

AUTO PARTS INDUSTRY IN SICHUAN AND CHONGQING

Industry Sector Analysis [ISA]

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SUMMARY

This report focuses on the auto parts industry in Sichuan Province and Chongqing Municipality, which was part of Sichuan before it was designated as a municipality reporting directly to the Central Government in 1997.

China is making great efforts to develop its auto industry into a pillar industry in the national economy by 2010. According to the Auto Industry Tenth Five-Year Plan (2001-2005), by 2005 annual production volume will reach 3.2 million vehicles of which 1.1 million will be passenger cars. The production value of the auto industry is projected to be RMB130 billion (USD15.7 billion). The percentage of diesel engine vehicles will be increased from 29% in 2000 to 35% by 2005. The main goals projected for the automotive components, parts and accessories industry are to improve technology and quality and to develop design capability. By 2005 the quality and standard of automobiles and key spare parts should reach or be close to that of the same categories internationally.

China's accession to the WTO will have a great impact on its automobile industry in terms of foreign competition in China. By 2006, tariffs on imported automobiles will be reduced to 25 % and tariffs on imported automobile parts and components will be reduced to 10%. The gradual reduction of tariffs on automotive parts and more importantly, China's agreement to eliminate local content requirements as part of their WTO commitment, will put domestic parts manufacturers in direct competition with their multi-national counterparts. American and other foreign companies will have the right to distribute most products including automobiles and related parts to any part of China by 2005.

The Western Development Program, promoted by the Chinese Government, will bring not only investment but also business opportunities to Western China. Although most of the

western regions are geographically isolated and less developed in terms of per capita GDP, they have rich natural resources and cheap labor. Moreover, many of these regions have already established industrial infrastructures. As a result of thirty years of development, Sichuan Province and Chongqing Municipality, the most important economic areas in Southwest China, have become key production bases for automobiles, auto parts and components. More and more foreign companies are exploring business opportunities in these areas.

Most local auto parts manufacturers do not have strong capabilities to develop new products due to the small scale of production and a shortage of capital. Even some leading firms spend very little on research and development (R & D). In the next five years, the Chinese Government will continue to encourage foreign investment in auto component innovation and manufacturing expansion. There is definitely a market for imports. American products enjoy high regard among Chinese customers for reasonable price and high quality.

A. MARKET HIGHLIGHTS & BEST PROSPECTS

1. Market Profile

Sichuan, the largest province in Southwest China, has a population of 85 million. Sichuan's economy ranks among the tops nationwide, which has determined its import position in the national economy. The auto industry is a key sector of the machinery industry in Sichuan. By 2000, Sichuan claimed to have 180 enterprises involved in the automobile industry of which there were 35 State approved auto manufacturers and re-manufacturers, 18 farm vehicle manufacturers, four motorcycle companies and over 120 auto parts and components producers. Most of the manufacturing companies are located in the following four cities, Chengdu, Mianyang, Nanchong and Luzhou. In 2001, Sichuan produced 86,100 autos and farm vehicles of which 20,100 were autos and rebuilt autos, 150,000 motorcycles and 80,000 engines. The total output value was RMB9.19 billion (USD1.11 billion) of which RMB3 billion (USD362 million) came from auto parts and components.

Lying in the upper reaches of the Yangtze River, Chongqing Municipality, formerly part of Sichuan, was designated as municipality directly reporting to the Central Government in 1997. It is the largest municipality in China with a population of 30.9 million. The automobile and motorcycle industry plays a very important role in the city's economy. Thanks to the 3rd Line Construction in 1960s and 1970s, when strategic industries were relocated in Chongqing, Chongqing built a complete industrial infrastructure with many heavy industries and defense facilities. In the past twenty years, many of those companies have turned into leading manufacturers of civilian products such as automobiles and motorcycles. Chongqing currently has 17 State designated auto manufacturers and 11 re-manufacturers specializing in heavy and light duty trucks, mini-buses, passenger cars and special vehicles. In addition, there are four farm vehicle, 11 motorcycle, and 14 engine manufacturing companies. In 2000, Chongqing produced 252,700 vehicles, 2.3 million

motorcycles, 6,200 farm vehicles, 240,000 auto engines and 4.65 million motorcycle engines. The export of motorcycles and spare parts was valued USD375 million which was 52 % of China's total exports.

2. Statistical Data

Auto Parts Market in Sichuan Province (USD million)

	2000	2001	2002	2003	Est. Growth
Import Market	0.44	22.42	3.58	3.11	7%
Local Production	362.75	411.12	N/A	N/A	14%
Exports	5.77	4.97	1.05	2.26	6%
Total Market	357.42	428.57	N/A	N/A	15%

(Source: Chengdu Customs)

Exchange Rate: USD1.00 = RMB 8.27

Estimated Future Inflation Rate: 1 percent

The import and export statistics above should only be used as an indication of market trends and may not reflect the actual value of the market in Sichuan. Many of the auto parts and components have been shipped to Sichuan through Shanghai and Tianjian Customs by product agents.

3. Best Prospects Products and Technology

China's State Development Planning Commission (SDPC), the State Economic and Trade Commission (SETC) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) jointly issued a new "Directory of Industries for Foreign Investment", which took effect on April 1, 2002.

The new Directory encourages foreign investment in the auto manufacturing industry related to the following fields:

- Whole passenger cars and motorcycles
- Engines for motor vehicles and motorcycles
- Key automotive parts and components including brake assemblies, axle assemblies, transmissions, diesel engine fuel pumps, turbo-superchargers for diesel engines, external emission control equipment for diesel motor vehicles, filters (lube-oil, air and fuel filters), constant velocity universal joints, combination instruments and special high-strength fastener parts
- Electronic fuel injection systems, safety air-sac equipment, and other auto electronic equipment systems

- Key motorcycle parts and components including carburetors, magnetos, starting motors and disk brakes
- Special-purpose desert vehicles for the petroleum industry
- Design and manufacturing of machine tools for motor vehicles and motorcycles including trimming dies, injection molds and die formings; clamping fixtures including welding fixtures and inspection jigs
- Casting and forging of semi-finished products for motor vehicles and motorcycles and
- Auto tail gas scavengers, catalytic agents and other assistants for motor vehicles.

(Source: China Automotive News 03/18/2002)

B. COMPETITIVE SITUATION

1. Domestic Production

In recent years, under the government's favorable policies, China's automobile parts industry has made rapid developments by increasing investment, making use of foreign capital, and absorbing overseas advanced technology. Many auto parts manufacturers have gone through product structural adjustment and increased local product content. Quite a number of State-owned enterprises (SOEs) and private companies can meet the requirements of domestic OEMs and are becoming competitive in the international market. Local product content of major types of vehicles accounted for 80% of all automobiles and the scheduled period for 80% localization content of passenger cars will be reduced from 6-8 years to 3-4 years. In the past decade, auto parts exports increased an annual average of 30.2% from USD84.3 million in 1990 to USD798 million in 1999. By the end of 1998, China had established over 600 joint ventures with more than 20 countries and regions in the world. Total foreign investment reached USD21 billion of which USD10.6 billion was registered capital and USD4.5 billion was actual foreign investment. In addition, China introduced over three hundred specifications of technologies for finished vehicles and spare parts.

Since the reform and opening up to the outside world twenty years ago, Sichuan's auto industry has achieved great progress. It has many cooperative ventures with foreign companies from the United States, Germany, France, Australia, Britain and Japan in the form of joint venture production, co-design, technology transfer, product processing and assembly. Sichuan now has twenty foreign joint ventures in the automobile industry. The establishment of Sichuan Toyota Auto Co. Ltd., a joint venture between Sichuan Station Wagon Factory and Japan Toyota Co. Ltd. has injected new energy into the Sichuan auto industry due to the size of the investment.

As the pillar industry in Chongqing's economy, the Chongqing auto industry now has annual production capacity of 150,000 mini vans, 100,000 economy cars, 70,000 light vehicles, 16,000 heavy-duty trucks, 10,000 rebuilt vehicles, 4 million motorcycles and over 6 million engines. It also has many strong auto parts manufacturers with complete

product categories. In 2000, annual output value of the auto industry reached RMB39.8 billion (USD 4.79 billion) which was one-third of the city's industrial revenues.

In 1999, the Central Government announced the Great Western Development strategy whereby central as well as local governments would channel public and private funds towards the economic development of western China. The auto parts industry is one of the main sectors the local government wants to develop.

Many local auto parts manufacturers are earnestly looking for joint venture partners to upgrade their facilities and make their products competitive.

Key Auto Parts Companies in Sichuan and Chongqing

Luzhou Shuangling Power Co. Ltd. is one of the largest auto parts manufacturers in western China and, claims to have a number of highly qualified technical and management personnel. Equipped with advanced Japanese and Swiss testing and measuring instruments and new technology for making piston-rings, the company can now produce 20 million piston-rings, 250,000 pistons, 150,000 axle shafts and casing pipes for axle shafts and 100,000 flying wheel gears per year. Products are exported to Southeast Asia, Latin America, Hongkong and Macao. The company is a reliable supplier to the major OEMs in China.

Mianyang Xinchun Engine Co., Ltd. is a joint venture of Mianyang Xinhua I.C. Engine Co. Ltd. and Huachen China Auto Shareholding Co. With a registered capital of USD8.6 million, the company started its operations in 1998 and is ISO9001 certified. The company has built up an internal computer network, a CAD design system and sixteen production lines with an annual capacity of 120,000 gasoline engines.

Sichuan CNG Machinery and Electronic Equipment Co. Ltd. is a manufacturer of conversion devices for CNG vehicles and has an annual capacity of 200,000. Its NGV devices are widely used by many domestic OEMs and re-manufacturers. The company has received many awards from government departments and four state patents for key technologies.

Sichuan Jianan Machinery Factory is a large State-owned enterprise under China North Industries Group. Sichuan Jianan North Automobile Co. has a total investment of USD16 million and is a joint venture incorporated with the Sixth Auto Company in the Virgin Islands. It claims to have over one thousand advanced processing machines and can turn out 200,000 sets of axles annually. Major products are mini-van front and rear axles and parts, light-duty truck driving axles, passenger car rear axles and farm vehicle axles and parts.

Sichuan Fanhua Aviation Instrument Factory is located in Yaan City, 120 kilometers from Sichuan's capital city Chengdu. It covers a land area of 320,000 square meters and has a production area of 81,000 square meters. The company has total assets of RMB210 million (USD25 million) and 1700 employees of which over 600 are technical professionals.

The factory claims to have CAD, U.S. MSC emulation systems and advanced numerical control machine tools for the production of automobile electronic devices such as auto harness assemblies, relay assemblies and non-standard measuring instruments.

Sichuan Hongguang Auto Machinery Electronic Co. Ltd. is located in the industrial development zone of Pixian, Chengdu. The company is a joint venture with investment from a Singapore financing institution. The total investment for the plant is USD 26.84 million. Major products are 462Q, 465Q mini-car carburetors for ALTO mini-sedans and series throttle bodies for electronic fuel injection engines. The company is ISO9001 certified.

Sichuan Feihong Bearing Co., Ltd. is a large State owned enterprise specializing in alloy engine bearings and bushes. Its products were awarded the Sichuan Provincial Brand Product and High Quality Product from the national level State Machinery Ministry. Sichuan Feihong is a leading company member of the Automobile Bearing Branch of the China Association of Automobile Industry. It is also an enterprise member of the China First Automobile Group, Dongfeng Automobile Group, Beijing Engine Group and Chongqing Changan Auto Group. Average annual output is 40 million units of bearings and bushes. Total export value has increased to over USD 3 million in the past three years.

Sichuan Chuannan Absorbers Co., Ltd. is a subsidiary of Sichuan Chuannan Absorbers Group, a long standing and large State-owned enterprise. The company covers a land area of 40,000 square meters and has fixed assets of RMB 160 million (USD19.2 million). It is the main absorber supplier to many OEMs in China and can produce 200,000 units annually. The company has successfully developed and manufactured a series of absorbers including the LZ111 front and rear absorbers, Mazda front and rear absorbers, Suzuki ST90 front and rear absorbers, Suzuki SK410 front and rear absorbers, etc. The company has set up more than forty offices in twenty cities and provinces, forming a close marketing network across the nation. In the past few years, the company has received many awards such as Class A Absorbers, Best Quality Absorbers by OEMs and Products of National Satisfaction by the China Quality Assessment Association. It plans to increase production capacity to 600,000 in the next five years.

Tongjiang Machinery Works is a subsidiary of the China Aerospace Science and Technical Group. Established in 1960s, this former military product manufacturer is well equipped with advanced devices and can guarantee reliable and high-quality products. Since the early 1980s, the company has been engaged in the development and production of clutch lever devices for MSB and its series, Isuzu100p and Toyota trucks.

Chongqing Qingshan Industrial Co. Ltd. is a leading manufacturer of mini vans and car gears. It has been listed in the top 50 enterprises in Chongqing since 1992. In 2000, the company produced 200,000 gears for mini vans/cars and 140,000 gearing parts for motorcycles, reaching an output value of RMB 350 million (USD 47 million).

Chongqing Xiyuan Camshaft Co., Ltd. was founded in 1985, specializing in the manufacturing of camshafts for vehicles and motorcycles and exhaust manifolds for vehicle engines. The company has CNC camshaft grinding machines Gch120B and GCS6311 imported from Japan and DV-4 and ADCOL CNC camshaft inspection and measuring instruments from the U.S. Total sales in 2000 reached USD4.58 million. The company is ISO9002 certified.

Auto Companies on The List of Top 50 Enterprises in Chongqing (2000)

Name	Sales (US\$ million)	Employees
Qingling Auto (Group) Co.	64	4,667
Chongqing Chanan Auto Co.	599	7,576
Chongqing Lifan Hongda Industrial Group	383	3,716
China Jialing Industrial Group	273	6,898
Southwest Aluminum (Group) Co. Ltd	236	8,567
Jianshe Group Northern Motorcycle Co.	128	2,162
Chongqing Heavy-duty Truck Co. Ltd.	121	5,025
Chongqing Longxing Gasoline Engine Co.	102	860
Chongqing Zongshen Motorcycle Group	95	867
Jialing-Honda Engine Co.	88	762
Chongqing Dima Special Vehicle Co.	45	285
Chongqing Qingshan Industrial Co.	43	2,038
Chongqing Cummins Diesel Engine Co.	42	1,945
Chongqing Changjiang Bearing Industrial Co.	18	623
Chongqing Hongyu Machinery Plant	15	1,347
Chongqing Changjiang Yizimi Piston Co.	13	1,203

(Source: Chongqing Statistical Yearbook 2001)

2. Third Country Imports

China's reform and opening up to the outside world has injected new vigor into the auto industry. Preferential policies have been provided to speed up the development of the industry. In recent years, the great potential of China's auto market has drawn the interest of many foreign businesses. By taking the form of joint ventures, co-operative or solely foreign funded enterprises, many joint ventures for finished vehicles, assemblies or auto parts have taken a big share of the auto market. Japanese firms are the largest competitors to U.S. in the local market.

Established in 1995, Chongqing Kansai Paint Co. is a joint venture between Chongqing Three Gorges Paint Co and Japan Alesco Paint Co. with a total investment of USD7.1 million. It is a major supplier to Sino-Japanese joint auto manufacturers. Kansai's paint products are used for Suzuki cars and motorcycles. Sichuan Kobelco, a Japanese invested engineering machinery plant, is a large user of their products. Changjiang Izumi Piston

Co., also a joint venture with a Japanese firm, produces pistons for different vehicles such as Isuzu, Toyota, Mitsubishi and Honda. Japanese firms are very aggressive in penetrating the China market and they usually obtain financial support from their government in the form of soft loans and sometimes grants. Large Japanese automakers also help their parts and components suppliers achieve strong recognition through networking support with associated firms. Yet Japanese firms have not taken the bulk of the local auto parts and components market. But with government support and the expansion of existing Japanese vehicle makers, once the capacity reaches scales of economy, they will undoubtedly become the biggest competitor to U.S. companies.

Sino-Japanese Auto Companies with over USD25 Million Foreign Investment in Chongqing

Chongqing Changan Suzuki Automobile Co., Ltd
Jialing Honda Motors Co., Ltd
Qingling Motors Co., Ltd
Chongqing Qingling Aluminum Casting Co., Ltd
Chongqing Qingling Axle Co., Ltd.
Chongqing Qingling NHK Seat Co., Ltd
Chongqing Qingling Plastic Co., Ltd.
Chongqing Qingling Mould Co., Ltd
Chongqing Qingling Casting Co., Ltd
Chongqing Qingling Forging Co., Ltd
Chongqing Wangjing Suzuki Engine Co., Ltd
Chongqing Qingling Technical Center

European firms have also been making great efforts to enter the Chinese auto parts market, but pose no major threat thus far, especially in Southwest China. Most of these companies are centered around the major OEMs as suppliers to China First Auto Works (FAW), FAW-VW Co., Ltd., Shanghai Volkswagen Auto Co., Ltd., and China Automobile Industry Group. In April 2002, a German company, Man, signed a contract with Chongqing Dajiang Industry (Group) Co. to set up a joint venture for high platform vehicles.

3. U.S. Market Position

Many U.S. firms have already begun moving into this fast growing industry. U.S. auto component firms have a good reputation for quality and reasonable price and some U.S. firms are already well known by Chinese end-users. Chinese OEMs recommend that U.S. suppliers establish plants in China or work more closely with local firms in order to meet domestic content requirements and consequently upgrade the quality of the local product. Since many parts are sourced locally, the total cost of production will decrease primarily due to not having to pay an import tariff.

Established in 1995, Chongqing Cummins Engine Co. Ltd is a joint venture between

Chongqing Auto Engine Factory and U.S. Cummins Engine Co. Major products are N.K. M11 diesel engines, diesel generator sets and boat engine sets which are widely used in heavy-duty trucks, commercial vehicles, mechanical engineering and petroleum engineering. In 2000, Chongqing Changan Automobile (Group) Co., Ltd signed with an agreement with four U.S. firms, IBM, Cisco, Oracle and UGS to jointly establish an IT company. These U.S. companies will help Changan Automobile Company to improve its management capability and upgrade its products with the aid of hi-tech and IT technologies. In 2001, the Ford Motor Company set up a joint venture in Chongqing with Changan Automobile Corporation Ltd. The Changan Ford Automobile Co. Ltd is expected to turn out 50,000 passenger cars in 2002. Total investment for the joint venture is USD98 million in which Ford holds a 50% share.

C. END-USER ANALYSIS

Automobile Manufacturers

As mentioned above, the auto industry plays an important role in the economies of Sichuan and Chongqing. Chongqing, in particular, has been regarded as the premier auto city in western China. Leading auto manufacturers such as Changan, Qingling, Dajiang Industry Co. and Sichuan Auto Group are well known for heavy and light-duty trucks, mini-buses, passenger cars and special vehicles. China's accession to the WTO has brought not only business opportunities but also great challenges and competition to the automakers and auto parts companies in these areas. According to industry insiders, the development strategies for automakers can be divided into two parts. First, automakers should form a self-reliant technical development system, including a new product development base, a quality control system and information service center. Second, leading automakers should work with strong domestic and international companies to achieve high quality and large scale production and try to produce brand name products which are competitive on the international market.

In order to facilitate delivery and minimize goods storage, most of the leading automakers still depend heavily on parts and components supplied by their directly affiliated factories located nearby. The government's regulation of local content rules for vehicles, for a specific period of time, also gave effective protection to domestic suppliers. Such protection made it possible for domestic parts makers to charge their OEMs a much higher price than the international level. Inconsistent quality of parts and accessories is a big headache for OEMs. With China's entry into the WTO, the local content requirement was eliminated. Some experts have pointed out that the more local in a vehicle, the lower the quality of the vehicle. Faced with challenges from other automakers supported by some large international auto groups, Chongqing Changan Auto Co. announced that it will make international purchases of auto parts and components so as to reduce production costs. Meanwhile the company has stopped receiving parts supplied by a number of domestic companies. Small auto parts companies with low scale production and backward

technology will be eliminated by the growing competition.

D. MARKET ACCESS

1. Import Climate

With China's accession to the WTO, the automobile market in China is gradually changing. Tariff rates will be gradually reduced (as shown in the table below) until July 2006.

WTO Automobile Tariff Reduction Schedule (Percentage)

Initial Rate	Yr.1	Yr.2	Yr.3	Yr.4	Yr.5	Yr.6	Jan Yr.7	July Yr.7
100	77.5	61.7	50.7	43.0	37.6	30.0	28.0	25.0
80	63.5	51.9	43.8	38.2	34.2	30.0	28.0	25.0

Source: China Business Update (2000)

The reductions in tariffs will make it much cheaper for foreign firms to export finished vehicles to China. Tariffs on automobile parts and components will also be reduced from the current average of 23.4 % to an average of 10%. Reduced tariffs on parts will allow companies to import essential components that cannot currently be found domestically, with reduced financial penalties. Quotas for automobile imports will begin at an initial level of USD6 billion and will grow by 15 percent annually until they are eliminated completely in 2006. Also, three years after China's accession to the WTO, American and other foreign companies will have the right to distribute most products, including automobiles and related parts, into any part of China. Currently, foreign companies can only distribute parts to one interior destination in China and they are not allowed to ship or distribute products between cities without working through a Chinese freight forwarding company.

To attract foreign investment, the Chinese Government allows Foreign-Invested Enterprises (FIEs) to import capital equipment related to production free of duty and value added tax. Furthermore, the Ministry of Foreign Trade and Economic Cooperation and the General Administration of Customs exempted high-tech industrial products from duty on January 1, 1998. The exemption is available only to FIEs engaged in projects classified by the State as "encouraged". Qualified FIEs should receive duty-free approval from the State Development and Planning Commission and receive pre-approval from the State Administration for Import and Export Commodity Inspection for each imported shipment.

2. Distribution/Business Practices

Basically, there are three ways for U.S. firms to enter China's market: find a qualified agent or distributor, set up a representative office, and establish a joint or solely funded

venture. Considerable market research should be done before making a decision. There are cases where some joint venture and technical cooperation agreements have encountered problems in funding, management and Intellectual Property Rights (IPR) protection. U.S. firms are advised to take normal business precautions when choosing the Chinese partners

For companies new to the China market, a good way to enter the market is to work with experienced parts trading companies which have established a regional sales network with a good business reputation. Agents and distributors are geographically contracted for the automobile and auto parts market since the China market can be divided into at least six regions such as the South (Guangdong), the East (Shanghai), the Beijing-Tianjin region, Central China, the Northeast (Shenyang) and the Southwest (Chengdu and Chongqing). American companies may need to find several agents for different regions. Each agent will cover one or two of the country's many regional markets. It is much easier for foreign manufacturers to enter the local market through technical cooperation with technology licensing and technology exports. Some foreign firms prefer to work with Chinese research and design institutes, that usually do project feasibility studies, to promote their exports to China.

3. Financing

With China's accession to the WTO, non-bank foreign financial institutions will be permitted to engage in automobile financing. This will allow Chinese citizens to apply for loans from car manufacturers or credit institutions and pay for automobiles on installment plans spread over several years. Currently, most buyers with significant personal savings pay for cars in cash and auto financing is only available through a handful of banks: the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Bank of China (BOC). Loans are given only for certain car models and the buyer must pay off the car loan to obtain title to the car.