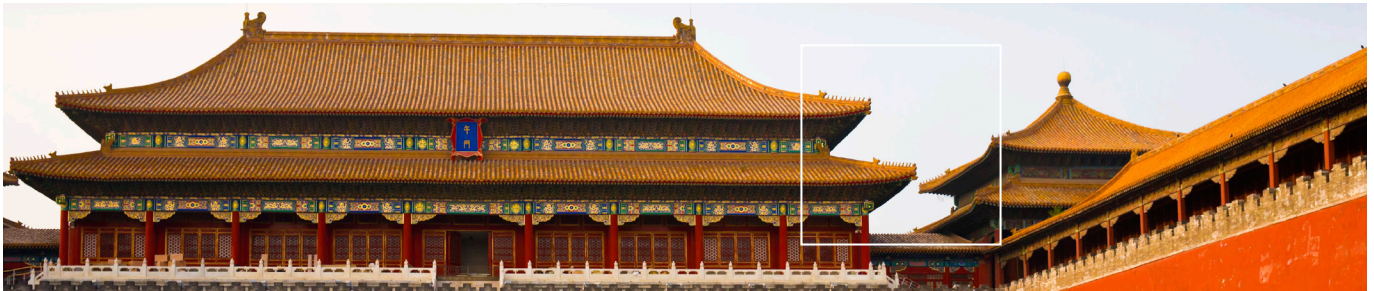


China's Automotive Market

A Bumpy Ride Ahead? – How automotive OEMs can plan for a smoother journey



China has become one of the most important markets in the world for the automotive industry. Multinational companies have identified significant business opportunities but are they fully aware of the challenges and risks associated with the Chinese market? Based on in-depth market insight and a long track record of delivering strategic projects for major automotive companies in China, Arthur D. Little assesses the outlook for the Chinese automotive market and identifies five key topics that should be on the CEO agenda for any international automotive OEM doing business in China.

Market outlook: growth, challenge and risk

Is growth in the Chinese car market sustainable?

In the twelfth five-year plan agreed by the National People's Congress in March 2011, China plans to reduce average annual growth in GDP from 7,5% to 7% over the next five years. This rate of growth is still considerable compared with the European Union which forecasts average growth of 2% p.a. until 2020. Additionally, for the first time, the Chinese five-year plan sets a CO2 reduction target (-17% per unit of GDP).

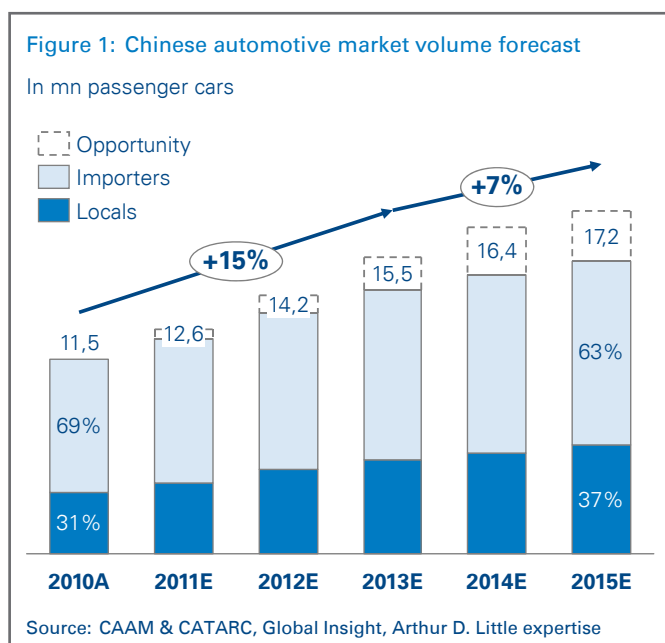
Arthur D. Little anticipates that the Chinese automotive market will experience growth of 15% p.a. for the next three to four years, with growth in market volume slowing down between 2013 and 2015 to 7% p.a. as shown in figure 1. Over the next four years, local automotive brands are likely to increase their market share, although we expect that there will be significant opportunities for international automotive OEMs too.

As the market matures there will be a change in the ratio of first-time to second-time car purchasers. Today, about 80% of customers are first-time purchasers; by 2019, there will be more second-time purchasers than first-time purchasers. Current market growth is fueled primarily by first-time car purchasers so growth is likely to decelerate in the medium term.

Top challenges for international OEMs in China

While market growth offers significant opportunities, international automotive OEMs aiming to compete in China also face significant challenges.

Joint ventures in particular pose complex challenges, most notably the requirement to align processes and to establish fast decision-making at headquarter level. In addition, OEMs' long-term strategies need to take into account increasing competition, changing urbanization scenarios and the inherent structure of the Chinese market. China's dimensions are not comparable to the home markets of automotive OEMs; the population of China is more than 2,5 times larger than that of the EU while China's landmass is double the EU's size.



The used car market presents specific opportunities and challenges. Still embryonic, it is currently growing at a rate of around 30% p.a. and by 2017 used car sales could outstrip sales of new cars. However, infrastructure and capabilities in the used car market are still underdeveloped at both OEM and authorized dealer level. Wholesale functions hardly exist and it remains unclear whether players will manage to capture the full potential of this market at this critical stage.

Across China, recruiting, developing and retaining talent remains difficult, with high employee turnover limiting organizations' ability to maintain efficient processes and knowledge sharing. A fierce war for management talent is already underway in the Chinese market.

Key risks for international OEMs in China

Ad hoc regulatory changes and a lack of transparency in this area characterize the Chinese market and are a core risk that must be monitored. For example, in December 2010, Beijing car registrations for 2011 were limited to one third of the number of registrations for 2010, with registrations being awarded through a lottery. The announcement of this limit saw the share price of major automotive players decrease by up to 5% in one trading day.

In the Chinese market, intellectual property deriving from research and development as well as relating to distribution and sales strategies is constantly at risk. Joint ventures and a shift from CKD¹ to CBU² mean that an extensive knowledge transfer has started and international OEMs need to manage this process in a way that protects their interests.

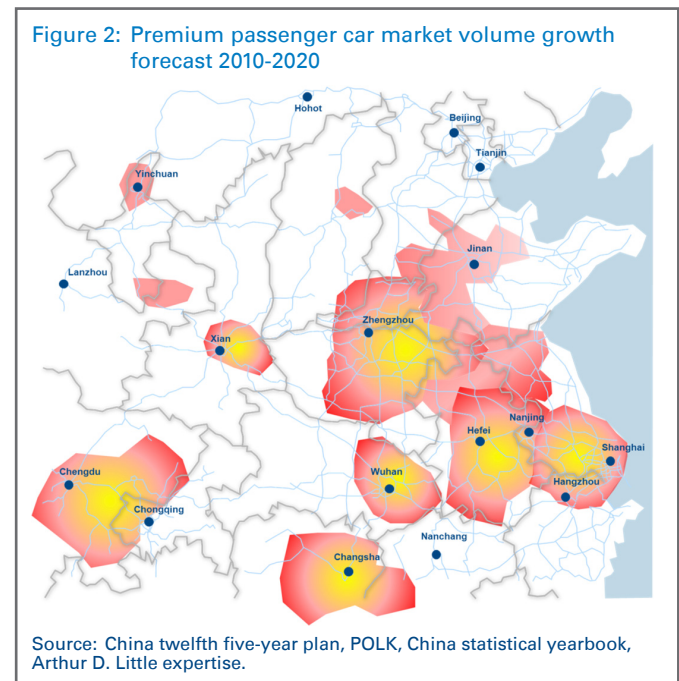
In mature markets, the decline in margins on new car sales is already forcing automotive OEMs to react. The situation is exacerbated in China where large fleet market volumes and the increasing strength of local brands are driving down margins. International automotive OEMs need to counter this by, for example, increasing their focus on the profitable aftersales business.

From an economic perspective, the weakness of the Chinese yuan compared with the US dollar gives local players a significant trading advantage. In addition, the high inflation rate, currently 5%, is causing rises in the cost of labor and capital. It is questionable whether international automotive OEMs will be able to pass these rises on to their Chinese customers.

Five hot topics for the CEO agenda

(1) Network planning and development

The Chinese premium passenger market is expected to grow at 12,5% p.a. between 2010 and 2020. However, a heat map analysis (figure 2) of volume growth (2010-2020 CAGR) for 300 Chinese cities illustrates that market growth will shift to second- and third-tier cities that currently have very low market volumes.



This shift means there will still be substantial volumes in the established Chinese hot spots such as Beijing (70.000 premium cars sold in 2010), but the greater challenge will be to access the potential demand in currently underdeveloped regional market.

The significant differences among the regions will require a tailored dealer network, dealer infrastructure and adjusted dealer formats as well as responsive aftersales service offerings. A key success factor for effective network planning and development is the systematic prioritization of provinces and target cities. Network implementation has to be fast and thus standardized in order to withstand competitive and regulatory pressures.

(2) Ramp-up of fleet and mobility offerings

China's fleet market is expected to grow by 5–20% p.a. between 2010 and 2020. It will attain significant importance as it boosts new car sales, increases brand strength nationwide, serves as supply for the used car market and, crucially, is exploited by international OEMs leveraging their global key accounts.

In addition, the characteristics of the fleet market are also expected to evolve. While the market for functional vehicles (for the sales force or field staff, for example) is already a well-developed segment, the market for so-called incentive vehicles is yet to be developed.

1 Completely Knocked Down (CKD) refers to a kit for export purposes containing the parts necessary to assemble a product.

2 Completely Built Up (CBU) refers to a product that is completely produced and just for export disassembled into few major product modules.

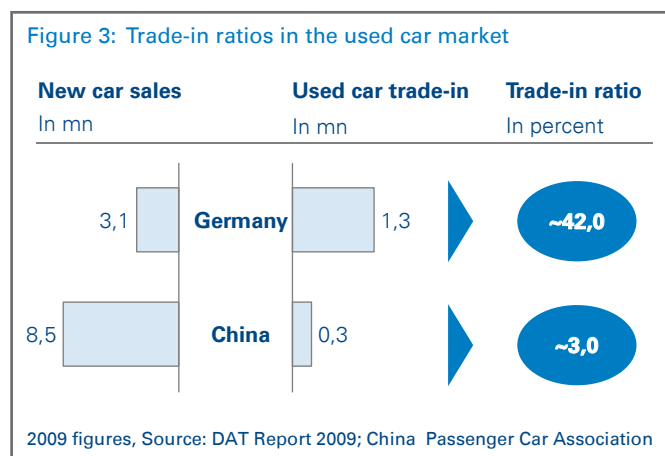
Newly developed city mobility concepts, such as the introduction of congestion charge zones in mega-cities, will soon begin to benefit the emerging car rental market in China.

To exploit the opportunities offered by the development of the fleet market and city mobility concepts international automotive OEMs should establish a strong position by first gathering in-depth local market knowledge. They must establish sales channels and customize products and services in line with customers' preferences. In the fleet business, high key account volumes impose pressure on margins so realizing economies of scale will become critical. Credit management, cash collection and a low-cost financing channel are core prerequisites too.

(3) Leveraging the used car business

In China, sales of used cars are likely to surpass new car sales in terms of volume for the first time in 2017 when 18,7 million used cars will be sold (vs. 17,4 million new cars). Today, however, this business is still at an embryonic stage; in 2010 only 3,6 million used cars changed hands and most OEMs have not yet managed to capture the full potential of this emerging market segment.

An important indicator of the used car business, the trade-in ratio (figure 3), is currently very low in China at approximately 3%. This is because, currently, 80% of Chinese customers are first-time buyers and thus do not own a used car to trade in. Nevertheless, lack of awareness and motivation among customers together with a lack of trade-in and used car competency in the dealerships are still strong barriers to tapping the full potential of this segment.



In terms of preferred trading channels, independent dealers have the highest used car volume share (approx. 65%) while C2C transactions follow (approx. 25%). The sales volume for authorized dealers is low (approx. 10%).

If this very young market is to develop, effective supply and demand must be established. Customers must be aware of the benefits of buying a used car while dealers must source a critical mass of cars by purchasing used cars for cash. OEMs hoping

to exploit this market must establish appropriate infrastructure, including wholesale stock management for used cars and a retail capacity that offers customers convenient access to used cars. Smart repair processes and residual value management will also be necessary to increase margins in the used car business.

(4) Investment in new business models and localized products

China's new focus on cutting CO2 emissions has seen it introduce lower targets for automotive emissions. The 2015 emissions target in China is set at 160g/km per passenger car, still above the EU target of 120g/km. The regulatory environment along with the evolution of consumer preferences and the demand for mobility solutions will require new business models.

For example, e-mobility needs a business model and concept of its own. This must include the development of modern electric vehicles for China, the development of new energy-storage systems and the provision of a widespread charging infrastructure. All of this needs to be embedded within the broader concept of seamlessly integrated mobility provision.

In the electric vehicle segment, Chinese automotive manufacturers have one of the few real opportunities to leapfrog established OEMs in mature markets. In this emerging segment, local manufacturers can invest heavily in technology and quality to compete on a level playing field with global car OEMs.

To keep up with this development, international automotive OEMs need to create a localized product strategy that reflects customer demands. International automotive OEMs must invest in non-conventional technology to ensure they are not overtaken by Chinese OEMs. They also need to establish an appropriate partner network to provide a fully integrated business model, helping them to lock in customers and meet their demands in terms of standards.

(5) Meeting prerequisites and managing risk

A core prerequisite for growth for international OEMs is effective people management. Many international automotive OEMs still lack expertise in recruiting and retaining local talent in China. Fierce competition for the limited number of senior managers with a sound technical skill set as well as people and managerial skills already exists and is set to increase further. Chinese staff have shown low company loyalty in the past – this can be an advantage or a disadvantage, depending on the perspective. A major reason for high staff turnover is the fact that expectations of training, coaching and development programs are often not met.

Arthur D. Little recommends that international automotive OEMs establish a solid human resource framework. The focus should be on employing people with high potential and on retaining talent. Recruitment through universities is vital to

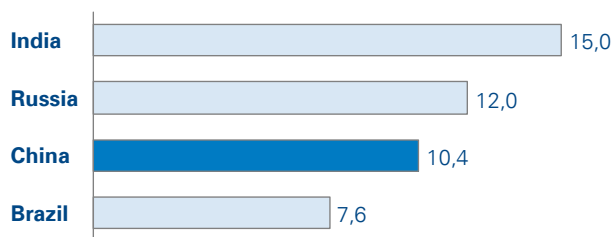
attracting future top performers early in their careers and to develop them for higher responsibility. Additionally, international OEMs must manage joint ventures carefully to prevent goal conflicts and diverse agendas as well as to safeguard intellectual property rights.

The next wave of growth: where will it be?

Of the BRIC countries, India (2010 sales volume 2,1 million cars; 2010-2020 CAGR 15%) is the most promising market for the automotive industry with a volume potential that is comparable to China (see Figure 4). In India, joint venture issues and the existing strong presence of Tata should not be underestimated.

Figure 4: Passenger car sales volume growth on BRIC countries

2010-2020 CAGR (percent)



Source: Global Insight, Goldman Sachs global research

The Russian market (1,8 million cars; CAGR 12%) lags behind in technology and thus is open for joint ventures, but the overall volume potential is lower. Brazil (2,5 million cars; CAGR 7,6%) will be a major market in terms of volume, but strong growth trends are less evident.

Moving ahead

Automotive OEMs active in China need to recognize that there are limits to growth and that major business risks do exist. As the market matures, they will face the challenge of maintaining current operations, as well as identifying new business models and revenue sources. In doing so, meeting the core prerequisites – effective talent management and strong risk management – should remain a priority.

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Arthur D. Little

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