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Revvng the
Growth Engine
*India's Automotive
Industry Is on a
Fast Track*



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EXECUTIVE SUMMARY

As India's economy continues to grow at a rapid pace, the automobile industry will be a key beneficiary. This is widely true across automotive markets—from those serving customers with two-wheelers and four-wheelers to those offering commercial vehicles. This Booz & Company Perspective provides an analysis of growth prospects in the Indian automotive industry. The main factors behind such growth are the increasing affluence of the average consumer, overall GDP growth, the arrival of ultra-low-cost cars, and the increasing maturity of Indian original equipment manufacturers (OEMs). However, India's path to mass motorization will be very different from that of developed countries; it must first develop the new technologies, business models, and government policies that will pave the way to increased automobile penetration. Other challenges—for example, the current global economic crisis and high commodity prices—may slow down the country in the short term, but they will not be able to stop it.

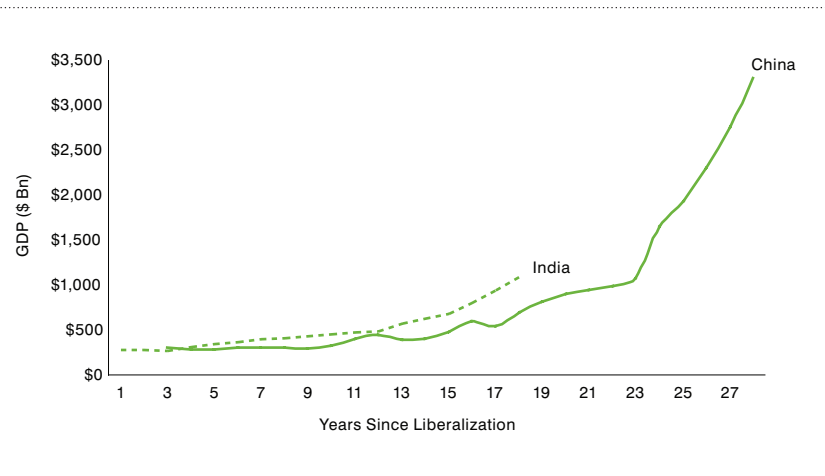
INDIA'S INCREASING AFFLUENCE

The Indian economy is booming. From 1998 through 2008, its GDP has grown at an average of more than 7 percent per year. Moreover, its contribution to world GDP is expected to increase from 2 percent in 2007 to 17 percent in 2050. Tremendous growth in wealth will produce significant increases in spending on discretionary items and consumer durables.

As in all emerging markets, a growing middle class fuels economic advancement. In India today, 13 million households earn US\$10,000 to \$50,000 a year; that segment is forecast to more than triple by 2012, to 40 million. Meanwhile, income for average middle-class households will approximately double. Local

and international banks, well aware of the opportunities, have increased consumer credit available to middle-class borrowers. Even in the current global recession, India's middle class has been less affected than its counterparts in developed countries. In the second quarter of 2009, India's economy grew by 6 percent while GDP in the U.S., Japan, Germany, and other countries declined. This is spurring a new wave of consumer spending unprecedented in India's history. In fact, by looking at such macroeconomic indicators as GDP and foreign direct investment growth for parallel markets, one could conclude that India is tracking the path of China, albeit with a 10-year lag (*see Exhibit 1*).

Exhibit 1
GDP Growth of China and India



Source: IMF

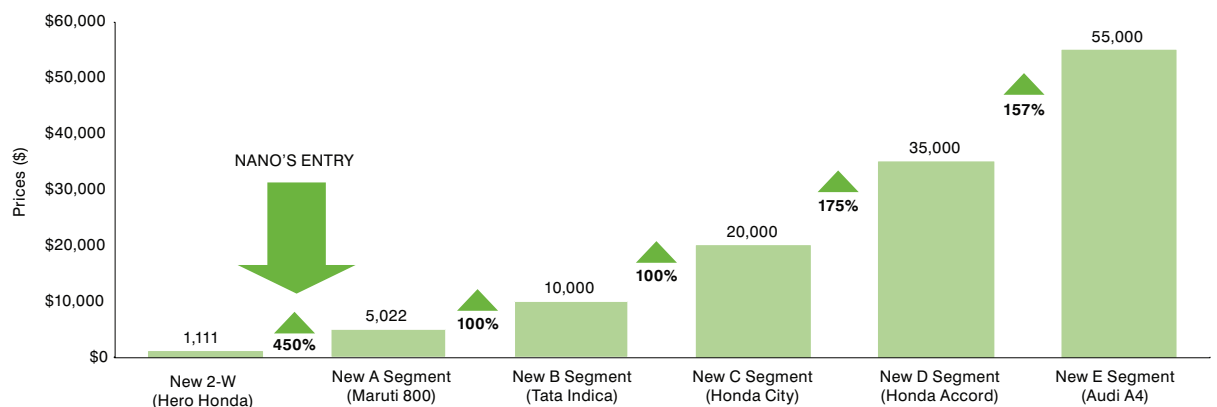
THE STATE OF INDIA'S AUTO INDUSTRY

India's auto industry is growing fast, but it remains a two-wheeler nation. More than 78 percent of motor vehicles on the road are two-wheelers, their popularity 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 a compounded annual growth rate of 13 percent; in 2007, 8 million units were sold. Over the next seven years,

we expect the number sold to nearly double, to 15 million units per year.

But even as the market grows, motorbikes face a pack of ultra-low-cost four-wheel challengers: the "Sub-A" segment automobiles exemplified by Tata Motors Ltd.'s \$2,500 Nano. The recently launched Nano bridges the gap between \$1,000 motorbikes and \$5,000 cars (*see Exhibit 2*). With the Nano and similar

Exhibit 2
Automotive Economic Ladder – From 2-Wheelers to Cars



Note: Percentages indicate increase in price from one segment to the next

cars from Tata and Bajaj Auto Ltd., the industry is walking the market down the demand curve; the low prices will quadruple the number of potential new-car buyers.

While the Sub-A segment gains traction, India's auto market remains dominated by cars in the A (small) and B (compact) segments, which together account for about 65 percent of sales.

Global small-car players like Hyundai, Suzuki (including Maruti), and Honda, traditionally the leaders in India, now face stiff competition from local manufacturers such as Tata and Bajaj. Renault has partnered with local players Mahindra and Bajaj. In the D segment (midsize) and higher, the market has been dominated by global manufacturers like Toyota, Volkswagen, Daimler, and BMW.

The overall passenger vehicle market in India is expected to grow from 1.7

million units in 2008 to 2.4 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 will become the world leader in small-car market growth.

The economic underpinnings of this growth are strong. A historic structural shift in the Indian economy will continue to generate great wealth. Back in 1950, agriculture accounted for more than 50 percent of India's GDP; today, agriculture accounts for only 15 percent and that share will shrink further. Rapid urbanization drives the need for commercial transportation. Consider the need to keep food cold: 30 percent of agricultural produce in India now perishes en route to the market due to refrigeration gaps in the supply chain; hence, there is a nationwide need for refrigerated trucks. Rail

transport once dominated the people-moving business. No more. Roadway passenger traffic is expected to increase from 40 percent of the total in 2007 to 55 percent by 2020.

Meanwhile, an expected increase in defense spending will prompt new demand for commercial vehicles intended for military use. Domestic manufacturers such as Tata and Ashok Leyland Ltd. dominate the military-commercial market with a diverse product portfolio, while foreign manufacturers like Daimler and AB Volvo remain niche players. The small commercial vehicle segment is growing most quickly, attracting new players both foreign and domestic.

Today, India boasts the world's third-largest market for new commercial vehicles. Because it is also the world's second-fastest-growing commercial market, its future looks even brighter.

OPPORTUNITIES IN THE INDIAN MARKET

A growth spurt in any industry presents an opportunity to shape a market for long-term prosperity. Motorbikes, the prime driver of two-wheeler growth, carry fairly high margins in a rapidly growing market. High-value sports and luxury motorbikes boast fat margins, too, yet global market leaders such as Harley-Davidson, BMW, and Ducati are not aggressively investing in the Indian market, which leaves an opening for domestic manufacturers. Sales of lower-margin scooters have increased somewhat, whereas sales of mopeds, with the thinnest margins, have declined.

Mainstream consumers use two-wheelers for personal or family transport. New engine technologies that increase horsepower while maintaining the high fuel efficiency of the four-stroke engine have strong potential to further boost sales. To sustain sales growth, manufacturers, dealers, and consumer finance groups must work together to build innovative financing options for consumers.

The four-wheel passenger vehicle market has grown impressively at the hands of the new middle class, although market penetration remains low. Four-wheel automobiles are still too expensive for the vast majority of Indian motor vehicle buyers, although the Tata Nano and other Sub-A segment automobiles will bridge a significant gap in the automotive ladder.

While the small-car market continues to develop, local players like Tata and Maruti are also aggressively pushing into the compact and entry midsize segments. The entry midsize market represents particularly fertile ground, expected to grow 27 percent over the next five years. At present, the Honda City, Hyundai Accent, and Maruti Esteem are the leading models in this segment.

To become a global player in small cars for both domestic and export markets, Indian manufacturers will need new innovations in power-train and manufacturing technologies to drive down costs and compete with

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two-wheelers. There are opportunities on the cost side of the entry midsize segments as well, as automakers utilize India's world-class engineering and low-cost manufacturing labor. Global OEMs now have an opportunity to develop cars in India and even manufacture them for export to the Western markets. Even in a moderate economic scenario, we expect the four-wheel passenger market to reach at least 2.5 million units by 2015 (see Exhibit 3).

India's commercial vehicle industry, although one of the largest in the world, is nascent by Western standards. Only 20 percent of the

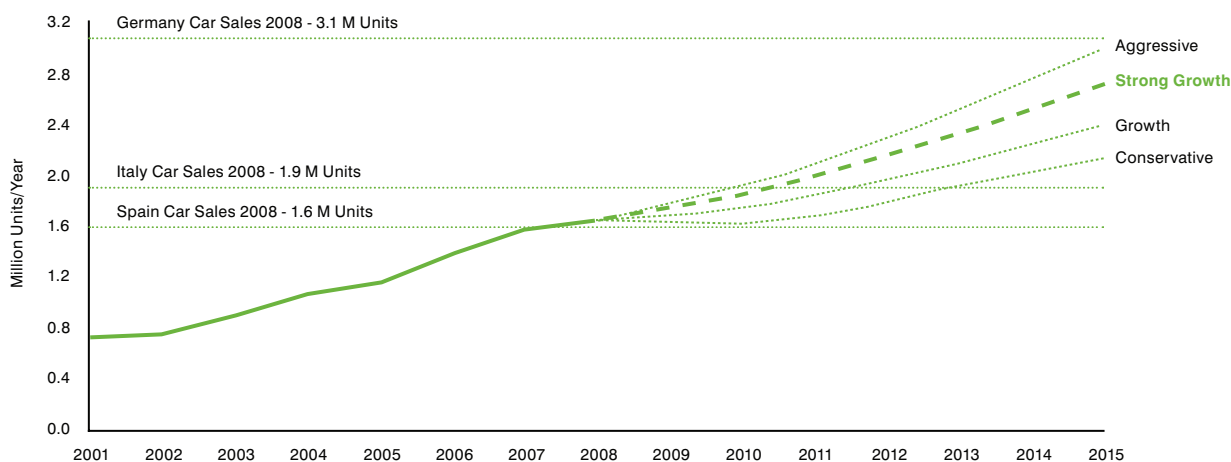
nation's commercial vehicles are in fleet ownership, compared with about 70 percent in the Western markets. An increase in fleet ownership will make the market more regulated, more consolidated, less price sensitive, and more apt to be driven by economics than by emotion.

At the segment level, small commercial vehicles like the Tata Ace have changed the industry landscape. Combining high utility with low prices and low maintenance costs, these vehicles allow consumers to trade up from load-carrying three-wheelers. India is already the second-largest exporter of small cars. The

Ace presents an opportunity to export small trucks to other emerging markets and will serve as a model that prompts other manufacturers to begin building and exporting similar vehicles.

Refrigerated trucks represent a segment that will grow naturally with increasing GDP. Such trucks must be economically attractive and environmentally friendly; development of fuel-efficient technologies in this area will further increase the market size. In the meantime, high-end trucks and ultra luxury buses present opportunities for the domestic market and for export.

Exhibit 3
Four Wheel Passenger Vehicle Sales Projections (2001–2015)



Source: Global Insight; Economist Intelligence Unit; Booz & Company analysis

INDIAN MARKET CHALLENGES

In addition to its many opportunities, the Indian automotive industry presents challenges for all players. Political and economic stability in India and stable global financial markets are the keys to meeting predicted growth rates; however, stability has been hard to come by.

Global Economic Crisis

For the short term at least, the global economic crisis has slowed India's economy and the commercial vehicle market. The medium and heavy commercial vehicle markets have been affected more than light commercial vehicles. Consumer lending has been severely affected. Although interest rates have been reduced, the percentage of loan approvals has also declined. Customer trade-downs mean lower trim levels and lower-end models.

Despite all this, the four-wheel passenger vehicle market is expected to reach approximately 6 percent

growth, far below the historic 14 percent CAGR, but a healthy level nonetheless. As noted above, the news is not so good for the commercial vehicle sector—sales are expected to decline by 35 percent for FY09. With support for financing from the government, sales should recover in FY10. The two-wheeler segment has shown some resistance to the global crisis; however, in a broader market collapse, this segment will suffer as well.

Commodity Prices

As discussed, the two-wheeler industry faces homegrown competition from ultra-low-cost cars priced at \$2,500 and less. A return to high steel prices will challenge these inexpensive four-wheelers. Manufacturers have little option but to pass cost hikes on to low-wage consumers. Oil and other commodity price increases will also challenge the four-wheel passenger market. Commodity prices may be depressed in a slowing worldwide economy, but they're in for another rapid rise once global economic growth recovers.

Infrastructure and Technology

If India is to achieve the full potential offered by motor vehicle

industry growth, it must address several challenges. Emissions and safety standards in India are not up to European or North American standards; without reform in these areas, India won't be taken seriously as a vehicle exporter. At the same time, the commercial vehicle industry in India faces legislation that would mandate anti-lock braking (ABS) and anti-skid technologies; with a high personal-ownership rate for commercial vehicles, it will be difficult to pass on the increased cost of such safety mandates to price-sensitive consumers.

Infrastructure development in India must keep pace with the growth of small cars on the road. Impediments to the construction of the Golden Quadrilateral, the highway connecting the country's major metropolitan cities in a giant ring, would directly affect commercial segment sales. Currently India has only 3,700 miles of highway, compared to 25,000 miles in China and 46,000 miles in the United States. Given this underdevelopment in infrastructure, India needs to redefine the normal commercial truck pyramid by emphasizing sales of small and light commercial vehicles.

CONCLUSION

The automotive industry is at the core of India's manufacturing economy. India is positioned to become one of the world's most attractive automotive markets for both manufacturers and consumers. The resulting benefits to society—in economic growth, increased jobs, and stability for families employed by the automotive industry—are considerable.

What does this mean for motor vehicle businesses? The total cost of ownership of two-wheelers over the past few years has increased while that of entry-level passenger cars has declined, primarily due to rising fuel prices and lower prices for Sub-A segment vehicles. This shift will result in increased entry-level passenger vehicle sales in urban areas. Hence, the two-wheeler manufacturers should focus on penetration of sales in rural markets where infrastructure is relatively underdeveloped. Motorbikes will still be attractive to younger consumers as a primary mode of transport; the product strategy must be focused on that segment. The two-wheeler manufacturers must also work to further improve fuel efficiency.

Automobile penetration in India is only seven or eight per 1,000 people, compared with nearly 500 per 1,000 people in mature markets. To increase this ratio, manufacturers should

campaign for better infrastructure, further reduce the total cost of car ownership, and bring financing and insurance models up to modern global standards. To beat rising input costs, manufacturers must improve their net cost position by increasing productivity and performance. Indian auto manufacturers such as Tata must increase their global sales for faster recovery of their fixed costs and match the product cycle times of international manufacturers like Hyundai.

The government can help by mandating higher fuel efficiencies for passenger vehicles and by setting antipollution policies that take older cars off the road. The government can also address the heavy blow dealt by the economy to the motor vehicle industry by providing funds to improve credit availability, especially for noncommercial vehicle buyers. To further promote the market, manufacturers must adopt new technologies that improve comfort, safety, and durability.

By promoting fuel efficiency, India can reduce its dependence on foreign oil. By reducing its fuel subsidies, the government could direct that spending to social programs. But to ensure that the benefits come to fruition, India and its automakers must act now.

Reference

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