Automotive Parts: The Industry’s New Sweet Spot

As the automotive service industry accelerates, it faces stiff headwinds spawned by a highly-congested marketplace, increasing regulatory scrutiny and extended car ownership lifecycles. As a result, OEMs, dealers and other players in the automotive value chain must find ways to extract greater revenue and profit from the aftermarket services area.

Executive Summary
Automotive companies have traditionally focused on building their brand in order to increase sales of new vehicles. In fact, they have worked relentlessly to enhance the way such vehicles are marketed and sold. However, with the average age of automobiles rising, the auto value chain is shifting towards the aftermarket. Key indicators of this shift include the increasing spare parts market, the expansion of the secondary car market, the changing nature of auto financing, and collaborative usage and pay per use.

However, the spare parts market is not without challenges, both external and internal. This white paper highlights the external obstacles and offers advice on how industry players can solve them through a “mixed strategy” that bundles parts with service. The paper elaborates on consumer purchase intent in the automotive aftermarket and suggests a framework based on “willingness to pay” (or reservation prices) to help OEMs reap the rewards of a fast-growing market.

Looking Through the Aftermarket Lens
The market for services and parts has experienced robust growth since the 2008 economic recession. In fact, services and parts now contribute about 30% of an average dealer’s profits, while accounting for 11.3% of revenues. Figure 1 illustrates the profit comparison between new vehicle sales profits vis-à-vis service and spares for an average U.S. auto dealership.

Though these two businesses have been traditionally treated as separate market segments, a few auto companies now view them as a unified whole and look at the auto lifecycle in terms of customer lifetime value (CLTV) rather than from a “total sales” standpoint. Thus, for many auto companies, aftermarket sales is now a strategic business, because of its impact on the bottom line, customer satisfaction, loyalty and repeat sales.
Key Business Challenges

The spare parts business is typically immune to economic and environmental factors and offers much-needed relief from the economic vagaries that new-car sales inevitably experience. As Figure 1 illustrates, new vehicle profits closely mirror the general economy while parts profits have remained broadly consistent over the last few years, highlighting the importance of parts as a “fixed operations” business. Figure 2 categorizes the major challenges faced by an OEM’s spare parts business.

Challenges in Automotive Spare Parts Market

<table>
<thead>
<tr>
<th>INTERNAL</th>
<th>EXTERNAL</th>
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<tbody>
<tr>
<td>Complex Parts, Supply Chain &amp; Reverse Logistics</td>
<td>Shorter Product Lifecycle</td>
</tr>
<tr>
<td>Increasing No. of SKUs</td>
<td>Branding Requirements</td>
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<td>Complex Vehicle &amp; Parts Configuration</td>
<td>Gen-X Perceptions on Spare Parts</td>
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<td>Inefficient Data &amp; Price Management</td>
<td>Gray Market</td>
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<td>Lack of Efficient IT Application</td>
<td>Regulatory Compliance</td>
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<td>Third-Party Supplier Penetration</td>
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The Inhibition of Customer Choice

The auto industry establishment is facing competition from various entities: smaller players, third-party suppliers, the gray market, etc. Moreover, from an OEM perspective, outsiders are deterred from entering the market when their cars are sold with service bundled in. However, this approach could invite an antitrust complaint. For the past several years, regulatory watchdogs in the U.S., Europe and Asia have uncovered multiple cartels, handing out record fines in some cases.²

- **Case in point #1:** The U.S. charged seven Japanese executives with price-fixing in a long-running probe into illegal practices in the auto parts industry. Over the past several years, U.S. justice authorities have fined 28 companies more than $2.4 billion.³

- **Case in point #2:** The Competition Commission of India (CCI) imposed a penalty of INR25 billion on 14 car manufacturers for violating competition law. CCI demands that OEMs reveal all facts in the public domain regarding price, processes, alternatives, etc. of spare parts to facilitate fair competition.

However, the larger picture here is that the entire debate revolves around “inhibition of customer choice.” Most warranty regulations advocate that simply using an aftermarket or recycled part does not void a vehicle’s warranty (see sidebar, next page). With such a clause, OEMs are often pressed for customer win-back, which is made even more difficult by a “one-size-fits-all” spare parts strategy.

Like any other product, automotive goods are also subject to the product lifecycle. Every stage in the lifecycle has a specific marketing objective - and a specific strategy as well. In automotive parlance, spare parts should not be any exception to this. Different vehicles and models are at various places in the automotive lifecycle; due to this, as well as changing consumer behavior, it is imperative that the industry reexamine its operating approach.
Why Inhibit “Customer Choice”?

The Magnuson-Moss Warranty Act makes it illegal for companies to void your warranty or deny coverage under the warranty simply because you used an aftermarket or recycled part. Still, if it turns out that the aftermarket or recycled part was itself defective or was not installed correctly, and it causes damage to another part that is covered under the warranty, the manufacturer or dealer has the right to deny coverage for that part and charge you for any repairs.

Shifting Gears
Willingness to Pay

Taking a cue from the aforementioned cases, companies should embark on initiatives that offer a greater choice to customers in the aftermarket and simultaneously innovate strategies to safeguard their bottom lines.

We suggest an approach based on the simple concept: “Price is the measure of willingness to pay (WTP).” Figure 3 illustrates our take on a WTP-driven example – an off-road enthusiast would be willing to pay more for a “tire care regime” than would a business executive who drives a sedan on a corporate lease plan.

If different customers – or the same customer under different situations – have a different WTP for different maintenance regimes, repairs and spare parts, why should the pricing approach, and hence marketing and selling, be identical for all?

Splitting the “Pocket”

An invoice bill has two components – the part price and labor charge (or job rate). Needless to say, tax is another obligatory expense. In other words, after a visit to a service station the customer incurs two categories of expense. Hence, it is very likely that the customer will have differential preferences toward the two categories and hence varying WTP.

So, does the customer spend more on parts or on labor?

An analysis of real life instances that broadly categorize a vehicle’s visits to service stations is quite revealing (see Figure 4).

Why Go To A Service Station: Four Broad Categories

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>EXAMPLE</th>
<th>LIKELY CUSTOMER BEHAVIOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 DIY Category Service</td>
<td>Small scratches on car, Engine oil refill required.</td>
<td>Parts are easily available. Customer can get the correct grade of oil/part no. at any shop and get it fixed anywhere or do it himself.</td>
</tr>
<tr>
<td>2 Accidental, Proprietary Items</td>
<td>The car has a mishap; part replacement required.</td>
<td>Customer seeks original parts and seeks cheaper labor alternatives. However, defects, if not arrested, are progressive and consequential over time.</td>
</tr>
<tr>
<td>3 Complex Design and jobs</td>
<td>Customer fitted an electrical accessory; requires a change in wiring harness.</td>
<td>Customer prefers the OEM. Though it can be reworked on a case-by-case basis, waiting time is generally high for customer. Here again, customer seeks cheaper alternatives.</td>
</tr>
<tr>
<td>4 Aggregate Parts, Safety Items</td>
<td>Customer lost his 2nd car key; wants to install a new set.</td>
<td>Customer puts safety above everything else. Due to security reasons and version complexity, job also sometimes mandates service at authorized facilities.</td>
</tr>
</tbody>
</table>

Figure 4

Quick Take

Why Inhibit “Customer Choice”? The Magnuson-Moss Warranty Act makes it illegal for companies to void your warranty or deny coverage under the warranty simply because you used an aftermarket or recycled part. Still, if it turns out that the aftermarket or recycled part was itself defective or was not installed correctly, and it causes damage to another part that is covered under the warranty, the manufacturer or dealer has the right to deny coverage for that part and charge you for any repairs.
The Strategy Quadrant

Based on an examination of consumer behavior, customers visit service stations with different expectations under various circumstances. The jobs carried out differ in nature, and under different circumstances customers have varied WTPs (or reservation prices) for parts and labor.

Figure 5 plots the major jobs in automotive service context into four quadrants. Our breakdown of the individual quadrants reflects our suggested action plan in line with the consumer behavior and provides a mixed approach to spare parts strategy.

Bundling as a Pricing Strategy

For both traditional and newer businesses, marketers have used bundling methods to effectively increase profits (for complementary goods), to reduce selling costs and to deter market entry. History shows that a bundling approach can yield great results when the concerned products/services exhibit inverse WTP among customers. Our “cross-sell” group (showing high WTP for parts and low WTP for labor charges) classifies products and services that exhibit such behavior. Rolling out calculated bundled prices of parts and labor can yield fruitful results here. The same argument can also be extended to the “replenish” quadrant, as well.

The customer who buys a discounted bundle (i.e., service plus parts) doesn’t care if either is discounted, as long as the total cost is lower. Furthermore, bundling does not require knowledge of an individual consumer’s WTP, but only the distribution of consumer choices on prices. (See sidebar for an example from an entirely different industry sector.)

WTP Quadrant

![WTP Quadrant Diagram](image)

**Bundling in Mobile Phone Retail**

Retailers frequently bundle the prices of several products and services together for their new customers. They offer the phone itself with a package that also includes the two-year phone plan, Internet access and phone charger. This bundle benefits the customers because it provides them with all the tools they need for their phone all at once and it benefits the mobile phone retailers because they are selling the customer supplementary products and services other than just a phone.

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Hence, “discounting” spare parts or service offerings is more effective for OEMs as it expands demand and, under most circumstances, delivers scale benefits. Smaller competitors - those that sell parts or service individually - do not have the same luxury. Even if these smaller competitors hold similar technical competencies, OEM market clout typically wins out. For example, OEMs will always have an edge by offering service bundles that provide an economic advantage to car buyers.

E-tailing as a Channel
OEMs understand the impact of digitization and its ability to increase market share and improve customer satisfaction. OEMs need to become independent of the demand for parts from authorized workshops, which necessarily means entering the online market and expanding their parts retailing network and supplying independent repair shops and service chains as well (see an example in sidebar, below left).

While increasing product complexity will continue to squeeze the do-it-yourself market, customer satisfaction will depend more and more on availability and brand visibility. Automotive e-commerce will emerge as a retail channel for parts and services, enabling the sale of items. The “penetrate” strategy quadrant represents such a scenario. Since this customer has a weak WTP towards both parts and labor charges, it is better for the OEM to proliferate through every channel possible.

3-D Printing as a Fulfilment Option
With additive manufacturing - the descriptive phrase for 3-D printing - considerably lower organizational effort is required for developing suppliers to maintain quality standards for complex and critical parts. This is because designs shared can be directly taken to mass production at any location. From an aftermarket perspective, this implies on-demand spare parts production at the distribution leg, thus reducing service lead time.

Final Thoughts
The spare parts business should not be looked upon as a derivative of a product, but as a product itself with its own 4P (price, product, promotion and place) strategy and technology road map. The average spare parts inventory for a U.S. dealership is nearly $330,000 SKUs. With frequent product launches and facelifts, organizations often end up with stocks that have a very low potential to be sold at normal price. As such, they incur a huge amount of revenue leakage through such distressed inventories.

OEMs and dealers are often led to believe that new vehicles are bread winners and spare parts are remainders in the top line. Hence, most aftermarket initiatives are meted out and given stepson treatment. As a result, the bottom line suffers. As discussed throughout this white paper, the auto services market is fragmented, subject to changing customer needs and evolving technologies. As a result, a “one-size-fits-all” approach simply won’t suffice. By viewing the market through our strategy quadrant prism, carmakers can take a different and more profitably textured approach.
About the Authors

Suresh Vickram is a Senior Manager of Consulting within Cognizant Business Consulting (CBC) and leads the Automotive Consulting Practice. He has more than 12 years of experience in IT consulting, leading transformational deals and driving strategic initiatives for automotive customers worldwide. Suresh has a strong background in automotive demand planning and order management, working with leading OEMs across the U.S. He specializes in dealer management, supply chain planning and execution. Suresh can be reached at SureshVickram.Selvarajan@cognizant.com.

Somnath Chatterjee is a Senior Consultant within Cognizant Business Consulting (CBC), focused on the automotive domain. He has more than eight years of combined experience in automotive and consulting functions. Somnath’s experience includes aftermarket operations, spare parts, channel development, manufacturing planning and quality management. He currently leads the consulting function for one of Cognizant’s marquee clients. Somnath can be reached at Somnath.Chatterjee3@cognizant.com.

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