Outlook for Domestic Brands in a Competitive Chinese Market

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Senior Market Analyst
Contents

- China Market Overview
- Status of Local Brands
- Key Market Drivers
- SWOT Analysis
- Outlook and Conclusions
Fastest-growing Market in the World… But Only Gradual Changes in the Segmentation Profile

- Overtook the United Kingdom and France to become the fourth most significant vehicle market in 2002
- Overtook Germany to become the third-largest vehicle market in 2003
- Overtook Japan by a very narrow margin to become the second-largest market in 2005
- Passenger car sales rose five-fold between 2001 and 2006
- Segmentation profile has only changed very gradually
Almost All the Global OEMs Present in China
Domestic OEMs Managed to Hold Their Own in Q1 2007

- Pricing war fired up in Q1: major price cuts from FAW VW, SVW, DF Nissan, SGM, PSA, Chery

- Market is becoming more fragmented: Hyundai lost market share while Chery raised its ranking

<table>
<thead>
<tr>
<th>CHN</th>
<th>JPN</th>
<th>EUR</th>
<th>US</th>
<th>KOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chery</td>
<td>Toyota and Mazda market share gained 0.9pp to 7.5% and 3.9% respectively.</td>
<td>By brand, VW remains #1 with 16.2% market share. FIAT sales dropped 21%.</td>
<td>GM still remains #1 as OEM, market share dropped to 9%.</td>
<td>Hyundai was the largest market share loser. Market share dropped to 5.1% from 6.8% in 2006.</td>
</tr>
</tbody>
</table>
Segment C Accounted For 42% of Car Sales … But Will Decline Slowly
Segment B/C Leads Growth
Limited Growth Potential For Segment A

Sales Growth Forecast 2012 vs 2006 (Thousand Units)

High growth potential segments
Local Brands Lead Growth in Segment C…Will Account For 42% of in 2012

Segment C Production by OEM Country of Origin (Thousand Units)

Local brands will more than triple from 2006 to 2012

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Strong Production Growth Expected Also for Local Brands in B and D Segments

B and D Segment:
Growth Very Low Levels in 2006

B Segment: Ten Fold Growth By 2012
D Segment: Seven Fold Growth By 2012
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Global and Domestic Companies Positioning For Growth

- **Sino-foreign JVs**
  - All Global OEMs now present in China

- **Traditional SOEs**
  - FAW, SAIC, Nanjing, Changan and Beijing Automotive now striving to develop independent brands
  - Conflict of interest with JVs

- **Traditional Mini-vehicle assemblers**
  - Changhe, Harbin and Changan

- **New Chinese companies**
  - Chery, Geely, Great Wall, Zhongxing, BYD and China Brilliance

- **Pure import brands**
  - Jaguar, Porsche and Aston Martin
Traditional State-owned Companies

- Independent car program kick starts from acquisition of MG assets and technology, emphasis on “original British flavour”.
- Weak financial performance, strong support from local provincial government.

- Limited progress in developing independent car.
- Re-badged JV partner’s model.

- Relying on international OEMs for technology.
- Lag behind SIAC in the development of independent brand.

- R&D activities lag behind emerging companies.
- Most are financially strong.
- Slow/complicated decision-making.
- Aging products/partly not market-oriented.
- Under pressure to build up independent car brands. Growth potential in medium-to-high end segment.

- Dual brand strategy: Roewe brand is launched based on Rover technology. Ssangyong brand focuses on SUV.
- Only the first model Roewe 750 takes the original Rover design. Other future models are re-designed in EU.
- Possibly the first local brand to succeed in medium-high end segment.

- Limited progress in developing own car designs.
- Independent car program launched in late 2006.
- Most of its fortunes will be closely linked to Nissan.

OEM Features
• Consolidation with Hafei does not go well.
• Pursuing a two-pronged strategy—cooperating with Suzuki and independently developing.

• Work closely with European design houses to develop passenger cars.
• Acquired by Dongan Auto Engine in 2006. Access to Mitsubishi engine technology.
• New plant in Shenzhen supported by local government.

• Set up R&D centre in Italy in 2003. Work closely with IDEA, EDAG, Getrag and FEV.
• Ambitious plan to expand to passenger car market (10 models in next five years).
• First model CV 6 Benben has been well accepted by the market.

OEM Features

• Military origins
• Reasonable scale of production and long track record in the automotive industry
• Technology base from aircraft and armament production history
• Key players in segment A
• Trying to tap into medium car segment as growth in segment A is limited

Traditional Mini-Commercial Vehicle Makers

Military origins
Reasonable scale of production and long track record in the automotive industry
Technology base from aircraft and armament production history
Key players in segment A
Trying to tap into medium car segment as growth in segment A is limited
New Breed of Chinese Companies – High Growth Potential

- Working closely with European/Japanese design houses
- Recognized as model of independent brand by government
- Full range of models including sedan, hatchback, MPV and SUV
- Significant increase in export since 2005

- Leading growth in SUV market, strong export to E. Europe
- Private owned, and listed in HK Stock Market, healthy financial performance
- Ambitious car program: 2.8 billion RMB investment

- The first Chinese company that outsourced design to Europe (1997)
- Suffered loss due to frequent management change
- Significant turnaround in 2006 after new management on board and the successful launch of M2

- Privately owned, and listed in HK stock market
- Aggressive expansion plan across the country, pending NDRC approval
- 2006 financial performance boosted by the strong top-line performance and an improvement in the sales mix towards higher priced models

- Less experience in auto industry, mainly known as motorcycle manufacturer
- Mainly cooperate with domestic design houses such as Tongji Tongjie

- Strong financial performance
- Modified from old Mazda models
- Aims to expand to SUV, mini car and light commercial vehicle segment
- R&D in Shanghai

- Privately owned, entered auto sector via acquisition of former Qinchuan Auto
- Impressive growth in 2006: 435% YOY in production
- Strong market/sales capabilities thanks to its IT industry experience
- R&D in Beijing, Shanghai and Shenzhen

- Relative newcomers to the industry
- Quick decision-making process
- Most are operating without JV with foreign OEM
- Actively rolling out new models and looking for developing own technology and expanding overseas
- Significant support from both central government and local government
More New Entrants on the Way

- Significant player in commercial vehicle market, listed in Shanghai stock market
- Launched Refine MPV through cooperation with Hyundai
- Ambitious car program supported by R&D centre in Turin, Tokyo and Hefei, invested 1.8 billion RMB to build new plant
- Full model range including MPV, sedan and SUV

- Total vehicle sales 488,000 units in 2006, ranked as no. 2 in the farm truck segment
- Acquired Zhejiang UFO auto in 2005, light truck assembly started in April 2007
- Aims to expand product line-up to SUV, pickup truck and economical car in next five years
- Jointly set up R&D centre with Jilin University

OEM Features

- Solid financial ground to support passenger car program
- Scale of production and long track record in the industry
- Technology base from commercial vehicle and components production history

- A major auto sheet metal part/die mould manufacturer & supplier
- Started to assemble small SUVs in early 2006
- Acquired 70% stake of Jiangnan Auto in April 2007, re-launched Jiangnan Alto in May
- Negotiating with FIAT to assemble at least 5 models via technical transfer agreement from 2008
Key Price Segment of Local Brands

More higher priced models expected after 2006, including Chery F11, Geely GH-1 and FAW HQE etc

1996-2006

2006

THOUSAND RMB

FAW-XIALI

CHERY

GEELY

BRILLIANCE

HAFEI

BYD

CHANGAN

HAIMA

LIFAN

FAW CAR

SAIC

NAG

BJ212

Vela

Vision

Zunchi

Saibao V

Lubao

Flyer

CV11

Freema

CV6

Familia II

520

Besturn

Roewe 750

MG75
## China Prices Already Below US Levels for Many Models in Segment A/B …But Prices Remain High in C and D

<table>
<thead>
<tr>
<th>Brand</th>
<th>Model Name</th>
<th>Retail Price in China vs. US (in US$)</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>China</td>
<td>US</td>
</tr>
<tr>
<td></td>
<td></td>
<td>LOW</td>
<td>HIGH</td>
</tr>
<tr>
<td>Chevrolet</td>
<td>Aveo</td>
<td>$8,670</td>
<td>$11,905</td>
</tr>
<tr>
<td>Toyota</td>
<td>Yaris</td>
<td>$8,699</td>
<td>$10,392</td>
</tr>
<tr>
<td>Honda</td>
<td>Fit</td>
<td>$10,262</td>
<td>$13,258</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Accent</td>
<td>$9,116</td>
<td>$14,820</td>
</tr>
<tr>
<td>Toyota</td>
<td>Corolla</td>
<td>$17,295</td>
<td>$26,020</td>
</tr>
<tr>
<td>Honda</td>
<td>Civic</td>
<td>$18,232</td>
<td>$23,442</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Elantra</td>
<td>$13,000</td>
<td>$18,232</td>
</tr>
<tr>
<td>Toyota</td>
<td>Camry</td>
<td>$25,760</td>
<td>$35,137</td>
</tr>
<tr>
<td>Honda</td>
<td>Accord</td>
<td>$24,093</td>
<td>$39,044</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Sonata</td>
<td>$21,592</td>
<td>$29,146</td>
</tr>
</tbody>
</table>

**Price of Chevrolet models considerably cheaper in China**

**Price of Fit 25% cheaper than USA**

**Civic and Corolla base version price higher than USA by 21% and 20%**

**Accord and Camry base version price higher than USA by 29% and 39%**
Government Policy: 11th Five Year Plan Emphasis on Independent Technical Development

• Aims to control the total fuel consumption growth within 50% when PARC reaches 55 million units
  – Reduce average vehicle fuel consumption by 15%
  – Encourage use of small displacement vehicles
  – Government funding hybrid/fuel cell vehicle program in “863” project to develop alternative fuel and powertrain technology
• Focus on promoting purely Chinese car manufacturers
  – Aim to increase market share of local brands to at least 50% in the passenger car market
• Strong support of independent R&D activities
  – Direct finance support and indirect tax incentives
• Aims to consolidate State-owned Enterprises

• Traditional Big 3 (FAW, Dongfeng and SAIC) are facing increasing pressure to build up independent passenger car brands and a high local R&D capability
• New emerging local Chinese companies will be able to obtain more government funding to accelerate independent technical development
High Cost of Ownership, Environment and Infrastructure Hold Back Car Consumption in Mega Cities

The environment for car consumption is not desirable and tends to become more and more restrictive in parts of big cities:

– Variety of taxes and fees, a city such as Shanghai charges a premium for vehicle registration

– Inflation of insurance premiums, expensive maintenance costs, expensive fees for parking and tolls for expressways

– Heavy traffic jams, limited availability of parking places

– Rising fuel prices and potential fuel taxes are also expected to increase costs
Sales Growth Diffusing Away From Mega-Cities

More opportunities for local brands

Per Capita GDP in US$  Car Ownership Per ‘000 people

- Tier 1: >5000  50
- Tier 2: 3000 - 5000  18
- Tier 3: 1000 - 3000  5
- Tier 4: <1000  <5

Per '000 people

2005  2006

- Tier 1: 25.0%  27.6%
- Tier 2: 8.1%  20.6%
- Tier 3: 33.4%  33.7%
- Tier 4: 36.0%  34.4%

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## Strengths and Weaknesses of Domestic Brands — Snapshot of the Main Drivers and Restraints

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<tr>
<th>STRENGTHS</th>
<th>WEAKNESSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Better understanding of local consumer needs, especially in the economy car market</td>
<td>• Lack of independent IP</td>
</tr>
<tr>
<td>• Government supports the development of domestic brands</td>
<td>• Low price — low profit — low R&amp;D investment; inconsistent product quality</td>
</tr>
<tr>
<td>• Low cost advantage, ability to provide better value for money</td>
<td>• Lack of economies of scale; consolidation is difficult due to local protectionism</td>
</tr>
<tr>
<td>• Efficient decision making process, quick response to the market change</td>
<td>• Weak brand image. Focus primarily on low end of market.</td>
</tr>
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</table>
Opportunities and Threats for Domestic Brands — Snapshot of the Main Drivers and Restraints

**OPPORTUNITIES**

- Low penetration rates in the vehicle market. Market shifting to budget segment.
- RMB appreciation, lower overseas R&D and components import cost.
- Improving supply structure. Easy to access advanced technology from suppliers.
- Favourable attention from national and local government.
- Hybrid/fuel cell project funded by Government, relatively small technology gap with international giants.

**THREATS**

- Foreign JVs shift product line-ups downwards, tapping into low end market segments.
- Long term sustainability concern due to low profit margins.
- Looming over-capacity in medium-long term.
- Upward pressure on cost; faster new product launches and higher marketing costs.
- “Glass ceiling” for domestic brand, competition from the growing used-car market.
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Technical Roadmap of Chinese R&D Build-up

**Step 1:** Imitation, reverse engineering of foreign OEM models. R&D complete outsourcing

**Step 2:** Improve collaboration with international suppliers, joint development with overseas R&D institutes

**Step 3:** Synchronize the supply chain, independent development, increasing R&D capabilities and technology transfer

**Step 4:** Be able to compete with global OEMs

- Low end
  - Over 60 Local OEMs
- Low-to-Medium
  - Around 10 major local OEMs
- Full Product Line-up

- Pre 2000
  - Shakeout, Market Reshuffling
  - Increasing R&D capabilities and technology transfer, stronger local supplier base
- 2000-2015
  - Further consolidation?
- Post 2015
  - Further consolidation?
### Most Chinese OEMs Rely on the Assistance of Foreign R&D/Engineering Firms

<table>
<thead>
<tr>
<th>OEM</th>
<th>Assistance from Foreign R&amp;D Institutes/OEMs</th>
<th>Projects Delivered</th>
</tr>
</thead>
</table>
| CHERRY             | Styling: Bertone, Pininfarina, Transcosmos  
Engine design: Ricardo/AVL  
Key suppliers: Siemens VDO, TRW, Delphi, ZF, Teves | B-21, B-22, B-23, S-16, M-11  
ACTECO series engine |
| GEELY              | Daewoo International  
ITCA, MAGGIORA, STOLA, PRINCE  
Platform Engineering: Lotus | CK-1, CG-1, M203  
Geely Formula |
| FAW CAR            | Styling: Giugiaro  
Platform: Mazda / Toyota | Besturn C301  
Red Flag HQ3 |
| SAIC               | Styling: Ricardo 2010 (former Rover R&D engineering team)  
Engineering: Ricardo | Roewe 750, W2 |
| GREAT WALL         | Styling: Bertone  
Engine development: Bosch | Hover  
Intec Diesel engine |
| CHANGAN/JIANGLING  | Engineering: EDAG  
Styling: Pininfarina/IDEA | CM8, CV6, CV7, CV8, CV9, CV11 |
| BRILLIANCE         | Styling: Giugiaro  
Engineering: Lotus  
Engine design FEA.  
QA: BMW | M1, M2, M2 FRV |
| HAFEI              | Styling: Pininfarina  
Engine: MITSUBISHI | Saibao 3/5 |
| HAIMA              | Styling: IDEA  
Engineering: Lotus  
Engine: TRITEC, MAZDA, MITSUBISHI | Familia II, Haima3 |
Growth Projection: Chery Is the Leader… But Others Are Catching Up

Passenger Car Production (Thousands Units) 2016 vs 2006
Breakdown by OEM

- DONGFENG 605%
- JAC 519%
- BYD 196%
- JAC 519%
- GREATWALL 643%
- CHANGAN 1275%
- FAW 77%
- GEELY 265%
- CHERY 232%
Market Share Trend by OEM Country of Origin — History and Forecast
Will Chery/Geely Become the Next Toyota/Hyundai?

- Although still weak in technology development, Chery/Geely are able to acquire the latest technology from component suppliers and independent R&D house
  - Chery ACTECO engine developed by AVL, with assistance from Bosch and Delphi
- The fast growth of Chery/Geely was partly helped by the strict auto policy in 1994
  - The strict auto policy in 1994 prohibited local companies entering passenger car market
  - Foreign JVs mainly focused on the medium-to-large car market in 1990s
- Management skills will be the key to drive Chery/Geely to next level
- Stable financial base is also crucial for the two companies to keep growing
Conclusions

• Market share of domestic brands will ramp up gradually to around 40% in 2012, being the leading OEMs in terms of country of origin.

• There is likely to be a shake up among smaller producers, but the Big 3 locals appear set to remain, plus 7–8 other young tigers.

• Big 3 will seek independence because of increasing technology transfer and a stronger local component supplier base, and also due to pressure from the Chinese government.

• Foreign OEMs will face an increasing challenge from local Chinese JV partners and independent players such as SAIC, Chery and Geely. Mounting tensions are likely with JVs over the coming years.

• Chinese new entrants who focus on mini or small cars may not find it easy to survive. More opportunities in compact and medium car market.

• Growth of domestic brands may lead to further price wars, which will further reduce OEM margins.
Thank You

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