the links break, the disruptions increase. From 2000 to 2020, mainland China went from producing 5 to 30 percent of the world’s manufacturing value added.¹ We have observed that industry leaders now have an increased sense of urgency over supply-chain resilience; several manufacturers in Europe and the United States are considering suitable backups, such as local sourcing or insourcing.

Companies will need to focus on specific areas to make their supply chains more resilient after the pandemic. For instance, they should perform rigorous checks on worker health and product safety, monitoring interactions and flagging concerns. They need to instill confidence among key stakeholders, restarting operations based on data and analytics-driven demand and supply-chain transparency. Overall, organizations should not return to business as usual, but should restart with new, faster processes and tools and scaled, agile practices.

Establish a strong decision-making cadence

Experience suggests that company transformations often fail to gain the necessary traction and rigor for successful execution and implementation. Yet to thrive in the industry’s “next normal,” excelling in these dimensions is key. Three principles can maximize a company’s chance of success.

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¹ “China and the world: Inside the dynamics of a changing relationship,” July 2019, McKinsey.com.

Fast decision making lays the foundation. When comparing the decision-making speeds of companies, we noted that fast decision makers will likely achieve 95 percent higher profitability in the next normal compared with their peers. Unfortunately, many traditional OEMs are still hampered by organizational silos and a hierarchical decision-making process, which is the opposite of what is needed in a fast-moving world.

Execution discipline forms the backbone for success. High-performing companies have management teams that are very disciplined when it comes to setting targets and negotiating key performance indicators (KPIs). Once a consensus is reached, there is little need to readjust afterward. Such teams hold frequent reviews in order to pinpoint minor deviations, explain them to the CEO, and make adjustments where necessary.

Clear accountability drives success. Historically, companies that have emerged stronger from a crisis have one thing in common: they do not hesitate to act when underperforming, even letting go of their top management team if necessary. For instance, one successful automotive OEM replaced 25 percent of its top managers during its transformation, boosting its market capitalization by a factor of four and raising operating profits by approximately ten percentage points within five years.

The automotive industry has reached a fork in the road: one path leads to reinvention and success, while the other maintains the current status quo. Business leaders will only have a brief window of opportunity to reimagine their core operations. To ensure their survival and success now and in the future, it's time for automotive industry players to act.

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