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# The Coming Structural Realignment of China's Automotive Sector



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## EXECUTIVE SUMMARY

*We are fortunate to be living in historic times. While in the grip of the most severe economic contraction since the 1930s, it is in such times – and only in such times - that truly transformational structural change is possible. While much has been said and written about the rapid emergence of China as the largest automotive market in the world, this obscures the reality of just how many structural problems remain unsolved in an industrial sector that China describes as a “pillar” of its economy. In this first article in a 3-part series on the China auto industry, we will describe how the global financial crisis is the triggering event that will precipitate a major restructuring of the Chinese automotive sector.*

The global car industry has long suffered from overcapacity resulting from overly ambitious assumptions for market growth combined with optimism surrounding whatever product or technology was being offered. Ambition and optimism are the first victims of a recession as businesses struggle to realign to a new era of fiscal conservatism. This translates into a major reduction in capital spending and asset sales as businesses attempt to adjust their size in order to regain a profitable footing. The financial crisis, which worsened in the 3rd quarter of 2008, has dragged the world into its deepest economic downturn since the Great Depression. A unique attribute of this recession is how quickly the financial turmoil has spread across the world

as a result of global interdependence along with a synchronization of business cycle among these interdependent markets. According to a recent forecast from Global Insight, 2009 will likely witness the first drop in global GDP since the 1930s.

In previous economic crises, the U.S. has always come to the rescue and restored hope to a troubled world. The \$838 billion economic stimulus bill enacted in February 2009 was designed to create millions of new jobs and jump-start the economy. However, most experts do not foresee a recovery until 2010 at the earliest. As a result, the world is increasingly looking elsewhere for leadership and signs of recovery. China has for many years experienced the most explosive

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## MANIFESTATIONS OF THE GLOBAL FINANCIAL CRISIS IN CHINA

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economic growth, and as such can be viewed as both an opportunity as well as a threat to the stability of the world's economy. After many years of double-digit GDP growth, China has seen a dramatic slowdown in its GDP growth in 2008 to less than 6%. However, this stands in sharp contrast to the declines witnessed virtually everywhere else in the world. As a result, China is increasingly viewed as a bellwether market for signs of an economic turnaround.

Much has been said and written about China's rapid rise to the top position in domestic market auto sales. In fact, China has surpassed the US in automotive sales for the first half of 2009, posting sales of 6.1 million units versus 4.8 million vehicles sold in the US market. In fact, since 2003 China's vehicle market has more than doubled in size from 4.56 million units to 9.67 million units (in 2008). Of this total, 61%, or 5.91 million units, represent passenger vehicles (excludes buses, trucks and other commercial vehicles).

Given recent developments, China will surpass the U.S. market in sales for the overall calendar year 2009. Given such startling developments, one might expect a bit of a "swagger" to emerge from the Middle Kingdom's automotive policy makers. But this is definitely not the case, for they recognize that they must now seize upon the crisis to trigger the necessary structural changes required to build a healthy and sustainable auto sector.

While auto sales indicate that things are simply humming along in China, one must look deeper into the facts before drawing quick conclusions. As noted earlier, overall GDP growth—while positive at 6%—was dramatically lower in 2008 and in fact well below the 8% target that Beijing views as "essential" in order to sustain the Chinese economic engine and maintain "harmony". There has been a steady rise in inflation over 2 years to a nearly 6% level in 2008, coupled with a strengthening of the Chinese RMB vs. the U.S. dollar. Additionally, there has been a significant reduction of Foreign Direct Investment (FDI) coming into China resulting from the stress placed on the balance sheets of companies investing globally. All of these factors create real challenges for sustaining the development of the Chinese economy. The impact of the crisis across the Chinese economy can be summarized as follows:

- Industrial production dropped 5.3%
- Money supply dropped 12%
- Vehicle exports saw first decline over past decade
- 9% reduction in year-over-year growth in exports
- 20 million migrant workers lost jobs
- 6.1 million new university graduates seeking jobs

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## CHINA'S COMMITMENT TO STIMULUS

Understanding the extent of the threat of the crisis to China's economy, the government has undertaken a series of focused stimulus actions that are designed to help China achieve its 8% GDP growth target. These actions can be grouped into four areas:

### **Boost Domestic Demand**

- Fiscal subsidy to farmers for electronics and vehicle replacement
- Car purchase tax rate reduction by 5%
- Tax and interest rate cut for housing transaction
- Relax consumer credit to promote individual and family buying

### **Stimulate Backbone Industries**

- Published stimulus plans of 10 key industries in January to February, 2009
- Encourage industry consolidation and technology upgrade
- Promote export and autonomous brand development

### **Increase Money Supply**

- New bank loans soar to 1.6 trillion RMB in January

- Government spending allocated to infrastructure and public insurance system
- Lowered bank interest rates by 5 times in 2008
- Eased deposit reserve ratio requirement of commercial banks

### **Secure and Create Jobs**

- Encourage development of medium/small enterprises and service industry
- Support SOEs to reduce job cuts
- Ease enterprise burden by suspension or exemption of social insurance fee
- Offer professional training to migrant workers and university graduates

Given the positive developments observed in 2009, it appears that these stimulus measures are having an impact: it is evident that Chinese consumers—especially first time car buyers—are in fact helping to boost domestic demand and are taking advantage of the tax and other incentives currently available.

## RISING FROM THE ASHES

While China pursues a plan to achieve 8% overall GDP growth, and continues to enjoy strong automotive sales growth, the global automotive industry faces a crisis of historic proportions. Global light vehicle production declined by 4.6% in 2008 to 67 million units and the Global Insight forecast for 2009 calls for a further double-digit decline to fewer than 60 million units in 2009, with the North American and Western European markets taking the largest reduction. As a consequence, the US, Canadian and other European governments have been asked to help companies like GM, Chrysler and others bridge the crisis. Lacking a blueprint or vision for transformation, there is a great risk that short-term government actions taken during a crisis either prolong the inevitable restructuring, or worse—generate unintended side-effects which weakens companies which would otherwise emerge stronger when the recovery does inevitably come.

However, this stands in sharp contrast to the situation in China. The volume declines in the global markets render China's recent growth even more remarkable. The expectation going forward is that growth in the automotive industry will in large part be centered on the growth of the China, India and ASEAN markets, and over the next 10 years China will account for more than half of the growth of the Asia Pacific region.

In spite of this, there are numerous structural problems in the China automotive industry. While light vehicle sales stand at historic highs, overcapacity and lack of scale remain major problems. This is true largely because of the highly fragmented and scattered OEM landscape. China's auto industry today includes over 150

registered automotive manufacturers. The top 10 OEM's account for 83% of vehicle sales and the top 20 OEM's account for 95% of sales. This creates a significant challenge to the health of the many businesses that struggle to sustain operations in an environment where economic growth is by no means assured. Additionally, approximately 66% of vehicles sold carry a foreign brand, which makes it very difficult for Chinese domestic brands to generate sufficient volumes or profit margins to remain economically viable. This fragmentation is mirrored in the automotive component supply base, where Jack Sayer of Sayer Partners LLC has recently estimated that 40% of auto suppliers face severe liquidity issues in 2009.

As a result, the Chinese government has pulled-ahead its plan to consolidate the OEM landscape in order to achieve economies of scale. Prompted by the economic crisis, the China government in January, 2009 published stimulus plans for 10 key industries including automotive. The plan clearly articulates the vision for industry consolidation, technological upgrade, export, and brand development. The main objectives of the policy can be summarized as follows:

1. To boost sales and production in 2009 to 10 million units and keeping growth at about 10 percent in the next 3 years
  - Market share of passenger vehicles with domestic brands should rise up from 34% to 40%
2. To consolidate numerous small regional manufacturers into bigger national auto groups
  - No. of OEMs account for 90% of total vehicle market to reduce from 14 to 10

3. To encouraging use of more fuel-efficient, lower-polluting vehicles
- Market share target of 1.5L and below passenger vehicles to increase to 40%, among which 1.0L and below will be 15%,
  - Building up total 500K new energy vehicle (NEV) capacity, and increase market share of NEV to 5% of total PV sales.

The most sweeping proposal in this plan is the intention to consolidate the industry into a “top 10” group organized into 2 distinct “tiers”: the Tier 1 group consisting of companies with an annual capacity of 2 million units that are encouraged to acquire smaller automotive companies throughout China, whereas Tier 2 consists of companies with an annual capacity of 1 million units that are encouraged to drive regional consolidation. The plan even names 4 Tier 1 companies as well a 4 Tier 2 companies:

**Tier 1:**

- Shanghai Automotive Industrial Corporation (SAIC)
- First Auto Works (FAW) Group
- Dongfeng Automobile
- Chang’An Automotive

**Tier 2:**

- Beijing Automotive Industrial Corporation (BAIC)
- Guangzhou Automotive Industrial Group (GAIG)
- Chery Automobile
- China Heavy Duty Truck Corporation (CNHTC)

It is noteworthy that this is not a final list of surviving companies as it represents only 8 of the “top 10”, and by calling it “top” 10 there is obviously room for others below the “top”. One can anticipate that OEM consolidation and rationalization will surely be accompanied by a major restructuring of the Chinese auto supply base.

It is also noteworthy that companies such as BYD, Geely and Great Wall are not included on the list. These companies are considered “independent” manufacturers and are not afforded the same level of government support as traditional State Owned Enterprises (SOEs). Many consider these companies to be the most nimble and entrepreneurial automobile companies in China, and therefore the most likely to become global players. In any case, China’s policy makers have clearly signaled the rationale and urgency around the issue of consolidation, and why the time to act is now. Clearly, the China government has a playbook for the industry and intends to use the economic crisis as the triggering event to start calling the plays, as the recently announced merge between Chang’an and AVIC shows.

**Please Note:**

This is the first in a series about the developments occurring in the Chinese automotive industry. The next installment will address the role of M&A—in particular, how the acquisition of foreign assets can further the development of the Chinese automotive industry.

**About the Authors**

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