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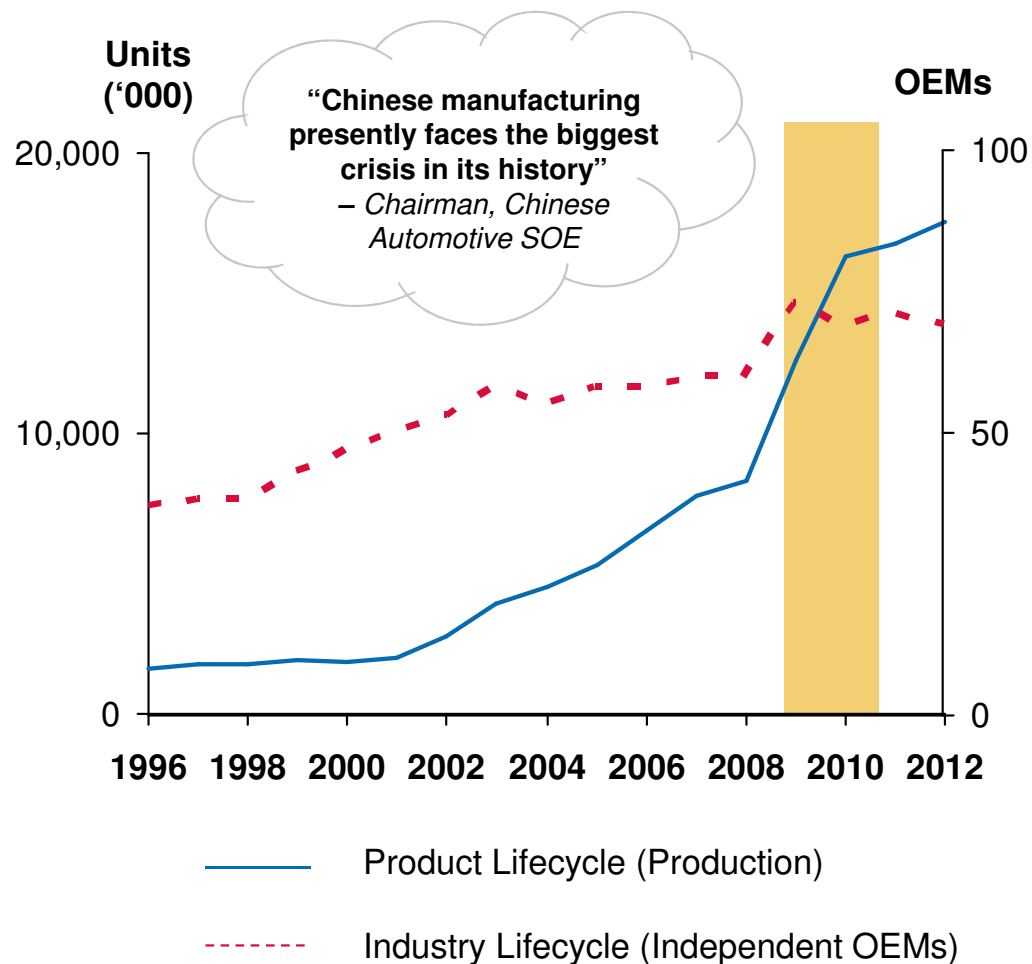
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# Racing to the Bottom

## Automotive Components Working Group Meeting

# China's auto industry is presently at an important inflection point

## Industry Dynamics



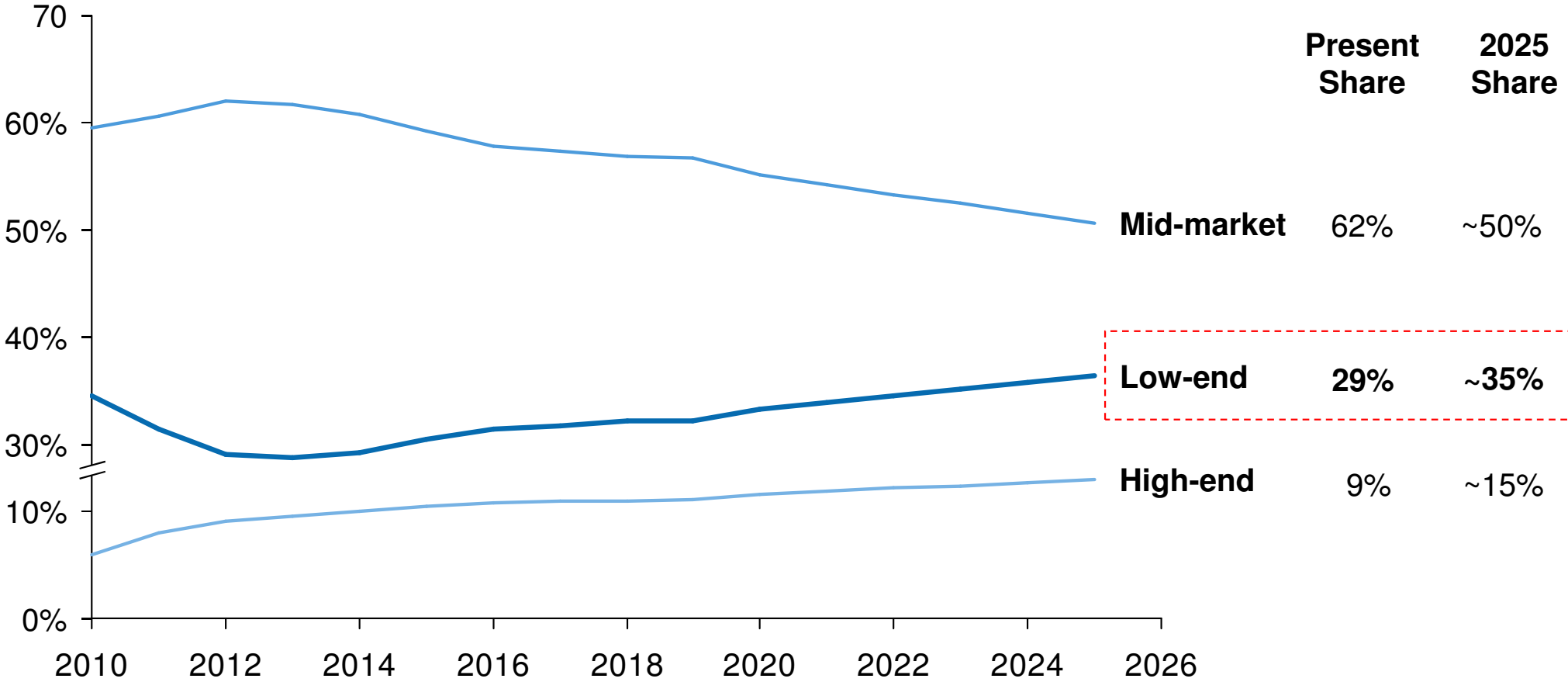
## Major Trends

- Annual sales expected to slow down from 25% CAGR before 2010 to ~6% CAGR during the next decade
- The product and industry lifecycles are beginning to decouple
  - High levels of overcapacity
  - Price and margin pressure
  - (Orderly) shake-out finally underway?
- Changing competitive dynamics increasingly resembling those of mature markets
  - Repeat purchases / owner loyalty
  - Used vehicles / parts & service
  - Lease / Finance?

Source: Global Insight, Literature Research, Booz & Company analysis

# The low- and high-end segments will likely continue to gain share at the expense of the mid-market

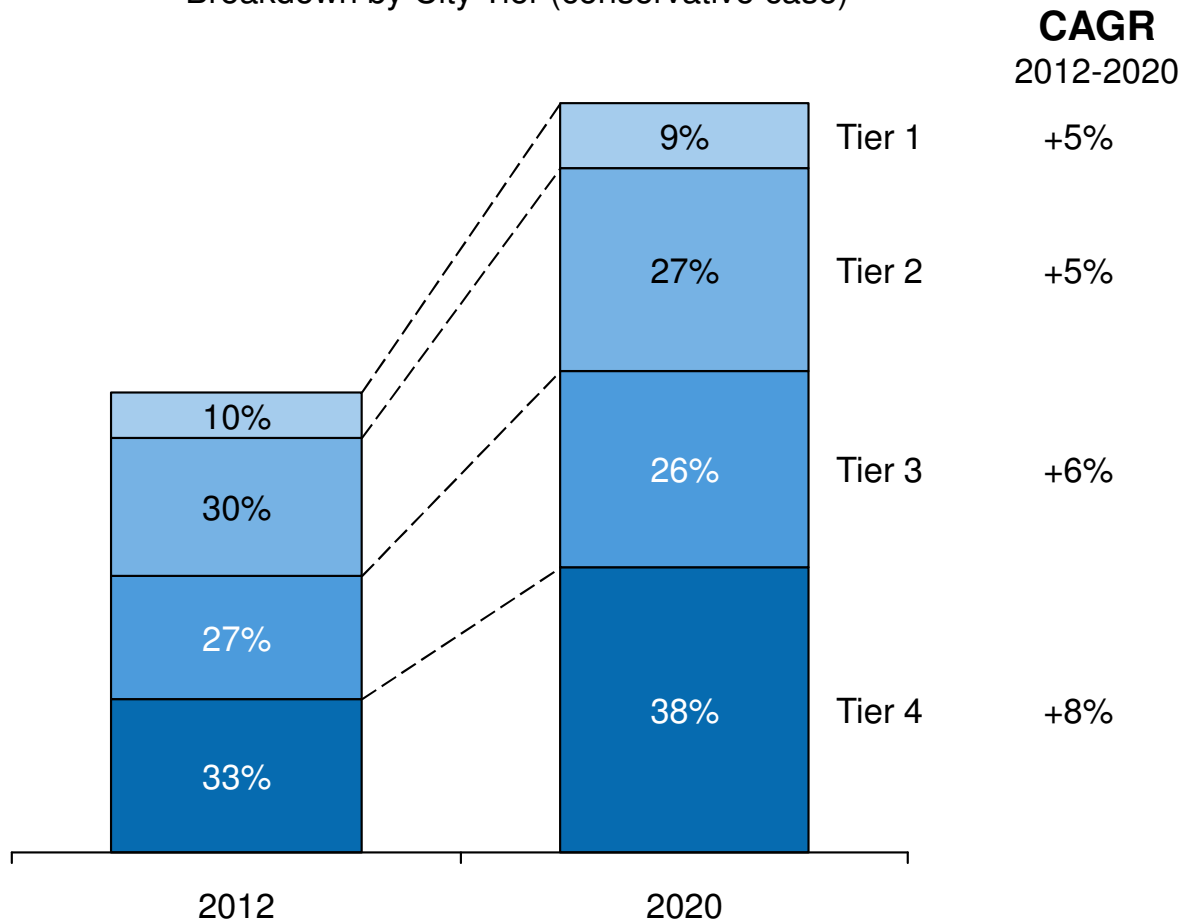
**China Vehicle Sales – By Segment**  
(2010 – 2026E, % of Total Sale Units)



Source: Global Insight, Literature Research, Booz & Company analysis

# Future low-end demand will likely come primarily from tier 3 and tier 4 cities

**Total Low-end Market**  
Breakdown by City Tier (conservative case)



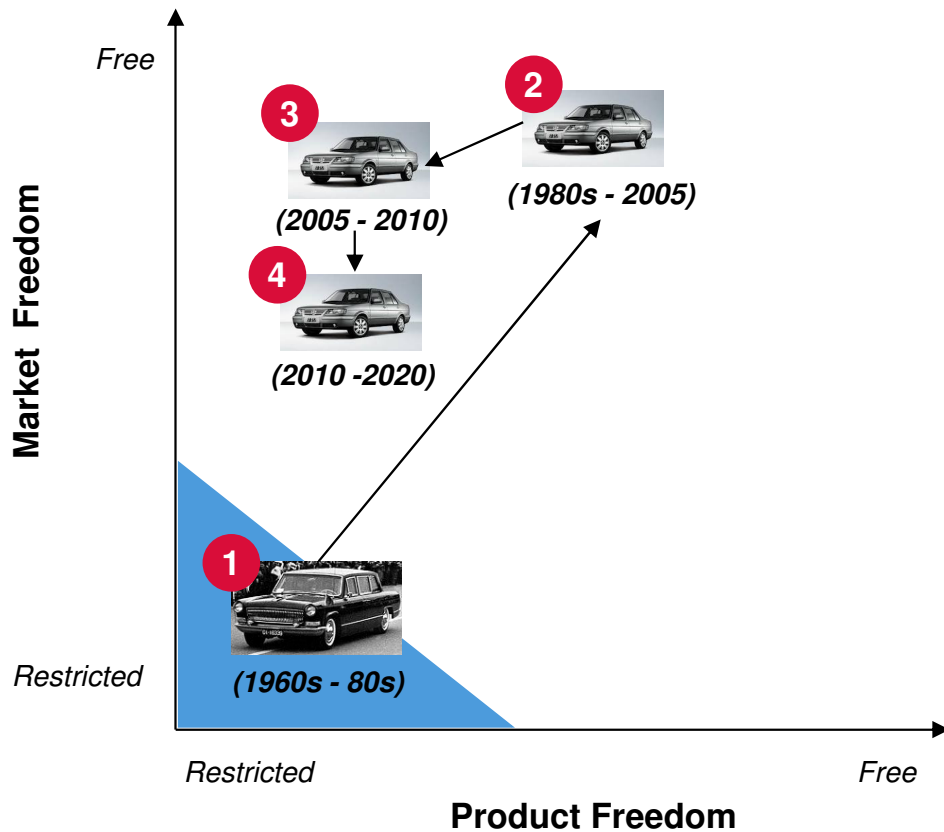
**Entry-Level Segment**  
-- Market Growth Drivers

- Lower tier consumers crossing the mobility threshold
- Urbanization / lifestyle changes
- Improved infrastructure

Source: WebMIS; Policy registration data; Booz & Company Analysis

# The recent IB regulation will be another important growth driver

## Regulatory Evolution - Automotive (1960s ~ 2010 ~ 2020e)



Period	Automotive Industry Development
1 1960s - 80s	<ul style="list-style-type: none"> <li>Develop indigenous automotive industry with Soviet help</li> <li>Centrally planned manufacturing and limited imports</li> </ul>
2 1980s - 2005	<ul style="list-style-type: none"> <li>Designated automotive as strategic sector</li> <li>Allowed foreign players to participate through minority JVs with intention of trading market access for technology transfer</li> </ul>
3 2005 - 2010	<ul style="list-style-type: none"> <li>China becomes largest automotive market in the worlds</li> <li>But still unsuccessful in acquiring world-class technologies and other capabilities due to high technical barriers and counter-productive industrial policy</li> </ul>
4 2010 -2020	<ul style="list-style-type: none"> <li>Introduction of IB regulation to further “encourage” technology transfer and domestic capability development</li> <li>New restrictions (e.g., minimum IB volume requirements)?</li> </ul>

Source: Booz & Company analysis

# Several foreign OEMs have already entered the low-end segment

## Recent Low-End Market Entries By Foreign OEMs



SGMW Baojun



Segment

Price

Compact

58-97k



Dongfeng Nissan Venucia



Compact

68-85K



GAIG Honda Everus

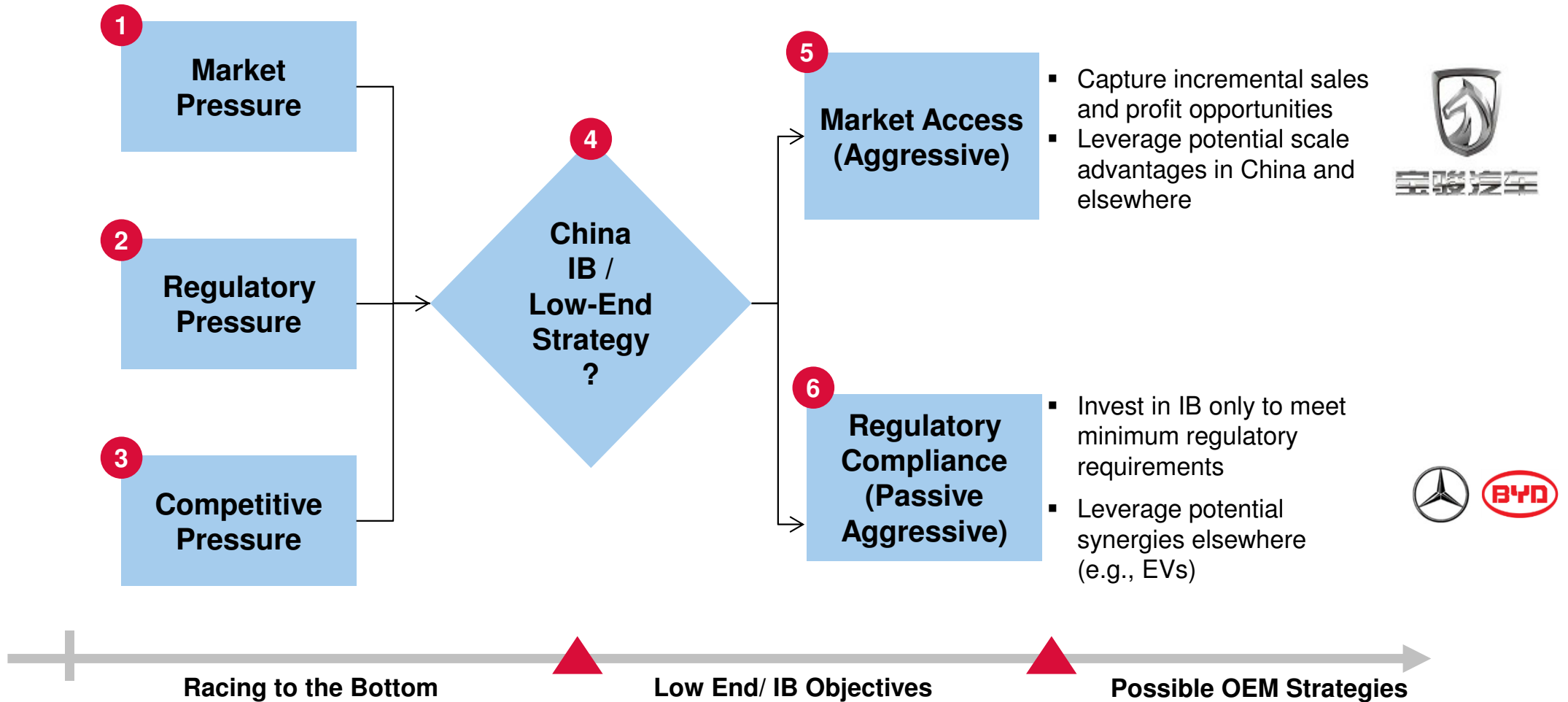


Sub-compact

58-100k

Source: Literature Research, Booz & Company analysis

# The remaining automakers must decide whether and how to enter the low-end segment themselves



Source: Booz & Company analysis

# The passive-aggressive strategy is probably not advisable for most OEMs, especially those in the volume segments

## Potential Risks of a Passive-Aggressive IB Strategy

### Market Risk

- Lost profits, competitive position, and prestige
- Scale disadvantage in China and potentially other emerging markets
- Inability to reach business plan objectives

### Regulatory Risks

- Potential negative impact on relationship with key government officials and other stakeholders
- Substantial investment may be required even to meet minimal regulatory requirements
- Potential challenges with expected tightening of IB policy (e.g., future minimum volume requirements)

Source: Booz & Company analysis



# A successful low-end vehicle strategy is a function of specific decisions and trade-offs on at least eight dimensions

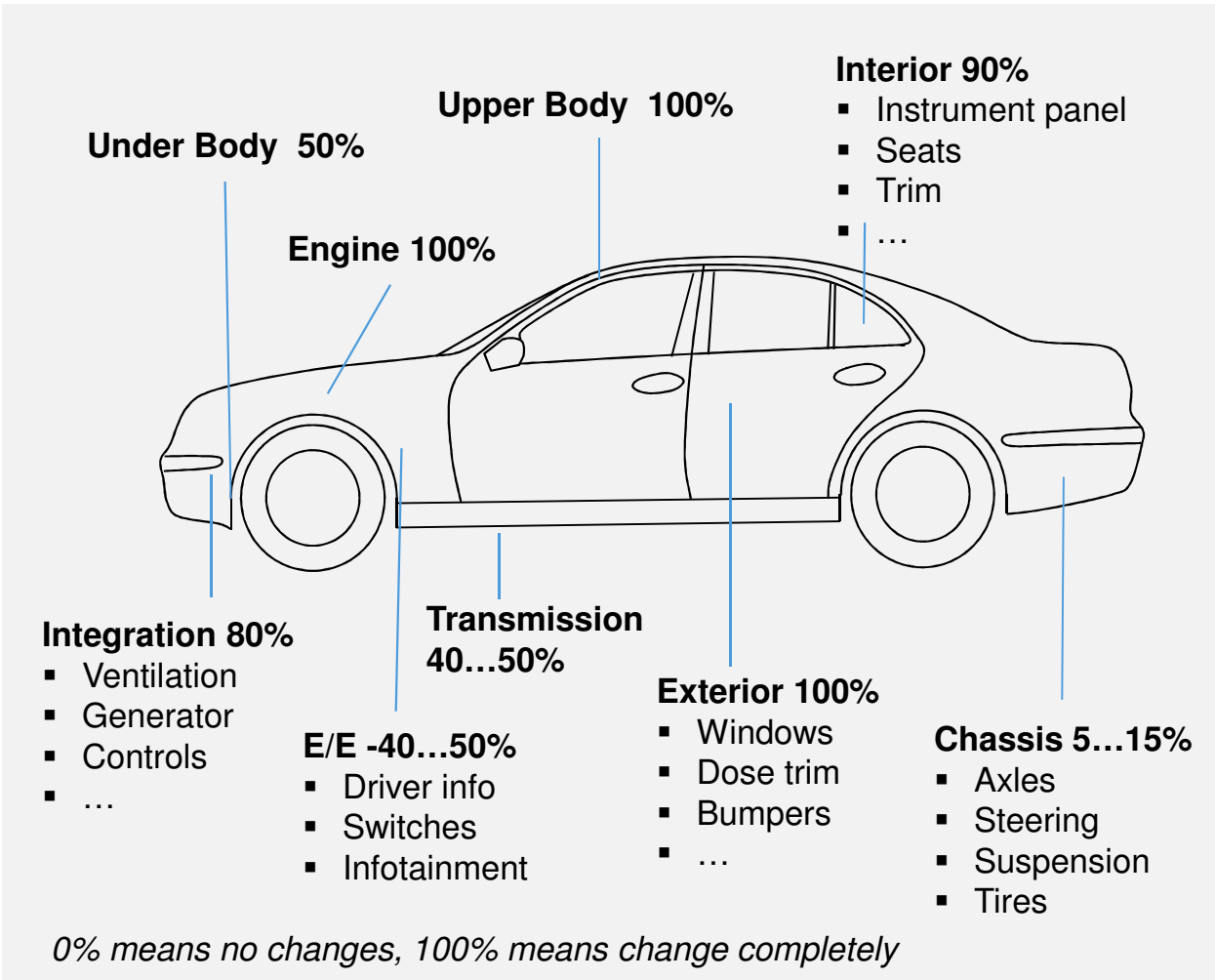
- 1 Entry-Level Business Model** – Rethink business model to support unique entry-level market requirements, including product, price, branding, marketing, distribution, and operations
- 2 Low-price Products** – Develop “low-priced” products specifically designed for Chinese mid-market customers, as opposed to merely introducing “low-cost” versions of existing world-class product
- 3 Value chain migration** – Transfer core activities to China to narrow cost gaps with domestic entry-level market competitors through local product development, sourcing, and manufacturing
- 4 Selective Partnerships** – Consider entering into partnerships with local suppliers to fill gaps in entry-level market product portfolio, develop optimal distribution footprint, and navigate China’s unusually complex regulatory environment
- 5 Multi-Brand Strategy** – Consider developing a multi-brand strategy to successfully operate across premium and entry-level market price points as well as multiple product categories
- 6 Multi-format Sales Channel** – Develop cost-effective ways of sale by employing multi-format dealerships including vehicle supermarkets, 2S stores, and brokers to penetrate entry-level regions
- 7 Strong Local Organization** – Ensure that management is capable and sufficiently empowered to enable fast decision-making and sensitivity to local market requirements. Clarify decision rights and put in place a strong governance structure
- 8 Global Mindset** – A firm’s success in China is tied to the mindset of its top managers. At a minimum, ensure that headquarters has at least a basic understanding of China’s unique business and regulatory context

Source: “China’s Mid-Market: Where “Good Enough” Just Isn’t”-- Strategy + Business, John Jullens, July 9, 2013

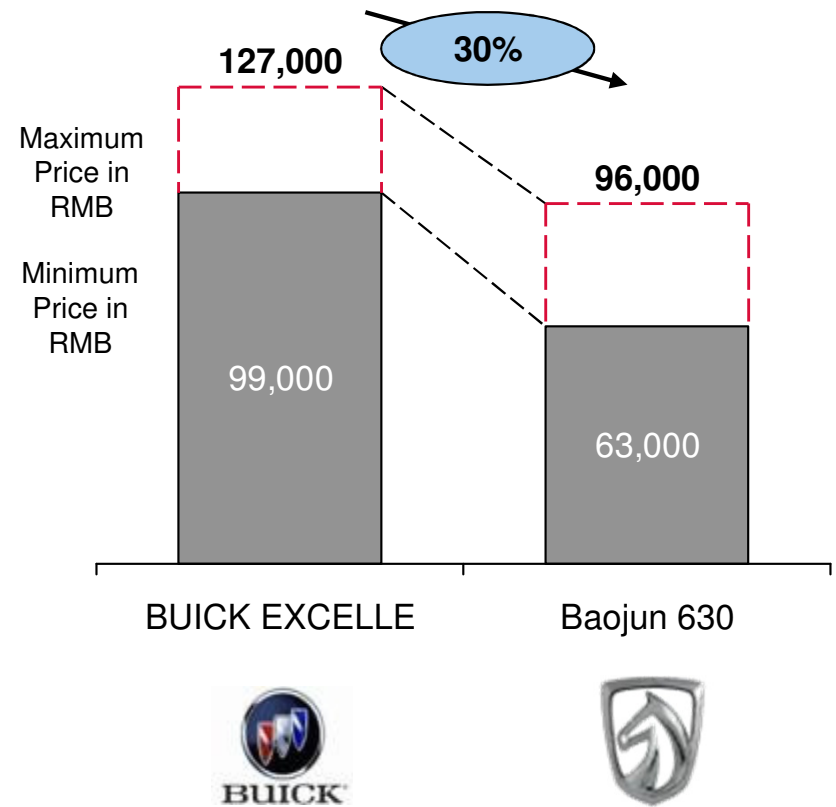
# Some global OEMs have achieved cost reductions of at least 30%

## SGM CASE STUDY

### Changes Between Baojun 630 and Buick EXCELLE



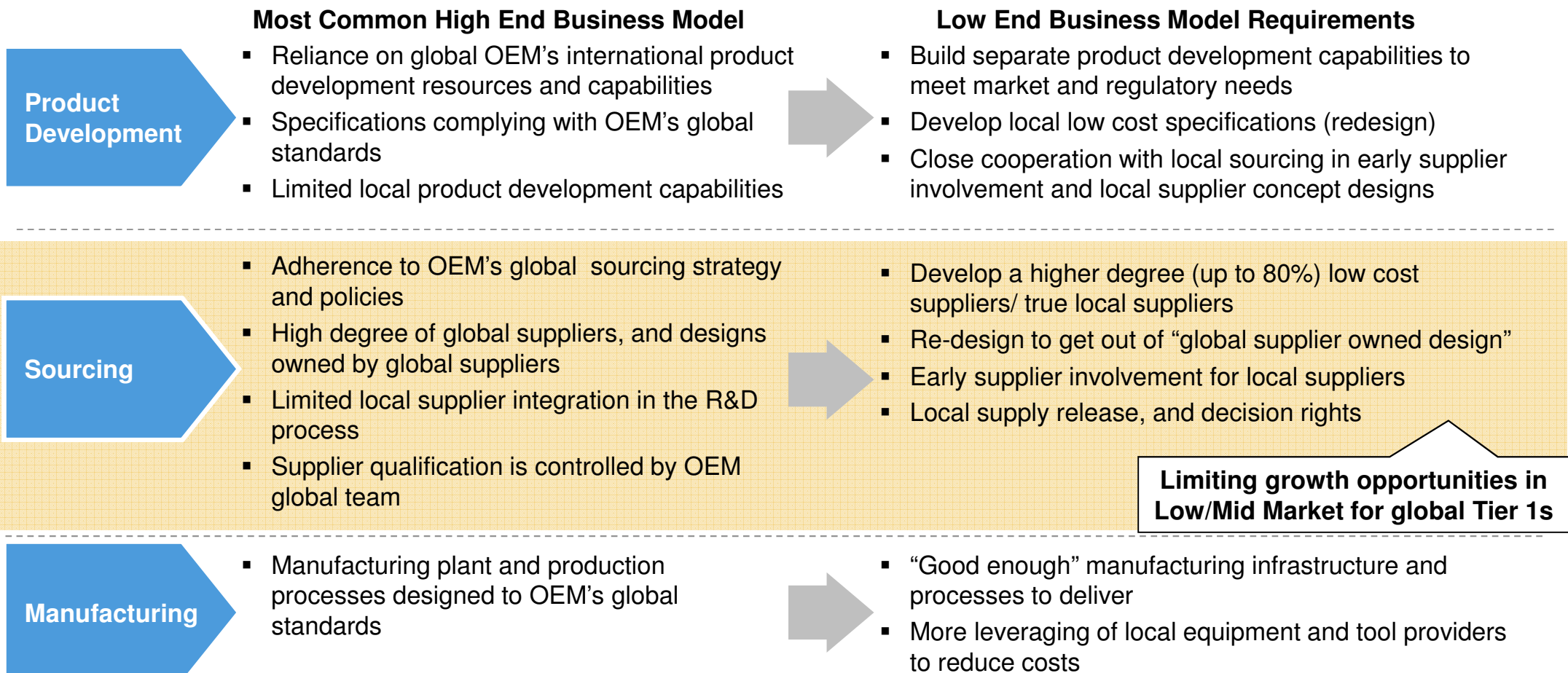
### Price Comparison between Buick EXCELLE and Baojun 630



Source: Literature Research, Booz & Company analysis

# To do so, global OEMs will be forced to change their business model and increasingly leverage local suppliers

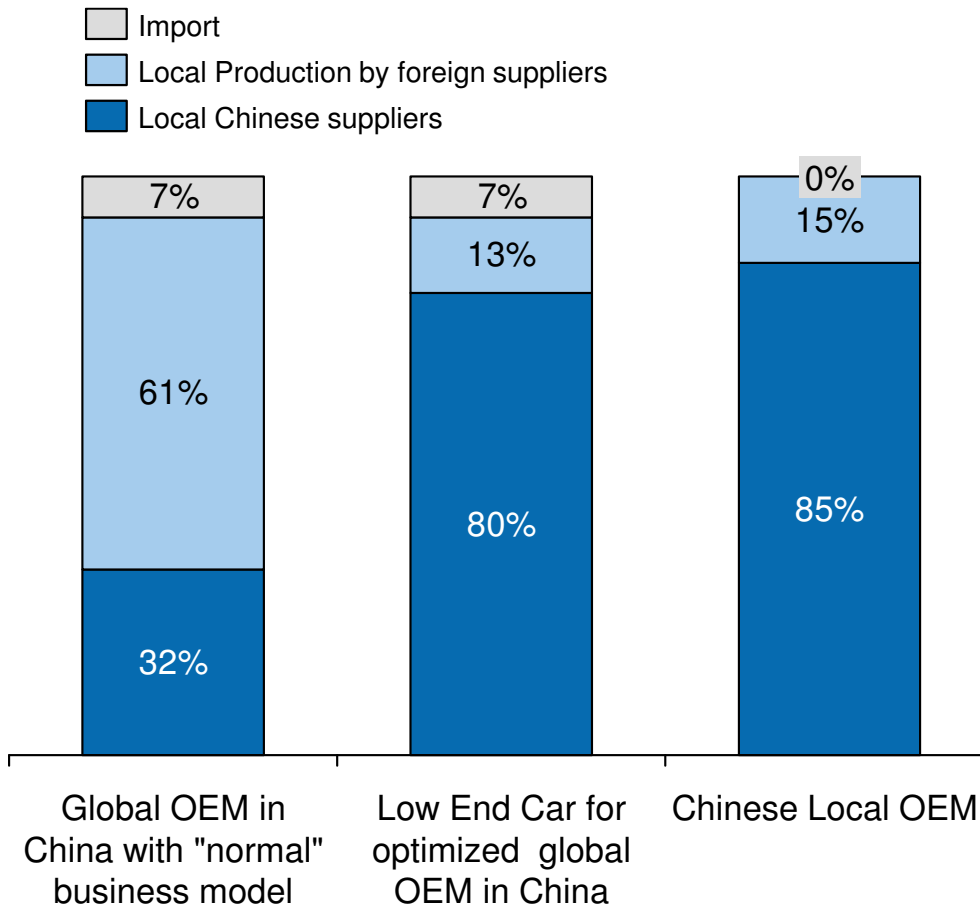
## Examples Of Changes in Business Model



Source: Booz & Company analysis

# As a result, local suppliers will become much more capable

## Supplier Base Distribution Examples



Comments
<ul style="list-style-type: none"><li>▪ Most global OEMs have already localized much of their supply bases in China</li><li>▪ However, many still use mostly foreign instead of local suppliers</li></ul>
<p><i>As local suppliers become stronger, it is likely that global OEMs will pull them along into the higher tier segments</i></p>

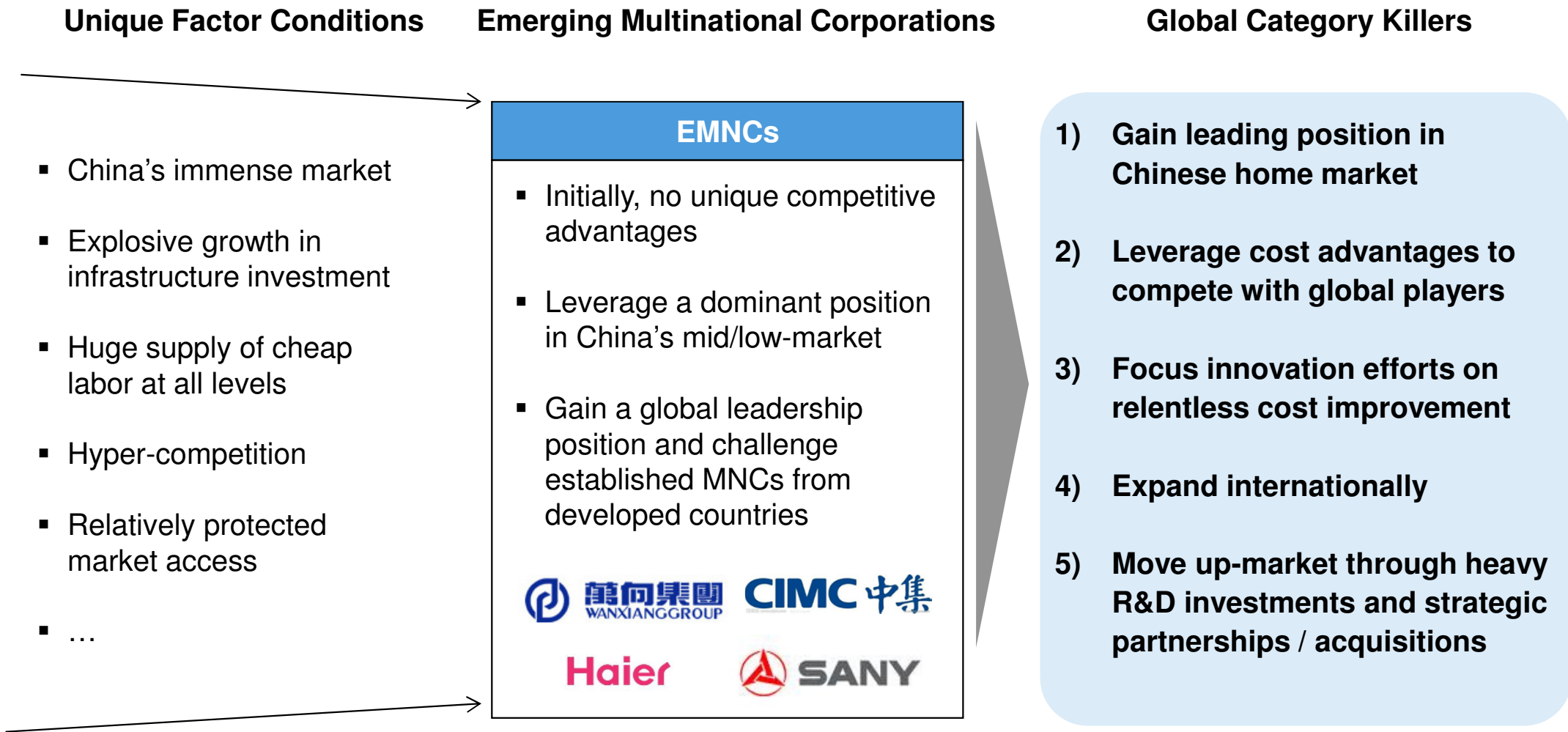
Source: Literature Research, Booz & Company analysis

# Many global tier 1 suppliers are structurally disadvantaged and may find it difficult to respond successfully to these challenges

	Key Drivers	Common Benefits for Locals	Typical Challenges for MNCs
R&D / Product Development	Localized Design	<ul style="list-style-type: none"> <li>“Leaner”, <b>market-back, pragmatic designs</b></li> <li><b>Broader use of supplier designs</b> to reduce own R&amp;D efforts</li> <li><b>Risk taking</b> in design and frequently cutting costs through <b>fewer/ synthesised tests</b></li> <li>Shorter product development cycle, and <b>lower pay to R&amp;D team</b></li> </ul>	<ul style="list-style-type: none"> <li>Higher salaries for R&amp;D team and longer design process</li> <li>More tests to ensure good quality</li> <li>Inherently tend to “over-engineer” and struggle to “truly localize” designs</li> </ul>
	Truly Local Supplier Base	<ul style="list-style-type: none"> <li>Higher sourcing percentage from truly <b>local suppliers</b></li> <li>More aggressive in moving supplier base to <b>lower tier cities</b></li> <li>Use of <b>local raw material suppliers</b> instead of imported materials</li> </ul>	<ul style="list-style-type: none"> <li>Usually struggle to “truly” localize majority of components</li> <li>Often use global suppliers with generally higher costs (global pricing) in China</li> </ul>
Manufacturing	Lower Cost Sites	<ul style="list-style-type: none"> <li>Use of <b>lower cost locations</b> for manufacturing ( labour, cost of land)</li> <li>Moving west more aggressively than MNCs</li> <li>In addition typically operating at larger scale</li> </ul>	<ul style="list-style-type: none"> <li>MNCs set higher standards for site selection - as such, many low-cost sites are not qualified</li> </ul>
	Favorable Loans	<ul style="list-style-type: none"> <li><b>Favourable financing rates</b> (even free loans in some cases)</li> <li>Some long-term loans are never repaid</li> </ul>	<ul style="list-style-type: none"> <li>Higher wage expectations due to MNC image</li> </ul>
	Labor Cost/ Worker Policies	<ul style="list-style-type: none"> <li>Attracting low-cost workers from Inland China</li> <li>Generally lower salaries across levels, and less strict policies overall</li> <li>Lower safety standards (sometimes may not pay workers)</li> </ul>	<ul style="list-style-type: none"> <li>Stricter policies and potentially worse morale</li> </ul>
	Low Global Overheads	<ul style="list-style-type: none"> <li>Almost no excessive international workforce and additional related costs</li> </ul>	<ul style="list-style-type: none"> <li>Often need to pay heavy global overhead costs</li> </ul>
Overhead / Others	Robust Governmental Relationship	<ul style="list-style-type: none"> <li><b>Favourable price terms by lobbying government / regulators</b> (e.g., land acquisition, facility establishment, subsidy etc.)</li> <li>Avoid market competition under government protection (regulation)</li> </ul>	<ul style="list-style-type: none"> <li>Building trusts with local government takes time and tactics</li> </ul>

Source: Expert interviews; Booz & Company analysis

# In fact, there is a realistic chance that at least some of these local Chinese suppliers may become global category killers



Source: Literature research, Booz & Company analysis

# Wanxiang is a good example of just such a global category killer

## How Wanxiang Obtained Advanced Technologies Through Acquisitions



### Background information on Wanxiang

- Established in 1969, Wanxiang has become China's second largest private company -- annual revenues of over US\$ 10 billion
- Focus in the 1980's and 1990's was on increasing quality and cutting costs
- Wanxiang has acquired a market share of 70% for universal joints and started supplying to Sino-foreign JV's such as GM and Ford
- Their only tech center, established in 1994, is located in Xiaoshan, with 150 engineers
- Annual R&D expenditure of the group exceeded 4.5% of total sales
- There is at least one component from Wanxiang Group in every three cars produced in US

### Schiller

- In 1998, Wanxiang acquired Schiller for US\$ 19 million
- Gained technology, patents and new customer base

### Universal Auto Industry

- In 2001, Wanxiang purchased a 21% stake in the brake component maker for US\$ 2.8 million
- Made Wanxiang the first Chinese purchaser of a Nasdaq- listed company

### Rockford Powertrain

- In 2003 Wanxiang bought a stake in Rockford
- Gained expertise in drive shafts and clutch manufacturing

### Neapco

- In 2006 Wanxiang acquired a majority interest in Neapco a leader in drive train technology
- Product development engineers were sent to China to work on the product development process

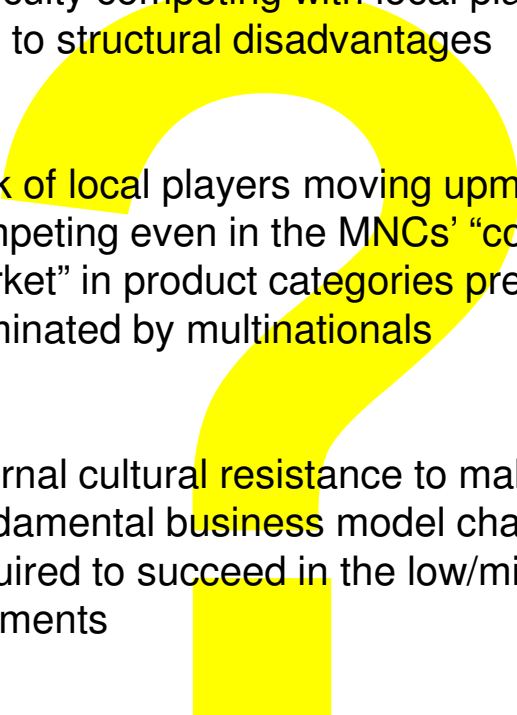
Source: Company Annual Reports & Websites, Booz & Company analysis

# In summary, we see a series of opportunities and challenges for global tier 1 suppliers in the Chinese low-end segment

Opportunities
<ul style="list-style-type: none"><li>▪ Capture additional volume and profit potential of the low-end segment (already &gt;4M units per year)<ul style="list-style-type: none"><li>– With global OEMs</li><li>– With local OEMs who want to improve quality and safety</li></ul></li><li>▪ Partner with local tier 1 suppliers to gain advantages both in China and abroad</li><li>▪ Remaining advantage for global tier 1s through breakthrough technology (for now), which is sought after by local OEMs moving upmarket</li></ul>



Challenges
<ul style="list-style-type: none"><li>▪ Difficulty competing with local players in due to structural disadvantages</li><li>▪ Risk of local players moving upmarket, competing even in the MNCs' "core market" in product categories previously dominated by multinationals</li><li>▪ Internal cultural resistance to make fundamental business model changes required to succeed in the low/mid-end segments</li></ul>



Source: Booz & Company analysis



# How ready are you to “win” in the China low/mid end market?

Step 1. Market Understanding	Y	N	Step 2. Market Entry Strategy	Y	N	Step 3. Implementation Readiness	Y	N
1. You know your product’s current market share across China low/mid/high-end market segments	<input type="checkbox"/>	<input type="checkbox"/>	1. You have a clear definition of which segments to enter, and with what positioning, target price and customers	<input type="checkbox"/>	<input type="checkbox"/>	1. You have target costing of your low/mid end product close to local competitor levels, and know how to reach these targets	<input type="checkbox"/>	<input type="checkbox"/>
2. You understand the market trends for the next 5-10 years across segments	<input type="checkbox"/>	<input type="checkbox"/>	2. You have a clear product strategy for the defined market positioning	<input type="checkbox"/>	<input type="checkbox"/>	2. You have conducted product tear down study, value engineering etc., and have a clear action plan of how to reach targets	<input type="checkbox"/>	<input type="checkbox"/>
3. You have modeled low/mid end growth scenarios for the next 5-10 years and understand implications	<input type="checkbox"/>	<input type="checkbox"/>	3. You have conducted a customer need analysis for target customers and understand the implications on the product design/ boundaries	<input type="checkbox"/>	<input type="checkbox"/>	3. You have available and released Chinese low-cost suppliers (not foreign JVs) to supply your product to >80%	<input type="checkbox"/>	<input type="checkbox"/>
4. You understand customer needs, and differences in needs between regions and tier cities within China	<input type="checkbox"/>	<input type="checkbox"/>	4. You understand the required business model to fulfill the target price and reach low/mid end customers, in:	<input type="checkbox"/>	<input type="checkbox"/>	4. You have released truly local raw materials (e.g. steel, resins)	<input type="checkbox"/>	<input type="checkbox"/>
5. You understand demand/ sales distribution between regions and cities	<input type="checkbox"/>	<input type="checkbox"/>	a) Low Cost Product development	<input type="checkbox"/>	<input type="checkbox"/>	5. You have production set up with local equipment and automation sufficient for low/mid end product requirements	<input type="checkbox"/>	<input type="checkbox"/>
6. You know the competitor landscape, their strategies, cost base and quality level vs. your own	<input type="checkbox"/>	<input type="checkbox"/>	b) Sourcing	<input type="checkbox"/>	<input type="checkbox"/>	6. You have multi-format distribution channels capable of penetrating even entry-level regions, including a network of possible agents and brokers	<input type="checkbox"/>	<input type="checkbox"/>
7. You understand current and future regulatory requirements and their implications	<input type="checkbox"/>	<input type="checkbox"/>	c) Manufacturing	<input type="checkbox"/>	<input type="checkbox"/>	7. You have a globally agreed brand image for your low/mid end product	<input type="checkbox"/>	<input type="checkbox"/>
8. You have a clear view of your company’s overall potential and barriers in low/mid end market based on regulatory, market and competitive drivers	<input type="checkbox"/>	<input type="checkbox"/>	d) Marketing	<input type="checkbox"/>	<input type="checkbox"/>	8. You have a strong local organization capable of domestically managing all points above	<input type="checkbox"/>	<input type="checkbox"/>
			e) Sales Channel	<input type="checkbox"/>	<input type="checkbox"/>	9. Your global management understands the unique requirements in China and supports the required business model changes	<input type="checkbox"/>	<input type="checkbox"/>
			f) After market services	<input type="checkbox"/>	<input type="checkbox"/>			
			5. You have conducted a branding study and considered multi-brand options	<input type="checkbox"/>	<input type="checkbox"/>			
			6. You have analyzed various organic and inorganic growth options– and decided	<input type="checkbox"/>	<input type="checkbox"/>			
			7. You have a solid business model confirming the viability of your strategy	<input type="checkbox"/>	<input type="checkbox"/>			

If any of the questions are answered “no”

**Market Explorer**

If 4 or more of the questions are answered “no”

**Undecided**

If less than 4 of the questions are answered no

**Getting Ready**

If 3 or more questions are answered no

**Fit For Growth**

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# Contact Information

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