

# MAXIMISING RESIDUAL VALUES THROUGH ANALYSING THE USED VEHICLE MARKET

*A report for BCA*



Second of a series of three Working Paper regarding residual values forecasting, issues associated with risk minimisation, and strategies to enhance vehicle prices in an unstable market. The UK has been used as the principal source of data.

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# Maximising Residual Values Through Analysing the Used Vehicle Market

Experience shows that relatively few organisations analyse who buy used cars.

The general assumption is that the used car market is an amorphous mass of buyers beyond rational analysis, making it difficult to match car buyers to stock – or proactively build a used car stock to satisfy specific market segments.

Nothing could be further from the truth.

*Used car buyers are every bit as sophisticated as new car buyers*

Used car buyers are every bit as sophisticated as new car buyers and have a much wider range of products to choose from. While new models in range of a particular marque are much the same, no two used cars are quite the same – different mileages, different treatments and driving styles render them heterogeneous and offer the opportunity for individual treatment when offered for sale.

In a mature market, like the United Kingdom, franchised dealers typically sell around 1.5 used cars for every new car sold. During periods of recession, that number tends to be even higher, as would-be new car buyers often balk at the price of new cars, electing to buy ‘something a little more modest’.

## Objectives

This Buckingham Automotive Working Paper seeks to review, at a high level, some of the issues associated with maximising residual values through managing the used vehicle market. Specifically, it seeks to;

- Review the role of dealers or used vehicle retailers in promoting the used car market, particularly in periods of economic downturn.
- Present some findings regarding used car market segmentation that might be examined in other used car markets.
- Consider issues associated with used car inventory strategy to support sales, enhance selling prices and lessen the impact of recession.

*Critical issues of the used car market and the supply chain*

It is against these three objectives that the comments on the following pages are offered. The notes highlight some of the critical issues of the used car market and the supply chain that brings cars from car manufacturers to the showroom, and their first owners, then ultimately to the used car lot.

## Role of leasing companies

It is important that leasing companies, however large or small, plan their new vehicles as the used cars they will ultimately become, and be 'in very close touch' with the used car market so they can achieve the best possible residual values on disposal.

The strategic role of a leasing company is to provide its customers with cars at a known price per month for an agreed amount of use. Within that deal, the lessor will also be expected to provide service and maintenance for the units.

While the lessor seeks to provide support for its customers, it also needs to look beyond the current situation in the marketplace and make an accurate assessment of used vehicle disposal values 2-3-4 years ahead. It must seek to achieve the best residual values for its vehicles, so it can minimise the monthly vehicle rental prices it offers, improve its competitiveness and enhance its own profitability.

*'You have to have a vehicle mix that is not too far from the average'*

It is a truism of the leasing industry that 'you avoid having a vehicle mix that is too far from the average mix of vehicles sold in any one year'. That way, you should at least match the 'best of the worst' and the 'worst of the best' and achieve residual values higher than your book figures. To achieve that neutral situation requires a deep understanding of the used car market.

In the 3rd and 4th quarters of 2008, Europe saw a slump in new car sales, accompanied by a big fall in used car volumes. However, the shortage of supply of ex-lease cars has not forced a significant rise in residuals; it has merely moderated the decline in used car prices.

A key part of a leasing company's role is to maximise residual value expectations. That means taking a lot of complex bets on the lessor's views against the developing used car market's views. It's a form of gambling in the same way as the stock market seeks winners – and not just those on horses.

## Dealers' role

Conventional wisdom in mature markets suggests the role of franchised dealers is to 'sell and service new cars'. Arguably, such a statement only covers a part of the role, especially in a period of poor sales.

*Role of dealers has Residual values have collapsed across much of Europe*

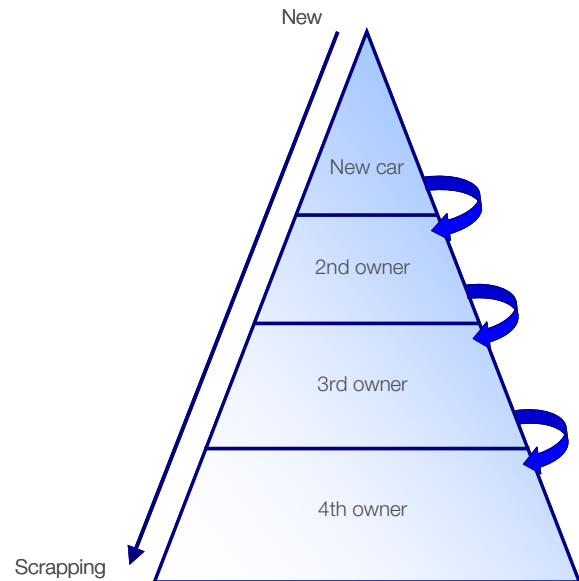
The role of dealers surely has longer roots in the supply chain. It should also include 'disposal of their customers' current vehicles so they can buy a 'new car'. In a mature market, the vast majority of new car sales are, in reality, replacement units.

Normally, one only has a true 'new car' once – everybody remembers it like their first kiss – after that, a new car will always be a 'replacement.' A critical role of dealers is to assist replacement car buyers by releasing the equity in their previous vehicle, so they have part of the purchase price of the new vehicle.

Figure 1 highlights this concept. At each stage of the exercise, the 'used car' is a 'new car' to its next owner until the vehicle is finally scrapped.

Such a statement may appear obvious, but it starts to place the used car in the pivotal role it fully justifies.

**Figure 1; New used car supply chain**



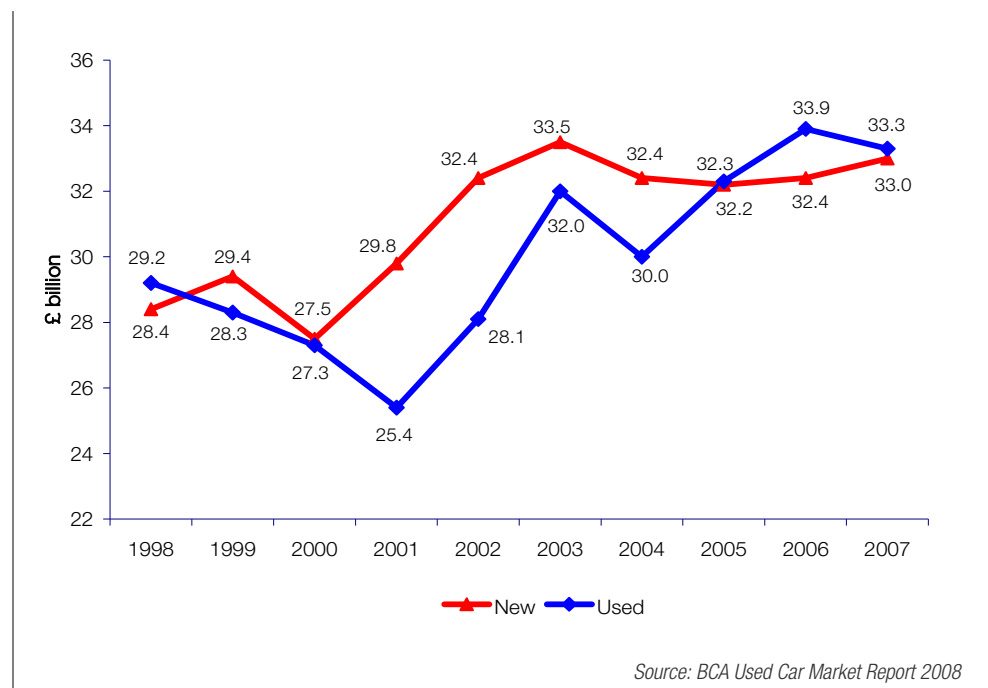
*Releasing equity needs to be an integral part of dealers' business*

Releasing the equity in the used car, and profiting from its subsequent sale, needs to be an integral part of dealers' business, especially during a period of recession and poor new car volumes. 'Two bites at the cherry' is how it might be described.

### The UK experience

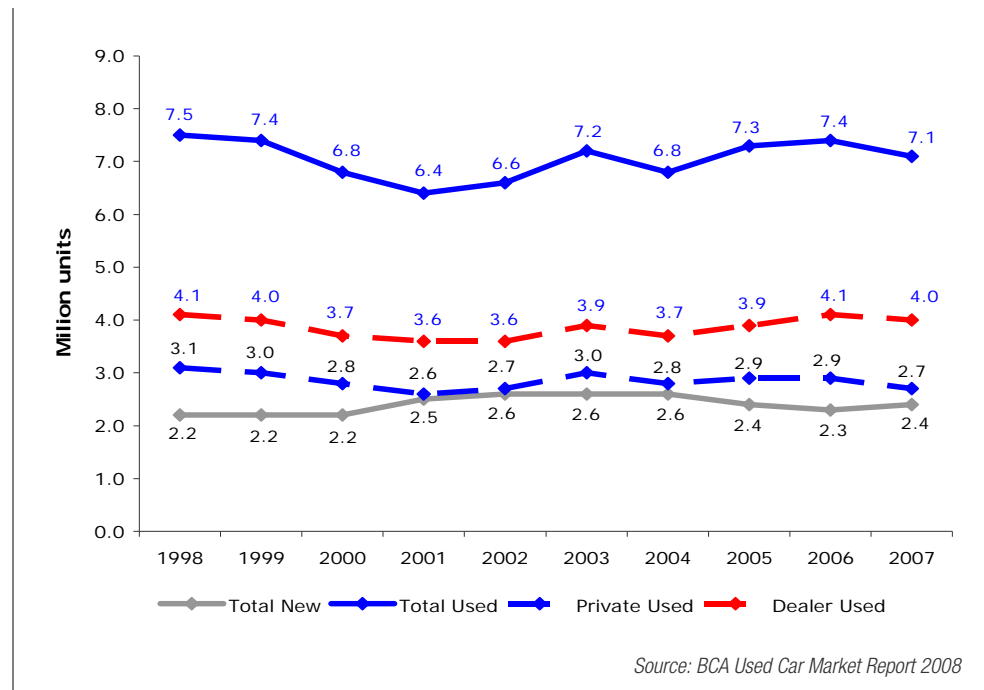
In 2007, the used car market value was some £300 million more than the new car market.

**Figure 2; New and used car markets; by value**



However, in volume terms, the gap is even greater as shown in Figure 3.

**Figure 3; New and used car markets; by volume**



The chart illustrates the three clear market segments in terms of car sales – new cars, used cars through dealers and private-to-private used car sales. Of the three groups, the majority of the oldest cars, at least in the United Kingdom, are sold on a person-to-person basis – a buying sector we will disregard for the remainder of this working paper.

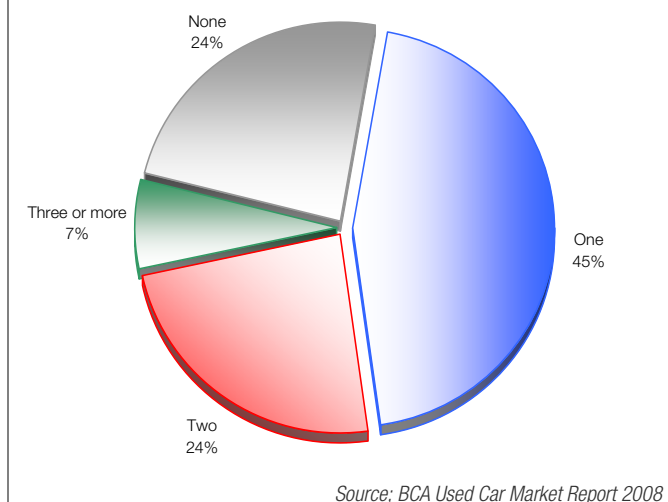
The second stage of the used car market might be identified by analysing the numbers of cars in a household. In the UK for example, the split between the various segments is presented in Figure 4.

*Many household own two or more cars*

It will be noted that, even in the United Kingdom, as many households own two or more cars than have access to no vehicles at all. How does it work in your market?

The high quality of modern motor cars means they have a far longer, practical, problem-free life than not many years ago.

**Figure 4; Cars in household**



*It is now regarded as good sense to 'buy used'*

With the growth in multi-vehicle families, more and more cars are being bought as second and third cars family cars.

While there may once have been a certain stigma in buying 'a second hand car', that seems to have largely disappeared. It is now regarded as good sense to 'buy used', particularly if that vehicle is bought from a reputable supplier. 'Used is the new' is a phrase increasingly heard in this period of recession.

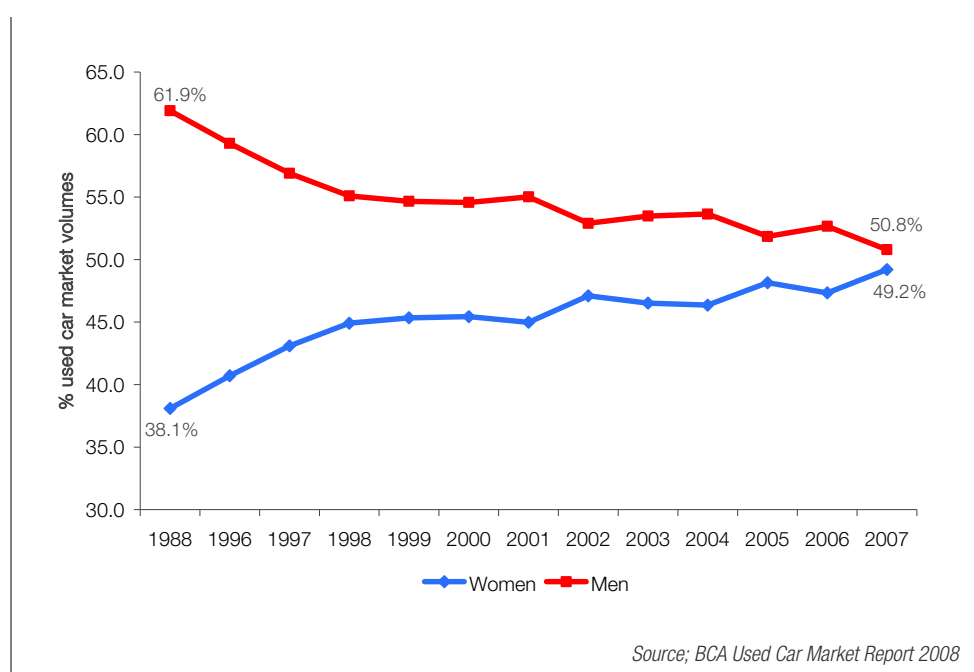
## Market segmentation

The previous paragraphs have suggested there is some order in the used vehicle market. Work undertaken by the Buckingham automotive team, analysing historic sales, suggest there are some very clear trends emerging in the UK market. One has to ask if such trends might also be emerging in European markets and, if so, what are the implications?

Sex and age appears to be a good place to start.

It has long been a truism that 'used cars are bought by men because they understand them'. An analysis of used car sales over the past 10 years suggests this might well have been the case many years ago, but no longer! Figure 5, shows the way the 'balance of the sexes' in used car acquisition has followed a pattern similar to the new car market.

**Figure 5; Used car buyers by gender**



The obvious question is – does this apply in your market? Have you ever researched it and asked what the implications are for your business? Work undertaken in the UK, provokes a number of strategic questions and implications

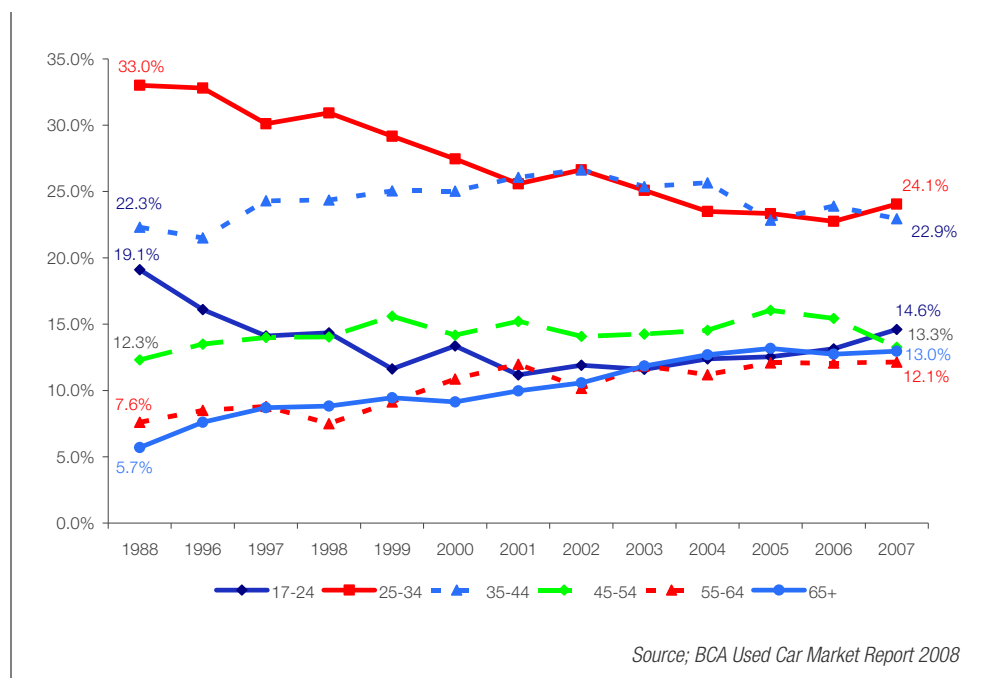
- Do female used car owners have specific vehicle requirements – smaller cars/family pickups; automatic transmission etc?
- Do female used car buyers have different questions and concerns when buying a used car?
- Are there specific female-friendly finance arrangements that might enhance the used car proposition?
- In your market, do female car buyers prefer to buy from men or women – and are your salespeople trained to and deal with female buyers?

*Word of mouth advertising and reputation are strong in the used car sector*

Such issues may well reflect in the market focus – advertising, vehicles offered and the way used car buyers are managed. Word of mouth advertising and product reputation are strong in the used car sector as the products offered are heterogeneous, but it is possible to generate a ‘female friendly’ image in the marketplace. Could that offer a premium product and price proposition too?

A second used car market analysis could bring further order to thinking about used cars and their profitable sale. Figure 6 shows the change in terms of used car buyer demographic profiles in the United Kingdom.

**Figure 6; UK used car buyer profile**



While some of the trends in this chart may be unique to the United Kingdom, there are two groups that might be of potential European interest.

The first group is older buyers – 65-plus motorists – the retired group in the United Kingdom. When one looks at the demographics of north west Europe, this is generally the fastest growing group of the population. Once upon a time, they would have lived for another five years – then died. No longer.

*Retirees offer an attractive market opportunity as used car buyers*

Retirees, if they are in reasonable health, may expect to live for another 15 years or so and, assuming they have reasonable funds, could offer an attractive market opportunity as used car buyers. They have specific characteristics. Consider some of them;

- Financially stable, but prudent in their expenditure; perhaps buyers of 'smaller used cars' – perhaps lower mileage and fuel efficient.
- Concerned by unplanned expenditure – why not offer a 'pay-by-the-month maintenance programme?' Tell them when to bring the car for service as part of the deal.
- Likely to keep driving for a further 10-15 years – perhaps three or four used car replacements. They are unlikely to move home or, if they do, are likely to remain in the same locality. Keep in contact with them for the next used car sale.
- As part of the service, provide insurance, finance, extended warranty – profit opportunities – 'a little but often'. There are insurance products for this group. Do you understand them?

One can develop a retired persons' marketing programme with profitable services for a tightly-focused audience. It has been made to work elsewhere.

At the other end of the age profile in the Figure 6 above, there are 17-24 years olds – the 'first time car buyers'.

A significant proportion of this group are in some form of further education – at college or university or even their last year at school. It is normally assumed this age group buys older cars as their first foray into car ownership. However, there are some interesting market trends emerging that might justify further investigation. Consider some headlines;

*Many parents do not want their children driving 'unsafe cars'*

- Many parents do not want their children driving 'unsafe cars' and may be willing to offer financial support to obtain a 'better car'. Dealers selling cars to families may well talk to parents about safer cars for their teenagers.
- Dealers may focus on this potential market group – acquisition may be seasonal to tie in with college terms. It's 'uncool' to have the same car for too long even in recession, this could be a replacement market.
- Suitable finance packages trading on parents' creditworthiness may be of interest. Parents' credit may well be much better – and it means the parents can have some minor influence on decisions, and favouring better quality units. There are also opportunities for insurance and other services too.
- Eventually, younger people will grow up and leave home and buy new cars. Work on their future business prospects. Keep in touch with them.

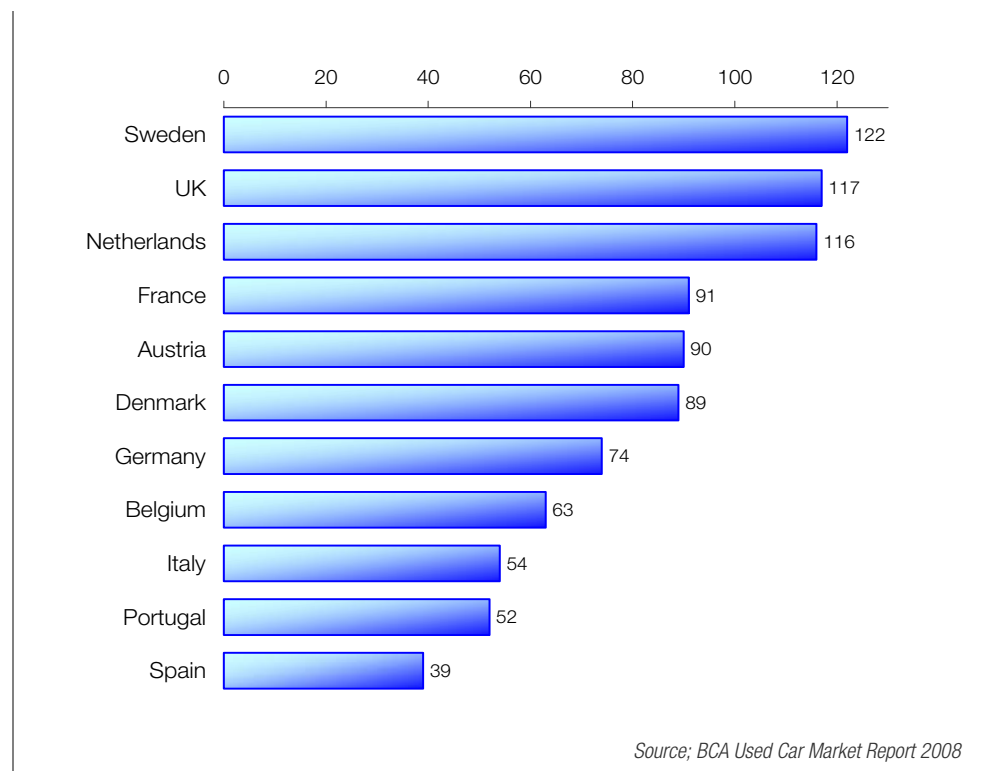


Does the dealership have a used car specialist who is able to deal professionally with such first-time buyers and build a profitable and long-lasting relationship with them – and perhaps their parents too?

### Demand for used cars

Used car sales per 1,000 of the population is an interesting guide to the market potential. Figure 7 shows current sales per 1,000 people – the figures vary widely between Sweden at 122 and Spain at a mere 39. It is accepted that markets are at a different level of maturity, but the chart does give an indication as to the opportunity over time – and the profit potential that it might represent.

**Figure 7; Used car sales per 1,000 people**

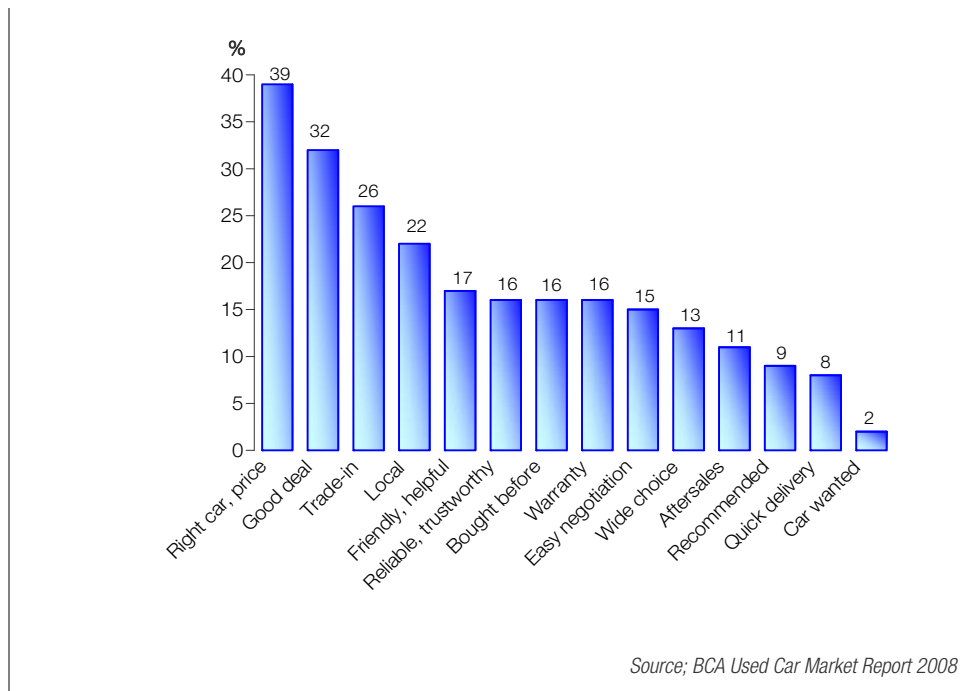


While these figures represent total new and used car sales, they do give an indication as to the strategic market opportunity. The challenge is how to communicate the quality used car message to potential used car buyers.

### Used dealer choice and market communication

Research in the United Kingdom indicates there are a range of factors that influence the choice of a dealer to buy a used car from. It is accepted this may vary from market to market, but the following chart provides a profile of a single market and the views of 3,000 recent used car buyers.

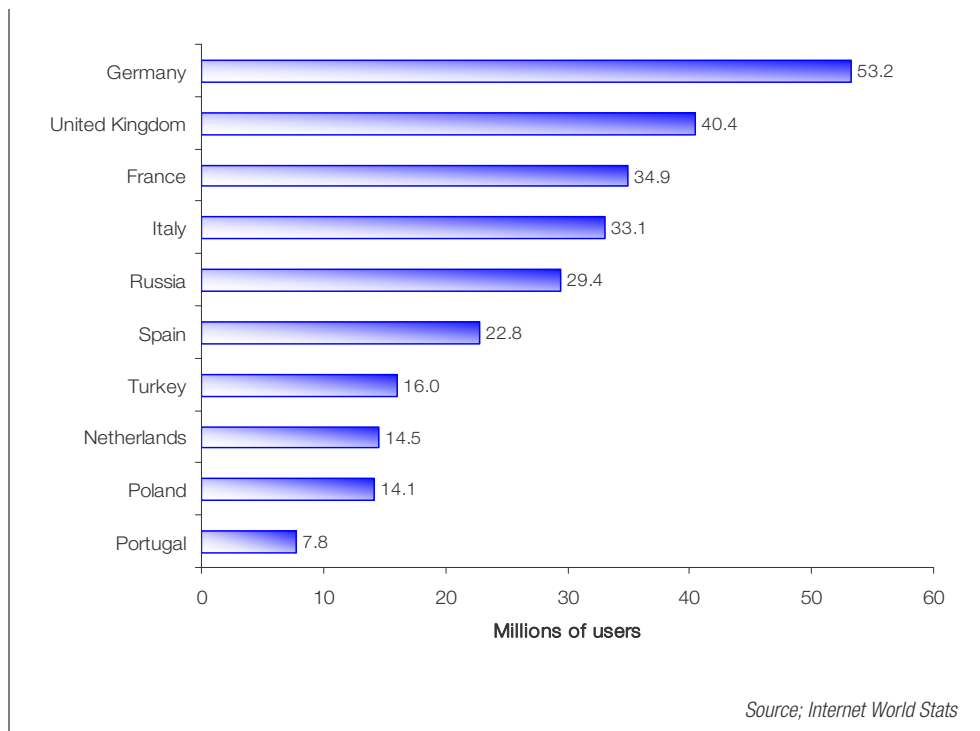
**Figure 8; Factors influencing choice of dealer**



Certainly nothing in the responses can be described as ‘rocket science’, but they do give an clear insight into what used car buyers think is important and, in the case of the UK, provided a useful basis on which to build a professional used car marketing programme.

## Used cars and the Internet

**Figure 9; Top 10 Internet Using Countries**



*The Internet has taken on a quite different role for used cars*

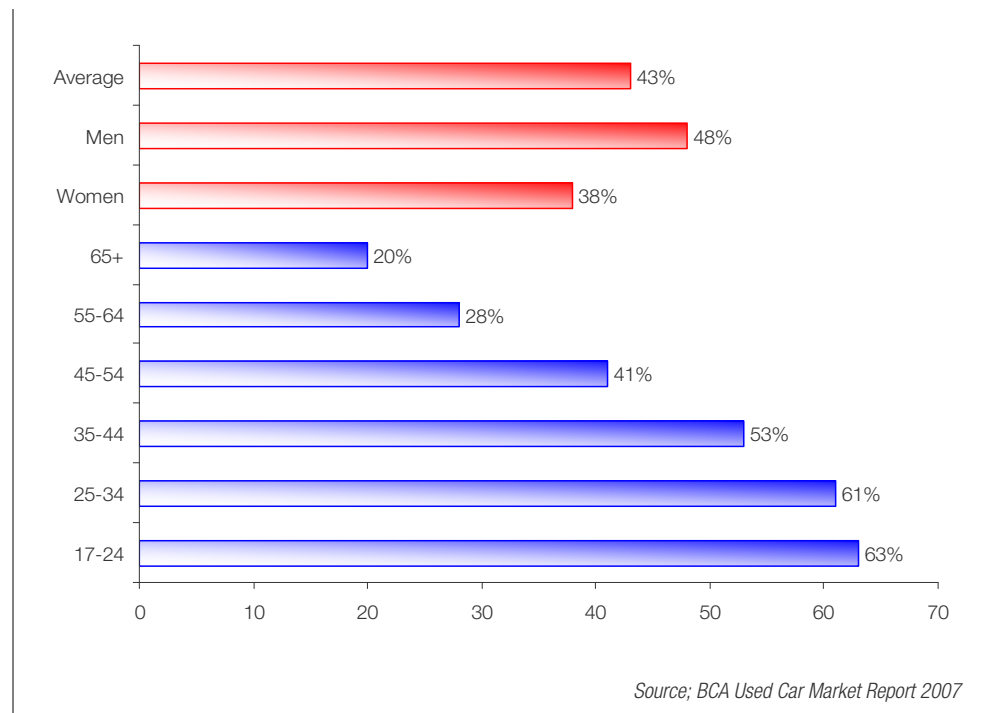
Figure 9 gives shows the relative use of Internet between countries. It certainly provides as indication as to the work used car outlets might undertake with regard to exploiting it to sell used cars.

In the UK, it was originally thought the Internet would have a critical role to play in the sale of new cars. While it certainly performs an important role in terms of providing prospects with information about different vehicles and prices, it has taken on a quite different role for used cars.

With the used car, and every unit being different, potential buyers use the Internet to search the market to identify used vehicles of interest to them and avoid wasting time on fruitless journeys to used car operations where there is nothing suitable.

The result is that the more sophisticated UK franchised and independent used car retailers now have informative websites for used cars, with detailed descriptions and specifications to tempt buyers to visit the dealership.

**Figure 10; Used Car Buyers Using the Internet to Source Cars**



### Market segmentation and used vehicle inventory

The foregoing notes have suggested the used car market deserves to be treated in much the same way as the new car market, except it is much larger and diverse. However, it offers significant profit potential and can take dealers into new revenue streams.

*It is possible to target specific sectors of buyers rather than work across the market*

Inventory and used vehicle market segmentation are key issues for dealerships. In a mature market, with the opportunity to trade used cars to ensure the stock is always fresh and interesting, it is possible to target specific sectors of buyers rather than work right the way across the market.

As noted above, different sectors have different requirements in terms of vehicles and it is possible to structure the product proposition to include finance and other services to minimise the hassle of buying in the same way one does with new cars.

Used car inventory is probably the key. It means changing the stock regularly, trading units that do not sell and replacing them with more attractive models. A used car depreciates daily – in the UK it costs about £10 a day to cover the cost of the site and depreciation.

Thus, if a car has not sold in a month it may have depreciated by £300 – which could be the margin. Constant pricing review, measuring interest, changing price is all part of the exercise – and so is the rule that ‘its not sold in 30 days – then trade’ and bring in an alternative vehicle.

### **Enhancing used car residual value**

The foregoing pages have sought to show there is a significant used car market in the United Kingdom. Would parallel evidence be available to demonstrate the availability in your market – and more importantly – routes to prospective buyers?

*The challenge is to identify the market, ideally broken down by segments*

The challenge is to identify the market and its requirements, ideally broken down by segments. Once these segments have been identified, it is possible to decide more accurately what the market needs in terms of used vehicles and under which terms buyers will be interested.

Taking that argument one step further; if there is an established used vehicle market segment, then it becomes possible to focus on that segment, to generate value-added used vehicles as product and, if sold under appropriate conditions, to create demand for a premium product.

Such actions mean there is an opportunity to create a premium price for that special product which will be marketed against a tight specification. That, in turn, may lift residual values of the vehicles bought in by the dealership, offering enhanced profit opportunities. Or, it may lift the residual values of more desirable units being brought to market by major leasing companies or fleet operators.

## Some conclusions

*Used cars – in many ways hold the key to success for new cars*

One could write a book on used cars – in many ways they hold the key to success for new cars. Certainly, they are hugely important in a period of recession when buyers may be reticent to go for new cars.

Increasingly, leasing companies have a role to play in the used car market by ensuring the vehicles they put on the fleet are those that will be attractive to the used car market.

Remember – the price forecast for the used car in 3-4 years time will be reflected in the monthly lease rate on that vehicle. Target a premium used car price through careful specification and management – and it will deliver long-term dividends.

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