

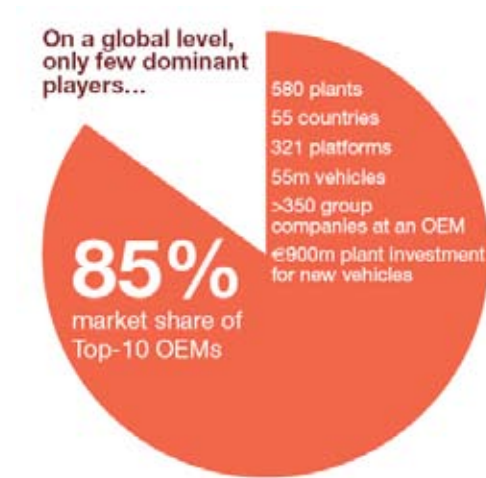
# *Rethinking the business operating model*

Corporate simplification in the automotive sector

*Global Automotive Perspectives*  
June 2012



# Introduction



Why is complexity such an issue for the automotive sector? The automotive industry is over 100 years old, and layers of complexity have been introduced at each turn of its evolution. It has one of the most complicated upstream and downstream value chains for a volume produced product, which becomes ever more complicated as the industry evolves.

... run assembly operations around the world relying on fragile supply chains...

>10,000 miles sourcing distance

50,000 companies making auto parts made in China

40 days shipping time

~1,600 companies supply an OEM

... to produce a highly complex product for a buyer's market...

>100,000 variants

146 brands

>80 regulations for the EU

1,036 name plates

~100 new patents for a premium vehicle

15 new patents per day at leading global supplier

... sold through different channels to different customers with diversified demand and mobility patterns...

\$1,000–\$1,6m price range

\$43b net trade contribution in the EU

>25,000 official retailers for a global OEM

What is the role of local distributors, and what activities should they be focused on? Can centralised direct invoicing work for OEMs? Is it advisable to consider cross-border mergers across Europe or the establishment of an European Single Entity (SE) rather than operating separate legal entities in each country? These are some of the questions and opportunities which go to the heart of the operating model of companies in the automotive sector. To secure sustainable competitive advantage, automotive companies should focus on getting fit for the future. For many, this will mean breathing new life into the organisation by simplifying the operating model to strip out unnecessary cost and complexity in the business operations, tax and legal structures. The benefits will include enhanced flexibility, greater operating and tax efficiency, and long-term cost control—all essential qualities, for high performance in a fast-changing marketplace.

### Introducing simplification to an industry in structural change

As companies in the automotive sector have grown and evolved over time, so has the underlying complexity of their business models.

OEMs and suppliers need to have different strategies for mature markets versus emerging markets. In emerging markets, companies must have the most efficient market access platform to position themselves to benefit from growth opportunities. However, without the right strategy and execution in mature markets, it is clear that companies cannot profit from emerging markets – the persistence of structural cost and complexity in mature market operations will eventually rob all but the most resilient competitors of the opportunity to compete in emerging markets.

During the last decade, the underlying complexity in Automotive companies has been hidden by a benign business environment. However the global recession has challenged the core operating models responsible for delivering the business strategy of many companies.

### A combination of factors has contributed to this trend, including:

- mergers, acquisitions, divestments and joint ventures
- the increasing burden of regulation and compliance, such as changing emissions standards, REACH compliance
- complex, global supply chains and low cost sourcing, requiring cross border movements of goods for products that are increasingly built-to-order, and covering a staggering array of potential configurations
- testing and research facilities may need to be headquartered outside of a company's normal operational sphere
- multiple sales and distribution channels in a highly competitive global market place covering a mix of channels such as national sales companies, wholly owned retailers, third party retailers, and including sales, after sales services, the provision of spares and financial services
- increasing electrification of the industry: introducing the need for organisational relationships with non-traditional auto companies in non-traditional automotive specialisms

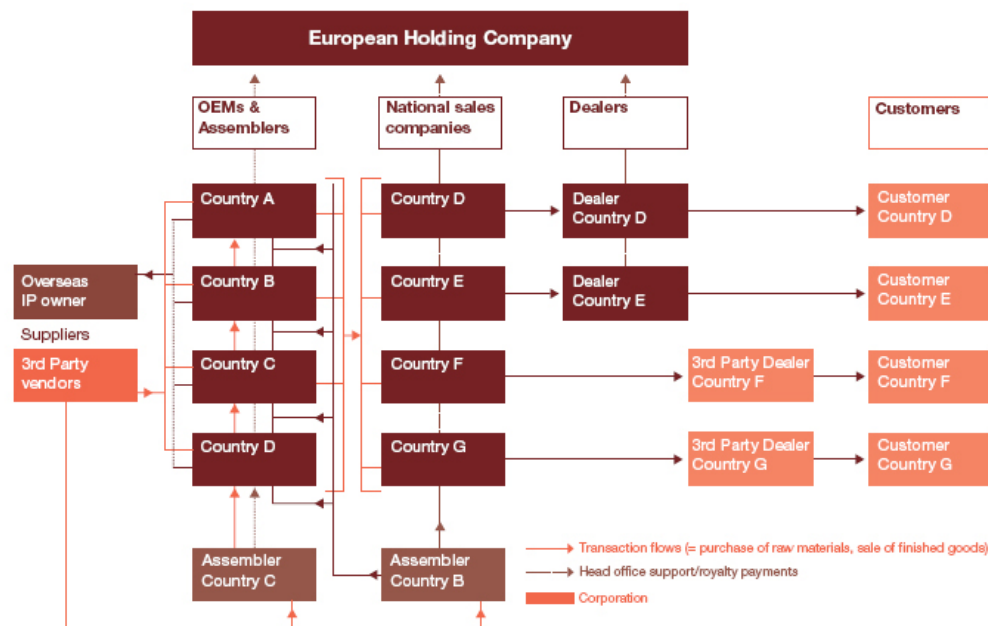
Instead of being equipped to cope with the profound challenges that arose, many companies found that their operating models were too complex to enable the flexibility and efficiency needed to *deliver business strategy* in an uncompromising market. For example, the ability to rapidly analyse and understand trends in the marketplace, and so make decision to reduce inventory and production levels, was hindered by the complexity in the organisation.

Figure 1 is a representation of the complexity in a European OEM in its simplest form.

As one executive in an OEM told us –

“For every external transaction, we seem to have at least three internal transactions – it looks like we are our biggest customer!”<sup>1</sup>

### Existing complexity in a European Automotive OEM



Source: PricewaterhouseCoopers

Further, unwieldy structures complicate the *process of doing business* with both customers and suppliers, for example in having a consolidated view of business being conducted with potentially “at-risk” suppliers. Excessive complexity can also hamper companies which need to adapt to changing regulatory environments. Proposed changes to the tax system in the US and other countries may also have profound implications for many corporations; we look at these in more detail in the section on tax optimisation.

Cost reduction programmes bring the most benefit when they are part of an overall simplification strategy.

Many automotive companies are already very aware of the level of complexity within their organisations, and over many years have embarked on projects such as lean manufacturing, which seek to simplify portions of their inventory management and production. While these have been useful steps on the journey towards a more streamlined organisation, companies need to take care. In response to the current environment, some organisations have effectively adapted their operating model by initiating cost cutting and change projects, sometimes without a thorough understanding of the impact each will have on the fundamental way they manage the business.

Ultimately the goal may be not only to simplify the existing business, but also to ensure that further growth of the business, be it through acquisitions, entering new geographic markets, or expanding the product line, does not add unnecessary complexity to systems or structures, and supports the overall business model. In order to ensure that individual projects are contributing to this overall goal, companies need to describe, in a clear, cohesive and comprehensive way, how the company will operate in future – the single *‘end-state’ solution* and vision integrating tax, legal and operations.

Once the end-state goal has been formulated, companies should identify and assess the impact of existing projects, and how these should be managed and redirected if needed, to remove conflicting priorities, objectives and duplication.

This document introduces a range of options which automotive sector companies could consider; which elements of simplification are most appropriate will depend in part on:

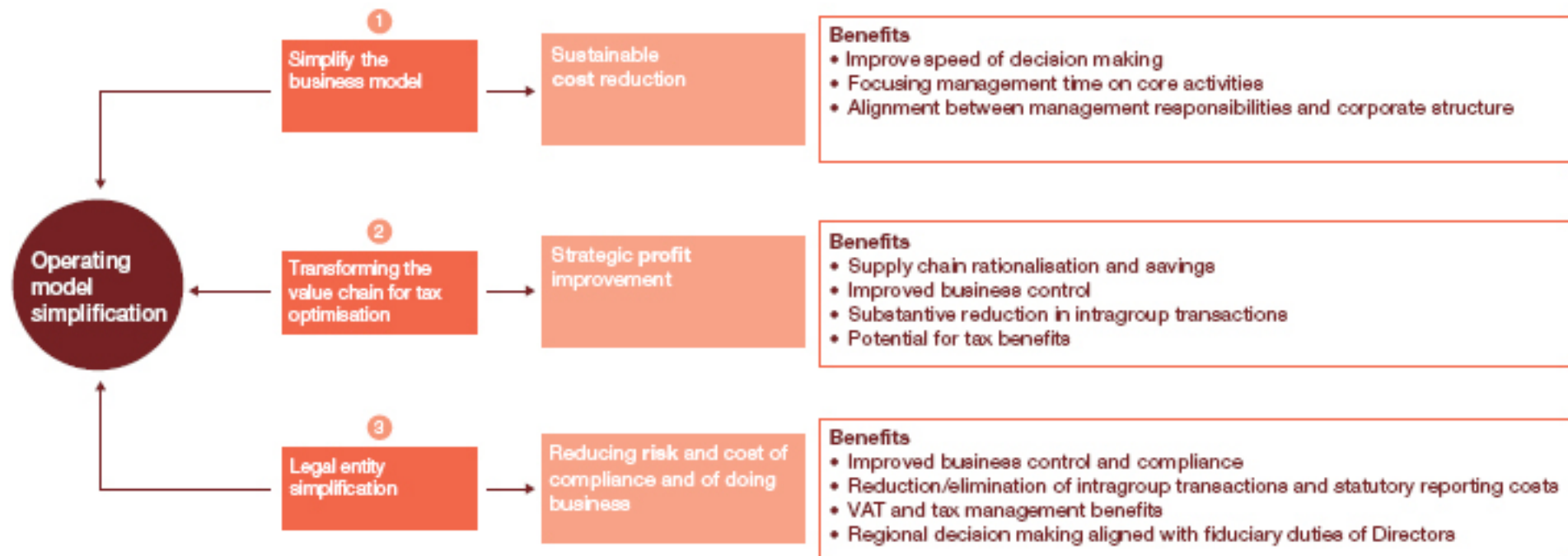
- simplification programmes currently in place,
- the level of ambition within the company as a whole, and
- the extent to which all countries and areas of operation are planned for inclusion.

Whilst the various approaches are illustrated by reference to the downstream distribution of OEMs, the principles outlined are applicable to any aspect of the OEM business chain, include manufacturing, sales, after market sales and services.

### Suggested approach to simplifying the business operating model

The diagram below suggests three ways in which automotive companies can set about rationalising their business operating models. Each is already being used to good effect by a wide range of companies to secure significant ongoing financial and operational benefits, and for some companies a combination of the solutions may be most effective. Automotive companies can choose to use any one or, most effectively, a combination of the simplification routes described.

### Routes to simplification



Source: PricewaterhouseCoopers Research

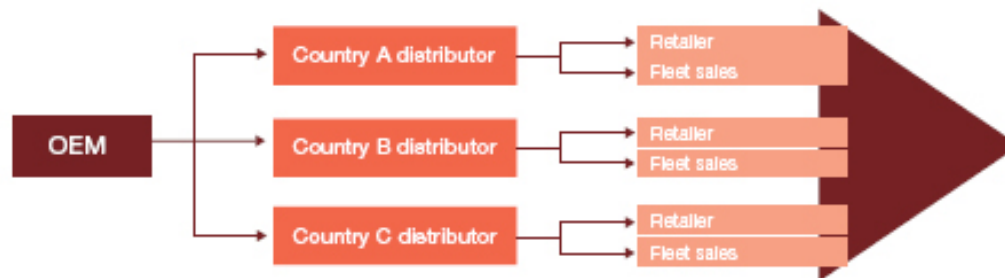
## Simplifying the business model

Every automotive company has its own history of growth, and its own management culture and degrees of autonomy between the centre and local operations. For example some companies tend towards wholly owned dealers, others have a mixture of wholly owned and third party dealers. However, winning companies are those which consciously map their operating model to the needs and priorities of the business.

Changing the management model requires a review of the business value chain to clarify and agree which decisions are owned centrally vs. locally, and where activities should be executed most effectively. Corporate level functions will likely include investor relations, brand management, statutory reporting, M&A, and strategic supplier relationships. By determining where consistency is needed, companies can achieve significant regional synergies in areas such as procurement and back office functions. Further, automotive companies may be able to better address product introduction and management, supplier management, and logistics by designing and implementing consistent regional structures.

One example is in sales and distribution. Today, most automotive OEMs typically still distribute their cars and spares via controlled wholly owned National Sales Companies (NSCs), who buy the goods and sell then in their own name and on their behalf to local retailers and fleet companies (such as hire companies, large customers etc), as shown below:

### Current sales channel model

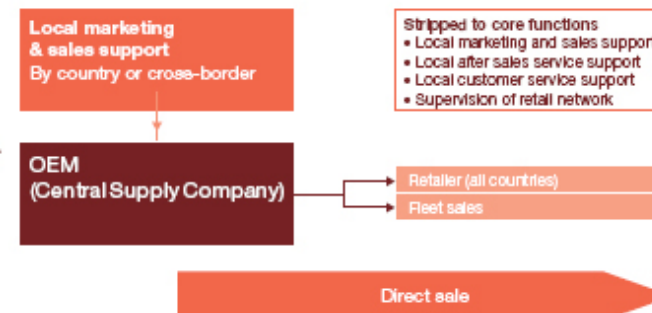


This model creates significant working capital needs, inefficient inventory management, significant administration costs (for example internal transactions, transfer pricing, statutory reporting), as well as making it harder to manage the business on a regional level. For example, trading with regional or global customers is harder via national companies. Until now, the automotive industry has been a slow mover, and other multinational companies (MNCs) in sectors such as high technology and consumer goods have increasingly been moving to a new distribution model, the most recent trend being towards a Central Supply Company.

In this model shown below, a Central Supply Company can sell products directly to retailers / wholesalers in each country. To facilitate and promote local sales, the Central Supply Company is supported by marketing and sales support services companies or sales agents (either one by local country, or a single marketing and sales support entity cross-border). The local service companies can be separate legal entities, however further benefits could be achieved from converting these into branches of the Central Company.

Since the inventory is owned centrally by the central supply company and the sales are made directly, such a model can optimise working capital, trade receivables and inventory management, as well as significantly reducing the administration costs and the group's overall business risks.

### Future sales channel model





## The new cross industry benchmark in distribution

Most automotive companies acknowledge the need for optimising their value chain and simplifying their legal structure. Nevertheless, the Automotive Industry has been a slow mover. The pace of value chain integration in other industries has been significantly faster. Tax optimisation has certainly been an accelerator for value chain integration in “high margin” industries.

Designing and optimising a network of operations takes time, and most benefits accrue over the life of investments. In the past, this certainly has been a blocker for initiating structural change in the automotive industry. Often, there still is significant segregation in management of functional, business unit and geographic divisions. On the positive side, it means that there is significant opportunity for supply chain redesign, legal simplification and, not to forget, tax-efficiency improvement.

A particular area of focus may be the distribution, marketing and sales channel. The consumer goods, electronics, pharmaceutical and chemical industries are actively streamlining their distribution and sales organisations. Over the last decade, they have gradually stripped functions, assets and risks from their national sales and marketing companies, to align them with business reality. Strategic and back-office functions, inventory, and major business risks have been centralised in a global or pan-regional principal company. The local force now primarily focuses on marketing support and customer servicing, though still with an entrepreneurial spirit.

Whilst so-called “commissionaire” structures have been the benchmark for many years, the latest trend is to move to local “sale agency” or “marketing services” companies, whereby the principal or central supply company directly sells to the customers.

The question is whether automotive companies should consider such wrenching change. The answer is yes, for many reasons. The automotive industry should benchmark its value chain against those of other industries that have proven to be successful. With the economic downturn, the international expansion into new markets, and the shortening product lifecycle, automotive companies will face mounting pressure to boost the efficiency of their value chain, to reduce costs and to avoid loss of competitive position. Pressured by competition in an oversupplied market, automotive companies should pursue opportunities to integrate (amongst other) their distribution and sales. The need to further streamline branding, marketing, pricing, inventory management, IT platforms, and the consolidation at the customers level (fleet and lease companies, retailers, other) on a pan-regional basis create an ideal momentum for automotive companies to revisit their current sales and distribution models. Business integration and legal simplification are therefore inevitable.

### Automotive Industry

### Other Industries: Manufacturing, Pharma and Chemical

**1950 – 1970**

#### Independent Country Distributors

In the beginning, most multinational companies distributed their products in local markets via independent importers and distributors.

**1970 – 1995**

#### Controlled Country Distributors

When sales had grown materially, many multinational companies have terminated the 3<sup>rd</sup> party distributors and have setup controlled country importers/distributors to distribute their products on the local markets.

**1995 – 2008**

#### Commissionaire structures

In the mid '90ies, multinational companies have gradually converted their local country distributors into commissionaires to streamline their value chain. The tendency had started in high-margin industries, accelerated by tax-effective supply chain planning.

**2008 – ...**

#### Central Supply Company

The most agile multinational companies have started to sell their products directly to the retailers/wholesale via a central supply company. The country distributors or commissionaires are being converted into local sales agents or marketing service providers supporting the local country sales and after sales. A recent trend is the cross border merger into cross country/ regional sales and marketing entities.

## Transforming the value chain for tax optimisation

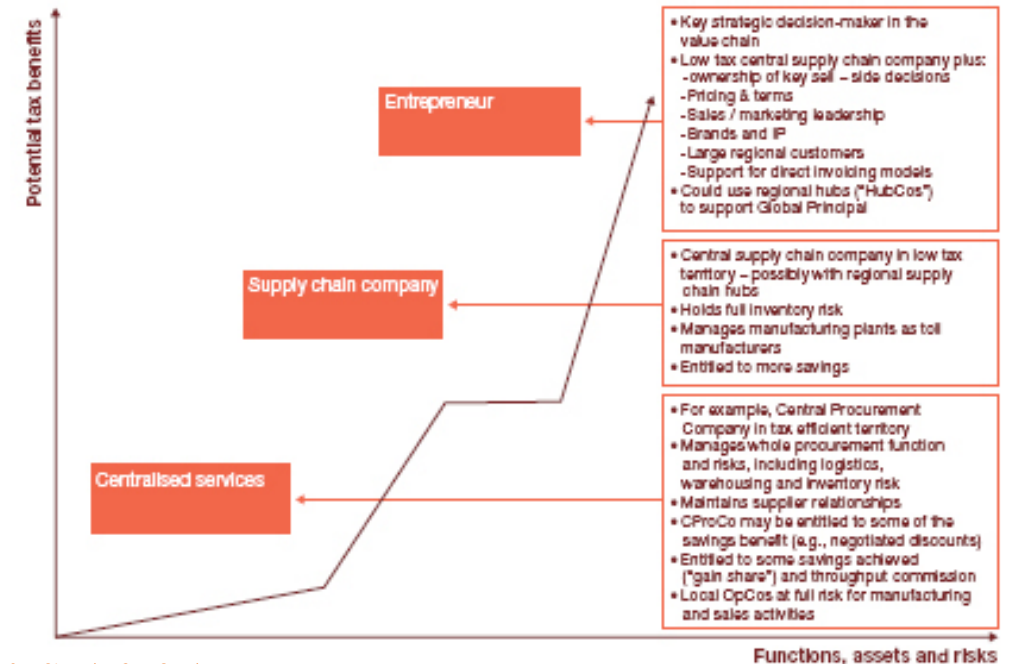
Tax optimisation projects design and implement a range of options that improve and simplify tax efficiency of the business, resulting in an optimised group tax strategy while being consistent with the operational and commercial business strategy.

Such efforts can also bring substantial operational cost benefits; they substantially reduce demands on finance and back office functions by reducing internal trading, reconciliations and administration, for example management service cross charges and internal contracts. Further, they can reduce local working capital needs and ensure cash flow is freely available to the group.

There are many non-financial benefits as well. Improving the tax structure of local entities enables these operations to focus on core local activities such as sales, as shown earlier in Section 1. This approach enables simplified in-country performance management and supports easier introduction of best practices across the business. A simplified business structure also facilitates an effective management compensations system and can reduce the negative behavioural impact of a transfer pricing policy that is set up for tax optimisation and does not reflect the economic realities of the business (such as the time and costs of tax compliance and defence).

There is a spectrum of tax optimised business models which Automotive companies can implement, as show on the diagram:

## Transforming the value chain for tax optimisation



Source: PricewaterhouseCoopers Research

Ensuring alignment between the tax model and how the business is actually managed (such as where key decisions are made, risks sit) is a fundamental pillar of a tax optimisation project. The tax model should have built-in flexibility to cope with turbulent economies. Some transfer pricing policies have proven to be tax-ineffective in an economic downturn; central entrepreneur companies in low tax countries incurring significant losses whilst the local entities in high tax countries continued earning guaranteed profits under net margin based pricing policies. Please see the article on Transfer Pricing in this issue.



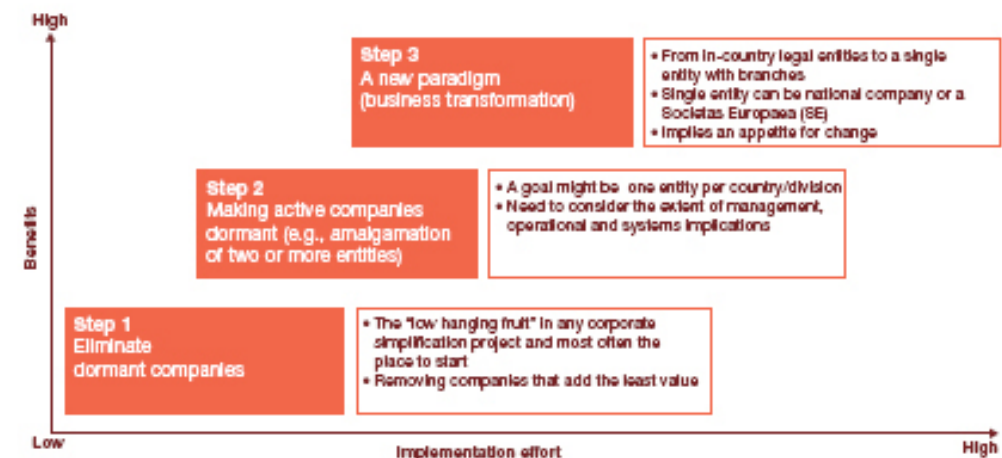
In some countries, changing tax laws and regulations may provide companies with a strong incentive to take a closer look at how their organisational structure impacts their tax strategy. In the US, for example, the Obama administration has proposed changes to its international tax regime which, if enacted, would affect US outbound corporate structures for tax years beginning after 31 December 2010. One of the proposals would restrict the ability of US multinationals to “check the box” to determine the tax classification, for US income tax purposes, of its foreign entities. If this proposal is enacted, many US owned foreign entities that are now disregarded for US tax purposes would be treated as corporations. This type of entity classification change could have adverse tax consequences on many US groups of companies. Accordingly, many companies are or will be considering additional changes to their current legal structure in order to avoid potential detrimental impacts. While certain tax planning options are being analysed and developed, this is an opportune time to further consider how such changes can provide additional tax and operational benefits.

### Simplifying the legal entity structure

Global companies are increasingly looking at a range of legal entity related simplification opportunities, including eliminating dormant entities, reducing the number of active companies, and using new legislation such as the Societas Europaea (SE) and the Cross Border Merger Directive in Europe as a means of driving entity rationalisation and aligning their legal and operational worlds, so unifying the management and financial reporting framework. This is particularly powerful when combined with moving to a local “sales agency” or “marketing services” company model described earlier, whereby the principal or central supply company directly sells to the customers, so moving from national sales operations into sub- or pan-regional operations. The European Union Merger Directive, is an accelerator by enabling such cross border mergers in a tax neutral way.

Simplifying the legal entity structure brings significant benefits. From a cost perspective, it can substantially reduce administration costs, including statutory and tax audits, complex internal trading such as intercompany transactions, intercompany contracts and transfer pricing arrangements. This in turn will reduce demands on finance and other back office functions.

### Simplifying the legal entity structure



Source: PricewaterhouseCoopers Research

Legal simplification may generate incremental tax savings, such as tax-optimised profit repatriation, potential cross border loss compensation, as well as profit and loss pooling in countries where there is no fiscal unity regime.

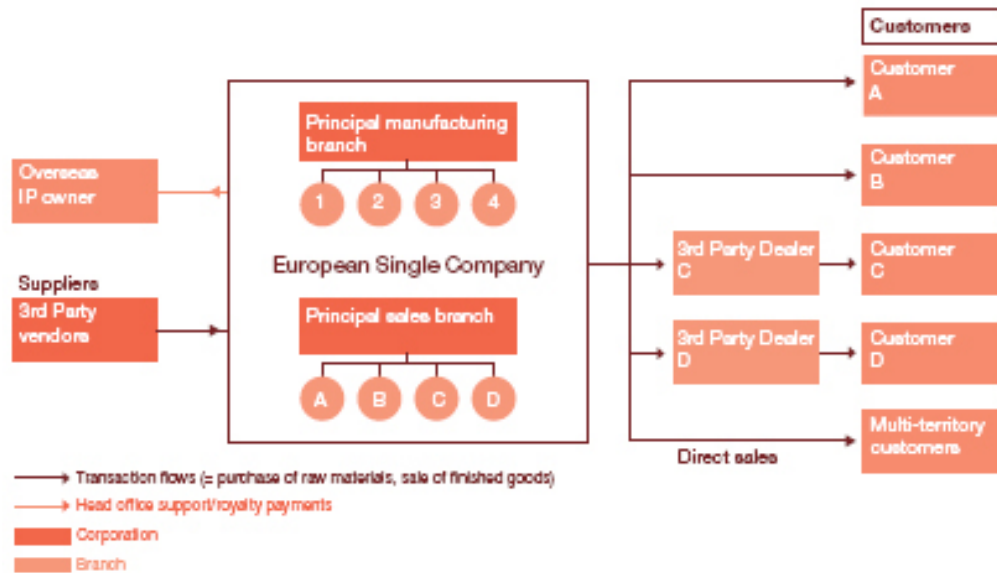
The ability to align management and legal structures may also substantially enhance risk management including Director accountabilities and risk, governance, controls and regulatory compliance, and also ease the transition to new regulatory, compliance and accounting regimes, for example IFRS.

Finally, while direct savings may be substantial, companies may also save significant indirect costs by becoming more flexible organisations which benefit from a common corporate culture and approach across multiple regions, and offering a single face to regional customers and suppliers.

## Bringing it all together into a future model

The following diagram shows a possible future structure, comprising the integration of the simplification approaches discussed earlier. This vision combines centralisation of business functions with tax optimisation, and with legal restructuring to a branch structure of a single European Company, which could be a European S.E or national company.

## Bringing it all together – a simpler model



Source: PricewaterhouseCoopers Research

The benefits of a such a structure can be significant – for one company, operational benefits and savings included: a reduction of more than 500,000 intercompany transactions, significant reduction in company reporting, administration and cost, opportunities to simplify and optimise local compliance, refocus of management time away from external accounting, and simplified treasury operations and improved cashflow.

## Making a successful case for change

When making any fundamental change to the business operating model, it is vital to be aware of the complex nature of such an undertaking, and the significant change management effort needed to ensure success. In our experience, the critical success factors are:

1. Effectively engaging key stakeholders, at all levels of the organisation, early in the process and maintaining engagement throughout the transformation
2. Aligning the business, tax and legal structures into one integrated operating model which supports the company's strategy, has strong sponsorship from senior management, fits the company's appetite for change and is within the company's ability to implement
3. Taking into account local jurisdictional considerations, understanding the specific legal requirements and approaches which different countries take to tax-efficient models. This assessment should including drawing comparisons, understanding and ideas from other organisations, in the automotive and other industry sectors.
4. Making a compelling case for change, including measurable benefits aligned to the proposed changes and assigned to specific owners to ensure realisation. Also seek operational 'quick wins' that link the programme to the front line.
5. Defining and embedding the organisation impact – the desired end-state may drive change throughout the organisation – roles, responsibilities and reporting lines, performance contracts and reward may need to be adapted. Take time to understand the impacts of the model on the way the business operates – including processes, systems and controls.
6. Ensuring sufficient operational and functional support is in place to enable the change – including prioritisation and phasing of change, minimising regret costs, on-going capacity of functional teams.
7. Building strong central co-ordination of the programme with alignment across operational, tax and support / back-office activities and across geographies

The next diagram shows a possible approach to structuring and delivering an operating model simplification programme, and details the outcomes of the first phase, Assess. This phase is critical, as it involves understanding the opportunity and potential benefits, aligning management support behind a compelling case for change, so laying the foundation for subsequent phases of the project.

## An approach



### Activities (Assess – typically 6-8 weeks)

- Review the current situation – the sources and cost of maintaining the existing complexity
- Define the options for simplification, and test senior management’s appetite for change. Align senior management behind the need for change, with agreement on a future vision and integrated operating model
- Learn from peers and competitors – what others have done, and what has worked
- Have a clear picture of what needs to change from a people and organisation perspective, and if needed engage early with HR to address Works Councils communication and people transition issues
- Develop a compelling case for change, covering the business benefits and linked to the company’s strategic goals
- Understand the legal and tax transition issues to be managed, and build these into an integrated project plan
- Ensure alignment to existing initiatives, and get support from back office functions such as IT and Finance, to ensure that required changes to support new model can be implemented in time
- Implement robust governance structure to manage and control the project
- Understand the organisation’s current culture, capabilities and ability to implement change, and use this to develop a comprehensive change management strategy and plan

Source: PricewaterhouseCoopers Research

## Summary

A complex corporate operating model can be costly to manage and to maintain. It can create specific challenges as well, not the least of which is impaired operational efficiency. Change is never easy, and successfully implementing any (or all) of the three simplification routes outlined in this article represents a significant challenge.

Provided that the change effort is recognised and managed as described, the size of the prize at the end of a successful implementation can be significant—potentially enormous financial benefits, combined with a cost-effective, risk-compliant, tax efficient, and flexible organisation which is truly fit for the future, whatever it might hold. This is a reward that a growing number of Automotive companies around the globe have already judged to be well worth the effort.

### Corporate infrastructure costs

- 10-20% of related accounting spend
- 50-75% of legal spend on intra-group transactions
- 30-50% reduction in EU statutory audit costs
- 10-30% of back office (finance, HR, treasury, tax, legal, IT) spend

### Business control

- 10-30% of local management labour costs
- 100% of local board related costs
- 10-20% of current project spend

### Supply chain

- 5-15% of procurement spend
- 5-10% reduction in manufacturing costs
- 10-20% of distribution costs
- Working Capital – optimised above market – up to 5% improvement

### Agility

- “One culture” organisation – with a single regional face to customers and suppliers
- Simpler in-country reporting so reduced management effort on performance management
- Resolves conflicts between national and regional management
- Allows the business to be operated with one set of books

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## *Contributing authors*



**Mohi Khan**

mohi.khan@uk.pwc.com



**Joel Segal**

joel.segal@uk.pwc.com



**Gerard Cops**

gerard.cops@be.pwc.com

### **Additional contact**



**Michael Suska**

michael.suska@de.pwc.com



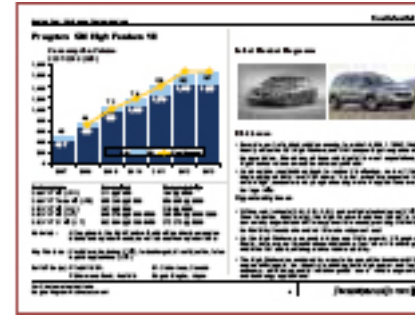




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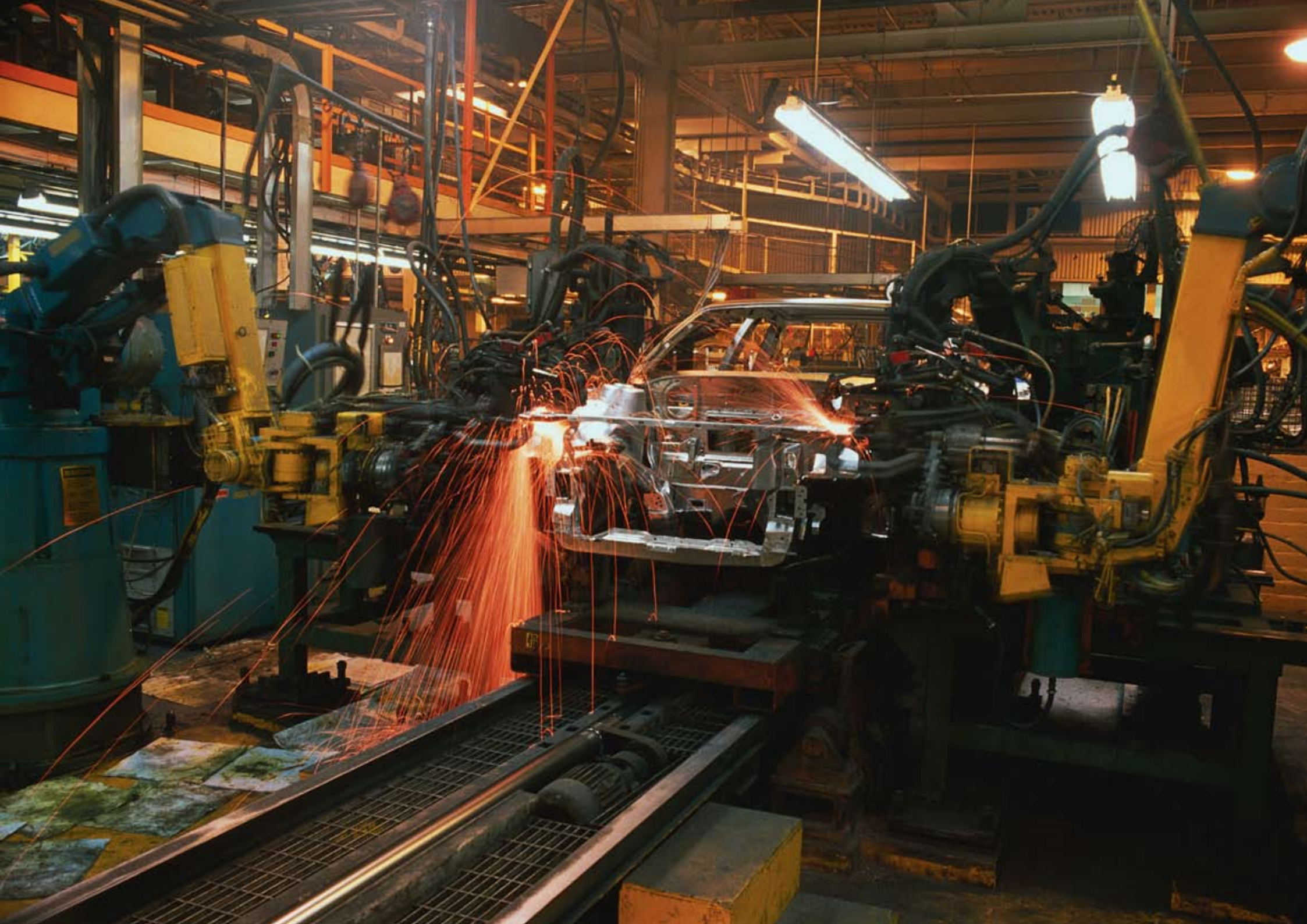
<b>Global</b> Stephen D’Arcy stephen.darcy@us.pwc.com	<b>Europe</b> Harald Kayser harald.kayser@de.pwc.com	<b>Central &amp; Eastern Europe</b> Matthew Pottle matthew.pottle@cz.pwc.com
<b>North America</b> David Breen david.j.breen@us.pwc.com	<b>South America</b> Marcelo Cioffi marcelo.cioffi@br.pwc.com	<b>Asia Pacific</b> Alan Yam alan.yam@cn.pwc.com
<b>Assurance Services</b> Global Automotive Assurance Leader Rick Hanna richard.hanna@us.pwc.com	<b>Tax and Legal Services</b> Global Automotive Tax Leader Horst Rättig horst.raettig@de.pwc.com	<b>Advisory Services</b> Global Automotive Advisory Services and Sector Leader Stephen D’Arcy stephen.darcy@us.pwc.com

Visit our website at [www.pwc.com/auto](http://www.pwc.com/auto) or contact the Global Automotive Programme Team:

Francis J. Cizmar  
+1 313 394 6100  
francis.j.cizmar@us.pwc.com

Alexander Müller  
+49 511 5357 5854  
alexander.mueller@de.pwc.com





[www.pwc.co.uk](http://www.pwc.co.uk)

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