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A virtuous cycle for top-line growth

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New data and better coordination can create value in the sales channel.

The CEO of an auto manufacturer was puzzled that its market share had been slipping for three years. The quality of its products was high, and it had made big strides in operational efficiency. But as one director had chided at the previous board meeting, "the sides of our sandbox are starting to pinch."

The CEO commissioned a report on one seemingly comparable competitor whose market share and margins had been steadily increasing. He discovered that it had unusually high loyalty rates and much lower marketing expenditures. A point of leverage seemed to be the way it was accessing revenues beyond the first sale. The vehicles its customers were turning in after their leases expired, for example, held their value better than his company's did, and these higher residuals made customers more likely to sign up for new products. Service and parts revenues were higher, too.

The CEO immediately challenged his top team to look across the value chain and duplicate what he saw as the competitor's virtuous asset cycle. The team responded by going deeper, identifying a surprising list of data sources, many unexploited by the company. One swath related to customers. These included the prices they had paid for their current and former vehicles, the incomes and personal assets of current and would-be customers, the leasing offers they had found attractive, their responses to promotions, their preferences about product features, how they became aware of an

OEM's brand as they navigated among competing product offers, and how service agreements tended to affect repeat business. Cars and related parts created a separate and equally rich data trail, including the value of a vehicle at resale, conditions of use, maintenance history (increasingly in real time), and disposal value.

Combining data on customers and products showed the OEM where and when it could improve coordination in the channel to create and distribute economic value to its customers and dealers. That would in turn significantly boost its own revenue growth and cut its expenses. Our research and work with OEMs in diverse industries show that by rethinking their sales-channel practices, nearly all of them can increase their operating margins by 15 to 25 percent.

At issue is a strategic challenge that has in various forms tested OEMs for years, not just in autos, but also in heavy construction, medical equipment, aircraft, farm machinery, IT, and other gear with a long asset life: how to increase returns on products requiring heavy up-front investments in product development, marketing, and distribution. Thanks to a new data-enabled transparency that helps OEMs see what happens to such assets over their full working lives, across a continuum of owners, these companies can now shed new light on the behavior and economics of customers and wholesalers throughout the sales channel. Many OEMs, of course, already generate additional revenues from parts sales and service contracts. But even such companies can benefit by becoming more disciplined in their use of new data sources and by addressing tricky coordination issues across financing units and dealership networks as products travel from initial sale to resale and, ultimately, to disposal.

What's holding OEMs back?

It's surprising, well into the digital age, how few manufacturers respond to intensifying competitive pressures as customers steep themselves in information and become more fickle.[1] New entrants are using fresh sources of data to offer maintenance, parts, and resale services and to capture segments of the value chain for themselves.

[1] See Martin Hirt and Paul Willmott, "Strategic principles for competing in the digital age," *McKinsey Quarterly*, May 2014, mckinsey.com.

While their prospects for ultimate success may still be unclear, new business models, such as those of urban car-sharing services Zipcar and car2go, are using apps to mine alternative revenues from automobile assets. More broadly, the Internet of Things—in which sensors embedded in physical objects (such as drilling equipment, wind turbines, and automated teller machines) allow the precise metering of their use—is making possible alternative pricing strategies.

Despite these pressures, OEM channel management has remained mostly fragmented. In the continuing rush to sell new products, companies overlook opportunities to increase margins and attract new customer segments—for instance, by bundling financing and service plans. One OEM's experience typifies how a life-cycle mind-set is missing. This OEM lacks even a centralized, shareable database of the buyers of its new or used products, let alone embedded sensors in its equipment. Sales reps have long pointed out that a customer's size is often the determining factor in its choice of new versus used equipment, as well as the type of financing it wants or its appetite for service programs. But without the relevant information, the OEM has consistently overspent on missteps such as product promotions.

Other OEMs, meanwhile, run their financing operations as silos—like third-party banks—and therefore often leave money on the table. Take, for example, the heavy-equipment maker whose reputation for strong products is the envy of competitors. Nonetheless, its dealers often complain that they are not aware when customer leases and lending packages are winding down and that they have little time to prepare sales strategies for new purchases or to recapture used equipment for resale. Better data on the resale intentions of the customers of these distributors, something they could acquire through better coordination with the equipment maker's finance arm, might allow them to create and offer service contracts that lock in loyalty with higher repurchase offers. When such programs are well run, according to our data, they can also increase an OEM's sales of parts by 35 percent and nearly double margins on parts and service.

Many OEMs also fail to capture revenue from equipment and parts that can be reconditioned and cycled back into manufacturing supply chains at the end of their lives—particularly when they've

been designed for reusability in the first place. Such practices, like those at automaker Renault, can help companies meet regulatory demands for the reuse of industrial products.[2]

Principles for a new operating model

Rethinking the fundamentals of sales-channel practices and organizations will take determined leadership with an appetite for cultural change. Our experience points to three areas where greater coordination and more aggressive use of information can differentiate strategy.

Managing and monitoring customers and value along the asset life cycle

More robust data can create better-defined customer segments, which OEMs can use to target activities along asset life cycles. One truck manufacturer, for instance, first divided its customers among four revenue segments. Digging more deeply into the data, it found that customers in each category had a markedly different likelihood of buying new rather than used equipment. That led them to make different financing choices—lease, loans, cash—and different demands for service agreements. The new segmentation allowed the OEM to create dozens of new combinations of offerings.

Not surprisingly, many customers base decisions about how much they are willing to pay for new equipment on what it will be worth at resale. Analyzing data on equipment use and maintenance histories provides a fact base for more accurately predicting residual values and new parameters for structuring maintenance agreements. To bolster the strength of the brand, advertising campaigns can highlight higher resale values. Furthermore, effective management of residual values should increase the flexibility of lease pricing, since less value erodes over the term of a lease, as we will see in a case study below. Higher resale values improve a dealer's margins, and our data show that an optimal mix of new- and used-equipment

[2] For more about the circular economy and Renault, see Hanh Nguyen, Martin Stuchtey, and Markus Zils, "Remaking the industrial economy," *McKinsey Quarterly*, February 2014, on mckinsey.com.

sales can buffer earnings during economic down cycles. At one truck manufacturer, for instance, sales of used vehicles rose by 60 percent between 2007 and 2010, compensating for a 30 percent decline in new-vehicle sales.

Increasing the influence of finance units

Financing packages, which influence decisions at the point of sale, can streamline the customer's purchase experience and make companies more willing to meet competing offers. Most significantly, captive finance arms, particularly those that are tightly aligned with sales and service units, are the one part of an OEM that has continuing points of contact with customers. These units can be the glue that maintains their loyalty, targeting them with new offers for equipment at key touchpoints on the decision journey and creating incentives for accelerated equipment buybacks that speed up sales cycles. Our research shows that loyalty to OEMs increases substantially when customers use a captive finance unit—70 percent of them sign up for repeat business. We have also found that well-integrated captive units contribute twice as much to operating margins as stand-alone units do.

Aligning dealers' roles with strategy

Many customer interactions also take place at dealerships, so dealers need information and financial tools to develop a life-cycle approach. With the right information, they and the OEM have a shared view of the entire installed asset base. This shared transparency can itself improve coordination between OEMs and dealers as both look to increase margins by expanding brand reach—for example, with sales of used equipment to new customers. The promotion and management of certified-used-equipment programs increases parts and service revenues. Cross-dealer information allows OEMs to better manage inventories of new and used equipment across dealer networks, maximizing sales for both dealers and OEMs while lowering their capital costs. This approach supports higher residual values by making it less likely for equipment to end up at auction, where its resale value is typically lower.

Two case studies

Two examples—one from a carmaker, the other from a heavy-equipment OEM—show how these principles create value for all the participants in the sales channel, from the OEM down to the end user.

An automaker establishes a virtuous cycle

The management of residual values was a key element of a complete rethink of the sales-channel strategy of one automotive OEM. After initiating a certified-vehicle program with a small group of dealers, the company monitored its resale-value data closely and found that the results far exceeded expectations. It marshaled the new data and experience to expand the program rapidly across its dealer network, allowing it to build an even more comprehensive database on resale prices, vehicle use, and customer behavior.

The OEM and its dealers found that the higher-than-expected residual value gave them a significant pricing opportunity for new cars (Exhibit 1). Armed with the knowledge that resale values were averaging 60 to 65 percent of invoice prices—compared with 50 to 55 percent at competitors—the OEM and its dealers could reduce both the customers' down payments at signing and monthly leases by as much as 10 percent. The OEM found it could actually increase list prices and still undercut competitors on total costs to customers, taking into account the higher value achieved on resale.

Higher margins allowed the company to offer free maintenance during the first few years of ownership. That further supported residual values, since the used cars coming in were on average of higher quality, having been better maintained by the dealers. Working with finance teams, the company also devised market-beating cash incentives for early lease terminations and vehicle buybacks as a way to sell new vehicles, thus increasing customer loyalty to the brand and building a higher-quality used inventory to improve the profitability of the dealer network. Greater leasing leverage also helped the OEM upsell additional options and option bundles, from entertainment systems to richer interiors, netting additional dollars per vehicle, though monthly payments were still below those of competitors.

Other evidence indicated that the company's approach was successfully changing behavior among target consumers. The share

Exhibit 1

One automotive player has been an industry leader in implementing the virtuous cycle.

Customer management and pricing

Has higher levels of conversion from dealer visits to purchases

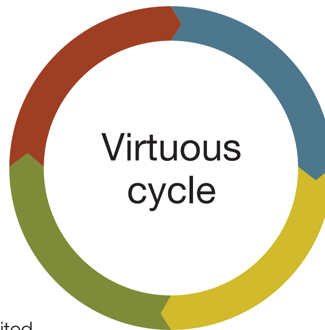
Prices its products 8–10% higher than those of competitors because its brand equity is stronger

Financing and service offerings

Leverages leases to raise sales volumes and upsell customers

Advertises residual value (eg, resale) of 60–65% vs competitors' 50–55%, making payments more affordable

Captive finance arm able to customize marketing offers



Residual-value management

Offers free maintenance for a limited time—competitors' total cost of ownership (TCO) tends to be higher

Actively manages certified used business; competitors do not

Dealer alignment and incentives

Dealer margin is higher because of higher average revenue per car

Dealer receives higher margins through parts and services

Source: McKinsey analysis

of leases as a percentage of the total sales base grew rapidly—from less than 50 percent to almost 70 percent within a few years. The better-equipped cars also enabled the OEM to raise average invoice prices by almost 10 to 15 percent over the same period for the same models.

Dealers, meanwhile, had incentives to attract more vehicles for certification and resale. Nearly two-thirds of the customers returned their vehicles, exceeding the industry average. That closer relationship has also paid off in higher growth rates for the parts and service businesses and in market-share gains. Finally, it helped the OEM and its dealers to navigate the financial crisis more successfully, since the certified used vehicles cushioned some of the drop in sales for new ones.

Establishing a virtuous cycle has also helped the OEM increase loyalty to its brand by almost a third, which further supports profitable growth thanks to lower customer-acquisition costs.

An equipment manufacturer maximizes the virtuous cycle's impact through smarter financing

A captive finance arm at one heavy-equipment manufacturer served as a market and customer-research and -information hub. The finance unit tracked residual values and analyzed customer profiles, thereby allowing the OEM to vary its leasing and other financial offers by type of customer segment. This "cascading" approach (Exhibit 2) allowed the OEM to plan multiple deals for the same asset—usually one for new equipment and two to three for later resale of used equipment—according to the preferences of customers. This not only increased the profitability of each of these

Exhibit 2

In practice, the virtuous cycle is best implemented through a cascading approach to sales.

Example of heavy-equipment manufacturer (OEM)

		OEM's and channel partners' sales approach		
Equipment cycle	**Buyer-segment needs**	**2008**	**2011**	**2013**
N	Values uptime and financial flexibility	**Customer A:** Leases new equipment in 2008 ►	**Customer A:** Returns original equipment at end of term Leases another new equipment offering in 2011 ► ▼	**Customer A:** Returns 2011 equipment early, terminates lease, and leases another new equipment offering in 2013 ▼
N+1	Values reliable equipment at a fair price		**Customer B:** Buys certified pre-owned (CPO) equipment returned by Customer A Opts for extended warranty and for financing ►	**Customer B:** Trades in old CPO equipment Buys "new" CPO with warranty and financing ▼
N+2	Price sensitive, but still needs decent reliability			**Customer C:** Buys used equipment owned by Customer B with warranty and financing

Source: McKinsey analysis

sales transactions but also helped the OEM to plan inventory and supply more effectively.

Further, as a result of the new survey data showing that customers would be more likely to purchase maintenance contracts if the availability of credit was expanded, the company began offering extended financing packages to cover the cost of parts and service. The finance unit also suggested that the OEM guarantee the residual value of its equipment in some select cases, to reduce the perceived risk of owning new gear.

In addition, the finance unit's market research also found that some segments in the company's customer base were willing to pay a premium for guarantees of equipment uptime. The OEM now writes these guarantees into some sales agreements for new equipment, while used-equipment customers signing on for certified programs get powertrain warranties. Furthermore, the company also created a rental unit when it learned that it was missing a segment of customers with only an occasional need for equipment—a segment that overlapped in part with current owners.

The finance arm also runs a newly acquired auction-services unit that helps manage used equipment and thereby bolsters the market strength of the OEM's far-flung garage and field-service network. In exchange for agreements to buy equipment back at guaranteed prices, the auction unit mandates maintenance by company-trained technicians—helping to maintain a cadre of highly skilled personnel. Overall, these efforts have contributed to the OEM's revenue growth, which is multiple times the industry average.

Pushing the organization forward

Supporting the channel collaboration necessary to create and capture value will typically require specific process steps by OEMs, as well as a rethink of their incentive structures and use of IT. In most cases, it will suffice to have a small team to promote and support deeper cooperation and teamwork among key sales-channels players—for instance, product development, parts, service, finance, and dealer networks. This team can also forge important links to relevant corporate functions within the OEM. Three areas of focus are particularly useful as these small teams get started.

Map the product's journey

To begin, sales and marketing leaders should identify the broad range of opportunities for influencing and strengthening engagement with channel partners and customers. It's especially useful for an OEM to map the journey its products make as they travel from "cradle to grave"—and to combine this with better data on customer experiences. Six months before the lease packages of one OEM expire, for example, it uses data on customers to begin guiding them to a cascade of choices around the resale, refinancing, or disposition of products at each of the key points in the asset journey. The goal is to maximize loyalty to the OEM's brand.

The same piece of equipment, for instance, may be deployed for different purposes, depending on whether it is used or new as one farm-equipment OEM discovered after sales-trend analysis revealed that customers employed new machines primarily to harvest sugar and used ones to harvest other agricultural products. Understanding those differences allowed product designers to give a new generation of equipment features that made it more attractive to grain farmers during its second life.

Change organizational incentives

New cooperative models won't take root if P&Ls for financing, service, and sales of new or used equipment are siloed within the OEM. Most organizations will need to reconfigure performance metrics to span asset life cycles, upending traditional practices that reward increased sales volumes or margins at individual units. We've found that giving a senior executive ownership throughout the life cycle provides that person with the necessary overview of the whole journey, improves cross-channel coordination, and realigns discordant incentive programs. This does not mean that a massive reorganization is needed right away. Cross-functional teams with dynamic senior leadership and sponsors can move the needle significantly in the early stages. Retooling the IT behind performance systems is another critical step in the quest to harness the profitable growth benefits of the virtuous cycle.

Use IT to empower channel partners

Channel partners often lack technology that can fast-track new practices. One OEM has tackled the tech gap with a systems application that links dealer inventories. That has paid dividends in

two ways: by lowering inventory investments and by enabling local sales teams to close deals more quickly when stocks are low and customers urgently need equipment.

Better IT tools also allow dealers to monitor equipment and alert customers to take action. A sophisticated product-support team at one OEM assembled data on every installed piece of gear and created an easy-to-use app for dealers, who now communicate with customers when maintenance deadlines are approaching. Next-generation sensors have steadily automated data gathering, so dealers have a minute-by-minute read on equipment use and maintenance needs.

It's a truism that B2B businesses, as compared with their B2C counterparts, are in a better position to know and predict the behavior and decision processes of their channel partners and end users. But new data sources, combined with advanced analytics, suggest that there is no room for complacency. As novel customer and market information shines a new light on the channel and on the economics and actions of customers within it, OEMs are discovering that they can intervene to shape and coordinate behavior and to enhance profitable top-line revenue growth and shareholder value significantly. They are realizing that they're no longer just in the business of selling new vehicles and equipment. As they establish a virtuous cycle, they are instead maximizing economic value over the lives of the assets they sell.

Through the virtuous cycle, the leaders are establishing a new paradigm by moving from selling equipment to treating each unit as an asset whose economic value should be maximized.

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