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China

An Automotive Industry
on the Verge

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To glimpse the future of
the automotive industry,
look to China.

“The world's most populous nation will drive the globalization of the industry into the next stage, vastly transforming today's automotive landscape.”

Richard D. Spitzer, Accenture's global automotive managing partner

As an emerging key player on both the demand and supply sides, China will become increasingly important—if not critical—for any OEM operating on a global scale.

Sales growth in China is expected to continue to exceed that of the rest of the world over the next decade, according to Accenture analysis. As a result, the nation will serve as a lever for growth; an OEM can significantly improve its global market share by increasing its market share in China. For example, for a player that has ten percent of global sales, the act of boosting a one percent market share in China to ten percent by 2010 would create a 23 percent increase in global sales. Similarly, a lack of participation in China can cause an

OEM to stagnate in the global market. If that same company with ten percent of global sales stagnates at one percent share of the Chinese market by 2010, it will only grow with the global market, thus losing the opportunity to gain market share and improve its global position. But in Accenture's opinion, only a few companies will be positioned to develop and serve the Chinese auto demand market while also developing and leveraging the Chinese supply market.

A Market in Metamorphosis

Indeed, China's automotive industry is surging as the newest player in the global landscape, following the trail

blazed by the U.S., Europe, Japan and South Korea. China's car market flourished in 1996, when deregulation allowed the entrance of foreign OEMs, and it began to heat up in 2001, when World Trade Organization entry loosened tax regulations, effectively lowering prices. The explosive growth peaked in 2003, when passenger car sales increased by 65 percent over 2002, additionally fueled by increasing private consumption.*

To cool its overheated economy, China's government tightened requirements for private loans and increased car restrictions and fees in 2003. For example, the government imposed significant license fees, registration permits, and proof of a



parking location prior to purchasing a car. It worked. Demand simmered. Given huge ongoing investments by OEMs, the drop in demand caused overcapacity, which recently forced OEMs to sharply cut production. Regardless, they continue to build capacity, even as they are having a hard time absorbing it.

The market had grown to include all of the toughest global competitors, in particular today's "blue chip" global OEMs like Toyota, Nissan, Honda and Hyundai as well as the big players like GM, Ford and VW. When you added to this mix low-cost, independent Chinese OEMs, the industry became a battlefield. Early entrants like VW and Citroen lost significant market share to new players like Hyundai and Toyota, while US-based company GM remained stable. The combination of softened demand and overcapacity,

tough competition and new market entrants with low-price strategies led to price cuts. Lower prices took a significant toll on net profits, which dropped from a car industry average of 20 percent in 2003 to 10 percent in 2004 and are expected to further decrease in 2005.* For now at least, margins in China remain well above the global industry average and are broadly spread over the various competitors in China, ranging from GM, which in 2004 had a margin of 19.6 percent to Citroen, where the margin was minus 6.1 percent in 2004.*

Enter a host of new challenges. Car buyers in China applied a Western approach to consumption: they're postponing their purchases until the prices are as low as possible. At the same time, automakers face a uniquely Chinese customer preference:

Chinese buyers are markedly brand-disloyal. European buyers are three times more loyal than Chinese car buyers. Chinese consumers buy on model, tangible assets and most importantly price. As a result, OEMs can't leverage a well-crafted brand image. Another challenge: a pending government tax regulation will favor local production of cars, including parts. That will force OEMs to manufacture—as opposed to only assemble—in China.

Success or Failure?

The overcapacity is expected to worsen until 2007, when all automotive analysts, ranging from investment banks to automotive research institutes predict a rise in demand, although nothing equivalent to the pre-2003 rates. Regardless, the mere act of selling in China no longer

guarantees extraordinarily high profits for all players. OEMs that perform at the highest levels will be those that strengthen and tailor their business models to the Chinese market characteristics.

Winners will need to produce a succession of high-quality, attractive models at relatively low cost while appealing to the Chinese preference for tangible, visible assets rather than high-tech performance. They'll also need to achieve operational excellence—increasing local sourcing of components, reducing assembly, and extending distribution networks.

Critically, an OEM's strategy will depend in large part on its position along the maturity cycle. A company in the earliest stages, like Chery, is best served to enhance quality standards, develop unique models, leverage its Chinese brand and improve their design and technological capabilities. A company farther along on the maturity cycle, like VW, needs to rapidly exchange aged products, conquer new segments and challenge current brand strategy.

The stakes for getting it right are huge. Success or failure in China will have a significant impact on an OEM's global competitiveness. Compare China's 4.8 million new car registrations expected for 2010 to the expected 3.8 new registrations in Germany in 2010, Europe's largest market for autos. And it is not yet certain whether the strongest brands in China will be able to defend their current shares.

And Now, Exports

The passenger car business in China has an emerging supply side, too. In 2003 China exported only 0.1 percent of the cars built on its shores. Now the industry is undergoing a transition phase toward making the car industry an export platform. The

government has set a long-term goal of exporting 40 percent of China's production.

Setting the stage for exports, suppliers are consolidating in an effort to lower costs and improve the global competitiveness. The government is imposing regulations for OEMs that allow a majority stake of foreign companies in Chinese joint ventures for export-only purposes and thus stimulates local production and local sourcing. Quality and emission standards are improving with regard to Western standards, and Chinese joint ventures and independent Chinese OEMs are extending to a global scope.

The first signs of exports are coming into view. Independent Chinese OEMs like Chery and the global OEM Honda via its joint venture lead this game. Chery is producing models tailored to Western markets, co-operating with global OEMs and European design and engineering experts, and forging alliances with US and European dealer groups. Chinese joint ventures are starting to create their own brands separate from their global partnerships, and using their know-how to position themselves for exports—although many foreign joint venture partners hesitate to pursue exports, fearing their local partners will copy their technology and compete against them. Meanwhile, most global OEMs are waiting to export until Chinese sourcing becomes more mature.

As China's independent OEMs and joint ventures prepare for exports, the only global OEM aggressively pursuing China as an export market is Honda. Through a joint venture in which it retains 65 percent ownership, Honda plans to produce up to 50,000 units annually of its Honda Jazz model, which it will sell in Europe and Asia.

Local Sourcing a Must

Whether cars will be exported or sold domestically, OEMs require a robust local sourcing platform. The need is driven by the market's rapid growth, increasing margin pressures, global pressure on low-cost country sourcing, and the Chinese government itself. Government regulations will require specific components to be produced in China. The new regulations are expected to require 40 percent of cars sold in China to have been developed in China.

China's existing crop of 9,000 local suppliers comprise an immature market—not all have the right skills and not all are in solid financial position. For OEMs seeking high performance, that creates a challenge: finding and nurturing the right mix of reliable partners to both support local production and fuel the company's global business.

Only when they find and develop cost-competitive, skilled suppliers, will OEMs be poised to fully leverage their investment in China, serving a growing market and also building a base for the exporting of cars and parts.

"The battle around China is accelerating the power shift from the Western to the Eastern OEMs."

Richard D. Spitzer, Accenture's global managing partner for the automotive industry

Outlook for the Global Shift

According to Accenture's analysis, in the battle for China's demand market, the clear winners are Japanese and Korean OEMs, which are steadily gaining market share from European OEMs, while U.S. OEMs stagnate. Particularly strong: Hyundai, which entered China in late 2002 and Honda. Moreover the Chinese OEMs secure their share of the market. As of February 2005 the Asian OEMs already control almost three quarters of the Chinese car market.

Leaders on the demand side, Asian companies are rapidly gaining ground on the supply side, too. Small, independent Chinese OEMs like Chery are producing cars for export, collaborating with European and U.S. dealer groups. Honda will become a growing exporter of cars manufactured in China, too.

Asian companies are helping hasten a decades-long power shift. Western OEMs have lost nearly half their global market share over the past 40 years—they controlled 93 percent of global sales in 1965 but only 54 percent in

2003, achieving a Compound Annual Growth Rate (CAGR) of two percent during that period.

In contrast, Asian OEMs—growing at a CAGR of 10 percent in the same period—have watched their global market share rise from four percent in 1965 to 39 percent in 2003.

*Data and figures are based on Accenture analysis, Ward's Automotive Yearbooks, internet press articles and various other sources (Access Asia Limited, Bear Stearns Asia LTD, China Auto Information, Daewoo Securities Co Ltd., Morgan Stanley, Worlds Markets Research Center; all used with permission from OneSource).

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To find out more about how OEMs can reach high performance, please contact:

Richard.D.Spitzer@accenture.com