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CONNECTED AUTOMOTIVE ECONOMICS: A NEW APPROACH FOR OEM PRICING PRACTICES

INDUSTRY INSIGHTS | AUTOMOTIVE

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EXECUTIVE SUMMARY:

The automotive industry is experiencing a quiet evolutionary change in the value proposition of the automobile to its owners, and it is being driven by the emergence of connected vehicle services. Historically, automobiles—like other types of mechanical devices—have their greatest value to the owner when they are new. Vehicles decline in value as they age and are used. However, connected vehicle services are different. Connected vehicle services actually grow in value to the owner over the lifetime of the vehicle. The real value proposition of connected vehicle services to the owner is the portfolio of information services that can be accessed through the connected vehicle. The portfolio of services grows as more vehicles are added to the network. As the owner consumes more of the services, additional services tend to be offered.

In short, the economics of value consumption for connected services stands in sharp contrast to the economics of the vehicle itself. Vehicle value diminishes with use over time, while connected services increase in value over time. There is no additional value of a sunroof to any individual owner if more people buy a vehicle model with a sunroof. There is definitely more value of the connected services to each existing owner as more new owners join the connected network and consume services.

The pricing implications of the inverse consumption models are dramatic. Traditional vehicle pricing of physical features appropriately prescribes that maximum price should be charged at the time of purchase as, over time, the value of the feature approaches zero. Connected-services pricing should start at near zero at time of purchase. In fact, we found in a recent consumer research study conducted in 2013, that auto buyers are starting to reject subscription pricing models that charge for connected vehicle services in advance of consumers receiving their full benefit. We predict that ultimately the industry will adopt pricing models that are aligned to the real economics of being connected. However, those manufacturers that lag behind may ultimately suffer a competitive decline that impacts their overall performance.

WHAT'S THE CUSTOMER OPINION?

In March 2013, CGS Advisors conducted a survey of recent new car buyers inquiring about perceptions of connected vehicle services and the value of these services. As can be seen in Figure 1, more than 90% of owners either agreed or strongly agreed that in the future all cars will connect to the Internet.

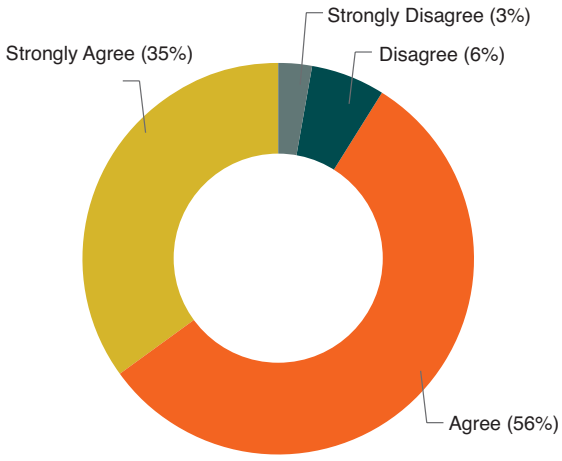

Figure 1: Level of Agreement - All Cars in the Future Will Connect to the Internet

Furthermore, as can be seen in Figure 2, the customers responding in the survey had high expectations about the opportunity for the connected vehicle to enhance their vehicle satisfaction and driving experience, improve their opinion of the manufacturer, and improve the value of their vehicle in their overall life.

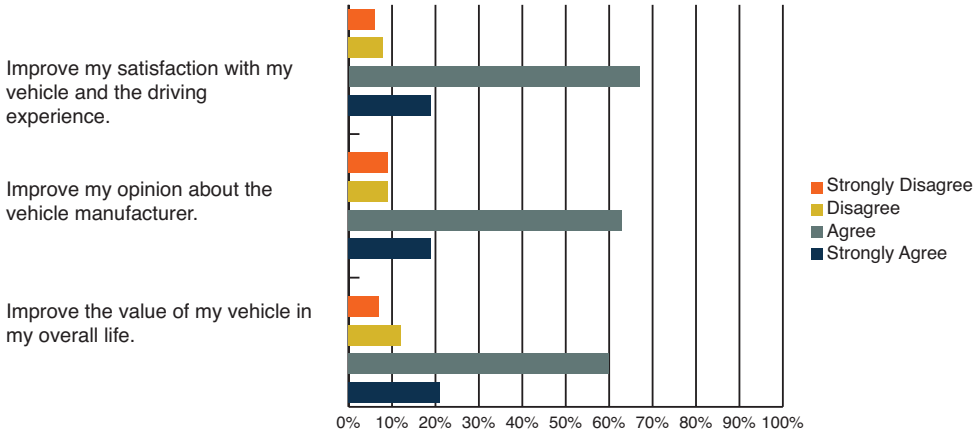

Figure 2: Type of Impact internet-Connected Vehicles Have on Ownership Experience

These opinions clearly reveal that—based on experiences with other mobile (smartphones and tablets) and non-mobile connected devices (computers, security systems, household entertainment)—vehicle owners are anticipating, and even waiting for, the automotive manufacturers to enhance and accelerate their connected vehicle offerings to the market.

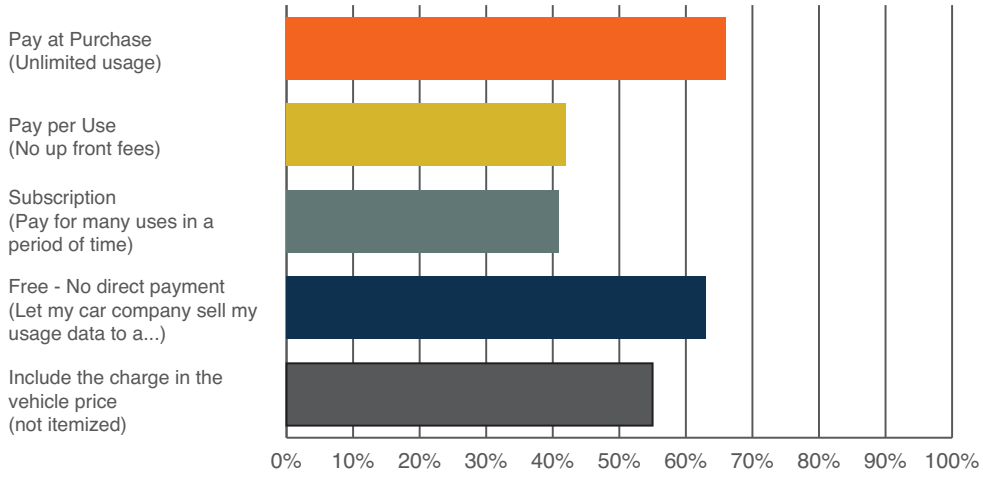

Figure 3: Percentage of Owners Who Find the Method of Connected-Services Pricing Acceptable

Our research also confirms that vehicle owners are shifting their preference about paying for connected services. See, in Figure 3, that the two most preferred options to pay for connected vehicle services were to either: exchange personal and vehicle usage data in return for connected services, or have the costs of the connected vehicle services included in the price of the vehicle at purchase. The least preferred option was the subscription model—which is, interestingly, the current OEM favorite method because of the payment-certainty aspect.

Ironically, the perception of some automobile manufacturers is that consumers are somewhat ambivalent to the value of connected services. There is concern expressed inside the industry that customer demand for connected services may be overstated by analysts. There is manufacturer concern about service subscriptions offered on low or zero initial payments having lower than forecasted renewal after the introductory trial period. Our research suggests it would be a mistake for automotive executives to see low subscription renewals as a function of inadequate consumer demand. We believe that it is the subscription pricing model that is being rejected and not the services. Consumers are being forced to subscribe before the value of a connected service is clearly established.

USER NETWORK-CENTRIC ECONOMICS OF THE CONNECTED VEHICLE

Traditionally, automotive manufacturers consider potential new features for inclusion in a vehicle by evaluating its direct market revenue potential against costs in manufacturing. This vehicle-centric economic model is functional for decision-making on the addition of traditional discrete features on vehicles; it is quite dysfunctional when applied to the connected vehicle.

Connected vehicle services belong to a unique set of offerings where the value of the services increases with usage over time, and the value of the services to any one user is enhanced when other users join the network. The forces that drive these types of value-consumption properties have been termed by economists Michael Katz and Carl Shapiro as "network externalities." Examples of services that are influenced by network externalities are: the telephone, the Internet, and smartphones. Using the telephone example: the value of a telephone to the very first user is more or less zero until a second user is identified and known. Then, for each additional person that acquires a telephone and joins the network, the number of potential connections for each existing owner increases. Consequently, the overall value of the network continues to grow.

THE NETWORK EMERGES TO BECOME A MARKET IN ITSELF.

Network externality forces tend to result in a network of users that becomes an attractive platform for other newly created forms of commercial services that can be offered to all network-installed users. The network emerges to become a market in itself, with each member of the network a potential consumer of additional commercial services. The network provider can then extract revenue from third parties wanting to market their services to the members of the network. With respect to the connected vehicle technology, the automobile manufacturer also has the opportunity to receive data about any individual owner's current use of the vehicle as well the performance and quality attributes of the vehicle itself. These two separate data streams are called vehicle in use (ViU) data and, when collected over time, become the basis for the manufacturer to truly understand the real ownership experience.

When connected vehicle services are viewed as under the forces of network externalities, the pricing implications for an automobile manufacturer become clear. The manufacturer should focus on keeping the prices of the connected services low or near zero to the vehicle owner to encourage the participation of all owners. The manufacturer should avoid the subscription models and instead offer valuable connected services at no charge to owners in exchange for the owner's permission to collect, analyze, and leverage the ViU data. The value of the ViU data in marketing is to influence the next vehicle purchase. And the next maintenance action will likely far outweigh the revenue from a simple subscription offering of connected services with the typical decay in retention at subscription renewal time. Furthermore, the opportunity to offer access to the connected network to third-party connected services developers offers the second wave of very high margin revenue. This revenue introduces almost zero incremental cost to the manufacturer and, if managed properly, has tremendous growth potential.

THE GREATEST REVENUE AND PROFIT POTENTIAL FOR THE OEM IS TO BUILD THE NETWORK OF PARTICIPATING VEHICLE OWNERS AS QUICKLY AS POSSIBLE.

An automotive OEM with a very high percentage of its vehicles connected with customers who have opted in to sharing some, most, or all of their ViU data has a tremendous business intelligence advantage over manufacturers that do not. A compelling use of the ViU business intelligence is to be able to "mico-segment" vehicle owners into various patterns of ownership experience (high mileage commuters

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versus weekend off roaders, etc.) based on attributes of their driving (e.g., distances, frequency, duration, location, speed). The segmentation will emerge well in advance of the customer-perceived necessity to replace the vehicle. Automotive manufacturers can use the segmentation of actual vehicle usage to inform prediction about the type of next vehicle or next service the customer may prefer.

Furthermore, ViU data can be used to determine how to properly package and price "transportation" for each micro-segmentation. Examples could include:

- New Vehicle Purchase
- New Vehicle Lease
- Updated Current Vehicle with New Downloadable Features
- Pay-Per-Use Fleet
- Etc.

We propose that this intelligence will be used to increase repurchase loyalty because the manufacturers and all dealers can know how the customer is using the existing product and begin to market for the next vehicle with insight into the customer preference. (Note: These concepts are explored more deeply in "Industry Insights: Your Customer is Connected – Are You?" where we describe the connected vehicle as the most important customer touch point in automotive Customer Relationship Management).

WHOSE CUSTOMER IS IT?

There is another movement afoot in the evolution of connected vehicle services that is noteworthy. Some automotive manufacturers themselves may be reluctant to commit fully to the connected services and take the risks to establish a dominant relationship with automotive customers. However, it appears that certain connected vehicle services intermediaries (telecommunications service providers, telematics service providers, etc.) have stepped up and offered to subsidize manufacturers' capital costs and take the financial risk associated with the initial customer adoption of the connected services. These providers apparently see different future potential revenues of connected vehicle services than some risk-averse manufacturers.

The intermediary third-party service providers are likely also viewing connected vehicle services with a network-centric approach and looking to build a direct relationship with the automotive OEMs' customers. Their aggressive strategy is to give the automotive manufacturers a very low-risk proposition of subsidized startup costs and then a small percentage of the revenue from each subscription activation and subsequent renewal. In return, the intermediaries control the customer experience and the customer engagement model around these services. Automotive manufacturers that allow intermediaries to control the connected vehicle experience risk losing the longer-term customer relationship.

SUMMARY AND CONCLUSIONS

Our research confirms that customers believe in the future of connected services and its potential to enhance their experiences with their vehicles and their lives. Customers are evolving to prefer the pricing model that fits more with the network-externalities view of value consumption. However, some automotive manufacturers may still frame connected services as being like new hardware features (e.g., sunroofs) and consequently have built pricing models which are based on the invalid assumptions. The danger in this approach is that customers may reject the pricing model and not the connected services themselves. The current practice used by auto manufacturers is quite likely to continue to constrain the revenue growth potential of connected services for the OEM.

Ultimately, the customer preference for visible incremental pricing increases for the connected services—and a low, or zero, fees-for-usage exchange for ViU data will be the standard practice for connected vehicle services. This may be applied differently based on how an automotive manufacturer choses to package its product (new vehicle vs. pay per use fleet). Regardless, the first manufacturers that break from the vehicle-centric views of the consumption of connected services will ultimately force other manufacturers to adapt to stay competitively neutral in this new place. The consumer will be the ultimate winner in the connected world. The only question that remains is: will the rankings of the global car companies be impacted by their hesitancy to recognize the need to shift the lens on the economics of the connected vehicle?

THOUGHTS FROM COVISINT, STUDY SPONSOR

By Tim Evavold, Covisint Director of Automotive Delivery

This latest study on automotive and consumer connectivity has revealed yet another fundamental change occurring within the automotive industry. Now that the vehicle is a connected device, customers no longer look at the stand-alone value of the product; they look at the value of the entire network and how it fits within their mobile lifestyle. Further, the data clearly shows that automotive value economics are changing, and OEMs need to recognize that they are undergoing yet another paradigm shift.

The new paradigm shift is actually the second battle in the connected vehicle landscape. The first battle was about which connectivity model worked best: embedded or enabled. It was internally focused. In the end, OEMs recognized that either choice limited the capabilities of the vehicle, or both offered certain advantages. Therefore, the correct answer was that both were needed.

The new battle is broader and has far reaching implications. It focuses on which economic model best serves the OEM and by extension the customer: subscription model or a free model.

Like the first paradigm battle, this one is heading in the wrong direction. It is not an either/or question, but one where the correct answer is again "both." The current subscription model has proven to be ineffective. Not because there is lackluster demand, but rather sub-optimal value delivery.
The subscription process is too complicated, too lengthy, too confusing and not adequately managed. This leads to low adoption, lower renewal, and ultimately is destroying the delivered value, and it is even risking the OEM-to-Customer relationship.

On the other hand, free services are also falling short due to inability to support required scale with the current economic approach. This approach is destroying the OEM-to-Customer relationship even faster than the subscription approach. The OEMs that recognize they need to provide a spectrum of choices (free, pay for use, and subscription) while taking control of the enrollment and lifecycle communications will emerge the victors.

Ultimately, we believe the successor will be the one that presents a comprehensive value network, simplified enrollment and delivery, and seamless lifecycle communication. This can be a complex undertaking for any one party. The use of an interoperability platform will be the key to success and longevity. This platform must enable the OEM to engage and manage communication across all extended relationships, simplify the registration and enrollment process, on-board/off-board partner services quickly, provide adaptable pricing delivery, and deliver in-context offers and renewal reminders.

ABOUT THE AUTHORS

Warren Ritchie, PhD

Dr. Ritchie leads CGS Advisors' Strategy Services Practice, where he advises an elite group of clients on dynamic market issues, and strategic changes necessary to grow. His practice specializes in corporate and business strategies, wrestling with the questions "what business are we in", and "how do we compete" respectively. The small team of specialists that he leads contributes in the formulation, and implementation phases of strategy.

Prior to working with CGS, Warren had a 25 year tenure in the automotive industry where he held leadership positions including CIO, Director of Corporate Strategy, Marketing Director in locations including the United States, Canada, and Argentina.

Warren holds a PhD in Strategy from the University of North Carolina at Chapel Hill, an MBA from Dalhousie University in Halifax, and a BA from Queen's University in Kingston, Ontario.

Greggory R. Garrett

Greggory R. Garrett is the CEO and founder of CGS Advisors, LLC. For the last 15 years he has pushed the limits of corporate cultures by developing and implementing unique market-based strategies. He is a visionary leader who prides himself in recognizing commonsense solutions for complex problems and motivating teams to reach well beyond the typical boundaries to achieve greatness.

Prior to launching CGS Advisors, Gregg was the Chief Strategy Officer for IT & Innovation at Volkswagen Group of America. Before his time with VW, Gregg led corporate strategy & marketing for Deutsche Telekom's business division in North America, and was part of Ernst & Young's Management Consulting practice.

Gregg holds an MBA from Michigan State's Broad School for Executive Management, and a Bachelors of Science in Systems Engineering from Oakland University in Rochester, Michigan.

ABOUT THE COMPANIES

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CGS Advisors, LLC is a boutique advisory services firm specializing in assisting enterprise leaders prepare for industry disruption. We assist clients through our three core practices: Strategy Services, Innovation Services, and Connected Services. Each useful on its own, it is the intersection of our practice areas where we most excel, allowing us to help our clients realize strategic value by harnessing enterprise innovation in the emerging connected economy.

We are:

- a small firm focused on solving meaningful problems;
- made up of experienced, transformational advisors;
- able to convert complex issues into simple visions & solutions;
- specialists in imagining the path, and running the first mile.

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Covisint provides the leading cloud engagement platform for creating and enabling new mission-critical external business processes. Our solutions enable organizations to connect, engage, and collaborate with the critical external audiences that define their success — including customers, business partners and suppliers.

Covisint's cloud engagement platform offers OEMs a robust, secure and proven platform for driving additional revenue and customer loyalty through connected vehicle initiatives. With Covisint, OEM CIOs, CMOs and LOB leaders can deliver a unified and global connected vehicle platform – based on their own business strategies, not their TSP's limitations – and one, integrated experience across the ownership lifecycle.

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