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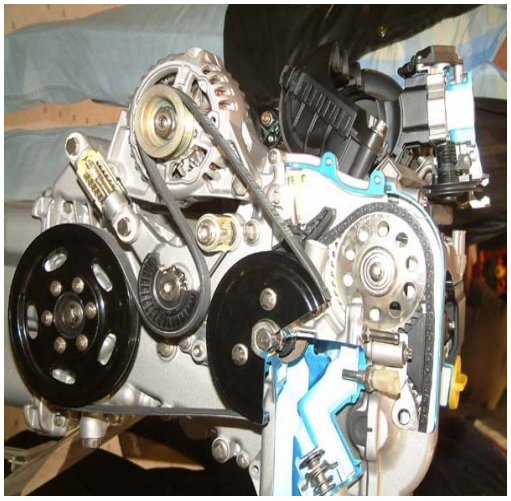
A Study on Investment in the Automobile Components Market in China

CONTENTS



1 Executive Summary

The automotive industry is one of China's 'pillar' industries and has witnessed a dramatic growth from 2001 to 2005, at a compound annual growth rate (i.e. CAGR) of 30.2 percent. Presently, China is the world's third largest automobile manufacturer with its total revenues amounting to USD 147.3 billion in 2005. This growth trend will continue in the future due to strong and sustainable demand.

The automobile component industry witnessed rapid growth from 2001 to 2005, with total revenues amounting to USD 42.7 billion in 2005. According to a research conducted by the China Automobile Industry Association (i.e. CAIA), the total revenue of the auto component industry is predicted to amount to USD 161 billion by 2010, representing a CAGR of 30.4 percent from 2005 to 2010.

Analysis of Automobile Component Industry

China's auto component industry demonstrates several competitive advantages, including sustainable growth, geographical centralisation effect, prosperous export business, and competitive cost structure. Unparalleled competitive advantages in China encouraged domestic companies and attracted foreign enterprises. In 2005, around 6,315 companies were involved in automobile assembly and components in China. All Fortune 500 auto component companies have their presences in China, either through wholly owned foreign enterprises (i.e. WOFE) or through joint ventures (i.e. JV).

One of the contributions that the Chinese government makes to develop the automobile component industry is promulgating regulations to nurture a competitive environment. For instance, it created the China Compulsory Certification (i.e. CCC) system with the aim to improve manufacturing quality, incorporated policies to lower investment barriers in order to encourage foreign investors to enter the local market, and decreased import duties to strengthen local market competition.

In comparison India, China's automobile component industry presents higher growth rate, superior infrastructure, and more stable profit margin. The factors measured in the following analysis depict that China has provided the favourable investment environment for foreign enterprises or investors.

Lessons Learned from Hyundai Mobis and Valeo SA Cases

Both Hyundai Mobis and Valeo SA are international automobile component enterprises. They have adopted different expansion strategies in China. Hyundai Mobis' strategy to enter into China is to set up WOFEs, whereas Valeo SA adopted to invest mostly in JVs. The differences in entry strategies reflect their individual preferences to explore businesses in China. Currently, five out of eight Hyundai Mobis' subsidiaries rank in the top 100 in terms of Chinese auto parts revenue. Valeo SA has set up one WOFE and eleven JVs.

2 Market Overview

2.1 Market Size of Automobile Industry

According to statistics provided by the CAIA, the total revenues of China's automobile industry increased from USD 51.3 billion in 2001 to USD 147.3 billion in 2005, with a CAGR of 30.2 percent. The total automobile sales volume in China amounted to 5.7 million units in 2005, reflecting a Y-o-Y growth rate of 12.4 percent. China has now become the third largest automobile manufacturing base in the world.

China's automobile export witnessed a rapid growth, with the total export value rising from USD 2.7 billion in 2001 to USD 19.7 billion in 2005, reflecting a CAGR of 64 percent.

2.2 Market Size of Automobile Component Industry

The automobile component industry in China has also witnessed remarkable growth in the recent few years, with the total revenues increasing from USD 16.4 billion in 2001 to USD 42.7 billion in 2005, depicting a CAGR of 27 percent from 2001 to 2005. According to the CAIA's forecast, the total revenues of automobile component industry are expected to reach USD 161 billion by 2010, representing a CAGR of 30.4 percent from 2005 to 2010.

The total exports of China's automobile components increased from USD 1.3 billion in 2001 to USD 8.5 billion in 2005, demonstrating a CAGR of 60 percent. In 2005, exports contributed 20 percent to the total revenue of China's automobile component industry, however contributed 8 percent in 2001.The CAIA also forecasts that the total exports will amount to USD 50 billion by 2010.

2.3 Market Size of Automobile Aftermarket Industry

The total revenue of China's automobile aftermarket industry increased from USD 1.8 billion in 1999 to USD 3.2 in 2004, with a CAGR of 12.2 percent. The total revenues of the automobile aftermarket industry is expected to maintain the upward trend and amount to USD 5.2 billion by 2008, with an estimated CAGR of 12.5 percent during 2005-2008. This growth can mainly attribute to the rapid increase in car possession, the emergence and maturity of the used car market, and a more reliable distribution channels for products.

Presently, the market size of China's auto aftermarket is small and accounts for less than 10 percent of the total revenue of the auto components industry. While the auto aftermarket in Germany and US accounts for approximately 40 percent and 60 percent, respectively, of the total revenues of auto component industries.

2.4 Automobile Possession

With the development in China's economy, automobile possession in China maintained a rising trend from 2000 to 2005. The Development Research Center of State Council believes that the total automobile possession will increase to 55 million units by 2010.

With reference to past evidence from other countries, there will be a corresponding increase in the demand for private automobiles when the per capita GDP is between USD 800 and USD 3,000. Since the per capita GDP in China has already been more than USD 1,000, it is estimated that there will be a higher demand for private automobile possession, which will powerfully drive the automobile component industry in China.

3 Industry Analysis

3.1 Advantage and Disadvantage Analysis

3.1.1 Advantages of China's Auto Component Industry

- **Sustainable Growth:** The Auto component industry is predicted to grow at a CAGR of 30.4 percent from 2006 to 2010.
- **Geographical Centralisation:** The industry has been concentrating on three regions: Yangtze River Delta region, Northeast China & Circum-Bohai Sea region, and Zhujiang River Delta.
- **Prosperous Export Business:** Export business of Chinese auto components has been on the fast growth track. The growth trend will continue at a CAGR of 42.8 percent from 2006 to 2010.
- **Competitive Costs Structure:** China possesses competitive cost advantages including low labour costs and low raw material costs, which facilitates the continuous investment in the auto component industry.

3.1.2 Disadvantages of China's Auto Component Industry

- **Lack of Economies of Scale:** Around 99.3 percent of auto component companies were small and medium sized enterprises (i.e. SMEs) by the end of 2005. The relatively small sized firms suffer a lot due to lack of scale.
- **Low R&D Investment:** The average R&D investment in China's auto component industry accounts for approximately three percent of the revenues. The rising R&D expenditure could help the industry to get into more high-end products as well as to help in operating cost savings.
- **Lack of High-end Products:** Compared with foreign counterparts, a majority of local auto parts manufacturers only supply the low-end products and do not have capacity to develop as well as manufacture high-end products.
- **Insufficient Horizontal Integration:** Most SMEs in the auto part sector manufacture stand-alone products instead of a total 'solution', which results in a low competitive edge.
- **Intense Competition:** A large number of SMEs provide similar products to the market, leading to commoditisation.

3.2 Influences of Relevant Regulations

3.2.1 CCC Scheme for Auto Component Products

- China Compulsory Certification (i.e. CCC) came into effect from December 1, 2006

- Policy Issuers are State General Administration for Quality Supervision, Inspection and Quarantine, State Regulatory Commission for Certification and Accreditation
- Some of the examples of auto part products that must be marked with CCC labels before being sold, imported or used in other operating activities are as follows:
  - Lamps, reflectors, mirrors and horns
  - Vehicle travelling data recorder
  - Automobile brake hoses
  - Fuel tanks
  - Door locks and hinges
  - Upholstery and decorative materials

3.2.2 Policies to Lower Investment Barriers

- Chinese provincial governments have the authorisation to approve projects with investments lower than USD 150 million, while lowering other investment restrictions from 2005.
- Policy for Automobile Industry Development released in 2004, reduced the restrictions on foreign investors' share holding in the auto parts industry.

3.2.3 Reduction of Import Duty on Auto Parts

In order to comply with China's commitments on tariff reduction for its entry into the World Trade Organization (i.e. WTO) in 2001, the Customs Tariff Commission of the State Council lowered the import duty on July 1, 2006. The tax rates on auto parts, including auto bodies, chassis and medium and low emission gasoline engines, have been reduced from the range 13.8-16.4 percent to 10 percent.

3.2.4 Establishment of Credit-rating System

The Ministry of Commerce, China International Electronic Commerce Center, Chinese Ministry of Automotive Engineering Institute started developing a credit-rating system for the auto parts industry on May 18, 2005. The Chinese government is planning to complete the credit rating for local auto part companies by 2008.

3.3 Country-based Comparison of Automobile Component Industry

Both China and India possess favourable environments for the development of the automobile components industry. The following aspects illustrate the particular situations in each country:

- **R&D:** In China, R&D investment accounts for about three percent of the revenues and foreign-invested companies contribute little to the technology development. In India, the government encourages R&D development and sponsored a programme of National Automotive Testing and R&D Infrastructure Project (i.e. NATRIP) with an estimated investment of USD 400 million in order to strengthen the technology capacity.
- **Market:** In China, the auto components revenues are expected to rise at a CAGR of 30.4 percent during 2005-2010, and a Y-o-Y growth rate of 10-15 percent in auto sales volume in 2006. In India, the auto components revenues are expected to rise at a CAGR of 17 percent during 2005-2014, and a Y-o-Y growth rate of 10-12 percent in auto sales volume in 2006. It can be deduced that growth in China is much higher than in India.
- **Infrastructure:** China's infrastructure is particularly well-developed in the coastal and major metropolises of China, thus, providing more strong foundation for the development of auto parts business in the future. India's infrastructure is not well-developed, bringing logistics problems for the auto component sector.
- **Policy:** The Chinese government has improved the investment environment by lowering the restrictions, simplifying procedures, and establishing a credit-rating system for auto part companies. The Indian government has also stipulated an export-oriented units (i.e. EOU) program to stimulate exports, and it plans to become the global auto parts manufacturing base.
- **Profitability:** In 2005, net profit margin of auto parts was around 5.8 percent in China. The average profitability of listed Indian auto part companies is approximately 10 percent in 2005.

4 Key Sub-sectors in Auto Component Industry

4.1 Global Automobile Component Companies Landscape

Global automobile component companies are centralised in the three regions of China, which are as follows:

- Northeast China and Circum-Bohai Sea region – major production base of automobile component industry

- Yangtze River Delta region – with the presence of 29 subsidiaries of global auto component companies and is the industrial heart of China
- Zhujiang River Delta – with enough space for the development of automobile component industry

4.2 Automobile Tyre Industry Landscape

In 2003, China was the second largest tyre manufacturing country in the world. Total 188 million tyres were produced in China, following 237 million units produced by the US. Total export of China's tyre industry increased from 28.4 million units in 2001 to 53.8 million units in 2004, at a CAGR of 23.7 percent.

In 2004, the top 10 players generated 50.02 percent of the total industry revenues. The top 10 players are GITI Tire, Triangle Group, Hangzhou Zhongce, Shandong Chengshan, Shanghai Tyre & Rubber, Shandong Linglong, Qingdao Doublestar, Aeolus Tyre, Qingdao Yellowsea, and Guizhou Tyre.

4.3 Automobile Engine Industry Landscape

The total output of China's engine industry witnessed a rising trend from 2001 to 2004; however, the growth started declining in 2004. The total output increased by 53.44 percent to 3.85 million in 2003, and the total output grew by 11.37 percent to 4.3 million in 2004. The gasoline engine accounted for 69.54 percent and diesel engine accounts for the remaining 30.46 percent of the total sales volume of China's engine industry in 2004.

In 2004, the top 10 players generated 75.37 percent of the total industry revenues. The top 10 players are Dongfeng Motor, ChangAn Automobile, Dong'an Auto Engine, Shanghai Volkswagen, Shanghai GM, FAW-Volkswagen, FAW Group, Liuzhou Wuling, Yuchai Machinery, and Yunnei Power.

5 Investment in China's Auto Component Industry

5.1 Overview of Investment Activities

According to statistical data from CAIA, overseas fixed assets investment in the automobile component sector will continue to rise at a CAGR of 33.48 percent from 2001 to 2005. The CAIA report states that all Fortune 500 auto component companies are present in China, in the form of either WOFE or JV. Foreign-invested companies are also performing well in China.

5.2 Case Study 1: Hyundai Mobis

- **Background of Hyundai Mobis:** It was established in 1977 and is headquartered in Seoul. Its operations are in Korea, North America, China, and the Middle East. The main business of the company is to cover aftermarket service parts sales, auto parts export, and module parts manufacture. Hyundai Mobis generated operating revenue worth USD 7.58 billion and net profit of USD 840 million in 2005.
- **Hyundai Mobis Activities in China:** It launched its business in China in 1993 and, by the end of 2005, operated eight production bases, six WOFEs, and two JVs. Five out of the eight companies ranked in the top 100 in terms of Chinese auto parts revenue. According to the geographic distribution aspect, Hyundai Mobis centralized its manufacturing bases in Beijing, Shanghai, and Jiangsu. This layout perfectly matches the Hyundai & Kia motor manufacturing plant.
- **WOFEs over JVs:**
  - Boosted Earnings: Make a direct contribution to revenues
  - Consistent Strategy Implementation: Implement corporate strategy consistently across global entities
  - Better Controls/Security: Protect proprietary technology
  - Coherent Culture: Maintain consistent corporate culture
  - Possession of Customer Base: Possess customer base fully rather than share customer base with other partners

5.3 Case Study 2: Valeo SA

- **Background of Valeo SA:** It was established in 1923 and is headquartered in Paris. Its operations cover 26 countries worldwide, with diversified automobile components products. Valeo SA generated operating revenue worth USD 11.89 billion and had 70,400 employees in 2005.
- **Valeo SA Activities in China:** It launched its business in 1994. Valeo took full advantage of the low costs involved in establishing manufacturing bases in China. At the end of 2005, Valeo operated 12 production bases in China, 1 WOFE and 11 JVs. In the beginning of 2004, Valeo was prepared to increase its shares in

JVs, and had a majority share in 8 out of the 11, by the end of 2005. Presently, Valeo operates businesses in 31 provincial-level entities around China and is also working in collaboration with different automakers.

- **Strategic Considerations of Setting up JVs:**
  - Better/Quicker Access to Market and Distribution Channel: Setting up JVs can give better access to local market and customers
  - Capitalising Local Partner Relationships: Better able to leverage relationships with local stakeholders, which will be helpful for its business expansion in China
- **Stimulation of Acquiring Majority Stake in JVs:**
  - Increasing Group Consolidated Revenues: Valeo can consolidate financial performance into group financial statements upon reaching majority share on JVs.
  - Realising Full Control: When a JVs' operation reach a steady state, further acquisitions can be helpful to realize full control of the companies.

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