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Revving the Growth Engine

by Vikas Sehgal, Matthew Ericksen, and Ganesh Panneer

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India's burgeoning middle class is fueling automobile sales, though most consumers still choose two-wheel vehicles — at least for now.

by Vikas Sehgal, Matthew Ericksen, and Ganesh Panneer

The Indian economy is booming. From 1998 through 2008, India's GDP increased at an average rate of more than 7 percent per year. And despite the global recession, in the second quarter of 2009, India's economy grew by 6 percent — even as GDP in the U.S., Japan, Germany, and other countries declined. This impressive growth will greatly change consumer spending patterns in the coming years, producing significant increases in sales of discretionary items and consumer durables, including (and perhaps especially) automobiles.

Indeed, India's auto industry has reached a pivotal moment. Although the nation's roads are still dominated by motorbikes and scooters, low-cost, stripped-down cars like the well-publicized Tata Nano are offering India's consumers another choice. Such vehicles could serve as a bridge between two-wheelers and compact cars, the latter of which will grow more popular as India's middle class continues to expand and individuals can upgrade to more substantial vehicles.

As consumers gravitate toward bigger and better cars, the Indian auto industry and the nation's policymakers will have to face certain challenges to help expand the market for new automobiles — including making consumer financing more accessible, upgrading infrastructure badly in need of modernizing and repair, and improving safety and environmental standards. If these issues are addressed now, Indian auto manufacturers will be able to reap the benefits of a vibrant domestic market, and, in time, export their products abroad.

Roughly 75 to 80 percent of motor vehicles on the road in India today are two-wheelers, used primarily for personal and family transport. Their popularity is driven by low price, high fuel mileage, and an ability to maneuver deftly through India's dense traffic. For the last eight years, the two-wheeler market has grown at an average compound rate of 13 percent; in 2007, 8 million units were sold. Over the next seven years, the number sold annually is expected to nearly double, to 15 million units per year.

Although the two-wheelers will continue to dominate the market for some time, the future is bright for automobiles, thanks to India's growing middle class. Today, 13 million households earn US$10,000 to $50,000 a year; that segment is forecast to more than triple by 2012, according to data from the Economist Intelligence Unit. Meanwhile, income for average middle-class households will approximately double. Local and international banks, aware of the opportunities, are making consumer credit increasingly available to middle-class borrowers in India. This is spurring a new wave of consumer spending unprecedented in India's history.

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In fact, when the trends in India's macroeconomic indicators such as growth in GDP and foreign direct investment are compared with the historical records of other developing nations, it appears that India may be tracking the path of China, albeit with a 10-year lag.

As the middle class expands, automobile ownership will increase in tandem. Indeed, automobile penetration in India is only seven or eight vehicles per 1,000 people, compared with nearly 500 per 1,000 people in mature markets. But the overall passenger (four-wheeler) vehicle market in India is expected to grow from 1.7 million units in 2008 to roughly 2.5 million units by 2013, surpassing the markets in Italy and Spain. By 2012, annual car sales worldwide will increase by about 11 million units per year, with India expected to account for 20 percent of the increase. At that point, India could become the world leader in small-car market growth.

Automobile market penetration has remained low because most cars are still too expensive for the vast majority of Indian motor vehicle buyers. But a pack of ultra-low-cost four-wheel vehicles — the so-called Sub-A segment, exemplified by the $2,500 Tata Nano and the $3,500 Renault-Bajaj offering currently under development — are entering the market to bridge the gap between $1,000 motorbikes and $5,000 cars. The rise of the Sub-A cars will allow the number of potential new-car buyers to quadruple, challenging the motorbike market even as it continues to grow. While the Sub-A segment gains traction, India's auto market remains dominated by cars in the small (Maruti 800) and compact (Tata Indica) segments, which cost between $5,000 and $10,000. Together, these categories account for about 65 percent of sales. Global small-car players such as Hyundai, Suzuki, and Honda, traditionally the leaders in India, now face stiff competition from new vehicles by local manufacturers such as Tata, Bajaj, and Maruti Suzuki.

And as the small-car market develops, Tata and Maruti are also making inroads into the entry midsized category ($20,000 vehicles), which represents particularly fertile ground — it is expected to grow by 27 percent over the next five years. At present, the Honda City, Hyundai Accent, and Maruti Esteem are the leading entry midsized models.

For the remarkable opportunities in the Indian automotive industry to develop, however, significant challenges must be faced. For one, India's economy, with its decade of strong growth, must continue to expand in an unstable global environment. Indeed, it has shown signs of a slowdown in recent months. By extension, consumer lending has already been affected. Although interest rates have been reduced, the percentage of loan approvals has also declined. Consequently, many customers are "trading down," choosing fewer frills or even lower-end models than they may have previously selected. To sustain sales growth, manufacturers, dealers, and consumer finance groups must work together to build innovative financing options for consumers.

Given that backdrop, the four-wheel passenger vehicle market is expected to grow at approximately 8 to 10 percent this year, far below the historic 21 percent compounded annual growth rate in 2006 — but healthy nonetheless. The two-wheeler segment has shown some resistance to the global crisis; however, in the event of a broader market collapse, this segment could suffer as well.

Meanwhile, higher commodity prices could also interfere with market development. Commodity prices may be depressed in a slowing worldwide economy, but most forecasters expect them to rise rapidly once global economic growth recovers. A return to high steel prices will impact sales of the new ultra-low-cost cars, because automakers will have little option but to pass on cost hikes to low-wage consumers. Oil and other commodity price increases could also make automobiles less desirable.

To succeed in the Indian market, local manufacturers must further reduce the total cost of car ownership and bring financing and insurance models up to modern global standards. And to beat rising input costs, Indian automakers must improve their net cost position by increasing productivity and performance. Moreover, if Indian auto companies such as Tata hope to compete effectively against their primarily Japanese and European rivals, they must increase global sales for faster recovery of fixed costs and match the product cycle times of international manufacturers.

To meet these challenges, the Indian government must also get involved. For example, mandating higher fuel efficiency for passenger vehicles, setting antipollution policies, and enforcing safety standards in line with those of Europe and North America will take older cars off the road and boost the image of the Indian auto industry, so that it can be taken seriously as an exporter. In addition, the government must maintain spending on infrastructure. India currently has only 3,700 miles of highway, compared with 25,000 miles in China and 46,000 miles in the United States.

In many ways, this period represents a once in a lifetime opportunity for Indian automakers to take advantage of a vast new market in their own backyard — a market that global companies thus far have enjoyed. ✚

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Vikas Sehgal, Matthew Ericksen, and Sunil Sachan, "Revving the Growth Engine: India's Automotive Industry Is on a Fast Track" (PDF), Booz & Company white paper, June 2009: The paper on which this article is based provides a deeper analysis of growth prospects in the Indian automotive industry. www.booz.com/media/uploads/Revving_the_Growth_Engine.pdf

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