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ONLINE SEPTEMBER 11, 2014

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A mere four years after overtaking the U.S. as the world's largest car market, China's automotive industry has arrived at an important inflection point. The days of growth rates above 20 percent are over, and rates may dip as low as 6 percent by the end of the decade. Several factors are driving this shift. At the national level, in order to implement long overdue structural reforms and contain a looming financial crisis, Beijing has had no choice but to put the brakes on overall economic growth. At the same time, in cities such as Beijing, Shanghai, and Hangzhou, local governments are imposing new vehicle sales restrictions to combat severe traffic congestion and air pollution.

In fact, the product and industry life cycles have already started to decouple, a key moment that typically results in high levels of overcapacity, significant price and margin pressure, and, eventually, a massive shakeout. As a result, the underlying industry and competitive dynamics will likely look very different within a few years. The business model itself will change from today's "hunter-gatherer" model, focused primarily on generating profits from new vehicle sales, to a "seed-harvest" model, wherein profits come mostly from selling complementary and aftermarket products and services.

At the same time, customer demand will become increasingly binary. Tier 1 cities in the coastal provinces will be characterized by much lower growth rates, replacement demand, and rising price points. In contrast, the lower-tier cities in China's interior will see much higher growth rates, but at lower price points, as demand will increasingly come from new buyers who are crossing the mobility threshold and exchanging their motorcycles and electric bikes for cars.

Although this low-end segment is currently still dominated by Chinese automakers, foreign automakers in search of new growth opportunities are taking notice. More subtly, the central government is effectively forcing them to move into this segment. For example, foreign automakers can set up manufacturing operations in China only through a joint venture with a local Chinese automaker (in which the foreign partner has no more than 50 percent ownership). Because many of these JVs have been quite successful and now dominate the local market, foreign automakers need to add new manufacturing capacity to continue to grow. However, under a recent government regulation, they can do so only if they also introduce a local indigenous brand with their Chinese JV partner.

Most foreign automakers are already capacity-constrained, and thus have little choice but to comply. In addition, noncompliance could result in loss of scale and a significant cost disadvantage in the most price-sensitive customer segments with the highest growth

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potential in China, as well as in other emerging markets. And few foreign automakers would dare underestimate the potential negative impact of noncompliance on their relationships with key government stakeholders. Not surprisingly, then, several have already introduced their new indigenous brands, most notably General Motors (Baojun) and Nissan (Venucia), whereas others, such as Ford, have announced their intention to do so soon.

These shifting dynamics have initiated a race to the bottom—to develop low-end cars. The most immediate impact will be on local Chinese automakers, which rely heavily on their dominant share of the low-end segment as a relatively uncontested source of profits. Today, few are ready to compete head-to-head in terms of technology, quality, and management with their more experienced and better resourced foreign competitors.

In theory, China's indigenous brand regulation would provide the country's state-owned automakers with competitive local brands through the support of their foreign JV partners. It would also make life increasingly difficult for their larger privately owned competitors, while potentially helping to consolidate the long tail of more than 80 smaller carmakers operating in local markets across China. Under this scenario, the likely end game would be continued strong support for the new state-owned indigenous brands, potentially even including minimum volume requirements—requiring a certain percentage of a foreign company's volume to come from the indigenous brand by a designated year.

Foreign OEMs will need to decide how aggressively to pursue the low-end market, and how much to invest in their indigenous brands, especially given the potential for technology spill-over to their Chinese JV partners. One of the most important decisions they face is whether to take a low-cost approach by lowering non-safety-related specifications and features (and accepting lower margins) or a low-price approach by redesigning the vehicle itself (and maintaining higher profit margins). The low-price approach may in the long term be preferable, but it requires significant up-front investment and considerable local engineering resources. Today, only GM, through the Pan Asia Technical Automotive Center (PATAC), its engineering JV with SAIC Motor, is well positioned to do this.

Finally, but perhaps most significantly, is the potential impact on the supply base—and not only in China, but over time elsewhere as well. As foreign automakers move downmarket, they will need to reduce costs by 30 percent or more to be competitive, a target that some have already met with their low-end vehicles but others are struggling with. Foreign carmakers will increasingly turn to local Chinese suppliers to achieve these savings. In turn, working with and being actively developed by world-class foreign automakers should enable local Chinese suppliers to improve their own capabilities and to gradually move upmarket and overseas themselves.

In fact, there is a realistic chance that at least some local Chinese suppliers may eventually become global category killers, especially in scale-sensitive product categories that are characterized by limited future innovation potential, little systems integration potential, and low entry barriers. An early example is Wanxiang, which has already become a major global player. It started with universal joints, but has methodically expanded into related product categories, including most recently the electric vehicle segment with its strategic acquistions of A123 Systems and Fisker Automotive.

To defend themselves, multinational suppliers in vulnerable categories may have little choice but to develop true low-end capabilities themselves or to partner with local Chinese players while these companies are still small enough to be interested. Multinationals that pursue the low-end segment aggressively can tap into new sources of growth in China and other emerging markets for years to come. Those that don’t may find it increasingly difficult to remain competitive, not only in China but also in their own home markets. +

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