

ADOPTION OF FRANCHISING MODEL FOR GROWTH AT CARNATION AUTO - IS IT THE RIGHT MOVE

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Disclaimer: This case is based on secondary data sources only and no primary research has been conducted. However, some information is based on informal interaction with various stakeholders in the passenger vehicle industry.

Abstract

The case is focused on the growth plans of Carnation Auto, an entrepreneurial venture of Mr. Jagdish Khattar, ex-CMD, Maruti Suzuki India Limited. Incorporated on January 3, 2008, Carnation Auto India Private Limited was engaged in the servicing of multi-brand passenger vehicles, body repair, purchase and sale of pre-owned cars, besides offering car insurance renewal, accessories and other value-added services. In 2011, Carnation Auto had presence in 15 cities across India including New Delhi, Mumbai, Chennai, Hyderabad, and Bangalore, using Company-owned-Company-operated model. In 2011, Carnation Auto was

well positioned to take the next leap of growth and therefore initiated the plan to expand its pan-India presence with new service as well as pre-owned car centers using the franchising model. But this aggressive growth plan was dependent on various challenges – was the price-sensitive Indian customer in non-metros and smaller cities going to accept the organized multi-brand passenger vehicle service concept; would the franchising model for growth work in this sector; with problems related to skilled manpower and spare parts availability, wasn't the plan to have about 200 pre-owned car showrooms from present 33 outlets an over-ambitious one. Before embarking on this growth journey, these challenges have to be properly addressed.

Incorporated on January 3, 2008, Carnation Auto India Private Limited was engaged in the servicing of multi-brand passenger vehicles, body repair, purchase and sale of pre-owned cars, besides offering car insurance renewal, accessories and other value-added services. In 2011-12, Carnation Auto had presence in 15 cities across India including New Delhi, Mumbai, Chennai, Hyderabad, and Bangalore, using Company-owned-Company-operated (CoCo) model.

In 2011-12, Carnation Auto was well positioned to take the next leap of growth and therefore initiated the plan to expand its pan-India presence with new service as well as pre-owned car centers using the franchising model. But this aggressive growth plan was dependent on various challenges – was the price-sensitive Indian customer in non-metros and smaller cities going to accept the organized multi-brand passenger vehicle service concept; would the franchising model for growth work in this sector; with problems related to skilled manpower and spare parts availability, wasn't the plan to have about 200 pre-owned car showrooms from present 33 outlets an over-ambitious one. Before embarking on this growth journey, these challenges have to be properly addressed.

Carnation Auto India Private Limited

Carnation Auto India Private Limited (formerly Hermes Auto India Limited) was an entrepreneurial venture of Mr. Jagdish Khattar. An Indian Administrative Services officer, Mr. Khattar had joined Maruti Suzuki India Limited in 1993, and had become its managing director in 1999. During his tenure as managing director of MSIL, between 2000 and 2008,

Maruti's revenues more than doubled – Rs 90 billion to about Rs 220 billion – while profits rose more than five times, from Rs 3.3 billion to Rs 17.3 billion. Widely considered as a giant in the Indian Auto Industry, Mr. Khattar started Carnation Auto as a multi-brand car showroom in 2008.

Early History of Carnation Auto

In September 2008, Carnation Auto raised its first round of funding of Rs 1.08 billion from PremjiInvest and IFCI Venture Capital Funds Limited and launched its first auto solutions hub at Noida, UP. The company provided services like General Repairs, Body Repairs, Workshop on Wheels (WOWs), Certified Pre-Owned (POC) Cars, Insurance Renewal, and Accessories & Car care. In 2011, Carnation reported net sales of Rs 809 million, operating loss of Rs 435 million and PBT loss of Rs 518 million¹. As of 2011, only 5 of the hubs were profitable, but the company projected all the hubs to have profit in 2012-13.

Growth of Carnation Auto

Carnation Auto adopted an integrated model and focusing on entire lifecycle of the car, it created the widest array of service offerings to meet all car related needs of a customer. The integrated model helped Carnation optimize car ownership of the customer and increase its share of wallet by increase in customer touch-points and opportunity for cross sale of business. The related verticals had helped Carnation to synergize and leverage the existing infrastructure, which was expected to help the bottom-line of the company.

To deliver customer service, Carnation adopted SAP suited – it was the only auto solutions company in India with SAP suite at all levels of operations – CRM, Finance, Service delivery, and Inventory management. These systems were capable of generating and gathering information from all touch points like customer contact and job card opening. These systems helped the company in generation of information at the most granular level like ability to drill down to job-card level profitability, track profiles and history of cars served, and customer demographics; analysis of information for drawing business intelligence; informed decision making; optimize acquisition and retention; and faster action

¹ICRA report on “Carnation Auto India Private Limited”, September 2011

on customer feedback. These systems were expected to support the growth trajectory of the company.

Carnation Auto had a strong management team headed by Mr. Jagdish Khattar. The senior team members had extensive leadership experience in auto and related sectors ensuring strong sector-related knowledge bank. The company also planned to establish training centers to build a strong operational team.

Over the years, Carnation Auto entered into various business and strategic alliances in all facets of its business. The relationships included Business partners like Mobil, Bridgestone, Michelin, Castrol; Technology partners like SAP, TCS, Genpact; Financing partners like HDFC, Kotak, Shriram; Insurance partners like National Insurance, Bajaj Alliance, Reliance Insurance, ICICI Lombard; and Strategic Collaborations like Magneti Marelli, 3M, Autocar, GuardX Protection. The alliance with Magneti Marelli, a Fiat Group company, headquartered in Italy with a turnover of US\$6.5 Billion and a leader in automotive systems, components and services, is focused on enhancing its technical know-how and spare parts offerings. Magneti Marelli After Market Parts and Services, the aftermarket division of Magneti Marelli, had a list of over 30,000 parts across 30 product lines in their catalogue and had the capability to sustain supply for almost all the premium brands that were being sold in India.

Carnation Auto, in short span of time, had developed a pan-India network with strong presence in North, West and South India. The company had presence in 15 cities across India including New Delhi, Mumbai, Chennai, Hyderabad, and Bangalore, using CoCo model, with 24 general repair hubs with 335 bays, 23 body repair hubs with 319 bays, 7 POC outlets, 47 WOWs, and Car accessories and care presence in 13 service hubs (**Exhibit 1**).

The Indian Passenger Vehicle Industry

The Indian passenger vehicle industry in India had five sub-segments – New passenger vehicle market, Pre-owned passenger vehicle market, Passenger Vehicle insurance market, Passenger Vehicle accessories and care market, and Passenger Vehicle service market.

The New Passenger Vehicle Market in India

With 13.2 million in 2011, India had the 7th largest passenger car park globally for passenger vehicles, larger than markets like United Kingdom, France and Spain by volume, but was relatively small compared to other emerging auto markets like China, South Korea and Brazil. Despite strong growth witnessed for a nearly a decade, penetration of passenger vehicles in India had continued to remain the lowest among emerging markets (**Exhibit 2**). The passenger vehicle market in India was changing rapidly with vehicles getting more sophisticated; households owning multiple vehicles (models and brands); emerging new class of customers in the form of fleets and corporate vehicles; significant growth being witnessed outside the metro cities; and growing number of OEMs.

The Indian passenger vehicles industry had been on a relatively steady growth phase over 2000-2010 and was expected to continue to grow (**Exhibit 3**). It had been one of the few markets worldwide which saw growing passenger vehicle sales during the liquidity crisis and recessionary phase witnessed during 2008-09. In 2011, new passenger vehicle sales resulted in an addition of ~2.5 million vehicles to the car park. The Indian passenger vehicle market was dominated by 3 players – Maruti, Hyundai and Tata, having a combined ~92% market share in 2010. To capture market share in Indian market, the foreign OEMs had adopted various strategic options like competitive pricing, high fuel efficiencies, presence of diesel versions, and modern designing. Due to aggressive expansion plans of new entrants, the market share of other players had been steadily increasing (**Exhibit 4**).

The Indian passenger vehicle market was expected to have a positive impact due to the economic and demographic factors in the new India. Barring marginal blips during the last couple of years, the Indian economy had moved into higher growth (8.5%+) trajectory during 2000-10 period, which was likely to be sustained over the medium term. In addition to steady economic growth, India's demographic profile was changing which was reflected by its very young population (50% of population under the age of 25), steadily improving dependency ratio, growing urbanization and trend towards smaller, nuclear families. India witnessed rising per capita GDP levels – the per capita GDP had almost doubled to US\$3,270 between 2000 and 2009.

In India, over 65-70% of passenger vehicles being financed in India, so availability of financing options at competitive rates played a major role in driving growth. The highly

competitive scenario among the banking and NBFC participants had resulted in improving India's performance in terms of higher vehicle financing availability. The vehicle financing cost had declined over a longer period of time supported by favourable interest rate regime and relatively healthy performance of the asset class amongst various consumer finance categories

The changing Indian economic conditions had positively affected the smaller towns and rural India. The share of new passenger vehicle sales from top-10 cities had fallen to 40-45% in 2011 from 60%-65% in 2006. According to Industry estimates, approximately 60% of the rural economy was dependent on non-agricultural income such as trading, remittances from cities, and employment in the manufacturing sector. This coupled with a substantial increase in crop prices, had resulted in higher disposable income. Rising land prices across the country and the implementation of the sixth pay commission had collectively helped in improving the purchasing power in the rural and semi-urban cities/tier III cities. The smaller towns and rural India was witnessing rising disposable income levels, improved road connectivity, and increased number of earning members in the family.

The Indian Pre-Owned Passenger Vehicle Market

The pre-owned passenger vehicle or pre-owned car (POC) market in India was expected to reach nearly 8 million vehicles by 2016 (**Exhibit 5**). In 2011, the new vehicle: used vehicle market was 1:1.2 of new vehicle market, but the market was expected to increase to 1:1.8 by 2016. In India, due to improved economic conditions, the first ownership lifecycle was shortened from 7 years nearly a decade ago to less than 4 years in 2011, and it was expected to reduce further.

Historically, the POC market in India had been highly fragmented dominated by unorganized sales including sales through neighborhood dealers, roadside garage mechanics and direct customer-to-customer sales. However, OEMs had started establishing a presence in this market since 2001 but primarily focused on single brand, thereby limiting the options for consumers. While buying a POC, the customers considered the trust on either the middlemen (neighborhood dealers and mechanics) or the point of purchase (OEMs' centers) as the most critical parameter.

The Indian Passenger Vehicle Insurance Market and Indian Passenger Vehicle Accessories and Care Market

The passenger vehicle insurance market, the largest segment of general insurance industry with 22% market share, was highly dominated by unorganized players or online channel, especially in metros.

The passenger vehicle accessories market in India was highly unorganized with limited transparency in quality, pricing and warranty, and was dominated by after-market localized retail shops. The demand was expected to grow driven by the need to fulfill perceived needs and comfort of car owners due to higher disposable income, changing demographics and change in customer attitude.

The nascent passenger vehicle care market was expected to provide services for performance enhancement and maintenance like Teflon coating, engine de-carbonization, and upholstery cleaning. This market was expected to grow slowly as higher awareness levels regarding services available and their advantages coupled with higher disposable income was expected to fuel the demand for vehicle care services.

The Indian Passenger Vehicle Service Market

The Indian passenger vehicle service market was divided into two categories – General vehicle service market and Body repairs market. The general vehicle service market included recurring or periodic vehicle service. With growing car park, the general vehicle service market was expected to grow to amount to Rs 301.5 billion in 2016 from Rs 117.0 billion in 2008 (**Exhibit 6**). As compared to the growing car park, the vehicle service infrastructure was lagging behind and facing constraints (**Exhibit 7**). The leading OEMs in India, Maruti, TATA and Hyundai, although accounted for 85% car park combined, were experiencing capacity constraints in the vehicle service network, while the other players, accounting for balance 15% market, were highly fragmented and had limited pan-India coverage. Due to strong competitive scenario, OEMs, which were pressured by rising competition not to increase price of their vehicles over the last decade, were focusing on increasing their sales network, thus the service infrastructure at OEMs was not expanding in equal proportions.

The body repairs market in India was dominated by body repairs usually performed against insurance claims. Due to excessive body repairs, driven by cashless insurance facility and dealers' preference to replace over repair, the insurance companies were incurring losses as expenses (claims + processing + other expenses) exceeded net premium collected (net of commission and other expenses). The insurance companies were incorporating stringent procedures to clear the insurance claims in order to overcome the growing incidences of highly inflated bills.

In India, roadside garages accounted for 58% of the total vehicle service market in 2011. These players were characterized as players having limited service offering capabilities due to limited tools and equipments; lack of quality of skilled manpower and processes; lack of availability of reliable parts; non-transparent pricing; and no cashless body/accidental repair work. The customers preferred these players in the non-warranty period as the cost associated with service is very low for these players. The second category was OEM workshops. These players were characterized as service stations having trained manpower and advanced tools and equipments; services at highly marked-up prices and high cost of spare parts; long waiting time; cashless body/accidental repair work. The OEM workshops had limited presence in Tier II/ III cities for some OEMs. Customers preferred these service stations during the warranty period and in case of any specialized needs. These players accounted for 41% of the total vehicle service market in 2011.

The third segment, organized multi-brand players, had trained manpower, relatively advanced tools & equipments, and provide service at competitive pricing. The customers preferred these service stations after completion of warranty period, but when the vehicle is relatively new. The biggest problem customers encountered at these players was delays due to non-availability of non-routine spare parts. These organized players had limited presence on pan-India basis. These players accounted for 1% of the total vehicle service market in India in 2011. Carnation Auto was a player in this category. The other major players present in this market were MyTVS, Mahindra First Choice, Carz, Castrol Pitstop, and Bosch Service (**Exhibit 8**). These players had to invest regularly in the infrastructure development (advanced tools and equipments) and manpower training to compete with the OEM workshops as the OEMs were rapidly changing technology, but the returns on such investment always had a lag. On the other hand, these players had to create robust processes

to differentiate from roadside garages, which posed challenges for these new entrants in Indian market.

Growth Strategy at Carnation Auto

Carnation Auto adopted a two-legged strategic plan to achieve growth focused on consolidation of existing operations and expansion of network & launch of new verticals. In consolidation of existing operations, the focus was to have brand consolidation and drive profitability by increasing awareness, increasing utilization levels, improving operational and cost efficiencies, and strengthening WOWs business vertical. The company planned to have tie-up with car leasing companies and corporate fleets to get traction for service operations and POC procurement and complete remarketing. For WOWs vertical, it planned to have exclusive arrangement with Delhi International airport to serve customers through WOWs at the airport parking facility to improve brand awareness.

On the other hand, for expansion, Carnation Auto charted out an aggressive route plan to expand its network. In the plan, the company had decided to launch CoCo hubs only in the existing cities for deeper penetration and franchised based roll out plan to expand the pan-India network. The company targeted to reach 99 cities across India with 160 locations and primarily focused on cities and satellite towns with no CoCo presence (this was done to avoid cannibalization). Carnation Auto expected to earn from royalty fees; margin on parts, paints, lubricants, VAS; sale of warranty packages in case of pre-owned cars; and one-time start up fee and refundable security deposit from franchisee units.

Challenges with Franchising Model

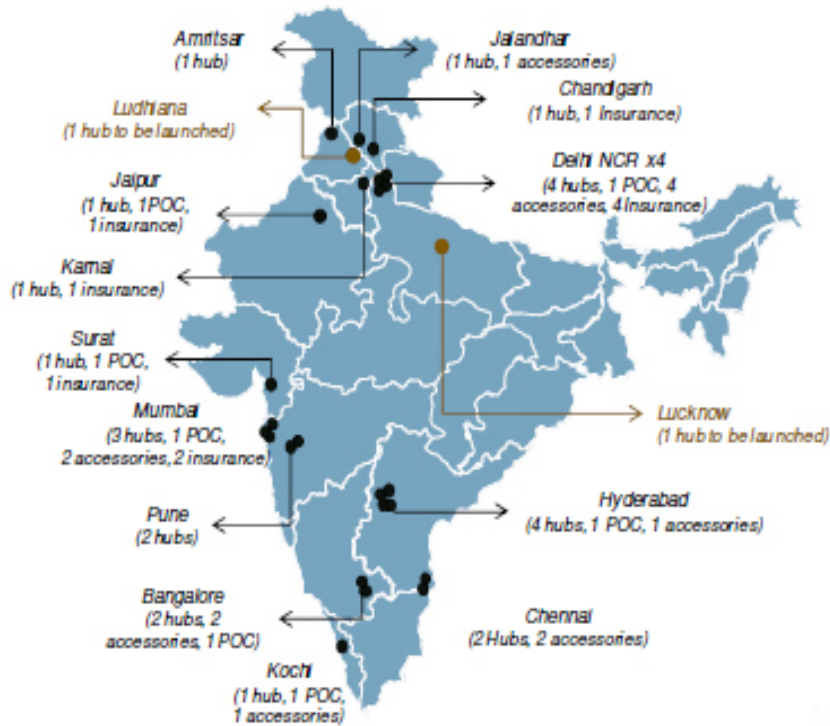
Although franchising model had been adopted by Indian entrepreneurs to have successful expansion of their businesses, there were doubts about the same in passenger vehicle service business as the experiences with franchise model had not been very encouraging².

In passenger vehicle service market, the brand image was considered as the most important competitive factor to differentiate in over-crowded market. While adopting franchising

²MyTVS had decided to exit the franchisee model due to shortcuts taken by franchise partners to earn profit like using spurious parts and untrained labor force, which had affected the brand image of MyTVS. MyTVS was planning on pan-India expansion but were still undecided about the model.

model for growth, the companies have faced the challenges of brand erosion due to non-adherence to standard operating procedures by franchisee partners. In such a scenario, whether, by adopting franchising model, Carnation Auto was putting the reputation at stake or going to change the dynamics of passenger vehicle service market, was to be seen in future.

Exhibit 1: Pan-India Network of Carnation Auto



Source: Case writers

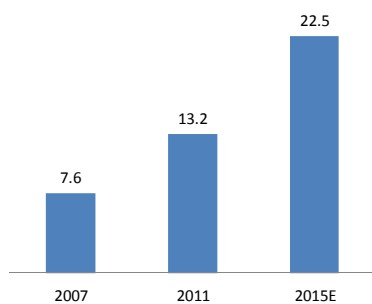
Exhibit 2: Passenger Vehicle Density of Select Countries (per 1,000 persons)

Country	Passenger Vehicle Density
USA	1,200
Japan	445
Russia	188
Brazil	158

Turkey	85
China	45
India	13

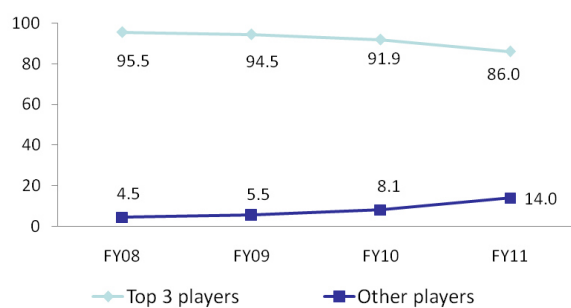
Source: SIAM and Industry Reports

Exhibit 3: Car Park in India (number of vehicle in millions)



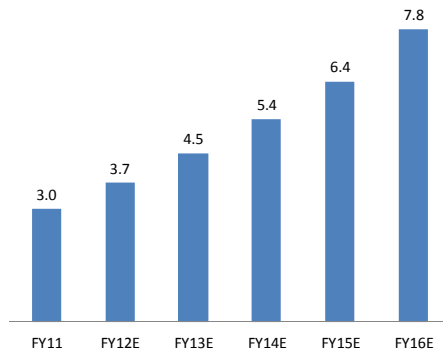
Source: SIAM and Industry Reports

Exhibit 4: Indian Passenger Vehicle Market Share (in %)



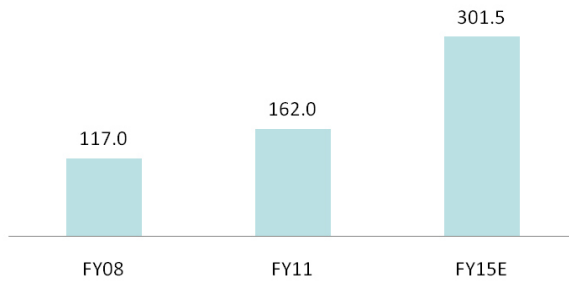
Source: SIAM and Industry Reports

Exhibit 5: POC Sales Volume in India (number of vehicle in millions)



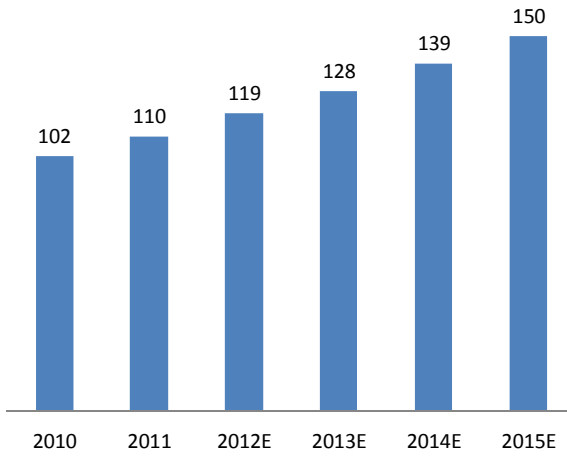
Source: SIAM and Industry Reports

Exhibit 6: Car Service Market in India (in INR billions)






Source: SIAM and Industry Reports

Exhibit 7: Number of Service Bays (number in '000)



Source: SIAM and Industry Reports

Exhibit 8: Competitive Landscape of Select Organized Multi-brand Passenger Vehicle Service Providers

Particulars			
Services - General Repair - Body Repair - POCs - 24X7 Roadside Assistance - Mobile Workshop	Offered Offered Offered Offered Offered	Offered Offered Not Offered Offered Not Offered	Offered - limited Offered - limited Offered Not Offered Not Offered
Network	Workshops - CoCo: 24 - Franchised: Nil POCs - CoCo: 7 - Franchised: Nil	Workshops - CoCo: 16 - Franchised: 51 POCs - CoCo: Nil - Franchised: Nil	Workshops - CoCo: 11 - Franchised: 5 POCs - CoCo: 5 - Franchised: 132
Growth Strategy	- Build brand and processes with CoCo in initial years - Network expansion using both CoCo and Franchise (only in non-CoCo cities to avoid cannibalization)	- Brand building using both CoCo and Franchise - Network expansion using both CoCo and Franchise	- Focus on POC market

Source: Case writers