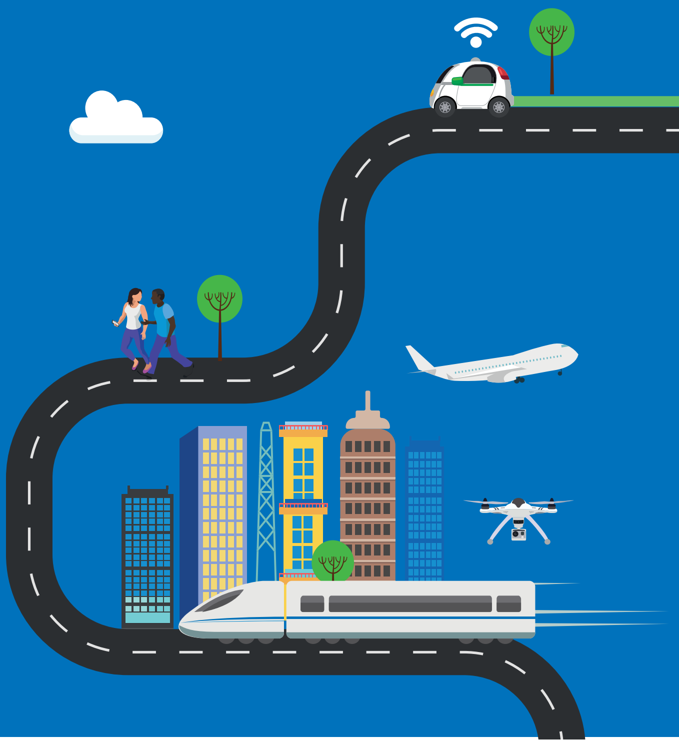
KPMG

Zero basing in automotive

Realizing value series

Global Strategy Group



Aligning resources with a future mobility strategy.

KPMG professionals believe zero based budgeting can help automotive original equipment manufacturers (OEMs) to find the funds to invest in vital strategic initiatives.

The automotive industry is in a turbulent period, with disappointing shareholder returns and poor return on capital. All of this is happening in the midst of huge transformational pressure brought on by three megatrends of electric powertrains, connected and autonomous vehicles (CAVs) and Mobility-as-a-Service (MaaS) – and exacerbated by uncertainties like Brexit and potential trade wars.

But strategic change won't come cheap, with an estimated US$90 billion (and rising) being invested in electric vehicles (EVs) – despite this segment currently being responsible for less than 1 percent of global car sales.[1] And, as OEMs shift from selling units to miles, the likes of Ford, Toyota, General Motors (GM), Volkswagen (VW) and others are starting to invest large sums into vehicle rental and subscription businesses. Technology for self-driving cars is another priority, as evidenced by Ford's billion-dollar investment in Artificial Intelligence (AI) startup Argo AI, and GM's autonomous vehicle unit – Cruise – which received a US$2.25bn investment from multinational conglomerate SoftBank's 'Vision Fund'.[2]

With so much funding required, we think it's time for the industry to reconsider zero based budgeting or zero basing.

This approach treats every new accounting period as a 'year zero', and demands that all costs and expenses be reassessed and justified in terms of their contribution to the business' overall value. The beauty of zero basing is that it makes businesses more agile, enabling them to swiftly allocate resources to the most strategically-important areas – rather than burdening them with historic costs related to outmoded activities. This can release funds to finance key strategic imperatives such as autonomous electric vehicles, mobility services and connectivity.

Done well, with the aid of advanced data analytics, zero basing can also increase cost transparency, enabling OEMs to get a better view of where costs are allocated, and which activities drive cost. The transition to electrification, for example, is dramatically altering powertrain production, with far fewer component parts than internal combustion (ICE) vehicles. As companies scale up EV production, transparency helps to quickly identify which processes and purchases to cut.

Despite these apparent benefits, zero basing has had its critics, who claim that it's unnecessarily disruptive, labor intensive and, worse still, does not deliver financially.

But KPMG professionals believe that it's built on the same principles that private equity (PE) houses apply in order to try to continually create value. By viewing the business through the eyes of an external investor, OEMs can focus on evidence-based decision-making and deal quality analytics.

To do this effectively, they should address five important principles:

- **Prioritizing human factors over a technical process**
- **Focusing ruthlessly on value creation**
- **Injecting tension into the system**
- **Tackling attitudes to risk head on**
- **Focusing attention on driving long-term value from zero basing**

Prioritizing human factors over a technical process

Zero basing can often be a difficult and emotional journey. Embedding experienced operators alongside existing leadership to provide coaching and support – something that many PE firms are very good at – can help both leaders and staff benefit from the challenge. In an industry that has had a fairly constant business model for over 100 years, seismic change introduces a new level of emotion. Part of the leaders' job will be to manage this tension, and not simply assume that change is a technical process. Auto companies are historically hardware specialists; but selling mobility services and building connected vehicles calls for a large injection of software and digital professionals, which could disrupt company culture and should be managed with great sensitivity.

Focusing ruthlessly on value creation

Don't try to zero base everything as the scale of such a challenge is simply too much. Instead, identify opportunities for value creation. For instance, a customer in a self-driving car will be more interested in 'infotainment' and other digital services than driving performance or mechanics. The trend away from car ownership is also likely to reduce the importance of brand – traditionally a large part of OEMs' sales and marketing budgets. By assessing just how much value a future brand will deliver, manufacturers should be able to release funds for initiatives like longer range batteries, and generally focus the budget on emerging areas more likely to deliver rewards.

Injecting tension into the system

Trade-offs create a healthy tension and force firm decisions rather than weak compromises. Take the critical choice of whether to develop automotive software or partner with a technology player;
when addressing this question, leadership needs to be highly objective and unencumbered by internal politics or culture.

Tackling attitudes to risk head on

The rapid pace of change in automotive markets is constantly shifting risk profiles. Where once a company may have sought powertrain dominance, it may now be aiming to own the car sharing space. Many PE firms seek to ensure a clear separation between those who create ideas and those who make ultimate strategic decisions, instilling governance, process and a data-led methodology. Leaders are best equipped to understand risk trade-offs, and should be making the ultimate decisions, leaving innovation teams free to be less cautious and more creative.

One popular tactic is to separate innovation from the mainstream business by setting up venturing arms with the freedom to explore ideas. For example, JLR's InMotion is an innovation unit with a venture capital arm, investing in mobility startups and early stage companies, as well as developing digital products for JLR customers.[3]

Focusing attention on driving long-term value from zero basing

One-off cost initiatives can be very attractive, but can actually be extended to create a culture with continual staggered 'waves' of zero basing focused on 'hot' parts of the business, delivering continued sources of savings. Training, processes, systems and incentives 'lock in' these ways of working, encouraging teams to constantly think like an external investor. And advances in data analytics make it easier and faster to assess costs.

Sectors like consumer goods and retail have long embraced zero basing, whereas automotive has been relatively slow in its adoption. Tomorrow's automotive winners are likely to be those companies that can adapt business models swiftly and reallocate resources to areas of greatest strategic need. In the face of continuous disruption, leaders need to constantly consider trade-offs between risk and value. After all, betting big on emerging business opportunities requires substantial financial muscle. Zero basing can help align resources with strategy and value to make budgeting a true source of competitive advantage in the fast-changing mobility ecosystem.

Sourcing and notes

1. Global carmakers to invest at least $90 billion in electric vehicles, Reuters, 15 January 2018. (https://www.reuters.com/article/us-autoshow-detroit-electric/global-carmakers-to-invest-at-least-90-billion-in-electric-vehicles-idUSKBN1F42NW)
2. SoftBank joins GM in self-driving car race; GM shares soar, Reuters, 31 May 2018. (https://www.reuters.com/article/us-gm-softbank-autonomous/softbank-investment-in-gm-cruise-could-speed-self-driving-cars-idUSKCN1IW1I3)
3. Forward Motion – Why Jaguar Land Rover is investing in technology startups, Forbes, 28 August 2017. (https://www.forbes.com/sites/trevorclawson/2017/08/28/forward-motion-why-jaguar-land-rover-is-investing-in-technology-startups/)

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Designed by **CREATE.** | CRT101007A | August 2018

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