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EXECUTIVE
AGENDA

IDEAS *and* INSIGHTS *for* BUSINESS LEADERS



ATKEARNEY

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Thinking Beyond 4,000 Pounds of Metal

Indego began as a piece of research that took a clean-sheet approach to the automotive value chain. It turned out to be a radical template for challenging any traditional industry structure.

Close your eyes and think of your next new car. Don't imagine the engine, chassis or tires. Don't cringe at the thought of spending time with the car dealer. Think about what you, as a car buyer, really want: Mobility. Service. Not necessarily ownership of 4,000 pounds of metal, plastic, glass and rubber. This presents a whole new way of life for the car buyer. Or car leaser. Or the I-live-in-the-city-and-I-don't-need-a-car driver.

Imagine that you never again had to worry about getting your car taxed, insured or serviced. Imagine that you could change it every year or two for a fashionable new model without worrying about residual

values or having to wrangle with a dealer. Imagine too that your car could tell you where to find the nearest parking garage, could book train tickets and could unlock and start itself if you lost your key.

This is the world of Indego, the hypothetical company invented by A.T. Kearney that could provide you with an enhanced mobility service more economically than you could imagine, and yet make more money than any other car manufacturer.

A WORLD WITHOUT CONSTRAINTS

With a few notable exceptions, shareholder returns for car companies lag behind those of other industries. The legacy of a century-old

industry has been high fixed costs in engineering, manufacturing and distribution infrastructure, a lack of flexibility in product, process and people, and overcapacity at all stages of the value chain. For many U.S. car manufacturers, this legacy means astronomical health-care costs for employees and retirees, all rolled into that 4,000 pounds of metal. General Motors, for instance, claims that health-care costs account for US\$1,400 of the costs for each car it produces.

This legacy prompts a focus on market share and intense competition for incremental sales, resulting in lower and lower profitability from the core car-making businesses.

generating high profit margins by designing a business model around what drivers really want.

Our inspiration came from other industries that had been shaken by the arrival of a new business model. Examples include the low-cost, no-frills airlines Southwest and Ryanair. These airlines don't reimburse travel agents or assign seats. They limit the aircraft types they use. They travel point to point rather than using the traditional hub-and-spoke model. And they offer limited food service or charge for it. These and many other measures keep costs low—the average Ryanair ticket costs US\$50.

*By leasing rather than selling the car,
Indego can capture the full lifetime value
of the “asset” that it has created.*

We devised the Indego project to answer a few fundamental questions. If you could reinvent the automotive industry without the existing constraints, what would it look like? What returns could it generate? Could a potential new entrant, without the burden of historical business practices, change the industry dynamics to create significant value?

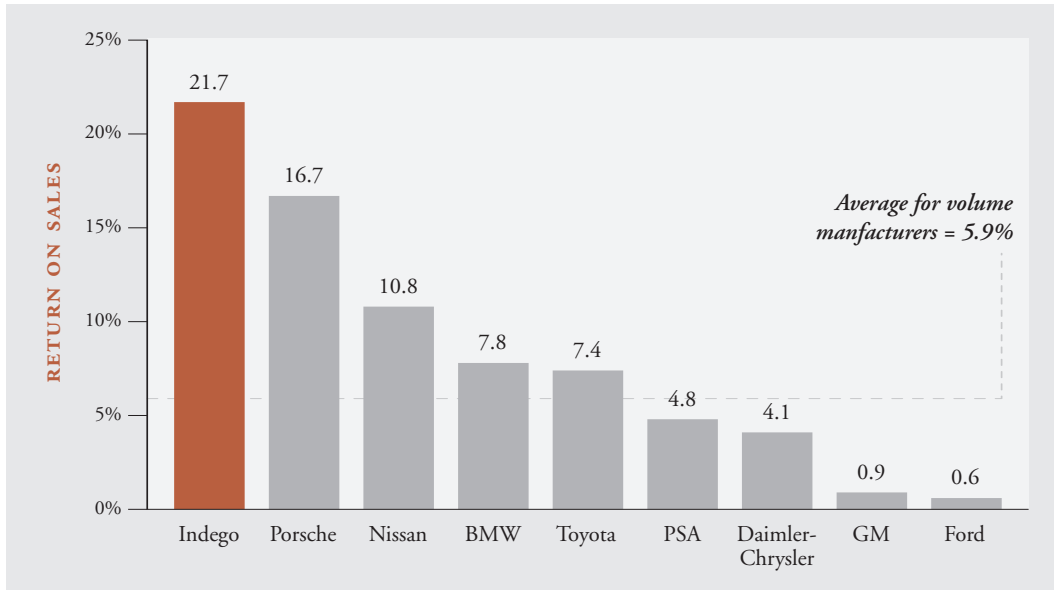
Just as the mobile virtual network operators (MVNOs) are new wireless players without a wireless network, the Indego concept can be adopted by industries that don't make cars (*see* M-Real Estate: The New Hot Property *in this issue*). We foresee start-ups without lots of cost baggage (such as retiree health-care costs) coming in and

Another illustration is Dell. The company sells direct; customers place their orders via phone or the internet with custom systems specifications. With Dell's modular designs and ultra-flexible supply chain, customers typically get their customized computers in less than five days.

In each case, the new entrant rethought what it was that the customer really valued—low costs in the airline example, customization and convenience in PCs—and then aligned its business model to directly meet those needs.

The result of these insights for Indego is a car company that does not sell any cars. Instead it meets the customers' need for flexible, reliable, low-cost mobility by

Figure: Operating Margin—Indego Versus Traditional Car Companies



Sources: Annual reports, 2002 data, and A.T. Kearney analysis

providing an all-inclusive package of premium product and services on an ongoing leasing basis for a daily fee of between US\$7 and US\$16 (US\$2,700 to US\$5,800 per year). And in the process, this “next-generation car company” generates a return on sales of around 22 percent compared with an industry average of around 6 percent (*see figure*).

NOTHING FOR SALE

By leasing rather than selling the car, Indego can capture the full lifetime value of the “asset” that it has created. This significantly closes the profitability gap traditional vehicle manufacturers encounter when they make and sell an asset that then provides revenue streams for a variety of industry players. The existing industry model generates a profit

at the vehicle’s first point of sale. That profit is often minimal, given the current overcapacity and level of competition.

The initial sale creates an opportunity for the car company to provide credit financing and eventually spare parts. However, from this point on, the vehicle manufacturer will see little residual value, with the ongoing benefits accruing to others.

The car will likely change hands several times, generating revenue for dealers on the sale and for finance houses that provide loans. The car has to be insured and maintained. It has to be repaired in the event of a crash. The owner may choose to upgrade the wheels, tires or in-car entertainment. It may be covered by a roadside-assistance contract. And it will ultimately have to be scrapped. Most of these revenues and

related profits currently flow to a broad spectrum of aftermarket players and financial institutions.

By leasing the vehicle, Indego maintains ownership and control of the asset over its entire life. Indego retains a “piece of the action,” even if separate entities ultimately provide the financing, insurance and repair services; Indego will negotiate the best deal for both its customers and its own bottom line. By capturing lifetime opportunities, Indego will generate revenues from all the cars it produces over an eight-year period—vehicles are assumed to be scrapped after eight years—even though its cost base will largely be defined by annual production capacity. In other words, a traditional car company that produces one million cars a year, with a corresponding cost structure, will only generate revenues on the initial sales of those cars over the course of the year. In the Indego model, the cost structure is set to produce 250,000 cars a year, but revenues will be generated by the two million cars owned by customers circulating on the roads. Even after adding the costs associated with servicing this large customer base, the math is still compelling.

OPERATIONAL AGILITY, NEW REVENUE SOURCES

New technology and industry developments also drive Indego’s increased profitability. Indego’s operations are largely outsourced, with digital links provided by the internet. Product development consists of a small internal core that leverages the expertise of design and engineering consultancies to

produce new, modular body styles based on a common platform every two years instead of the industry norm of six to eight years. These frequent redesigns will create excitement and support the branding and fashion appeal of the vehicles. The fashion chain Zara exemplifies this lesson. The company has been successful at rapidly bringing haute couture to high street. The focus is on rapid renewal and undersupply, thereby increasing desirability and decreasing the need to discount last year’s models to clear stock.

Suppliers will also take on more of the production responsibility for the cars’ components, with steel-body structures outsourced to low-cost countries and plastic skin panels produced close to market. Final assembly will be in small, flexible plants, in or close to national markets. Cars will be made to order, eliminating the need to carry costly inventory.

The increased ability of automotive suppliers to design and manufacture large parts has been driven by carmakers’ acceptance that they cannot manage the increasing complexity of each and every element within their vehicles. With the increasing number of niche models—for example, compacts, midsize, convertibles, minivans and SUVs—some suppliers are even taking on responsibility for the engineering and manufacture of entire models, another industry development that enables Indego’s model.

A traditional dealer network is not required. Test drives will be organized via a network of daily rental outlets that will also provide a pool of courtesy cars for service needs. Customers place orders over the

internet, and the cars will be delivered to their doors. Service intervals will coincide with lease-end refurbishments.

By outsourcing most of the design, manufacturing and distribution, Indego's cost base contains a high variable-to-fixed-cost ratio, protecting it from the industry's cycles.

Ongoing and continuous customer contact is a critical element of the Indego business model and also a source of additional revenue. Onboard telemetry will enable customer contact. A call center will continuously monitor the cars' use and provide customers with traffic alerts, navigation advice, roadside assistance, directions to the

We believe the investment required is around US\$2 billion over four years, so it is unlikely that a true start-up will enter this new mobility industry. But some large, non-automotive companies could follow the Indego route to leverage their brands, consumer base, technology expertise and financial strength. GE, for example, could leverage its financial services, Microsoft its IT skills, and Wal-Mart its infrastructure. Both Microsoft and Wal-Mart are under pressure to grow into areas that will not run afoul of antitrust regulators or hostile communities. Another likelihood is that a number of parties working together could

By remaining close to customers and capturing their information, Indego will be able to build accurate customer profiles and a clear understanding of its customers' needs.

nearest Chinese restaurant or music and video downloads—all of which would provide additional sources of revenue. By remaining close to customers and continually capturing their information, Indego will be able to build accurate customer profiles and a clear understanding of its customers' needs. This in turn will drive the creation of additional services and enable a seamless migration of the customer from one service or product to the next—once an Indego customer, always an Indego customer.

A HOME BASE FOR THE INDEGO CONCEPT

The implications of the Indego model are far-reaching for the automotive industry.

reduce the initial investment. For instance, a consumer brand could partner with a financial services provider and an automotive supplier.

The existing automotive OEMs, encumbered by the structural legacies of the industry, could not transform overnight into an Indego-style player, but they could adopt elements of the model or work toward them over time. Possibilities include teaming up with dealers to jointly capture more of the life-cycle revenues or accelerating the adoption of lean and flexible engineering and manufacturing. Emerging carmakers from India and China might also adopt some of the concepts when expanding into new Western markets.

RETHINKING AN INDUSTRY

The concepts explored in the Indego research are relevant to just about any other well-established industry, and can be synthesized into six key principles. These can be applied when you consider how to take your company into a new industry model—but they can also be used by a new entrant attacking your business.

1. Take the best from other industries.

Indego takes many best practices from other industries, including the way retail companies (think Tesco) capture and leverage customer information, and how PC companies (think Dell) manage a flexible supply chain. Collaboration between companies could also facilitate cross-industry learning, such as Ericsson turning to Sony when mobile phones moved from being a communications device to a consumer electronics product.

2. Capture lifetime revenue streams.

The major driver of increased profitability for Indego is the change from sale to lease. The aerospace industry often adopts automotive concepts, but Pratt & Whitney was a pacesetter in capturing lifetime revenues from its jet engines with its “power by the hour” concept. Instead of focusing on a single sale, it locked in the lifetime service, repair and spares revenues, while at the same time offering customers a flexible, variable cost. Pratt & Whitney was also able to directly gather information about the use and performance of its engines, information that was previously captured by airline engineers.

3. Create adjacent revenue streams from products and services. Indego requires

an increased emphasis on customer handling, which requires providing additional services. For example, the old Radio Rentals business understood that one of its core competencies was its delivery and repair workforce. It leveraged its in-home repair skills to expand its market to repairing many types of electronics and providing additional services. This required a workforce with a combination of logistics, electronics and customer interaction skills. National Car Parks provides another example. When faced with a potential reduction in cars entering central London due to the city’s congestion charge, the company expanded its parking services, posting parking attendants out on the streets and setting up out-of-town park-and-ride facilities.

4. Capture and exploit customer information.

In a business model focused on lifetime revenues and adjacent services, “know your customers” is not a cliché. The telemetry technology used in the Indego model is just one way of capturing customer information. Another method is loyalty cards, popular with retailers and airlines. Such tools help businesses create a detailed picture of customer behaviors that can be exploited to meet the needs of increasingly well-defined segments.

5. Periodically assess the impact of technological innovations.


Be alert to the strategic impact of new technologies. The Indego concept would not have been possible five years ago—a different, technology-enabled model could well appear within the next five years. When Jack Welch embraced the internet at GE with his “destroyyour-

business.com” initiative, he established a new way of thinking that should be applied to every major technological innovation.

6. Guard against future legacy. Legacy costs for the three big North American car manufacturers—Ford, GM and Daimler-Chrysler—are structural disadvantages compared with the recent Japanese transplants. In addition to high pension and health-care costs, the North American companies must also work with inflexible labor contracts and obsolete plants. Even the low-cost airlines, which began not long ago with a clean sheet, are starting to develop a legacy as one-model fleets become complicated with various aircraft types that require different servicing, training and spare parts. The Indego model

deliberately sets out to create a sustainable agility with limited future legacy by having a highly variable cost structure, leveraging outsourcing partners, and applying modular concepts in both the design of the company and its products.

WHAT ARE WE WAITING FOR?

These six principles could be applied to any industry, either by incumbents wishing to protect and grow their market share, or by new entrants looking to develop a new model to challenge the existing industry structure. Indego’s message is that all industries are at risk from an agile new entrant with a radical business model. If you are an inflexible incumbent, watch out. 

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