Auto finance changes gear

In many ways the Chinese auto industry has undergone seismic transformation in the past ten years. It surpassed the US as the largest vehicle sales market in 2009, and is now also one of the largest motor insurance markets in the world.

With this growth, we have also witnessed a significant change in the industry structure, a trend that we see is playing out in China as it is in Europe. Be it Tesla's electric car launch, Google's driverless car technology or the emergence of Uber and its Chinese equivalent Didi, new technologies are changing the mobility preference of a generation of Chinese consumers.

The pressure to rationalise production capacity is likely to intensify. Sales of new vehicles, though still growing, are unlikely to continue at the brisk pace that they once did. In many ways China is now following the footsteps of more mature auto markets such as the US. OEMs and dealers in mature markets have long turned to alternative revenue sources to make up for their vehicle sales which enjoys at best anaemic growth.

Auto fmance in particular has been a focal point of their efforts. This is unsurprising given its complementarity with vehicle sales: not only do financial products facilitate vehicle sales, they also help OEMs and dealers capture a large share of the customer wallet.

We believe that similar trends will be increasingly at play in China, which will allow the industry to signlficantly improve its revenue and profit model. However, with the advent of in-car technologies and multi-channel consumer touchpoints, opportunities in auto finance are for the picking by those who have a coherent customer proposition and channel strategy.

Great leaps

The Chinese auto finance sector has made huge strides in recent years. By way of illustration, the auto loan market grew more than three times in size from RMB 15bn in 2009 to RMB 66bn 2014, or 30% year-on-year growth.

Having only recently overcome the cultural barrier that prevented most from buying consumer goods on >>

>> credit, the average Chinese buyer is beginning to embrace the benefits of auto finance, namely the liquidity and convenience that it brings.

However, a comparison between China's market and more mature markets in terms of auto industry profit contribution by source would indicate that the China auto finance sector still has much room to develop.

Whilst auto finance is typically the largest profit contributor in mature markets, accounting for 28% of total industry profit, the corresponding figure for China is a mere 7%.

Looking at penetration of auto-related financial products tells a similar story. Penetration was around 30% of vehicle sales in 2015, a significant increase from 18% in 2011. By 2020 this is expected to reach 50%, primarily supported by higher consumer demand and pushed by OEMs and dealers to increase penetration. Even then, auto finance in China would still be lagging more mature markets such as the US and UK, pointing to significant headroom for development in the long term.

But serving future consumers would require a re-think of the current business model. We believe auto finance providers need to do much better in understanding and engaging their customers in order to serve the new generation of Chinese consumers who will be the driving force of growth in auto finance.

Compared to the prior generations, younger consumers are more financially sophisticated and appreciate the benefits of financial products. They are also more technically savvy and increasingly rely on a multitude of web-based resources to inform their purchasing decisions. One could therefore easily imagine a consumer who arrives at a dealer having a relatively well-formed view of the cars to buy as well as the source of financing to use. This is likely to create challenges for auto finance companies that have relied mostly on physical dealer networks as channels to market.

Increasing use of the Internet for research has also made product comparison easier, creating a need for auto finance companies to differentiate themselves, either from a product or a consumer experience angle. As a case in point, some auto fmance providers are tailoring their products to different customer segments to better differentiate e.g., for customers who have less predictable cashflow, repayment is split into two tranches: 50% upfront and 50% by end of payment term. Some auto finance providers have also begun to bundle their financial products and services, billing them as tools to deliver superior customer value. For example, Toyota now offers eight repair services for free as a part of their purchase loan offer.

The answer to these must be a re-think of the customer proposition and channel strategy. Some OEMs in mature markets have already embarked on this strategic shift: Mercedes has recendy launched Mercedes Me, a web-based portal that combines financial services, repair services, roadside rescue and mobility services, with a stated aim to deliver a "one-stop-shop" customer experience.

The Chinese auto finance market is primarily served by three types of providers: commercial banks, auto finance companies and other specialist providers including leasing companies, web-based financial companies and P2P lenders. Commercial banks have a natural advantage with low capital costs and extensive geographical reach through their branch networks. But they are poorly configured in an increasingly consumer-centric environment: their approval processes are long and their ability to tailor products to specific requirements is low. Above all, they are slow to respond to changing consumer trends.

In comparison, auto fmance companies and other specialist providers, which collectively account for the remaining 50% of the market, are better positioned. They are much closer to the consumers and have been at the forefront of many of the innovations in auto finance. Their product range is wide and deep, and approval processes are much more efficient. These providers also have lower qualifying requirements than commercial banks and could therefore tap into a much wider addressable market. Indeed, it is their ability to respond to customer needs that has allowed them to prosper despite having higher capital cost than commercial banks.

With the wealth of customer data that these auto finance providers possess, the challenge would be to leverage it to develop insights into customer demographics, purchasing behaviour and channel preferences that can ultimately inform their customer strategy. This is no easy feat for many of these companies, but there are a compelling strategic reasons to act now.

The value chain of auto finance in China is likely to change in the coming years, with large and well-funded players entering the sector. For instance, Alibaba has set up an "internet car" fund with SAIC Motor to develop vehicle telematics, with the first model launching in July 2016.

In April 2016 Alibaba also rolled out a new purchase loan app called "Instant Automobile Financing". It promises loan approval within 24 hours, which is a significant reduction in leadtime when compared to the 3-5 day approval process that is typical even for the more efficient auto finance companies. By analysing wider consumer data on the web (using big data tools), a full consumer credit profile could be constructed in a matter of hours, allowing credit approval processes to be accelerated significantly.

The credit profile could also help auto finance providers tailor their products and pricing for specific customers. Tencent, JD and Baidu have already joined forces to roll out a competing service called DaiKuan.

The emergence of these new technologies have allowed auto finance providers unprecedented access to their customers and their information. In return, consumers will be increasingly demanding in the products and services they receive and the speed with which they are delivered.

A successful player in the future would have to combine customer insights, product portfolio, channel strategy and speedy execution. Technologies have always proved more destructive than industry participants are willing to believe. The time to act is now. ◆

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. *Auto Finance Changes Gear* is written by Helen Chen and Benjamin Chang, both are from L.E.K. Consulting's Shanghai office. For more information, go to www.lek.com.