HOW TO AVOID THE AUTO INDUSTRY'S LOOMING PRICE WAR

By Karen Lellouche Tordjman, Jonas Stein, Szymon Walus, David Langkamp, and Nicolas Manuelli

As a result of the COVID-19 crisis, the automotive industry faces a collapse in sales volume of at least 20% in 2020 as stay-at-home decrees prevent customers from traveling and keep factories shuttered. That predicted decline is above and beyond the annual decline of 3% that the industry has experienced since 2018. Website visits, one gauge of consumer interest, have fallen more sharply for the automotive industry than for most other industries, with weekly visits down in hard-hit countries—including France, Italy, and Spain—by as much as 68% since late January.

The full extent of this unprecedented plunge in demand will depend on the duration of stay-at-home decrees, on whether a second wave of COVID-19 infections ensues later this year, and on governments' responses to the crisis. Ultimately, however, the actions of the OEMs themselves, both now and during the pending recovery, will have the greatest impact on their market positions and financial performance when the pandemic has receded.

OEMs need to take immediate steps to look after their employees, manage their manufacturing, and stabilize their supply chains. And they face critical marketing decisions as well. But the overarching challenge for automotive OEMs is to control their discounts and avoid price wars. Overcoming those challenges will allow them to safeguard their margins, weather the crisis, and prepare for the industry's recovery.

Key Challenges for Automotive OEMs

If OEMs are too aggressive in their efforts to stimulate demand, they could cripple their pricing power for years to come. That's what happened in the long growth phase that followed the global financial crisis of 2008. In an effort to stimulate demand in the winter of 2009, OEMs sharply increased their average discount per vehicle, a move that proved costly in the long run. From 2009 to 2019, new-car prices were several percentage points below their historical trend line, reflecting a structural break that resulted in persistently lower margins for the OEMs.

In light of that lesson, the objective for recovery after the novel coronavirus outbreak is to reestablish OEMs' market positions without slashing prices, and thus sacrificing margins, in the process. A disciplined commitment to controlling discounts and avoiding price wars will help OEMs address the other significant challenges they face, including how to:

- **Manage stocks of used and new cars.** Right now, production and demand are trending to zero in major markets. Nonetheless, a significant amount of available inventory sits in storage or on dealers' lots, and an expected increase in leasing terminations will add to the existing glut of used cars. As long as supply exceeds demand, OEMs will need to define a strategy to reduce this inventory without relying on deep discounts.

- **Adapt to rapid changes in markets.** Because COVID-19 is a global crisis, the car market will not experience one episode of recovery but rather several episodes, of various intensities, staggered across markets. The timing, shape, and magnitude of the upturns are anything but certain. Nor is it clear which of the major markets—China, the European Union (EU), or the US—will recover first or fastest. In mid-April, Germany announced plans to allow car dealerships to reopen, while at the same time, early signs of recovery emerged in China. OEMs need to watch trends in their key markets carefully and remain very agile regarding what vehicles they produce, so that they can pivot when necessary.

- **Manage new-model launches.** The original volume targets for many OEMs, beginning in 2020, hinged on the success of new-model launches—but then along came the COVID-19 crisis. OEMs could revive those launch plans and stick as closely to the original pricing targets as possible. (Underpricing a new vehicle in the short term might seem like a good way to jump-start a launch, but it would have detrimental effects over the new vehicle's life cycle.) But that's a best-case scenario. More realistically, OEMs may delay launches and focus instead on managing the ends of older models' life cycles.

- **Limit CO_2 emissions penalties in Europe.** The crisis will render many OEMs unable to comply with new, stricter CO_2 emissions requirements in the EU. According to an IHS Markit study released on March 19, an estimated 60% of OEMs will fall short of those targets and face up to €20 billion in penalties, unless policymakers offer some relief. Regardless of any actions that governments may take, OEMs should use incentives to steer customers toward vehicles and option configurations with lower emissions to improve compliance with the guidelines.

- **Adapt to new customer behaviors.** After the pandemic has subsided, we expect to see changes in consumer behavior that will accelerate the ongoing transformation in the industry. Lower consumer confidence and lower incomes may shift demand to smaller vehicles, as initially happened in the US after the global financial crisis. At the same time, the expected recovery will create an opportunity for OEMs to make an even stronger commitment to online direct-to-consumer (D2C) engagement and sales, sales on a subscription basis, and innovative mobility solutions. Each will require new pricing models.

Immediate Steps

The tactics to address each of these challenges, as well as their timing, will vary from market to market. But the challenges themselves are global, and we recommend that OEMs take several immediate emergency measures to develop the resilience and discipline needed for effective crisis management.

The first priority is to create a pricing task force. Operating in a virtual war room, this global, multifunctional team—which should include members from the pricing, commercial, production, and distribution functions—will be responsible for implementing clearer and tighter pricing governance throughout the organization. Because the team will have both a holistic view and discrete local views of how demand is evolving across markets and segments, it will be able to vigilantly monitor pricing in order to prevent unnecessary margin losses caused by overly aggressive discounts or undercharging for additional services.

OEMs will then need to quickly implement a set of actions to unlock demand in a very challenging environment. Many OEMs have already rolled out such measures, such as large payment deferment programs for customers to alleviate their financial burdens. Some have also launched innovative remote commercial-negotiations services designed to overcome lockdown restrictions and enable sales.

The other immediate priority for OEMs is to avoid a price war. Tighter control over discounts will be necessary to maintain price levels. In addition to avoiding unnecessary discounts, OEMs should also strive to innovate their discount structures by offering upsell, cross-sell, or free services instead of using cash as an incentive. Partnering with sales finance companies to fund customer purchases will also be an effective way to manage visual pricing without compromising margins.

Respond and Recover

Once OEMs have implemented these emergency measures, they will enter the response phase. But before taking the first step, they will need to have a good sense of real-time market dynamics and a solid forecast of how those dynamics will evolve. Because the COVID-19 crisis has rendered existing forecasting tools obsolete, OEMs should focus their efforts on identifying new sets of data, such as web traffic and consumer sentiment analysis, taking advantage of what they learn from markets further along in the recovery curve. They should then build a dedicated market analysis and prediction tool to analyze the new data.

The first step of the response phase is to figure out how to manage the existing inventory. If dealers yield to the temptation to destock as quickly as possible, they will damage vehicle margins significantly and perhaps permanently; dangerously low anchor prices can linger long after markets recover. OEMs can help their dealers to resist that temptation through direct incentives to limit discounts, updated financing programs, and buyback programs that allow an OEM to reallocate vehicles to markets with higher demand. A last-resort measure to avoid damaging new-vehicle price levels would be to adopt an inventory registration strategy and sell new vehicles as used. If an OEM is compelled to adopt this strategy, it should prioritize the registration of low-emission vehicles and optimize compliance with CO_2 emission regulations.

Demand can reemerge quickly, and in unexpected ways, as markets overcome the pandemic and begin to recover. The best way for OEMs to meet that demand is to continuously adjust the allocation of vehicles as well as the form and amount of customer incentives and discounts. OEMs need to remain very flexible with regard to the types of vehicles they produce, and they should carefully watch the trends in key markets so that they can pivot accordingly.

Agility in discounts and incentives, allocation, flexible production, and demand-based vehicle reallocation are no longer aspirations for automotive OEMs—they are now mandates. OEMs will need to harness their advanced-analytics capabilities to recalibrate their existing models and assumptions as fresh buying patterns emerge. Ideally, they will establish guidelines to optimize volumes and margins on a weekly basis, always keeping emissions targets in mind.

OEMs should also expect their after-sales revenue streams to be more resilient than they were before the crisis and act accordingly. For example, if customers want to maintain their current vehicles longer and postpone new purchases, OEMs can reassess their after-sales pricing strategies and craft packages to help maximize revenues. Such packages could include either traditional bundles or innovative packages and pricing models, such as retrofit connected services.

As they define their response measures, OEMs should closely collaborate with their dealer networks and ensure alignment. Dealers will bear the ultimate responsibility for implementation and need to be brought onboard and supported on each measure. This will be crucial to maximize the effectiveness of the OEMs' response plans.

OEMs will then need to develop a battle plan for the recovery. They will need to anticipate the competitive landscape and how their competitors will respond to the crisis. The threat of a price war is a tinderbox that will ignite with only one spark. OEMs will need to reduce that threat creatively.

The Role of Advanced Analytics

If there were ever a time for OEMs to make a clean break with traditional marketing practices—such as steep price cuts and large, blanket customer incentive programs—this is it. Advanced analytics will help automakers carefully define a pricing strategy that balances the need for selective price aggressiveness with the objective of preserving margins. By collecting rich data and adapting models in light of the crisis and of changes in consumer behaviors, OEMs can fully understand the impacts that pricing levers produce. Price elasticities at a micro level will enable them to model demand by segment and to define appropriate discount levels, taking into account willingness to pay, competition, price sensitivity, and customer lifetime value.

Advanced analytics will also enable OEMs to identify where incentives have strong leverage and where they have little or no impact on a purchase decision. The allocation of incentives should take profitability and CO_2 emissions into account and drive the most beneficial and effective outcome for an automaker beyond the traditional primary objective of boosting volumes. The insights from advanced analytics can help an OEM to differentiate its incentives and approach the right customer with the right discount, rebate, or promotion.

The Role of Innovative Business Models

With recovery in view, OEMs have a compelling opportunity to look at new ways of doing business. The COVID-19 crisis will likely reinforce two trends that were emerging before the pandemic began. The first is the growth of the e-commerce channel and D2C relationships. The second is the demand for innovative mobility models, such as subscriptions and usage-based pricing. Both models will require OEMs to build up the depth and richness of their online interactions with both current and potential customers.

Growing and optimizing D2C sales presents a new pricing challenge, given that the traditional OEM selling model of dealers negotiating prices with customers is no longer feasible. An online transaction may limit the scope of negotiations and require a different set of incentives. The subscription models, stretching beyond vehicle subscriptions to include carpooling and ridesharing, will require OEMs to rethink current pricing models and make adjustments throughout the entire value chain.

The effects of the COVID-19 crisis on the automotive industry have been severe and sudden. Not surprisingly, therefore, the road to recovery will be steep and arduous. Two factors will determine how well the OEMs can thrive in such an environment. First, they will need to be more responsive than ever, in terms of recognizing patterns and defining and implementing responses. Second, they will need to be very agile and iterative in the way they define their responses if they want to quickly adapt to rapid market changes and succeed in the recovery. There will be no one right answer for how OEMs can avoid price wars as the recoveries unfold around the world.

About the Authors

Karen Lellouche Tordjman is a managing director and partner in the Mexico City and Paris offices of Boston Consulting Group. You may reach her by email at lellouche.karen@bcg.com.

Jonas Stein is a managing director and partner in the firm's Hamburg office. You may reach him by email at stein.jonas@bcg.com.

Szymon Walus is a partner and associate director, automotive, in BCG's Paris office. You may reach him by email at walus.szymon@bcg.com.

David Langkamp is a partner in the firm's Hamburg office. You may reach him by email at langkamp.david@bcg.com.

Nicolas Manuelli is a principal in BCG's Paris office. You may reach him by email at manuelli.nicolas@bcg.com.

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