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A New Era for  
Chinese Vehicle  
Manufacturers  
*Opportunities and  
Challenges for Chinese  
Automakers as They  
Expand Overseas*



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# A New Era for Chinese Vehicle Manufacturers

## Opportunities and Challenges for Chinese Automakers as They Expand Overseas

Recent announcements make it clear that Chinese vehicle manufacturers (VMs) intend to establish an international presence. Shanghai Automotive Industry Corporation (SAIC), Great Wall Motors, Lifan, Geely, Brilliance, and Chery, among others, have announced their plans to start exporting cars under their own brand names, or to establish production outside China.

However, there will be room for just a few globally successful Chinese VMs. The global auto industry will support only a limited number of players over the long term, due to the fundamental microeconomic pressure to build and maintain scale. Most of these positions are already occupied by capable competitors with huge stakes in the industry. Therefore, the “white space” for Chinese VMs that seek to play at parity on the global stage is likely very limited and will be heavily contested by the leading domestic multiline players and niche players. For Chinese VMs to succeed, they must embrace the changing structure of the industry and, more specifically, become much more competitive in those areas of the automotive value chain where future profitability is likely to be best, particularly distribution.

There will be significant challenges: VMs will need to build their product-development capabilities, especially in the realm of features that Western consumers expect, such as advanced safety electronics and comfortable, adjustable interiors. They will have to improve their marketing capabilities, particularly brand

positioning, and develop world-class organizations with global best practices that can compete against the most competent foreign players. They will need to be able to extend their activities offshore, across the value chain, which will require learning how to work in partnerships on marketing and sales and supply bases. Moreover, they will need to manage increasingly complex enterprises that span local and overseas markets. In summary, Chinese VMs need to develop a set of convincing strategies first, then make a quantum leap in key capabilities across the automotive value chain.

Although the circumstances of Chinese VMs and their Asian predecessors are similar, they are not identical. Unlike Japanese and Korean VMs, Chinese VMs have had strong foreign VMs in their home market during their formative years, which has brought both benefits and drawbacks to Chinese companies. For example, Chinese automakers did not have the luxury of a protected home market; even now, Korean automakers enjoy more protection from the Korean government than Chinese automakers do from the Chinese government. However, this disadvantage is arguably offset by the fact that having foreign companies as both competitors and partners has provided a significant learning opportunity for Chinese automakers in their early years that Japanese and Korean VMs did not have—the opportunity to develop their knowledge about cars and about how to run a car company.

It will be tempting for Chinese companies to look to the previous successes of Japanese and Korean

automotive companies, but it will also be important for them to look at the distinct circumstances they will face, understand what is different, and realize that success will require a different playbook.

Rather than trying to imitate their Asian predecessors, Chinese VMs should view changed circumstances as an opportunity to reinvent the automotive business model—not just their own, but potentially the model of the industry itself. To do so, however, they will need to understand and capitalize on the advantages they enjoy in China, including rapid market growth, a loyal supply base, and low-cost labor. More important, they will need to take stock of the gaps in their capabilities and face the sobering reality that they fall short in such vital areas as product innovation, manufacturing quality, and business-model innovation. Ultimately, they will need to determine how to build sufficient scale to be competitive; they will also need to find the best strategy for penetrating Western markets. Finally, they will have to manage differences between Chinese and Western business models to create a new model of superior value. There's no denying that it will be a challenge, but for those that can accomplish these goals, the rewards will be significant.

### **Government Support**

The Chinese government clearly supports the overseas aspirations of Chinese VMs (and other major Chinese companies). It can be expected, however, that the government will also put in place a set of regulations designed to ensure the orderly export of vehicles and avoid ruinous price competition and the export of low-quality vehicles. By way of support, four companies—Chery, Geely, FAW, and Yutong—have been declared “Pilot Enterprises for Innovation” by several governmental agencies, including the State-owned Assets Supervision and Administration Commission (SASAC) and the Ministry of Science and Technology. These companies will receive further support to develop their independent brands and portfolio of vehicles, including those for export.

### **How China Is Changing the Game**

China, unlike most other emerging markets in history, is in a unique position to change the face of the global automotive industry, due to the size and growth rate of its market, its structure, its supply chain, and its sources of innovation.

- **Market Growth:** China has a large and rapidly growing domestic market, providing companies with the scale and scope to fundamentally alter their global positions (for better or for worse). For Western companies that are already global, China is the last major growth frontier (with the possible exception of India, which will eventually be able to offer major market-growth potential). For Chinese companies, however, the relative opportunity is even greater: Capturing just a small share of this fast-growing market could catapult them into substantial market positions globally.
- **Structure:** Whereas the market for commercial vehicles is firmly in the hands of national players, the Chinese passenger vehicle market is currently dominated by joint ventures between foreign VMs and national players. We can expect Chinese carmakers to gain more traction within the passenger vehicle market with their own independent brands, up from their current 25 percent market share. The major reasons for this growth will be increased competition and government support.
- **Supply Chain:** China will enjoy long-term labor cost advantages in component supply and vehicle assembly, especially as the domestic market grows and companies are able to achieve scale. These advantages will be further fueled as supplier and VM assets migrate closer to China itself, driven by China's likely status in the future as the largest auto market worldwide and a low-cost base for many components. As a result, China is a natural export base comparable to Japan and Korea in their early days, but potentially on a much larger scale.
- **Innovation:** Unique constraints, such as energy shortages and the strong regulatory role of the government in shaping the automotive industry in

## The First Wave

Chinese VMs can learn some significant lessons from the first generation of Chinese companies that expanded overseas. It's worth pointing out that there is a major difference between simply going overseas and truly going global; the latter is a more substantive shift away from a largely domestic business. Companies such as Haier, a manufacturer of major appliances and electronics; TCL, a consumer electronics company; and Lenovo, a manufacturer of personal computers can offer examples for VMs of what to do as they expand, as well as some scenarios to avoid.

Haier has taken a somewhat conservative approach to developing its business overseas. Upon entering the U.S. market, Haier made a deliberate effort to build a local business, including setting up plants and hiring locals in the United States. Notwithstanding its failed attempt at acquiring Maytag, Haier has successfully grown its business in the United States one step at a time.

TCL, by contrast, acquired the business of Schneider and Thomson in Europe. Unlike Haier, TCL tried to succeed by applying its homegrown Chinese management model to a situation that clearly required much more understanding of the European market, and one that required local managers to navigate the nuances of dealing with a highly volatile market situation rather than the Chinese managers that TCL put in place. TCL has not succeeded, and its European operations have incurred significant losses.

Lenovo, which most recently made a bid for global expansion, attempted to develop a more integrated organization and approach from Day One. With a Chinese chairman and an American CEO, Lenovo maintains its main corporate headquarters in the United States, with another headquarters in China. After its acquisition of IBM's PC business, Lenovo clearly realized that to maintain the confidence of global business customers, the company would have to retain the best of IBM's Western capabilities in order to deliver on the brand promise to customers—which meant either retaining or acquiring and incorporating the international management and operational capabilities. At the same time, capturing the synergies of the two would require leveraging assets and capabilities from the former Legend, Lenovo's Chinese predecessor, and growing capabilities on the Chinese side over time.

China, position China well to take the lead on new concepts, such as alternative energy sources and vehicle technologies. China today has high and rapidly growing energy consumption on an absolute as well as on a relative basis, but also heavy air and water pollution nationwide. Recognizing this, the current government, which has set "harmonious development" as its key focus in the coming years, has implemented a set of regulations designed to foster fuel-efficient vehicles and alternative powertrain technologies. The CHN III and IV regulations (which mirror Euro III and IV, respectively) require new vehicles to comply with strict emissions standards. New sales tax legislation that supports sales of smaller, more fuel-efficient vehicles was launched

in April 2006. These regulations require an energy-efficiency increase of 15 percent, compared to 2003 levels of vehicle fuel efficiency, by 2010. Universities and VMs have both responded to the legislation; Tsinghua University, for example, now has an alternative powertrain research lab, and many carmakers are busy developing new powertrain technologies.

### Will Chinese Companies Go Global?

Although circumstances in China may be the catalyst for many changes to the global automotive industry, Chinese VMs will not automatically be the major beneficiaries of these changes. In this respect, VMs may be able to learn from Chinese companies in other

industries that are ahead of the automotive sector in their globalization efforts (see “The First Wave”).

The automotive sector requires a unique combination of local knowledge and global scale. The prize for the most successful Chinese companies, those that become truly global, will be substantial. Global size and scale create positional scale advantages in many areas of the value chain, especially manufacturing and purchasing. Success at home and abroad creates a virtuous circle that in turn improves companies’ ability to sustain a stronger competitive position in China itself, by leveraging experience from other, more established markets. Finally, globalization can bring Chinese VMs long-term stability as they are able to balance a portfolio of markets and capabilities through outstanding networks of assets and alliances around the world.

Examples from Chinese VMs currently showcase four different strategies for expanding internationally:

- **Export products into Western markets under a Western company’s brand.** DaimlerChrysler, for example, is in discussions with Chinese companies to find a partner for the production of subcompact vehicles for export into North America. No foreign car company has so far established a sustained export business from China to the United States, whereas Honda is exporting its Jazz hatchbacks to Europe from Guangzhou.
- **Export products into Western markets under a Chinese brand, capitalizing on value-chain integration.** Ambitious Chinese suppliers like the Wanxiang Group have already made huge strides in setting up their operations abroad. Wanxiang currently has six plants in North America with approximately US\$450 million in revenue. The group makes steering systems and driveshafts, and is currently in negotiations with ailing American suppliers to potentially acquire some of their assets.
- **Set up a business abroad via an acquisition.** SAIC and Nanjing Automobile have acquired established brands for their international expansion plans.

Nanjing has bought MG and is building a plant in Ardmore, Okla., to assemble the MG TF Coupe. The company has laid out ambitious plans to establish a North American headquarters, R&D center, and parts and distribution unit with more than 500 employees. SAIC has acquired the production rights for the Rover 75 and has announced it will market the vehicle under its own Roewe brand—initially for the domestic market, but it has plans to start exporting to the European Union in 2007, as part of its new-model offensive to have 30 new models between 2007 and 2010.

- **Set up a business abroad under a Chinese brand without an acquisition.** Geely, Great Wall, and Brilliance are examples of Chinese carmakers that are going abroad under their own brands without major acquisitions—at least, so far. Most of the players in this group have made first moves into other emerging markets (including Malaysia for Geely and Russia for Chery and Great Wall) and are about to grow further into more mature markets, first through exports, later through their own production.

Our examples suggest that Chinese VMs have already built manufacturing facilities in emerging markets, including Eastern Europe, Africa, and ASEAN countries.

This seems a wise move, as it gives Chinese VMs the chance to improve their capabilities in markets that are less competitive than developed markets. Many of the developing markets are also growing much faster and have emerging customer preferences that arguably provide an opportunity for a new entrant to innovate a new product or business model before it goes head-to-head with the most capable VMs in the world, which have spent decades understanding the intricacies of the U.S. and European markets.

China has been a net exporter of motor vehicles since 2005, underlining the trend. Moreover, non-Chinese VMs like Honda and Volkswagen have announced that they will export to ASEAN markets from China. Honda has already started; VW will follow in 2008. We expect that overcapacity in the Chinese car-making industry will drive further exports.

## Lessons from the Past

Three automotive companies from emerging markets can offer timely lessons for Chinese companies seeking to export to Western markets.

### **Yugo: Never Compromise on Quality**

Yugo, which was originally named Zastava, began manufacturing cars in the 1930s. In 1985, the company entered the U.S. market as the cheapest car available, selling at a \$4,000 base price. In the following years, however, consumers discovered that the quality of the vehicles was not acceptable. Dealer service was poor as well. When sales dramatically slipped, Yugo America went into bankruptcy. Attempts to revitalize the brand with a new model failed to gain consumer trust, and the company left the United States for good in 1991.

Yugo's failure underlines the fact that cost leadership is not the end of the story. It may lead to initial product acceptance, but substandard quality is quickly exposed, and it can be fatal. Companies cannot attain global scale by simply duplicating existing models and investing minimally in R&D and product innovation. Careful selection of front-end partners in sales, marketing, dealership/distribution, and aftermarket services is critical for foreign entrants.

### **Hyundai: Recover Quickly from Setbacks**

The Korean company Hyundai started with a car that it tested in low-risk countries before entering the U.S. market. The initial quality of the first vehicles in the United States, however, was very poor, and consumers immediately lost confidence in the new brand.

Hyundai decided on a bold move to overcome sales decreases and introduced an aggressive warranty program with coverage for 10 years and 100,000 miles. The company also invested heavily in improving quality and committed large sums to localize R&D. The result was a No. 3 ranking in the most recent J.D. Power and Associates survey.

Hyundai is a compelling example of the fact that setbacks are frequently unavoidable. What truly makes a difference is having the commitment and capabilities to address shortcomings and make improvements.

### **Toyota: Attain Success Through Engineering Excellence**

Toyota decided to enter the U.S. market as the size of its domestic market, Japan, limited the company's growth. Its first American car, the Tiara, entered the market in 1964, followed by the Corona. These and most subsequent models were specifically designed and engineered for the United States. When Toyota decided to enter the luxury segment in the early 1980s, it invested large amounts of effort in R&D, and the first Lexus vehicles were immediate successes because of their reliability and features. Toyota has since enjoyed an unparalleled reputation for quality and reliability.

Overall, Toyota's focus on performance and people has been essential to its success in Western markets. One primary success factor is its product-engineering system, which allows for superior QRD (quality, reliability, and durability) performance. The other key success factor has been the core VM network model, which comprises more reuse, design stability, and supplier networks and provides significant cost advantages. In summary, Toyota wins by providing superior cost of ownership and product features.

### **Finding the Right Strategy to Go Global**

Chinese VMs that want to achieve global scale, particularly when setting up production facilities abroad, need to figure out a number of critical issues. In doing so, they can learn from the experience of their predecessors (see “Lessons from the Past”).

**Companies must understand how they will differentiate themselves in Western markets.** The rapid pace of market growth in China has allowed some Chinese companies to succeed locally, even though their strategies or capabilities may be insufficient to sustain them over the long term or in a mature and stagnating market. Indeed, China’s rapid market growth can make up for deficiencies in a company’s business model, at least in the short term. Hence, success in China is not a recipe for success in Western markets, especially the United States. Many Chinese carmakers have been protected by the government and lack capabilities in key areas compared to their non-Chinese competitors. In addition to needing to develop high-quality cars at an appropriate price, Chinese VMs will face issues adapting to new management requirements and creating a mixture of Western and Chinese business models.

On the other hand, Chinese VMs going global enjoy several structural advantages, such as regulatory protection at home, access to cheap capital, scale in the domestic market, and low labor costs. The question is whether they will be able to turn these into sustained competitive advantages in product engineering, operations, and distribution.

In terms of product, it makes little sense for Chinese companies to try to create a better mousetrap. In other words, outpricing the Koreans might not be the most sensible position going into the U.S. and European markets. Both markets are big enough to justify considering only a specific, motivated minority of buyers. In that sense, Chinese companies could actually create their own segment by offering something completely new. Volkswagen did something comparable with the original Beetle. Today, fuel-efficient powertrains, innovative body styles, or configurable interiors could be winning differentiators. In a recent interview, Carlos Ghosn, CEO of both France’s Renault SA and Japan’s

Nissan Motor Company, commented on the lack of new vehicles in the U.S. market priced at less than \$10,000. He suggested that someone, perhaps a Chinese automaker, is likely to find a way to address that product gap.

**After deciding how to compete, companies must determine where to go.** Although automotive markets in North America and the European Union are mature and have some common ways of operating, they may not be equally suited for Chinese carmakers looking to set up their own production. Important issues for Chinese VMs with global ambitions to consider include market and political circumstances, product requirements, and established and emerging distribution models.

Canada, for example, might be a viable entry point into the North American market because of its overall attractive ecosystem, including a low cost structure; the knowledge assembled in existing suppliers, universities, and R&D networks; its high productivity; and its NAFTA membership.

**Companies must be able to articulate why customers should buy their vehicles.** It will be crucial for Chinese VMs to think about why customers should choose their vehicles over competitors’ offerings. They need to figure out the identity of their target customers, these customers’ chief buying criteria, the cycles in which they buy, and the factors that influence their purchasing decisions.

The key will be to figure out how to overcome loyalty to existing products. Potential value propositions are better value, based on quality, reliability, and durability (QRD); a better product in terms of styling and branding; better value for the price, based on total cost of ownership; more convenience during the buying process through targeted offerings or time savings; and better service with respect to financing and dealerships.

Chinese VMs, moreover, need differentiated brand positions, and they need to decide whether they should be positioning themselves to take share from other Asian VMs (such as Hyundai and Daewoo) or

from Western incumbents. Another key aspect will be deciding in which segment to enter. In some segments in mature markets, customer loyalty runs as high as 75 percent, meaning that customers will rarely consider another brand, Chinese or otherwise. Chinese VMs thus should think carefully about which segments might have the most likely conquest buyers. Young buyers, who tend to be highly price sensitive, might be one option.

**Companies must decide how to distribute their products and sustain sales.** Chinese companies entering mature markets are unlikely to win by copying existing business models because they lack an installed base of loyal customers. They will likely start with a limited product portfolio, lower volumes overall, and limited geographic coverage. On the other hand, there is more to sell than the car alone. There is also distribution, financing, and the service proposition. It might be possible for Chinese VMs to differentiate themselves by offering a new distribution concept, innovative financing, or spectacular service. Because many established brands are actually prisoners of their business models and existing infrastructure, this will be an important differentiator for the Chinese newcomers.

For example, Chinese VMs could develop their customer-sensing capabilities in order to differentiate customers, detect their needs, tailor and bundle information and offers for them, and ultimately develop products and services in real time. The key is to offer only services that customers really value, but in a fast and efficient manner. VMs will need integrated expert systems with new practices and processes to develop insights about customer needs and preferences and then deploy those capabilities through multiple channels, such as the Internet, call centers, kiosks, desktops, and sales advisors. Leading-edge retail models tailor their sales channels to their customer segments. In its purest form, this could evolve into separate showrooms for new and used cars, and clearly recognized flagship stores that manage several outlets.

**Companies must develop a sense of business diplomacy.** In addition to the traditional sources of competitive advantage that Chinese companies will have to develop to be successful with overseas acquisitions, they will need to learn how to develop and apply elements of “soft power,” or business diplomacy. Coined by Professor Joseph Nye of the Kennedy School of Government at Harvard University, the term *soft power* refers to an indirect way to get what one wants. A company may achieve its goals because its stakeholders and other companies admire its values, emulate its example, and aspire to its level of achievement and openness. Exercising soft power—getting others to want the outcomes that you want—co-opts others rather than coerces stakeholders; it rests on the ability to shape the preferences of others.

One of the key lessons learned from a recent international acquisition attempt by a large Chinese company, CNOOC’s failed acquisition of Unocal, was the importance of selling the seller; CNOOC failed to communicate the comprehensive proposition that it would bring to the entire stakeholder group who would be affected by a takeover. The American protectionist camp succeeded in blocking the deal, largely because CNOOC failed to make its case first. Put simply, CNOOC did not sufficiently anticipate sources of resistance and develop or apply business diplomacy to the degree that was required.

Chinese companies need to recognize that an acquisition of overseas businesses, especially high-profile companies or those in high-profile industries, requires communicating to key influencers that there is more than a commercial deal at stake and that the Chinese acquirer would actually create more value and certainty for the future for the stakeholders—in particular, the employees of the company to be acquired. Most successful acquisitions ultimately provide benefits to the broader stakeholder group and even the broader ecosystem affected by the acquired company. These stakeholders include customers, channel partners, suppliers, regulatory bodies, and, in some cases, even competitors. Developing a mystique about your company, and the positive impact that

your company will bring to these stakeholders and to the broader business community, is a critical part of business diplomacy that Chinese companies will need to master. The difficulties that SAIC is experiencing with its acquisition of Korea's Ssangyong Motors may offer useful lessons for Chinese companies seeking to expand overseas. The success of GM with its integration of Daewoo, on the other hand, underlines the importance of a compelling joint vision, sufficient management capacity, synergy realization, and clear economic benefits for both parties.

As with other elements of business management, Chinese companies will need to acquire these capabilities and do so as well as they have with other "hard" skills in manufacturing and supply chain management, which over time should increase the efficacy of their overseas acquisition efforts.

#### **Putting the Right Capabilities in Place to Go Global**

Chinese carmakers will not win by copying existing business models and outpricing the Koreans or the Japanese. The new launches of attractive products from these players in the United States demonstrate that this will be hard to accomplish, particularly in the short term. Chinese companies can consider two avenues for getting the necessary capabilities in place to go global: deconstructing the value chain and developing partnerships or making acquisitions.

#### **Deconstructing the Value Chain**

**Vehicle Design and Engineering:** Automotive development is an activity that requires a lot of experience and know-how. Chinese VMs are not quite ready to launch competitive offerings that meet acceptable standards of reliability, technology, or attractiveness. But contrary to popular belief, this activity is easy to "delocalize," compared to distribution or even manufacturing, because there are no logistics or transportation costs. In China, the high level of education and working time associated with modern development tools such as computer-aided engineering (CAE) should allow VMs to develop their design and engineering capabilities at a low cost and in a relatively short period of time.

Chinese VMs can reengineer development processes and skip prototypes to achieve development lead times that are one-third shorter than Western VMs' lead times, at an engineering budget that is one-third of Western VMs'. (This estimation assumes that Chinese labor costs are half of developed countries' and working times are 50 percent higher.) As a result, Chinese VMs could potentially develop three times as many vehicles for the same engineering budget in the same period of time as Western VMs. In the short term, however, they will require the capabilities and support of foreign engineering specialists like Magna Steyr, Pininfarina, or Ricardo.

**Manufacturing:** Manufacturing is the area in which Chinese VMs should be able to develop competitive advantages compared to their overseas competitors, owing to low labor costs. However, foreign VMs already benefit from these low costs through their joint ventures and network relationships. Unless it is a necessary step to learn (as in the case of the possible contract between Geely and DaimlerChrysler), manufacturing might not be a sustainable competitive advantage; Japanese manufacturers, for instance, have developed their own production systems, such as the Toyota Production System (TPS), and have an existing manufacturing network, including China and other low-cost countries. Alternatively, suitable components can be manufactured in China, while the car is assembled abroad through a Tier 0.5 supplier such as Magna.

**Retailing and Distribution:** China used to have the lowest-cost distribution system in the world, with almost no marketing expenses. However, one could argue it also had the lowest service levels in the world, with no distribution network to speak of and nonexistent branding. Chinese VMs hence have little experience in setting up and operating efficient distribution networks in mature markets, where established VMs have provided higher service levels to dealers and end customers than Chinese VMs have in their home market. It might be a better strategy for Chinese companies to engage with independent chains or use existing VM networks to sell vehicles and provide basic maintenance.

### **Partnerships and Acquisitions**

The second avenue, relying on selected acquisitions and partnerships with established players, is one that Chinese VMs should consider in light of the speed of evolution in the current environment and the fact that established players already enjoy a global presence with economies of scale, as well as a network of engineering, supply, and manufacturing facilities. The recent breakup of Chery and Visionary Vehicles showcases the difficulties of making partnerships work. Here as well, elements of “soft power” are important in aligning objectives and establishing joint business models that work.

Chinese VMs that have the necessary cash available and some capabilities in place can consider strategic alliances with players that already have established networks and product or manufacturing know-how. The Renault–Nissan partnership shows that regional or smaller players can develop strong alliances with a limited number of expatriate managers. Candidates exist and opportunities will evolve, considering the number of players that lack either critical size or healthy financial results.

Finally, Chinese VMs will need to hire skilled managers, whether from the automotive industry or elsewhere, who can fill key gaps in expertise for Chinese VMs—in particular in the areas of management, engineering, sales and marketing, product planning, purchasing, and design. SAIC, for instance, recently hired a former General Motors chief executive in China.

Only some Chinese VMs will be successful in their efforts to export vehicles and establish a manufacturing presence in global markets. Winners will develop a clear strategy on where to compete; convince consumers of their value promise, superior QRD, and service; differentiate their vehicles from competitive offerings; and manage distribution and sales efficiently. Superior Chinese players will also succeed in overcoming differences between Chinese and Western business models to create a new model for superior value. Finally, they will put in place the right set of capabilities to leapfrog their competition.

The globalization of Chinese VMs will happen: It is a consequence of the nature of the automotive industry. It will, however, take at least a decade before the first Chinese global players will emerge at a level comparable to that of established global players. This time will be needed to develop and implement winning strategies and build sustainable competitive positions with compelling products and brands. Success will also entail a huge learning and corporate transformation effort that ultimately only a few players will successfully implement.

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