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The Path to Globalization of China's Automotive Industry



Contact Information

Beijing

Bill Russo

Senior Advisor

+86-10-6563-8300

bill.russo@booz.com

Shanghai/Beijing

Edward Tse

Senior Partner

+86-10-6563-8300

+852-3650-6100

+86-21-2327-9800

edward.tse@booz.com

Tao Ke

Principal

+86-21-2327-9800

tao.ke@booz.com

EXECUTIVE SUMMARY

China is the world's factory for "everyday low price" merchandise. Sara Bongiorni's amusing yet engaging book titled A Year Without 'Made In China' chronicles an American family's futile attempt to boycott purchases of Chinese products for one year. The unexpected challenges of fulfilling such a resolution were felt when attempting to purchase footwear, eyewear, clothing, print cartridges, children's toys, mousetraps and many other things. According to the US Census bureau, the trade deficit with China in 2008 stood at \$266.3 billion, with China imports valued at \$337.8 billion compared with U.S. exports valued at \$71.5 billion. The message is clear: China dominates the production of everyday household goods. It just seems logical to assume that it's simply a matter of time before China becomes an exporter of the most symbolic cultural icon: the automobile. In this second article in a 3-part series on the China auto industry, we will describe the challenges faced by Chinese original equipment manufacturers (OEMs) in going global, and will highlight the role of Mergers and Acquisitions (M&A) as a plausible but high-risk means of accelerating this process.

FIRST THINGS FIRST: FIX THE BUSINESS MODEL IN CHINA

Let's consider a few facts. As featured in the first article of this series entitled *The Coming Structural Realignment of China's Automotive Sector*, China has rapidly become the largest car market in the world. 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 U.S. market. It seems like all the ingredients are there for the "Chinese automotive factory" to expand to the global markets. In fact much of the content in cars sold in the US and elsewhere today already does come from China. Because a significant percentage of the total cost of a car is in the manufactured components, there has already been a significant movement of the production of supplied parts to China. A great many of the components used in cars today either are or can quickly be manufactured in China. This is purely driven by the efficiencies gained from sourcing in China. So, for those who are awaiting the arrival of the Chinese car: what you may not

realize is how much Chinese content may already be in your current car. However, our focus here is on the export of Chinese-branded vehicles.

Despite the rally in China's domestic sales, China exported only 61,000 vehicles in the first quarter of 2009, a decline of 62% from the previous year. China auto insiders have pointed to the overall decline in worldwide demand as the reason, particularly in such key markets as Russia where protectionist measures have had a direct impact on vehicles entering the market. But this is not a complete explanation. This article attempts to explain why China has not become a major vehicle exporter, what challenges must be addressed, and highlights the pathways to globalization of the China automotive industry, drawing historical references to the trajectories taken by the Japanese and Korean car makers. Finally, the role of an "inorganic" approach through M&A or the purchase of foreign assets is discussed in detail.

As was noted in the previous article, there are numerous structural problems in the China automotive industry that result from the highly fragmented landscape of licensed car manufacturers. The fact that there are over 150 registered manufacturers is an outgrowth of a start-up phase for China's auto sector. Provincial governments, with the support of the central government, were encouraged to develop industrial bases to create investment opportunities and jobs in order to accelerate China's economic development. However, the highly fragmented industry that results from this creates enormous inefficiencies in the area of capital investment.

This fragmentation also makes it very difficult to focus and allocate resources to the development of critical technologies related to safety and fuel economy. This is

an area of particular weakness for Chinese OEMs who have relied on their foreign partners to lead the development of key component technologies. The determining factor in whether a car company can compete in the international markets is whether they have the capacity to meet local consumer as well as regulatory requirements. While Chinese firms have learned very quickly how to assemble cars and develop supply chains, they are very inexperienced at the vehicle development and synthesis process. An automobile is a complex engineered system requiring advanced technology and know-how in order to test and validate the achievement of benchmark targets in the areas of performance, fuel economy, safety and quality. It is in this area that Chinese firms are weakest. Chinese vehicles, while improving rapidly, are still not up to the world-class standards required to compete in the mature markets of the world.

THE BRAND CHALLENGE: THE CHINESE VALUE PROPOSITION

Savvy and pragmatic as they are, Chinese consumers understand this quite well—which is the main reason why foreign brands held a 66% share of the China market in 2008. The China government understands that in order to create a healthy industry, they need stronger companies capable of competing globally, but they too are pragmatic when tackling this challenge. Before taking on the world, Chinese OEMs must first raise the perception of “Made in China” cars in the minds of Chinese consumers. This is why there is a goal for Chinese OEMs to achieve a 40% share of domestic sales in 2009. To support this, the government has reduced tax rates by 5% on the purchase of vehicles below 1.6L engine displacement, as well as fiscal subsidies to farmers for vehicle replacement. This resulted in a surge in sales for sub-1.6L vehicles of 56.5%. Year-to-date, sub-1.6L engine vehicles captured 71% of the market. These policies clearly favor the local brand manufacturers who tend to build small, compact cars with smaller engine displacements.

The capabilities of local Chinese OEMs have come a long way in a short time. This is, after all, a relatively new industry for China and the Chinese firms will learn quickly as they grow their share of the domestic market. However,

much work needs to be done to gain acceptance of the Chinese consumer of Chinese manufactured goods. This must be the first priority as it stands to reason that if it is difficult to convince a Chinese consumer, it will be even harder to convince a foreign consumer to accept a “Made in China” car. The fact is that with the proper attention to quality management discipline and with the transfer of critical know-how in the area of vehicle synthesis and development, it is indeed possible for Chinese firms to compete globally. A key challenge for China in Western Europe and North America (mainly USA and Canada) will be to engineer cars that meet regulatory requirements. They will need at least another product cycle to achieve this “organically” on their own... but the even larger hurdle will be to gain market acceptance of the Chinese branded car. This hurdle may be insurmountable in Europe where the domestic brands in each market

enjoy high market shares. However, Americans have always been willing to buy branded products from any country - provided there is a clear value proposition. The even larger challenge will be to overcome the perception that “Made in China” is equivalent to “Cheap and Poor Quality”. Just look to Japan and Korea for evidence that this too can be overcome.

The core markets of North America and Western Europe are dominated by companies that already have a lot of experience in delivering technologies and solutions that most markets understand and already accept. Well-known brands with established value propositions dominate these markets. Unlike China, these are mature markets that are not growing—and competing for a slice of a pie that is not growing is not a game the Chinese have a lot of experience in playing.

Chinese auto companies should start by developing their Chinese brand value proposition in their own country and then target emerging growth markets first. Companies like Chery, Great Wall and others have already started to export Chinese-manufactured vehicles to Latin America, the Middle East, Africa, and Southeast Asian countries. Less mature markets have demographics that lend themselves to new market entrants who compete primarily on price.

However, greater rewards accrue to those firms who understand how to adapt their positioning to the unmet needs of the local consumer. Successful firms find a way to take their brand value proposition and uniquely position it relative to competition in their target markets—creating a unique selling proposition (USP).

LEARNING FROM HISTORY: HOW JAPANESE AND KOREAN CAR MAKERS BECAME GLOBAL

The Chinese automakers are trying to compress the timeline for going global. For the most part, their domestic companies have been around for 10 - 15 years (in some cases less) and have already started to export to the emerging markets. By contrast, Toyota Motor Company was born in 1937, and didn't export a car to the US until 1956. They sold poorly until the oil embargo in 1973. It took 36 years to even be marginally accepted. They are now a top selling brand in the US. By comparison, Hyundai began in 1946, started exporting to the USA in 1986 and have a strong position in the market.

The success of the Japanese brands in the US market was triggered by the first oil shock that occurred in the 1970's. America's post-war love affair with the automobile met up with a changing reality in the area of oil supply dominance, which came to a head with the Middle East oil embargo. Americans who had grown fond of American muscle cars and "sofas on wheels" were confronted with higher prices, rationing of gasoline, and long lines at the pump. Americans suddenly began to seek smaller, fuel-efficient transportation.

Until that time, Toyota struggled to gain acceptance in the US market for decades. Suddenly, the Japanese brands had a relevant unique selling proposition: it was the era of small, fuel-efficient cars.

Interestingly, when Toyota and Honda's fortunes started to pick up, they weren't known for high quality vehicles: their USP was small, fuel-efficient cars. Over time, they converted their USP over to high-quality, reliable compact vehicles and in the process, were able to expand their product offerings into new and higher-margin segments. The Korean brands came into the US market much later. When Hyundai, Kia and the other Korean brands first made their entry into the US, they followed the same trajectory as Japan did at the outset. The Korean brands entered with a low-priced basic transportation USP.

The Chinese companies with global ambitions would do well to study the lessons learned from those who have successfully gone global. History tends to repeat itself when it comes to new market entrants—they generally capture entry-level consumers looking for value and attempt to grow from this base. The value proposition for new market entrants usually starts with affordability and evolves over time as consumers accept the brand.

While it is important to study the history of car companies that have successfully gone global, we must also acknowledge that the world is a very different place today, which makes it much more difficult for Chinese brands to expand internationally:

1. There is a lot more competition in the US market than when Japan and Korea entered and OEMs are fighting fiercely to defend that in the face of a shrinking market size.
2. Recent negative press on Chinese product quality and safety (from toys to milk products to pet food), make consumers wary of Chinese brands—even if they are low cost. While low cost is a positive value proposition—"cheap and unsafe and shoddy" are not.
3. Recent protectionist sentiments triggered by the economic crisis will make consumers think twice before buying a foreign branded vehicle, especially from an economic powerhouse like China. Late entrants—especially ones without a clear and accepted value proposition will have to overcome this bias.

Realistically, Chinese OEMs are at least 1–2 product cycles (5–10 years) away from selling their own branded vehicles in mature markets if they try to do it "organically". If they try sooner, they will likely fail.

LEARNING FROM HISTORY: INORGANIC GROWTH

A pragmatic approach would be to grow “inorganically” by acquiring the assets of a distressed but well-known international manufacturer, and use these hard and soft assets to accelerate their expansion plans. The historic restructuring underway in the global automotive industry will result in a redistribution or liquidation of automotive OEM assets. Whole companies, brands with installed dealer networks, product platforms and associated component technologies are all available for a mere fraction of the investment needed to create these assets. It stands to reason that such an approach could significantly shorten the time frame for going global.

Chinese companies with global ambitions who are considering a major acquisition would do well to study the lessons learned from those who have tried to create a cross-border alliance. While it may be relatively easy to negotiate a deal to acquire such assets, there is enormous risk and the vast majority of cross-border acquisitions ultimately fail. The most recent case of SAIC’s acquisition of Ssangyong ultimately failed because the interests of both parties were not aligned. SAIC was unable to secure concessions from Ssangyong’s labor union to lower costs, unwilling to inject billions of RMB incremental capital to fund the business, and unable to manage the loss of leadership at Ssangyong.

Ultimately, SAIC decided to dissolve the deal. Sadly, cross-border acquisitions are rarely successful. The 9-year marriage of Daimler-Benz and Chrysler dissolved in 2007 largely driven by an incompatibility of products, brands, business models and management structures.

Even the more successful partnerships have had mixed results: by all measures, the Ford alliance with Mazda has been a very good example of a successful cross-border alliance. Ford benefited from access to Mazda’s fuel-efficient technologies and platforms, and both sides benefited from a shared global production and distribution footprint. However, Ford recently made the decision to liquidate its shares in Mazda in order to raise much-needed cash. Lenovo’s acquisition of IBM’s PC division is still struggling to deliver results in spite of the compatible interests of both sides. This deal also had to overcome challenges from the U.S. authorities fearful of national security risks. It remains to be seen if the merged company will be a stronger competitor in a highly competitive electronics industry.

REALIZING RESULTS REQUIRES MITIGATING RISKS

Clearly there is a need, on the part of the European and North American OEMs and suppliers, to find additional sources of funding in order to keep their operations going, while the rapid growth of China auto market in recent years has provided Chinese companies more capacity to invest. The shifting of economic and industrial power to the east will require a corresponding redistribution of the asset base of the industry. However, there are real challenges in finding suitable partners. Partners in the west are not necessarily going to be compatible, both from a technological and from a cultural standpoint with a Chinese suitor. A Chinese company investing in a western company or its assets must understand how to align the interests of the partner in the transaction with their own, or they will likely end up owning assets without the technological development know-how that went into creating those assets.

It all should start with a comprehensive risk-assessment and plan for post-acquisition integration. The risk-assessment should encompass the following high-failure rate causes:

Lack of Synergy

- Limited complementarities among target markets and customers
- Significant complexity in sharing resources/technological capacities
- Difficult to jointly develop new concept or product platform for global sales

Political/Legal Risks

- Anti-trust restrictions and strict audit by in-country government
- Potential resistance from public and other stakeholders who have interest or deep-rooted connections with the acquired brand/company
- Potential objection from national security authority if company is military supplier

Financial Risks

- Capital investment requirements in transition process
- Increased cost level by resulting from increased capacity and staffing

Operational Risks

- Shortage of qualified management with international experience
- Difficulties to integrate the parent company's systems with the acquired company

Cultural Risks

- Conflicts caused by huge differences in language, culture and values
- Misunderstanding and failure due to ineffective communications

Successfully anticipating these issues and developing a post-acquisition plan for asset integration will increase the success rate and ensure that technology transfer could then happen in the context of the new partnership.

TRANSACTIONAL BARRIERS TO CHINA'S GLOBAL AMBITIONS

With time, Chinese car companies can get there organically—but going it alone will be slow and may never work. The global financial crisis is presenting very enticing opportunities for Chinese companies to fill their remaining technology and competency gaps using an inorganic approach. For China to play a role in the restructuring of the global automotive industry, several transactional barriers remain.

China government policy and financial support is essential for overseas acquisition

- China Commission of State-owned Asset Supervision and Administration (SASAC) has stated that they are not ready to approve any overseas acquisition project by China vehicle manufacturing or financial enterprises in near term since they are not clear on the OEMs' asset/brand value
- Limited funding capacity of local OEMs necessitates that the government provide a source of investment capital needed to complete the transaction

Select asset/technology acquisition is still an economical and feasible alternative for China OEMs to access globally advanced technologies.

Examples include:

- SAIC's acquisition of Rover brand/assets for development of own brand vehicles

- Geely's acquisition of Manganese Bronze in 2006 (London taxi)

Shortage of expertise in international acquisition and post-merger integration is yet another major hurdle for China OEMs

- Local OEMs would likely rely heavily on outside experts with knowledge of international markets
- Such advisory services will help a smooth execution and successful restructure in early stage:

1. Develop acquisition strategy and proper methodologies
2. Define the right target of acquisition through a broad range of evaluation
3. Advise the due diligence and business negotiation
4. Provide project management services and track full execution
5. Aid to cross-cultural communication and facilitate conflict resolution

THE WAY FORWARD

It is clear that China's auto companies aspire to be on the world stage. However, for Chinese brands to successfully compete in the global auto industry they must:

1. Strengthen their domestic base through consolidation
 2. Determine the Chinese brand value proposition first domestically and ultimately globally
 3. Build critical vehicle development competencies required to achieve benchmark targets in line with the brand's Unique Selling Proposition
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While the China government is concerned over the readiness of domestic firms to take on a foreign acquisition, it is likely to happen. Those who dare take on such acquisitions are also wise to learn the lessons from others who have gone global before them, and from those among them who have tried—and often failed—to use an acquisition to accelerate the process.

Note:

This is the second in a series about the developments occurring in the Chinese automotive industry. The next installment will address the China's role in the transformation of the business model and technological underpinnings of the automotive industry.

About the Authors

Edward Tse is

Booz & Company's senior partner and chairman for Greater China, specializing in definition and implementation of business strategies, organizational effectiveness, and corporate transformation. He has assisted several hundred companies—headquartered both within and outside China—on all aspects of business related to China and its integration with the rest of the world.

Bill Russo is a senior advisor with Booz & Company as well as the Founder and President of Synergistics Limited. He lives in Beijing and has more than 20 years of experience in the automotive industry, most recently serving as Vice President of Chrysler's business in North East Asia.

Tao Ke is a project principal with Booz & Company and is a member of the core financial services leadership team in Greater China. He has more than 10 years' consulting experience in a broad range of strategy, operations, organization, and risk management assignments, covering the financial services, automotive, consumer, and telecom industries.

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