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Driving out of the crisis

The impact of the global turmoil on the Chinese car industry

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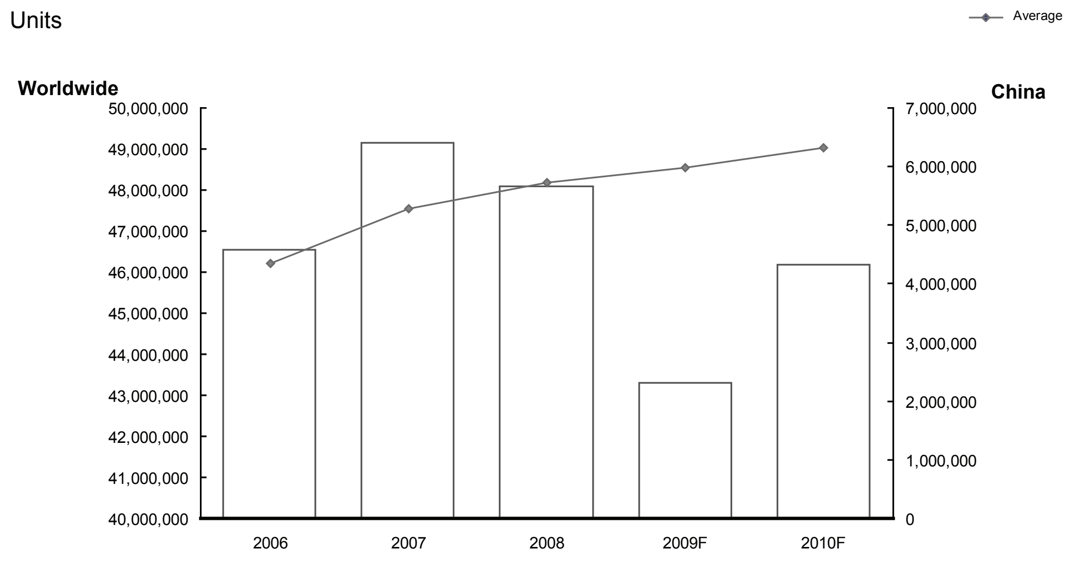
Amidst the desolating prospects for car makers worldwide, Chinese players are looking to a more optimistic future. With a stable demand, a solid financial situation, an easier access to bank credit and the encouraging government policies, domestic automakers could gain a predominant role in the global automotive industry.However, Chinese players will have to overcome a series of critical challenges, including the execution of crossborder M&A processes, the upgrade of their technology, product and execution capabilities to the western standards, and the eradication of widespread stereotypes about Chinese companies in order to truly become global leaders and succeed in the international automobile market.

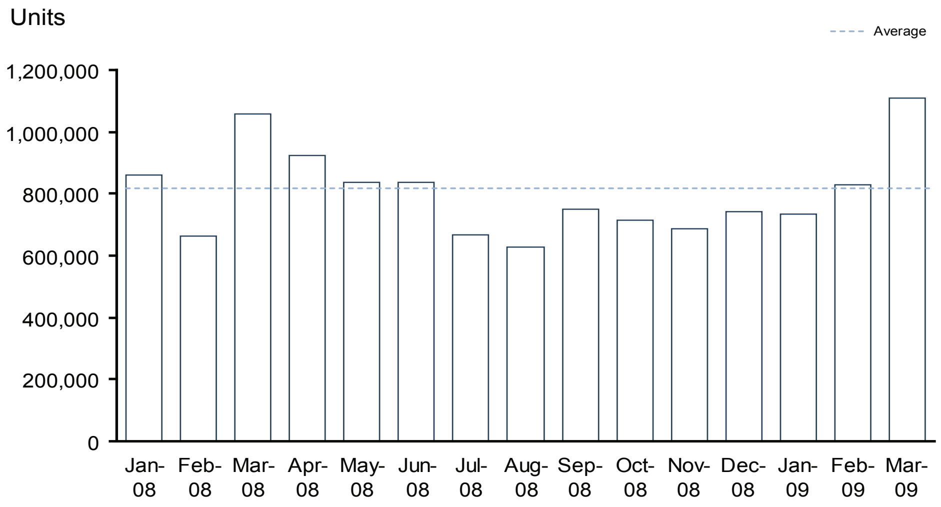
World car makers are facing gloomy prospects in these days. With sales plummeting as much as 30-40% from last year, they are trying to cut costs as quickly as possible amidst a deluge of profit warnings and new low records hit by their share price. Some of them are facing bankruptcy, many are calling for substantial state aids. This will force a wave of consolidation in the industry and most experts agree that in the future there will be room for less than ten global car makers. Recent moves like the Fiat – Chrysler agreement can be interpreted in this sense.

Global automobile demand is strongly hurt by the economic crisis, while Chinese demand is holding



Source:GI-Global Insight

Domestic automobile sales in February surmount the average over the past 14 months



Source: China Association of Automobile Manufacturers

Chinese players on the other hand seem less affected. They never relied historically on exports so the collapse of international demand is not hurting them. Domestic demand is holding and is going to benefit greatly by the stimulus package recently injected in the economy – as a matter of fact, China will become the largest car market in the world in 2009, surpassing even the United States. Prices have somehow slipped but profit margins are still fair at least in the medium-high segments.

Rather, they could potentially emerge among the drivers of the coming global consolidation. They have in general a fairly solid financial situation so they can profit from bargain prices for assets around the world, leveraging also the easier access to bank credit in China compared to the rest of the world. They are encouraged by the Government to become global and invest in international M&A. Following Chinese policy guidelines, they are investing heavily in clean technologies and thus positioning themselves as future leaders in this market.

As a matter of fact, signs of this are already evident on the market. There are insistent rumours – so far denied – that Geely could be a potential bidder for Ford Motors' Swedish Volvo unit. Chery is said to be scouting for acquisition targets in the United States and in Europe. BYD does not hide its ambitions of growing into a leading global player, although on a more organic route. The recent 200 unit strong delegation led by the Chinese Minister of Commerce to ink strategic deals in four European countries had certainly automotive as one of the key sectors in mind.

At the same time, there is still a lot of space for domestic consolidation in China and this trend is very likely to be accelerated by the global crisis. Some domestic car makers seem well positioned to take advantage from the weakness of their overseas competitors and might embark on international acquisitions to emerge from the crisis stronger on both the domestic and the global markets. The smallest Chinese players are likely to progressively lose ground, as they will not be able to keep pace with stronger rivals in R&D, quality and operational efficiency. In between there is a group of companies whose future will be decided by the moves they will make in the next months: either they will be able to ride the consolidation wave and join the group of future winners or they will see their positions eroded over time.
Consolidation will become more and more important in a sector that it is re-inventing itself to capture not only price conscious clients but also an increasingly sophisticated customer base that now pays attention to design, safety and technological contents. Many foreign manufacturers established in China can already offer a good blend of these attributes: domestic brands need follow the same path to convince people that choosing their products is a good alternative. However improving on these dimensions is not an easy task, money itself is not enough: a clear vision about the ideal target positioning and the skills to reshape the company in that direction will distinguish winners from losers.

Joining forces with other players is one of the possible ways to proceed, as well as establishing cooperation with foreign institutions (e.g. Chery with Pinifarina) or betting on cleaner fuels such as lithium batteries (BYD, among many other rumoured local players) are alternative options. Being able to distinguish themselves and maintaining a proper scale will become success factors, while players caught unprepared will likely have to face hard times.

Even for the strongest domestic players, the transition to become global companies still presents significant challenges. Chinese companies still lack expertise in cross border M&A, as shown by many examples in recent years in which they struggled to integrate the targets within their own organizations. The technological divide with foreign companies is still relevant and requires Chinese companies to accelerate progresses on R&D, product development and operations to protect even their domestic market from foreign rivals. Their organizations are often too bureaucratic and require a profound transformation to cope with the complexities of competing on the global markets.

Therefore, to emerge as global winners, Chinese companies need to strengthen their execution capabilities and renew their organizations. They need to invest in product development skills that will allow them to develop products that domestic customers will prefer over foreign ones. They need to improve their production efficiency to maintain their cost advantage. They need to set up global teams and equip themselves with managers capable of dealing with foreign partners and potentially drive post acquisition integration processes. This in turns places a great emphasis on recruiting, training and retaining high profile talents, which explains why Chinese companies in the automotive sector, as well as in other industries, are taking advantage of the present crisis to recruit high calibre foreign managers.

Moreover besides technology, execution capabilities and organizational gaps, a further barrier needs to be overcome by Chinese automakers if they really want to fulfil their ambitions to become truly global players. Indeed, even the most advanced among them are still penalized by poor perception from foreign customers, potentially clouding their achievement in state-of-the art technologies and compromising their attempts to move initial steps abroad. It is clear in fact that Chinese manufacturers are looking at Western markets with increasing interest and the presence of BYD with two hybrid "dual mode" vehicles at Detroit Auto Show last January is an explicit signal of their commitment. Signal that is even more powerful because it clearly states that BYD aims at competing on the same ground of its counterpart: not with the old "cheap product" concept but anticipating the competition on leading edge technologies, leveraging on its impressive R&D department which seems to rely on more than 10,000 resources. However stereotypes difficult to eradicate about Chinese companies will likely prevent their success in the short term on Western markets: for this reason we believe that acquisition of a troubled foreign competitor can constitute a shortcut to accelerate their progress. And the acceptance of such a deal might be welcome now more than ever considering the liquidity of Chinese companies in clear contrast with a sector where players are striving to survive…

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