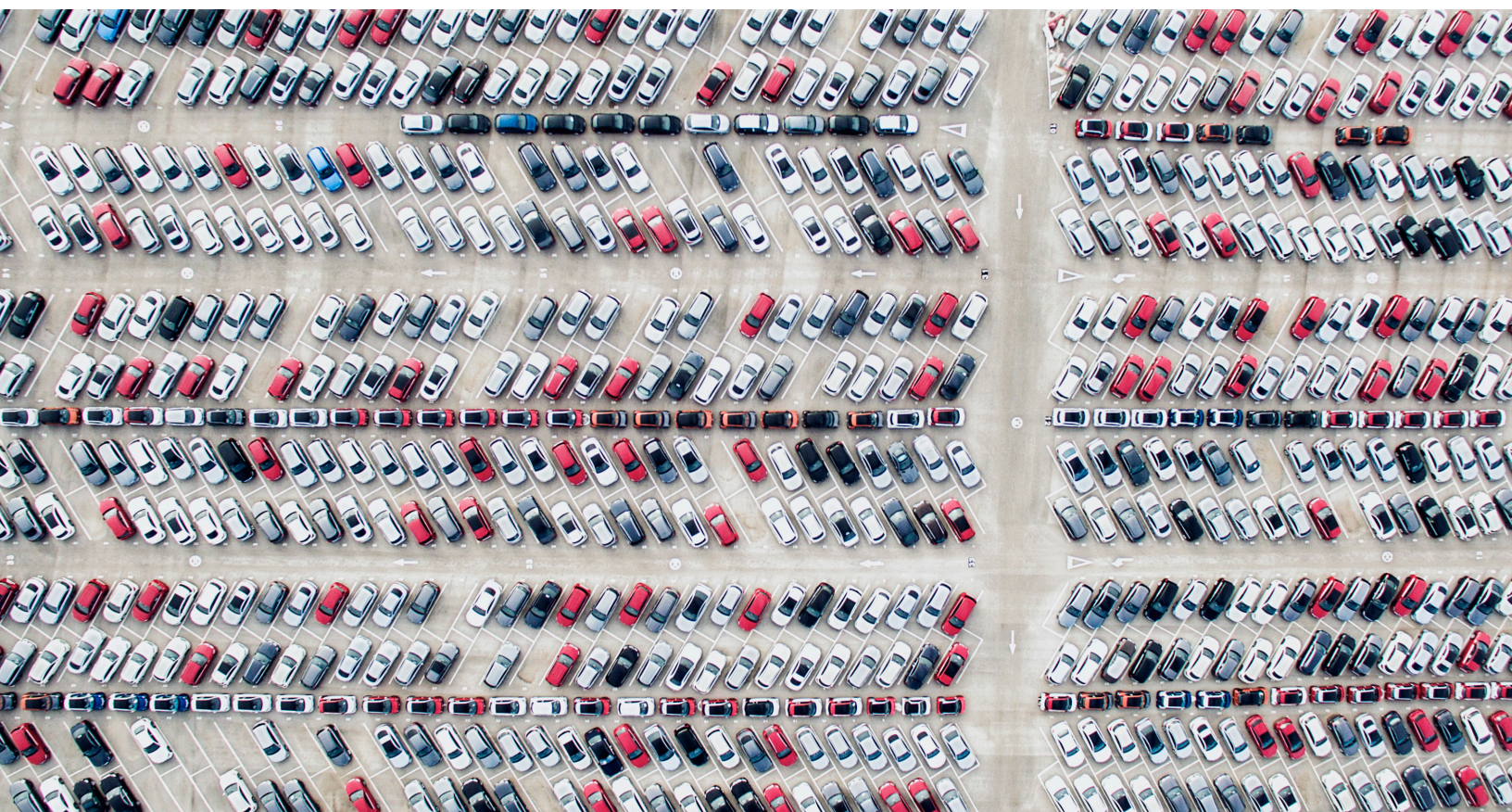


McKinsey Center for Future Mobility

# Used cars, new platforms: Accelerating sales in a digitally disrupted market

Dealers, investors, and disruptors can up their games to cater to digitally savvy used-car consumers.

*by Ben Ellenweig, Sam Ezratty, Dan Fleming, and Itai Miller*



**The digital revolution** is disrupting used-car retailing—for the better. This new wave of digital retailing represents more than technology alone because it focuses a spotlight on the importance of the customer experience in the used-car-buying process.

As revealed by our proprietary customer research, online providers are beginning to dilute traditional used-car dealers' positions and drive growth by empowering digitally savvy customers via three major capabilities:

- complete end-to-end purchasing capabilities (desired by 59 percent of buyers)
- extensive vehicle data and photos, along with effective search tools (desired by 64 percent of buyers)
- unique delivery options (desired by 28 percent of online buyers)

With the rise of digital players and potential incumbent-dealer consolidation on the horizon, the evolving market will feature new threats and opportunities for players trying to capture value in an already competitive environment. Furthermore, while the ways customers purchase vehicles are changing, it's also true that the needs of used-car buyers differ far more than those of new-vehicle purchasers. As a result, to generate a uniformly distinctive and differentiating customer experience, all used-car retailers must identify their target customer segments and rapidly develop the best approaches among a growing array of available options.

### **A big, stable, largely countercyclical market**

The US used-car market is more than twice the size of the new-car segment and is outpacing it in growth. McKinsey's auto retail micro-market model (ARM3) for used-car demand in the United States estimates that Americans buy 39.4 million used cars each year, versus 17.3 million new ones (2018),

and that used-vehicle sales will increase faster than new-vehicle sales over the next five years. Used cars offer a relatively countercyclical safe harbor from the dramatic sales highs and lows seen among new vehicles, with peak-to-trough declines averaging about 11 percent over the past two decades, compared with 23 percent for new ones. Historically, used-car sales have had less volatile reactions to market shocks, such as the 2009 recession (Exhibit 1).

### **New players, new retail models**

New digitally fluent entrants—such as Carvana, Fair, and Vroom, among others—are attempting to disrupt the industry. These companies can employ a range of sophisticated digital capabilities, like big data analytics and advanced digital platforms, that set them apart from conventional used-car dealers. Concurrently, established new-car dealer groups and OEMs are moving to protect and grow this important source of revenue.

The US used-car inventory is becoming both younger and pricier. The market has seen a strong shift toward later-model vehicles. Our analysis projects that, between 2017 and 2022, the used-vehicle profile will become increasingly younger, with major drop-offs occurring in cars seven years and older as more people trade up from older, less expensive vehicles (Exhibit 2).

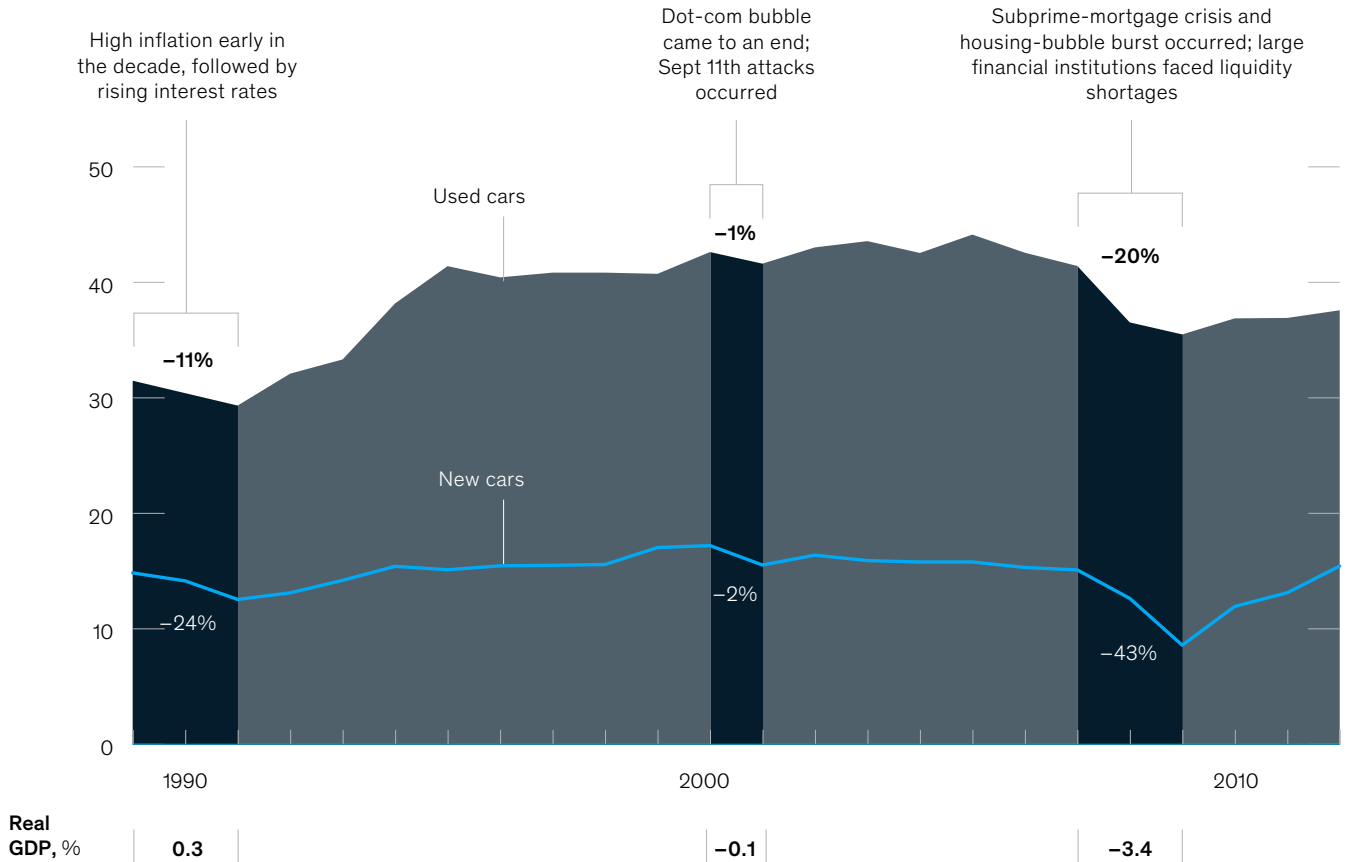
We estimate that the number of used vehicles three years old or less will increase from 51 percent of the total in 2017 to about 60 percent in 2022. A key part of this age shift will likely result from the greater supply of off-lease vehicles, many of which fall into the category of newer certified preowned (CPO) vehicles.

Used-car prices are rising due to the richer mix of available SUVs and pickups (Exhibit 3). For example, more customers are choosing full-size pickup trucks and midsize or larger SUVs among three-year-old vehicles, causing prices to rise 4.0 and 2.2 percent, respectively, between 2012 and 2017. Hence, while the prices of used three-year-old midsize

Exhibit 1

**The used-car market is less susceptible to market shocks.**

**Used- and new-vehicle sales peak-to-trough decline in sales volume, million**



Source: Federal Reserve Board; National Bureau of Economic Research; McKinsey analysis

and compact cars declined 1.3 and 1.6 percent, respectively, the overall used-vehicle-market average transaction price increased 2.7 percent. This shift is likely an early reflection of the auto industry’s general move away from cars toward light trucks and SUVs in the new-vehicle market.

There has been an increase in financing penetration as customers use credit to avoid laying out cash to meet higher used-car purchase prices.<sup>1</sup> Additionally,

customers are purchasing more protection products, such as extended warranties, to limit their financial risk if their used cars break down.

**Winning in an evolving market**

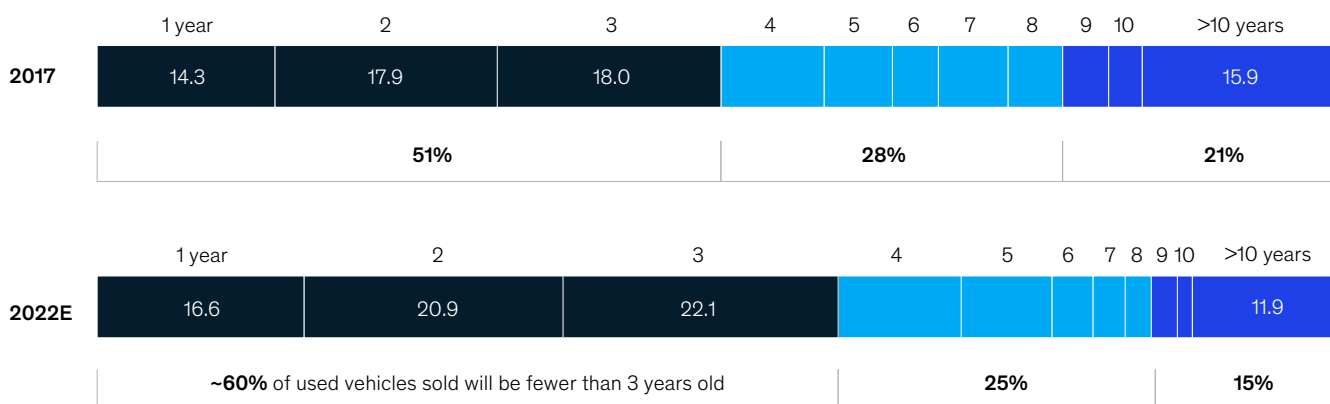
To understand how to win in this market, investors, OEMs, and retailers need to know who their used-car customers are, what they consider important, which players are meeting those

<sup>1</sup> National Automobile Dealers Association data.

Exhibit 2

**Used vehicles are becoming increasingly younger in a shift largely driven by greater off-lease supply and newer certified preowned vehicles.**

US used-vehicle market share by vehicle age, %



Note: Figures may not sum to listed totals, because of rounding.

Source: Edmunds.com; Frost & Sullivan; McKinsey analysis

needs, and how the industry can surprise and delight these customers to win their business and loyalty. Because customer preferences can vary so much across segments and geography, used-car retailers need to identify specific customer attributes and know how to attract and sell to them.

**Used-car buyers differ from new-car buyers**

A key part of our research involved a comprehensive survey of more than 2,500 shoppers, which revealed both similarities and differences among new- and used-vehicle buyers.

There are major similarities in the two segments, namely regarding age and experience: roughly three-quarters of both groups are more than 35 years old, and more than 90 percent of both groups have experience with car purchases. However, there are some major differences in the approach to buying. Used-car buyers spend about

40 percent more time researching online during the buying process than do new-car buyers, who spend fewer than seven hours, on average.<sup>2</sup>

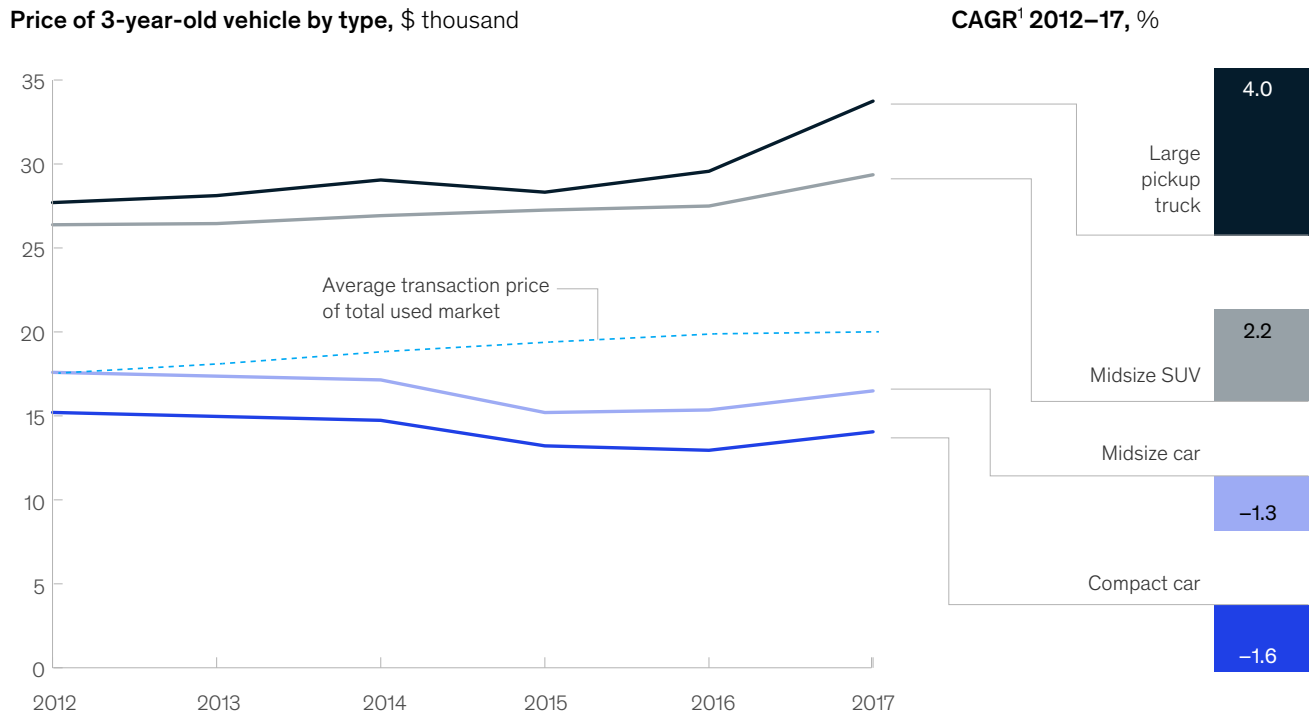
We believe the disparity results from several important drivers:

- **Variability in used-car quality.** Major differences can exist in the reliability and pricing of otherwise identical used cars compared with new cars, which have no ownership history and feature factory warranties.
- **Budget and creditworthiness.** More used-vehicle buyers are on tight budgets, and their average credit rating is lower, which limits their access to financing options.
- **Trust in salespeople.** Only 8 percent of used-car buyers rely solely on in-person salespeople at a dealer when purchasing a

<sup>2</sup> "2018 car buyer journey study," Cox Automotive, January 28, 2018, coxautoinc.com.

Exhibit 3

**The industry shift to light trucks is causing used-vehicle prices to increase.**



<sup>1</sup>Compound annual growth rate.

Source: CarGurus; Edmunds.com; McKinsey analysis

vehicle; the rest make decisions based on their own prior research.

Ultimately, these differences arise from the nature of used versus new cars: customers usually assume any new car of a given model is largely the same in quality and reliability and has strong brand backing. On the other hand, many used-car shoppers assume each vehicle has unique wear-and-tear characteristics and often does not enjoy the same brand guarantee. These factors, along with the credit differences, encourage them to do more research and trust their own findings. Consequently, used-vehicle retailers have a greater chance of losing buyers before they ever walk in the door, compared with new-car dealers.

**‘Table stakes’ are rising**

Our research shows that a plurality of used-car buyers demands services that allow them to make educated decisions about their purchases. These “table stakes” include the option to test-drive and inspect the vehicle and the ability to obtain multiple clear photos of it, along with detailed, factual data on elements such as service maintenance and accident history. There are several new online entrants that are doing this particularly well and have been driving customer expectations up, in comparison with traditional brick-and-mortar stores.

However, a new wave of tech-savvy customers, accustomed to the service levels of big online retailers, are demanding more innovative features,

like an end-to-end transaction, home delivery, and advanced search and recommendation features (for example, by lifestyle, driving style, or other attribute). The same cast of digital players enable this trend by offering home delivery, digital test-drives, and other solutions to cater to these customers.

As more used-car customers begin to expect the same seamless digital service they receive in other retail environments (either as table stakes or leading-edge innovations), preowned-vehicle retailers need to adapt so that they can maintain their competitiveness while protecting profits, especially finance and insurance (F&I) margins. The challenge is communicating the value of these products and services online, as it becomes especially tough when customers rely less on salespeople. The question then becomes, What can used-car retailers do in an omnichannel environment to deliver the benefits of a salesperson?

Retailers can find ways to use the digital-oriented used-car buyer's desire for advanced technology to their advantage in the sales process. For example, they could offer digital assistants, videos, and guided F&I-selection processes to enable easy access to car specifications, quality reports, inventories of selected vehicles, benefits of various products, and other detailed information to help shoppers make an informed choice.

**Brick and mortar still has appeal**

Brick-and-mortar dealers can still win in some critical nondigital areas, such as test-driving and servicing. In fact, used-car buyers see the inability to conduct in-person inspections and test-drives as the biggest barriers to purchasing a used vehicle online (Exhibit 4). Traditional dealers also have a strong incumbent position compared with new digital entrants and can benefit more from servicing

Exhibit 4

**Traditional brick-and-mortar operations have advantages over online-only players in perception of quality and test-drive availability.**

Top 5 barriers to online purchase, % of respondents



**Recommendations for customer retailing**

**Effortless test-driving**

- Test-drive specific vehicle at hub location or similar vehicle within a defined range

**Clear inspection process with certified mechanics**

- Full list of repairs made during reconditioning
- "Meet the mechanic" featuring real certified mechanics

**Transparency on imperfections**

- Clear photos that reveal any visible dents, dings, or scratches

**Painless returns**

- Return vehicle at any hub location or have it picked up

Source: McKinsey Used Car Survey

revenue, which new digital entrants have yet to figure out, potentially adding \$610 per vehicle, according to McKinsey's proprietary aftermarket-model estimates, which include part replacement, inspection, and fluid maintenance.

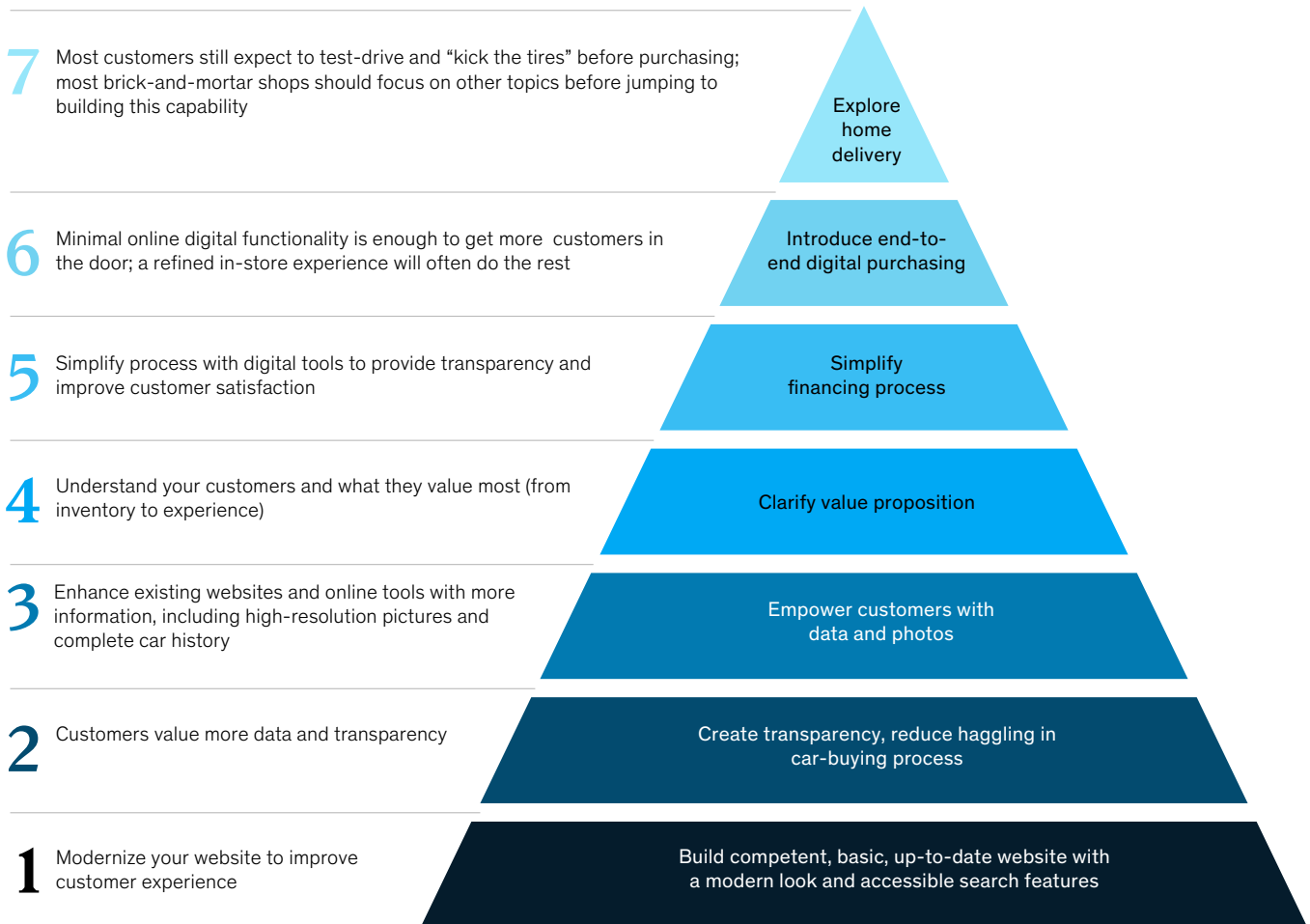
When we asked customers what they care about most when making used-car purchases, a clear hierarchy in the general population emerged (Exhibit 5). While digital savviness receives a lot of focus, customers also seek enhancements in the more basic elements of the used-car buying

process. For example, they want retailers to do the following:

1. **Build a competent website.** Customers want retailers to provide a basic but up-to-date website with a modern look and feel that they can easily access and search.
2. **Create transparency and reduce haggling in the car-buying process.** Existing players can easily update their current websites and people processes to provide transparency and reduce haggling.

Exhibit 5

## Retailers should focus on basic improvements before taking on more complex retail-model changes.



3. **Empower customers with data and photos.** Retailers can leverage existing websites and online tools to provide customers with more information, including high-resolution pictures and complete car histories.
4. **Clarify the value proposition.** Understanding customers and what they value most (from inventory to experience) can help give retailers an advantage over competitors, especially when targeting high-value segments.
5. **Simplify the financing process.** Customers dislike spending time in “the F&I box,” but it takes nearly 61 minutes to complete the financing process.<sup>3</sup> They desire a faster, more transparent, and more convenient process. Introducing digital tools to simplify and shorten the process can improve customer satisfaction and insurance penetration rates.
6. **Introduce end-to-end digital purchasing.** While customers want to conduct more of the transaction online, only a fraction expect to do it sight unseen. Adding minimal online digital functionality may be enough to get more customers in the door, and a refined in-store experience will often do the rest.
7. **Explore home delivery.** Home delivery represents a major disruption, but most customers still expect to test-drive and “kick the tires” before purchasing vehicles. We believe most brick-and-mortar shops should focus on other topics before jumping to building this capability.

#### **Different plays, different challenges**

Each one of the described moves comes with its own set of considerations. For example, building a transparent, no-haggling pricing model will require advanced pricing practices, great competitive intelligence, and high-quality data. What will it take to guarantee customers a great online experience? At minimum, that will require leading-edge

photography technology, solid user-experience design, and superb back-end systems. Protecting gross profits in the digital age also requires special modifications. For instance, with customers doing more online, dealers need to protect the F&I opportunities that traditional purchasing processes offer.

Other considerations involve trade-in valuations (if a company accepts or guarantees trade-in values, how does it ensure it's not losing on each deal?) and delivery and logistics (how does a player deliver vehicles to its customers without breaking the bank?).

#### **Recommendations for used-car players**

The implications of the digital trends discussed here will be different for each type of used-car-industry player. Depending on a company's position and evolution in digital retailing, priorities for improvements will also differ. The following suggestions provide companies with ways to adapt successfully to the future digital landscape, both in the US market and globally:

- **Dealer groups.** *Traditional brick-and-mortar dealers* with a lower digital presence should concentrate on improving website design and navigation by developing clean websites that are mobile ready and put the products at the center of the experience. To do this, they should include critical features such as high-resolution photos, advanced filtering, and up-to-date vehicle inventory across stores and geographies. Incumbents should also identify target segments based on locations and existing customer profiles and ensure that key processes, vehicle inventories, and go-to-market models focus on those segments.

In contrast, *established digitally savvy dealers* should marshal their existing capabilities to create a seamless omnichannel experience for customers by improving real-time

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<sup>3</sup> “It’s about time: Streamlining in-store processes to improve the customer experience,” Cox Automotive, November 2014, [coxautoinc.com](http://coxautoinc.com).



competitive-intelligence and digital-marketing capabilities. They should ensure that offline processes match online ones in transparency and simplicity for the customer and that the processes align with the segments they are trying to target.

- **Nontraditional digital disruptors.** Industry disruptors can employ strategic alliances with third-party financial institutions and other tech providers to improve customer experience and maintain profitability through videos, virtual sales, and chat capabilities. They should further target improvements to relieve ongoing customer pain points, such as the need for quicker delivery speeds and the ability to take test-drives. They can also find ways to provide additional customer security and build confidence by adopting service and maintenance models that demonstrate to customers that a digital player can take care of all their needs, end to end, just as a traditional dealer can.
- **Private-equity investors.** Private-equity players can identify and focus on dealers that lag behind in digital savviness and customer experience but inhabit markets poised for future growth. They can make traditional retail upgrades on dealership assets, such as promoting the go-to-market brand and expanding and diversifying sources of inventory (for instance, through consolidation or an improved auction strategy), as well as pursue

omnichannel improvements, such as website-design upgrades and enhancements.

- **Automakers.** OEMs should continue to strengthen the competitive position of their dealer bases by beefing up CPO programs and creating a seamless omnichannel experience. They can set more robust standards for preowned-vehicle dealers and continue to improve their used-car-reconditioning capabilities to cater to the higher customer-demand expectations for more expensive and newer used-vehicle inventory. Another suggestion: consider centrally managing inventory across the dealership network as a more efficient and effective way to match market demand at the microlevel (for example, city or postal code) to attract specific customer segments.

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More stable, more countercyclical, and arguably more profitable than the new-car market, the big but predictable used-car industry will soon diverge from its traditional path. New digitally savvy players are entering the market and courting car shoppers in ways that today's plugged-in customers identify with and appreciate. While the used-car market in the United States is late to the digitization party, we believe it will quickly make up for lost time. This is why both incumbents and disruptors need to move now to secure winning positions in the digitally powered used-car market of tomorrow.

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