

P R E S S R E L E A S E

Oliver Wyman Study "Chinese Automotive Market 2010"

Brand, Sales, and Service Will Determine Who Wins on the Chinese Market

- **Surplus capacity and plunging prices despite solid growth**
- **Low-price cars overrated, mainstream segment booming**
- **Highest growth in private customers and medium-size cities**
- **Customer retention and brand loyalty very low**
- **Unique market situation demands innovative brand strategies**
- **Huge efforts required to expand dealer networks**
- **Profitable after-sales business is key to success**

***Munich, November 24, 2004* – Brand management and customer retention, not production strategies, will decide who wins the battle for the Chinese automotive market. Thus the findings of "Chinese Automotive Market 2010," the latest study from Oliver Wyman, which concludes that only producers with strong and distinctive brands will survive the impending consolidation of the industry. Ultimately, the battle for China will be won in the minds of consumers. That is why auto manufacturers should focus their China strategies on building up a solid brand image based on a tailored model policy and bolstered with improvements and expansions in the sales and service networks. These networks lend local support to the brand image and redeem the brand's claim at point-of-sale by projecting the dealer's image and safeguarding the quality of service. In China, too, customer satisfaction, customer retention, and brand loyalty will be critical for success on the market.**

The Chinese market is one of a kind, and not only in its high growth rate. More than fifty brands are vying for the buyers' attention. In recent years Japanese, Korean, American, European, and domestic OEMs have built up sizable surplus capacity. Nearly six million cars may be turned out every year, while sales figures for 2004 have been up to 2.3 million. Not until 2009 will the Chinese market grow to reach or exceed the six million mark. By then, manufacturers will probably have expanded their capacities to almost eight million cars per year - and that's not even counting imports. Prices dropped 9 percent last year, despite a huge 50-percent growth in unit sales, and unsold stock ballooned to 200,000 cars.

Thanks to political steps to cool the market – and hesitation on the part of buyers, who are disconcerted by the plunge in prices – this year's growth will probably reach a "mere" 15 percent, which is less than manufacturers had hoped for. Oliver Wyman's extensive study "Chinese Automotive Market 2010" paints a realistic picture of further developments in this market. Interviews with experts, a consumer poll, and secondary research supply the requisite data for large-scale industry-wide scenarios. "Our study explodes a few myths about the Chinese automotive market that have been around for years," claims Dr. August Joas, the Oliver Wyman Director in charge of

the study. "One of them is China's purported 1.3 billion potential buyers. Another is the belief that Chinese customers primarily look for cheap means of transportation."

Mainstream cars are the number-one growth market

The Oliver Wyman study reveals that the need for low-price cars in particular has been vastly overrated. Although the segment will grow at a healthy rate of 14 percent over the next few years, the manufacturing capacity already in place – nearly 3.5 million cars – will still far outstrip demand in 2010. This miscalculation applies in particular to cheap domestic brands: the three leading domestic producers - Changan, Changhe, and Hafei – are positioned very low on the price scale and will also find it hard to satisfy the government's impending environmental strictures. Others, such as Juanhuai, Red Flag, and Zonghua, do not have sufficient volume of production to survive in the long run. These brands will either bite the dust or be forced to enter cooperative ventures.

The best-positioned companies are volume manufacturers of mainstream cars. Here, too, the current annual production capacity of 2 million exceeds demand by a factor of 2. But Oliver Wyman forecasts that even when production expands to 3 million in 2009, it will no longer be sufficient to meet demand. Mainstream cars are the segment with the highest growth rate on the Chinese market: the current market share of 53 percent will rise to 63 percent by 2010 – an annual growth rate of 21 percent. Yet the mainstream segment will also witness the fiercest competition. Eight foreign and four domestic manufacturers already have good starting positions to jump to the front of the mainstream pack: Buick, Citroën, Honda, Hyundai, Mazda, Nissan, Toyota, and Volkswagen, as well as Chery, Suzuki, Wuling, and Xiali. Many other brands will try to capitalize on the growth in the mainstream segment.

The premium segment, currently growing at 13 percent, has largely been parceled out. According to the Oliver Wyman study, Audi in particular has a head start in local production among premium mass producers, followed by even higher-positioned imports from BMW and Mercedes-Benz. To date, Lexus and Volvo lag well behind these three "brand champions."

Enhancing productivity is a major homework assignment

China is currently the most profitable market in the world for auto manufacturers. This is mainly due to its high price levels: despite the current drop in prices, Chinese prices for new cars are still 10 to 15 percent higher than the international norm. But the ongoing battle for market shares is causing prices to plunge further, and by 2005 they may already have reached German levels.

This is bad news for OEMs, for it is not only retail prices that are high in China. Production, too, is 10 to 20 percent more expensive than at other locations. In the case of low-volume models, the difference in costs can even amount to 40 percent. The main reasons for these high production costs are substandard plants, high costs for raw materials and subcontracted parts and components, and low job productivity. Further problems arise from cumbersome joint ventures, low quality in locally supplied parts and components, and a nonexistent infrastructure of specialist equipment suppliers and service providers for this demanding high-tech industry.

Other problems that beset the Chinese automotive industry are lack of protection for intellectual property and widespread industrial espionage. Chinese authorities do not recognize international patents or trademarks. Imitation is not considered intellectual piracy. The consequences are dire: Toyota lost a lawsuit against the Chinese manufacturer Geely for copying the Toyota brand logo. Honda and GM are conducting similar battles against such domestic producers as Chery regarding trademark violations and product imitation. More than half of the entire spare-parts market belongs to gray and counterfeit parts.. OEMs reach a 20-percent market share at best – a fact that makes the current decline in new car prices to world market levels particularly painful.

"All manufacturers are currently working at full throttle to get this quintessentially Chinese problems under wraps," says Joas. "But our study reveals that this is only a necessary homework assignment. The market shares of the future will be won in the minds of consumers. This means that the only way to achieve a sufficient brand image, and thus long-term customer retention, is through the magnetism of precisely positioned brands."

Brand awareness is still low

The Oliver Wyman study shows that foreign brands, thanks to their image, have a head start in the competition for buyers, despite government support for domestic brands. Foreign brands also have a clear lead in customer satisfaction. But given the confusing and rapidly expanding range of products on the market, brand awareness and brand loyalty are naturally still low: only 25 percent of the customers choose the same brand when they buy their next car, compared to almost 80 percent in western industrial countries. Long-term brand images and positions will only emerge over the next few years.

"This is where manufacturers have to buckle down," Joas continues. "The brand is the only way to escape direct competition. Image is the best sales pitch, even in China." Still, the study points out that 46 percent of mainstream buyers, and 34 percent in the case of premium cars, would again buy a car of the same brand. Image weakness and lack of differentiation are especially noticeable in the low-price segment: only 7 percent of current car owners maintained that they would buy a car of the same brand.

The Chinese customer: poised to become king

Oliver Wyman's "Chinese Automotive Market 2010" study reveals vast changes in the minds of Chinese consumers. Currently 80 percent of all car owners indicate that they bought their last car primarily for business reasons. Yet 70 percent will buy their next car for its greater convenience and status. Business reasons, once so important, lie where convenience used to be: at 10 percent.

Nevertheless, the prototypical Chinese customer for automobiles is a first-time buyer – and the car is usually the largest investment he's ever made. The need for advice and information is correspondingly high. Given fifty competing brands, many of which have only been on the market for one or two years, the customers' brand awareness is extremely low. The Oliver Wyman study shows that Chinese car buyers are especially concerned about maintaining the value of their large investment. Yet the current drop in prices kindles a strong feeling of uncertainty among buyers regarding the lasting value of their purchase and leads to restrained purchasing behavior rather than a rise in unit sales.

Safety, reliability, low maintenance costs: all three are high on the wish-lists of car buyers and are much more important to customers than list prices or rebates. The Oliver Wyman study reveals that Chinese buyers are willing to skip so-called "starter models" and aim directly at the mainstream bracket. 29 percent maintain that they want to buy a premium model in the future, and 55 percent tend toward the mainstream category, which will therefore become the number-one growth segment in the Chinese automotive market. "In many sectors China works like a mature market," Joas explains. "From the very beginning, people who can afford a car usually want more than just a means of transportation. Status, comfort, and safety are already major customer preferences today."

Brands in the joint venture jungle

With its myriad joint ventures, the complex structure of the Chinese automotive industry considerably lowers brand visibility as well as the feasibility of brand strategies. VW is working concurrently with two partners: FAW and SAIC. Thus, the market has an FAW-VW and an SAIC-VW – not to mention a VW import. Additional confusion arises from the fact that both VW partners also have their own purely Chinese brands and operate joint ventures with other foreign manufacturers – FAW with Mazda and also Toyota (via a subsidiary), SAIC in two joint ventures with General Motors.

"To implement a clear brand strategy," Joas explains, "the key factor initially is a rigorous product policy emphasizing the core values of the brand. The current mare's-nest of brands and models is counterproductive: the number of brands skyrocketed to over fifty in a matter of years, and the number of locally produced models jumped from less than ten to more than sixty. There will have to be consolidation over the next few years: fewer overlaps and more clearly positioned brands give consumers greater confidence and security."

The Oliver Wyman study sees especially good opportunities for producers firmly positioned in the mainstream segment, which promises the greatest growth both proportionately and in absolute terms. Pure imports will decline significantly due to regulatory restrictions. This will have an especially strong impact on the premium segment, which has depended almost exclusively on imports. Local Chinese suppliers have opportunities most of all in the low-price segment since the international magnetism and development expertise of the world's leading brands will win out in the higher brackets of the market.

Car sales will take place in growth regions

To date, China has only had 1.2 cars per 100 inhabitants. The corresponding figure for western industrial countries is over fifty. The growth anticipated in the automotive industry by all observers will result from the sharp rise in per capita income in the booming Chinese economy: if a mere 3.7 percent of all Chinese earned enough money to buy a car in 2002, the figure will reach 13 percent in 2010. In absolute terms, this implies a growth of today's 50 million potential buyers to more than 170 million. This stratum of the upwardly mobile is expected to lead to an increase in new car sales in China to 7 million vehicles by 2010, making China the second largest market for automobiles in the world and almost half as large as the US market.

Yet new customers will not be found everywhere in China, for the Chinese economy is not booming at the same pace throughout the country. The coastal regions already have incomes far above the national average and are ripe for auto sales. "63 percent of the total gross domestic product is earned in the provinces of Guangzhou, Beijing, and Shanghai," says Joas. "These developing regions will also witness the bulk of auto growth in the coming years. That's why it is crucial for manufacturers to set up a comprehensive sales and service network right here."

To date, car owners have been concentrated in metropolises such as Beijing, Shanghai, and Guangzhou. In the future, more cars will be bought in China's many other major cities, which will spearhead further growth. The Oliver Wyman study reckons with an average increase in car sales over the next few years amounting to 13 percent in the metropolises, but 17 and 25 percent in the second- and third-tier major cities.

Sales and service underdeveloped

The current predicament in sales and service is highly unsatisfactory for OEMs: there are not enough dealers and workshops, and most of those that exist lack sufficient skills. On average, a Chinese car dealer buys only 70 vehicles per year, and repair standards are extremely low. Given this situation, it is no wonder that lackluster consultation and customer care by dealers, and poor service at workshops are the main criticisms of Chinese customers. Another frequent cause for complaint are the long paths to the workshop, which amount to more than half an hour for some 40 percent of all customers.

By 2010, according to the Oliver Wyman study, licensed dealers – mostly large outlets handling one or more brands – will grab roughly half of the workshop business and 70 percent of new car sales to end customers. Moreover, especially in rural areas, there will also be small traditional shops that handle some 15 percent of new car sales and 20 percent of repairs. Workshop revenue missing in the large dealers will mainly be captured by "fast fit" chains, which will conquer roughly a quarter of the service sector by 2010. Here international chains are already highly active, especially Japanese chains such as Yello Hat and AUTOBACS, though European suppliers such as Bosch are also hard at work on expanding their networks in China.

All automobile brands are currently trying harder to attract skilled sales and service partners. However, many who invested in the training of their dealers and mechanics in the last few years have seen them headhunted by other brands. Many OEMs are willing to concede large margins to good dealers – even at the cost of their own profit.

The currently underdeveloped used car sector is estimated to grow to 21 percent annually over the next few years. It is severely regulated at present and will probably be dominated at first by specialist used car dealers. Thanks to their close proximity to customers and their brand affinities, the impending deregulation of the used car market will provide good opportunities for licensed dealers and workshops to increase their shares of the market. It is thought that four million used cars will already be traded in China by 2010.

Consequences for auto manufacturers

Competition & Brand: The brand models outlined in the Oliver Wyman study foresee a clear split among segments in the automotive market. The top segment will offer solid business for premium niche brands such as Jaguar or Porsche. Mass-produced premium brands such as Audi, BMW, and Mercedes will have it even better: they can expect to achieve attractive growth rates of 13 percent on average. Their China strategies should focus on sterling quality and image projection, techniques that have already proved their worth in the classical industrial countries.

The mainstream segment is the actual "sweet spot" of the Chinese car market. Due to the large number of players, however, market shares will be hotly contested. There is no telling who will win out. The crucial question for the future will be whether Chinese customers will remain open to foreign brands or will tend to choose national Chinese brands and manufacturers, as happens, say, in Korea and Japan.

To prevent such an outcome, foreign manufacturers in the mainstream sector must continue to expand their already strong position. The high percentage of first-time buyers lends great importance to marketing strategy and the design of the "first impression." Complex and confusing brand images must be streamlined so that products and messages are congruent. Unlike premium brands, which can afford to support their positioning with lavish image campaigns and exclusive dealer networks, image in the mainstream and low-price market segments is mainly formed by the appearance of the products themselves.

Sales & Service: A functioning and image-enhancing network of dealers and workshops will be a key factor in establishing car brands. Up to now, most manufacturers have limited the presence of their dealers mainly to major cities. It is now time to tap the smaller cities in China's growth regions. But a lot also remains to be done in the metropolises, where large car malls offering customers an integrated multi-brand assortment are being established. Manufacturers must try to control and positively influence the critical interface to the customer in all their sales channels. Brand-specific dealer organization will be especially suitable for mass-produced premium brands and high-quality mainstream cars.

As yet, there is no money to be made in the Chinese aftermarket. The market for spare parts is dominated by gray and illegal producers. The used car market is still underdeveloped, and auto financing is subject to strict regulation. However, the first automobile financing licenses were already granted to such suppliers as Volkswagen and BMW in 2004. As in the European and American markets, automobile financing will be crucially important for the future evolution of the Chinese market.

Oliver Wyman's Joas sums up the situation: "The highly dynamic Chinese market harbors great opportunities, but we already face huge surplus capacities and a sharp drop in prices. Besides clear winners, a few manufacturers are bound to lose a lot of money in China. It's important to set up efficient assembly lines, but brand image and customer loyalty are even more important. In the future they will spell the difference between success and failure."

The Five Major Challenges Facing Auto Manufacturers in the Chinese Market

Strengthening the brand profile: the cornerstone for the future

It is now that the long-term brand images in China will be established. Many automobile brands that are stretched in their home markets will have to focus on their core values to obtain a sharply differentiated profile in the Chinese market.

Rethinking the model policy: less is often more

The brand message must primarily be communicated via the products. At present, the range of vehicles on offer in China is vague and generally confusing. An excessively broad range of brands and models within a brand is harmful.

Expanding dealer presence: greater coverage, higher quality

Dealer networks must be expanded and improved to redeem the brand claim at the point-of-sale. Experiences with dealers and their services are crucial "moments of truth" for the brand and the customer.

Developing downstream services: capturing sales revenue and potential earnings

Services are increasingly serving as a means of brand differentiation. As in mature markets, profitable exploitation of after-sales potential is becoming a key success factor.

Loyalty is critical: customer satisfaction and customer retention are the ultimate test

Only those companies that manage to bind customers to their brand have a chance of achieving sustained profits in China. Customer satisfaction across the entire life cycle and activities to attract the loyalty of specific target groups are the keys to success.

Some Defunct Myths About China

Oliver Wyman's study "Chinese Automotive Market 2010" explodes several widespread stereotypes about the growth of the Chinese automotive industry.

Myth No. 1: China has 1.3 billion potential automobile customers

Wrong: To date only about 50 million Chinese earn enough money to afford a car. By 2010 this figure is expected to grow to more than 170 million.

Myth No. 2: The Chinese are mainly interested in cars that function

Wrong: The car is at least as important as a prestige object in China as in Germany. Thus, in China as everywhere else, long-term sales volumes will result from the power of the brand.

Myth No. 3: The Chinese are looking for simple compacts

Wrong: Their priorities center on comfort and safety, not on transportation. Thus, most Chinese aspire to own a mainstream car.

Background of the Study

Oliver Wyman's study "Chinese Automotive Market 2010" was prepared jointly at the end of 2004 by Oliver Wyman's office in Beijing and a Chinese market research institute. It draws on more than forty directed interviews with executives in the Chinese car industry and on a poll of more than 2,200 current and potential automobile customers from seven selected regions of China. All kinds of automobile customers were polled: consumers, small-size entrepreneurs, purchasing agents from large firms, and taxi companies.

A secondary research project conducted at the same time analyzed and evaluated ten industry-wide databases, thirty market reports, many studies of the industry, and published opinions on the future evolution of the Chinese automotive market. The result was a large pool of market data and trends that attaches equal weight to opinions from experts and to current viewpoints of customers.

"Chinese Automotive Market 2010" points out market trends and outlines a number of scenarios for probable developments in the industry. In a follow-up stage, this fact base will make it possible to develop strategic options for auto manufacturers and equipment suppliers interested in exploiting the opportunities in the Chinese market.

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ABOUT OLIVER WYMAN

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Technical University Munich (TUM) is divided into the four main schools of Engineering Sciences, Natural Sciences, Medicine and Life Sciences. This constellation of disciplines is unique in Europe. More than 20,000 students, 20 percent of whom foreigners, attend TUM, which has twelve faculty departments. At its three main campuses in Munich, Garching and Freising-Weihenstephan, Bavaria's only technical university has about 350 professors and about 6,000 employees. Another 50 professors and 1,000 scientific employees work at the university hospital *Rechts der Isar*.

In 2002, TUM created an Economics Department, divided among its three sites, to broaden the range of interdisciplinary sciences it offers. The focus on Engineering, Management and Life Sciences gives TUM an unmistakable profile.

Prof. Dr. Dr. h. c. Ralf Reichwald is the Dean of the Economics Department and holds the Chair for Business Administration - Information, Organization and Management. The chair held by Professor Reichwald is widely considered to be among the most prestigious German professorships in the fields of organization and management, technology-driven management strategies, customer-driven value-added creation and service innovation.

Professor Reichwald is co-author of the book *Grenzenlose Unternehmung* ("Boundless Enterprise") (Gabler, 5th edition 2003), one of the most successful and highly regarded German textbooks in the field. He has authored more than 20 other books and many other publications.