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A New Vroom in Beijing

How consumer behavior is changing China's auto market

By Paul Clifford, August Joas, and Frank Leung

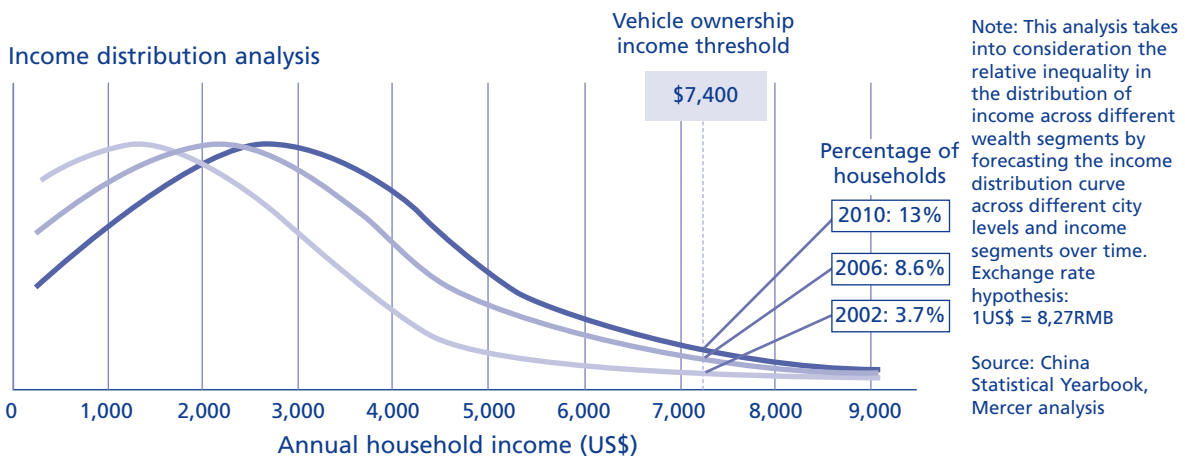
China's emerging middle class is buying more cars—but not the same old cars. Our research of the market, including a major survey of customers, points up major challenges for the industry in marketing, branding, and taming chaotic sales and service networks.

Until recently, Chinese consumers were not in the driver's seat; their employers were. The automotive market was dominated by government vehicles, corporate limousines and fleets, and taxis. Following the Henry Ford philosophy of choice, the dominant color was black. Chauffeurs drove passengers who were hidden behind nylon mesh curtains, and Shanghai Volkswagen's move to extend the rear passenger space of its Santana model by a few inches was lauded as a major design innovation.

But as a large middle class has emerged in China's major cities, there is finally sufficient wealth and appetite to support a viable consumer market (see Exhibit 1). Private car ownership is showing explosive growth, shaking the assumptions of auto makers, suppliers, and dealers. The stereotype has moved from dozing in the back seat to dishing out engine performance statistics over a latte at Starbucks's.

This shift has major implications for how cars and related services are designed, built, and marketed. Charting profitable growth in this market will not be easy. Auto makers have already sunk massive investment funds into China, to the extent that capacity far outstrips demand. Chinese economic policies, meanwhile, have been erratic as the government seeks to restrain growth. Yet, while China is full of risks, it represents a rare case of potential growth in a world full of mature markets.

Exhibit 1 **Growing wealthier**



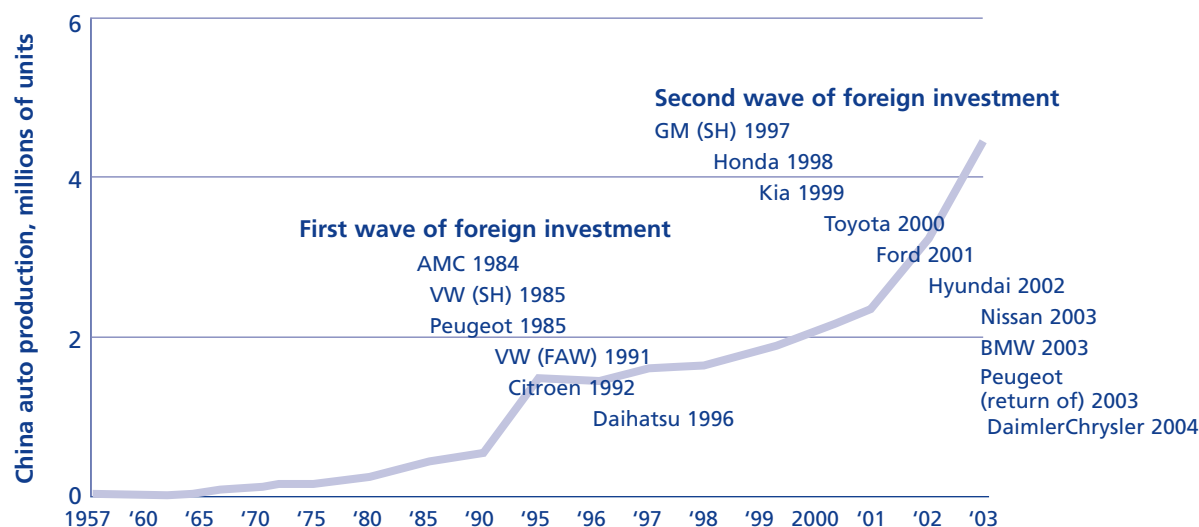
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Historical data are of limited use here. Instead, one way to anticipate what lies ahead is to understand how consumer priorities are changing, both in car buying and in various after-markets for parts and service. To that end, we recently undertook a study of the China auto market, including a survey of car buyers. This article summarizes those results and provides insights into one of the largest and fastest-changing auto markets in the world.

Background and forecast

In market entry, timing is critical. The first wave of foreign auto makers investing in China from 1984 to 1992 did so far ahead of demand and suffered from a lack of scale. Some such as Citroen remained, while Peugeot pulled out only to re-enter in 2003 (see Exhibit 2). The second wave began in 1997 on the heels of China’s economic surge that included widespread wealth generation. Most of the global auto makers now operate in China, while more than 20 local players, such as Hafei and Geely, have also sprung up, creating intense competition.

Exhibit 2 **Two waves of investment**



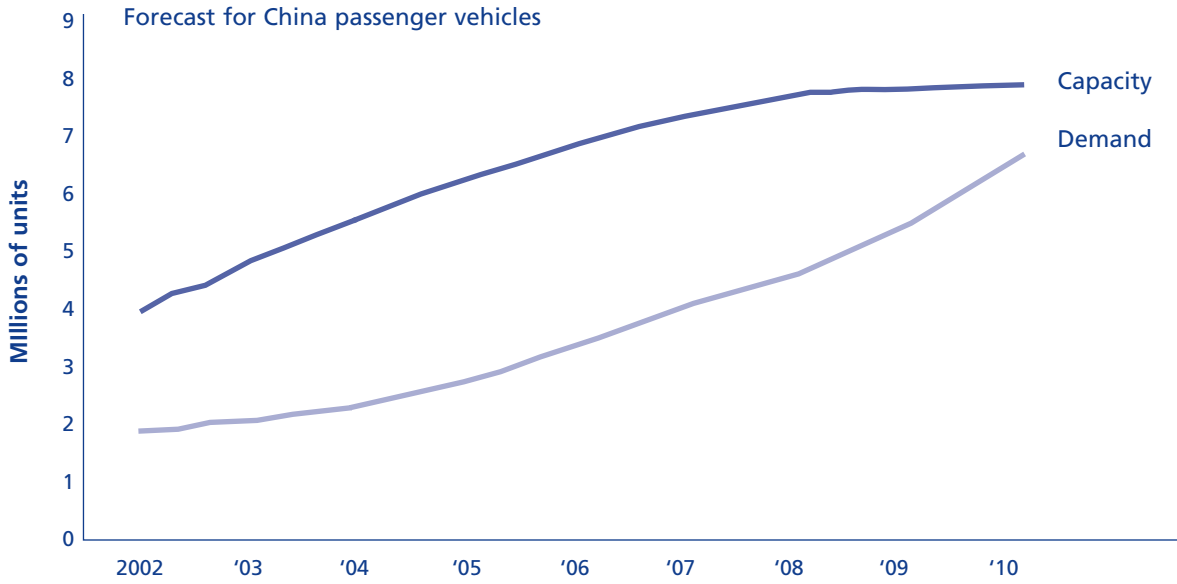
Source: CATARC

Looking ahead, our forecast derives from an analysis of trends in China’s income distribution, passenger car affordability, road development, GDP growth, and price movements. We also factored in bumps in the road caused by perennial government measures to cool the economy.

China’s passenger vehicle market should see robust growth, reaching between 6 million and 7.5 million units by the 2010, creating the second-largest passenger car market after the U.S. (see Exhibit 3). But existing and planned capacity will still be significantly larger than demand, so competition will intensify, retail prices will continue to erode, and many sub-scale players, especially Chinese firms, will likely drop out or be acquired.

The consumer segment will likely grow from 67% of the total market in 2004 to 80% by 2010 (see Exhibit 4). In a more consumer-centric world, automotive firms will need to pay more attention to the product features and service aspects that individuals care about.

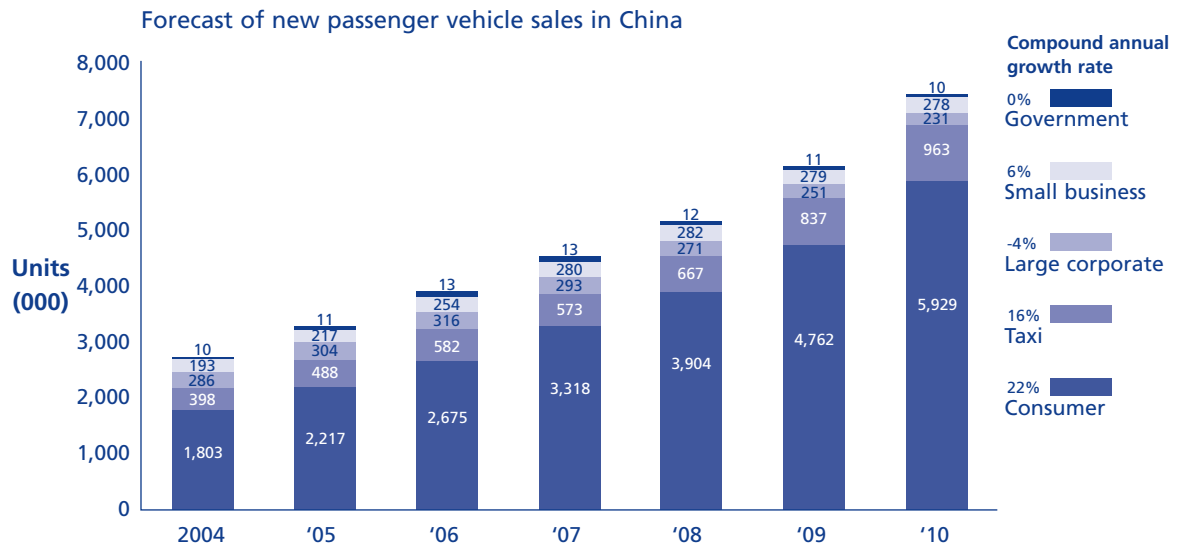
Exhibit 3 **Overcapacity will persist**



Source: Mercer analysis, base case scenario

To that end, we surveyed more than 2,000 participants in five auto customer segments: individual consumers, government, large corporation, small business, and taxis. The survey covered the cities of Beijing, Shanghai, Guangzhou, Shenyang, Nanjing, Zhengzhou, and Changsha, providing a representative sample of China’s megapolises on the Eastern seaboard and other cities in the interior.

Exhibit 4 **The rising consumer tide**



Note: Passenger vehicles are all vehicles with nine or fewer seats and exclude motorcycles.
Source: Mercer survey and analysis

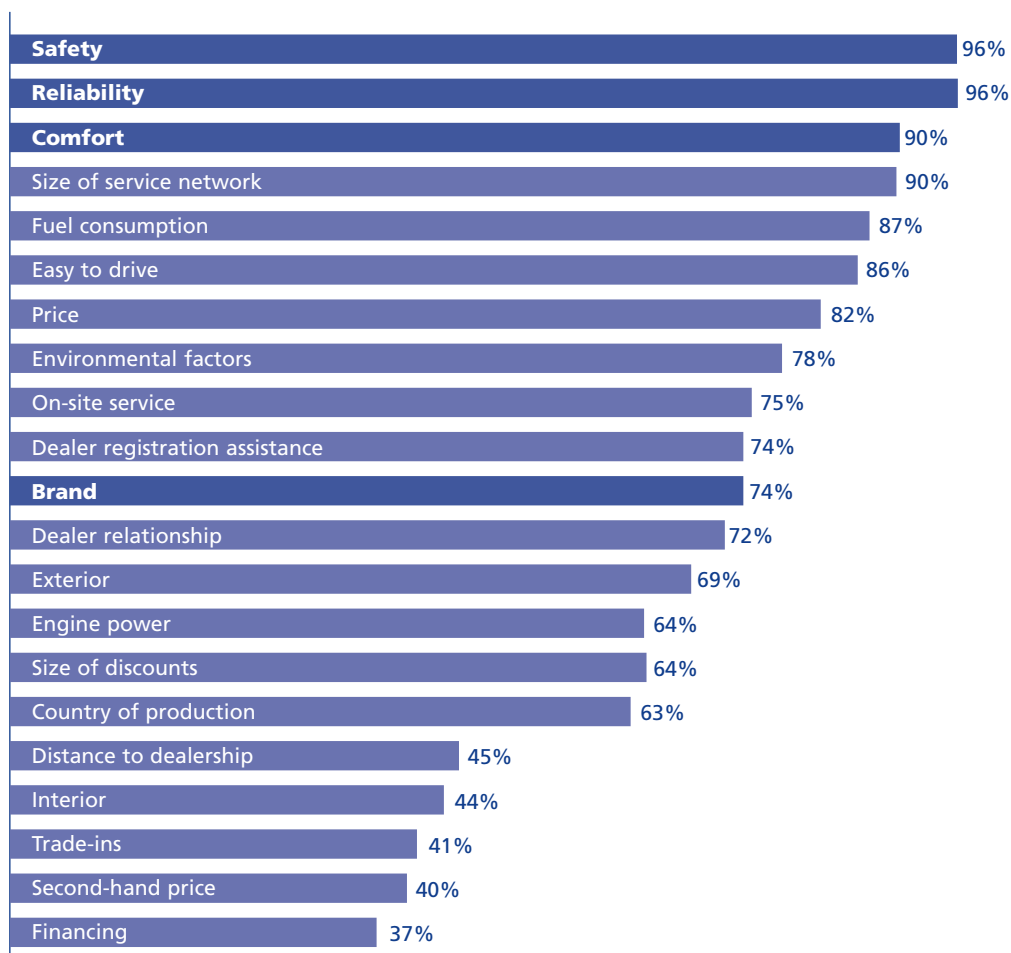
What consumers care about

The new class of professionals and entrepreneurs leading the consumer surge are relatively wealthy and not very price-sensitive. Old habits linger, to be sure: 31% of people interviewed about luxury vehicles expressed a preference for black, the dominant color for government and corporate fleets. In other ways, however, the trend toward private ownership of cars is already changing attitudes. Customers in Tier 1 cities (Beijing, Shanghai, and Shenzhen), when asked about future car purchases, rated individual rationales such as improved quality of life and convenience as more important compared to their preferences when they bought the vehicles they currently own.

Brand loyalty, meanwhile, is very weak. Across all market segments, the key purchasing criteria are safety, reliability and comfort, while brand is less important (see Exhibit 5). And brand loyalty is weakest in the fast-growing consumer segment where wealth has been rising, the choice of brands has expanded, and trading up has accelerated. Whereas the average age of a vehicle in developed markets is between six and seven years, it's just 2.3 years in China; as a result, Chinese consumers have less experience in selecting vehicles and are more keen to try different brands.

Exhibit 5 Brand? What brand?

Purchasing criteria, percentage cited by respondents

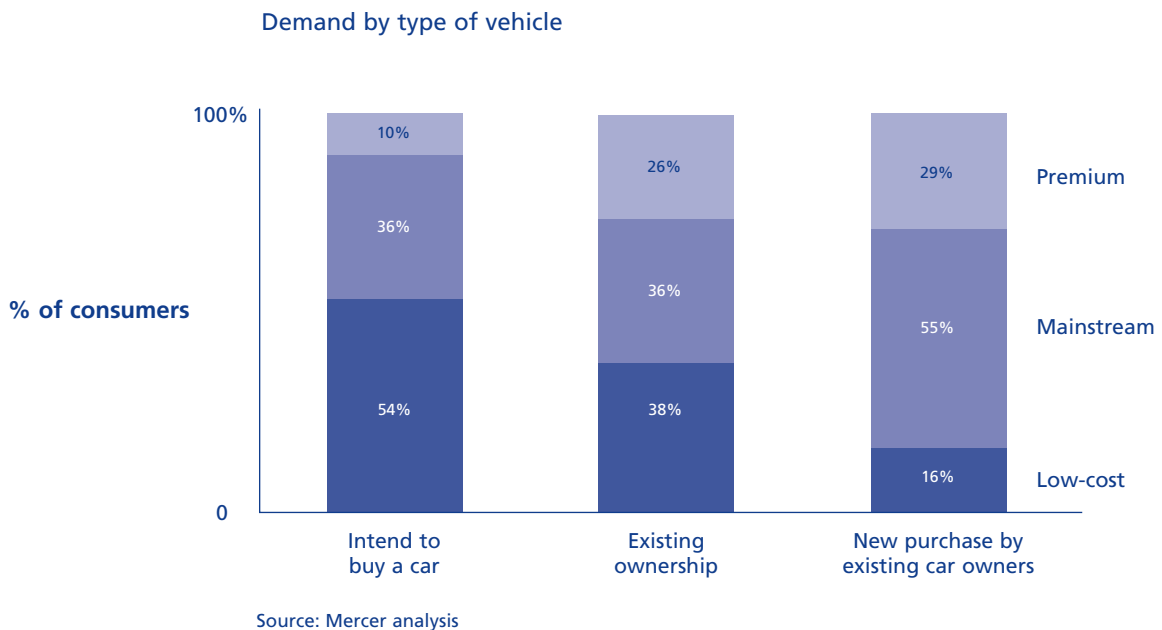
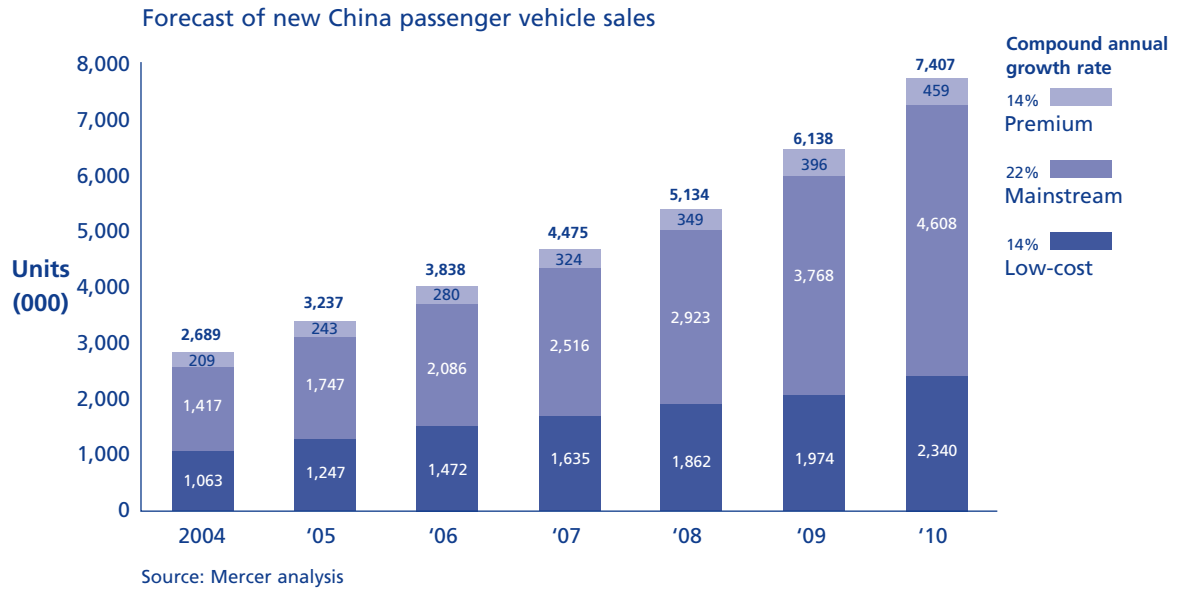


Source: Mercer survey and analysis

Moving up-market

Volume will move away from low-cost vehicles to mainstream and premium models. While 38% of car owners currently drive a low-cost vehicle, only 16% of that group intend to stay with this segment on their next purchase, and just 7% expect to buy the same brand of vehicle again, primarily because quality and reliability have been so poor. Thus, the mainstream segment will grow to 63% of total car sales in 2010 at the expense of low-end vehicles (see Exhibit 6).

Exhibit 6 Trading up



Chinese auto makers, such as Hafei in China's Northeast region, are already responding by diversifying away from an early focus on microvans toward more expensive vehicles that can compete with the foreign bands. Geely, an emerging Chinese firm, has launched the Meirenbao, proudly displayed in the National Museum in Beijing as China's first home-grown sports car. However, Chinese consumers are cautious about saluting Chinese cars as the wave of the future. Domestic auto makers have not yet accumulated the experience needed to provide excellent service support through the life of the vehicle. For most models, access to foreign capital, technology, and components is critical, as illustrated by Hafei's Saibao model, with a body designed by Italy's Pininfarina and a chassis and engine of Japanese design (see Exhibit 7).

Exhibit 7 A market sample



Hafei Min-yi microvan



Hafei Saibao sedan



Geely Meirenbao sports car

The sales and service challenge

Dealership networks in China are highly fragmented and, unlike other geographies, are dominated by "tier 2" dealers that account for 77% of sales, buy from other dealers, and have little interaction with auto makers. The sales network is rife with poor practices such as selling across their designated regions, opaque and confusing price structures, and debilitating discounts in a bid to reduce inventories. Service and repair is also dominated by small family-owned shops. Auto makers, thus, will have to nurture larger, stronger dealers and service centers.

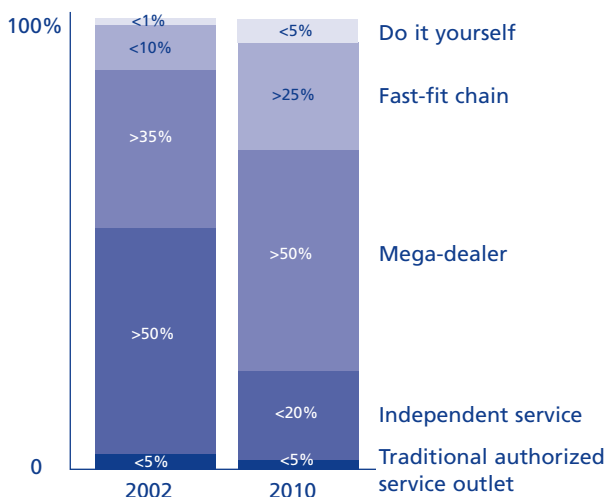
Our survey shows that Chinese consumers place a higher priority on dealers offering maintenance and repair versus insurance, financing, leasing, and other factors. Large dealers are already increasing their presence in retailing, and we expect them to account for about half the market by 2010. Mega-dealerships authorized by auto makers are acquiring small dealerships and managing regions with a bundle of outlets. And we expect global service chains such as Jiffy-Lube to achieve a 25% market share by 2010 (see Exhibit 8).

One element of vehicle ownership that has been difficult to obtain in China is financing. The population has a very high savings rate, and many large purchases are still made in cash. Between 20% and 30% of auto sales are financed, or roughly one-third the level of financing in developed markets. Chinese banks have sustained serious losses on auto loans and have largely pulled out of this activity. Local courts have been reluctant to enforce claims against vehicles registered in other localities. Meanwhile, foreign auto maker finance arms, which fought to open the market, now face the challenge of weak credit information, the absence of insurance for car loans, and restrictions on funding sources. It's not clear how long it will take to address the significant unmet demand for auto credit.

Another major challenge is to tame the notoriously chaotic market for replacement parts, which is plagued by gray market and counterfeit parts. Suppliers find it hardest to be profitable in non-critical or frequent replacement parts, such as oil filters, headlamps, batteries, and fan belts. Chinese car owners are open to buying gray market parts, particularly after the

Exhibit 8 Service gets supersized

Forecast share of total after-sales market



Source: Mercer analysis

warranty expires. Gaining more control over the service network and working with parts suppliers will help, but this promises to be a long battle.

To address the evolving consumer behavior in China, auto makers should adapt their strategies and tactics along several dimensions:

- *Develop a clear and differentiated value proposition around car specifications, styling, and price.* This should be done at the level of individual customer segments and then brought together under a brand. The value proposition can be developed and tested by rigorous research with consumers and sales channels across different geographic markets within China.
- *Devise ways to develop brand loyalty.* Creating a broad range of products and sub-brands that permit the consumer to upgrade as his or her wealth increases can help. Internet-based marketing should support the physical channels and help drive customer acquisition. And improving downstream service support should improve brand loyalty for foreign OEMs.
- *Clean up and consolidate sales channels.* To address the fragmented nature of dealer networks and the chaotic behavior in distribution and service channels, identify and nurture the top-performing regional distributors and local dealers through financing, technical, and other support, thus forcing consolidation and improvement in service.
- *Move rapidly towards sales, service, and spare parts.* Foreign OEMs can use their global experience in this area to compete against Chinese OEMs that can increasingly produce up-market vehicles but have a less-developed sense of consumers' various needs over the lifetime of the vehicle.
- *Create a more sustainable business model.* The first task here is to bring order to the chaotic aftermarket for parts, where, unlike in other markets, foreign OEM and parts suppliers make little or no profit. The solution must go beyond government intervention against counterfeit products to include measures by the foreign OEMs and partner suppliers that create stronger incentives to foster new behavior.

Over the next five years, the China auto market will increasingly resemble other major markets with regard to consumer behavior and preferences. The challenge for auto makers and suppliers lies in anticipating and responding to the shifts in consumer priorities. Product quality, reliability, and design will still matter. But closer connections to consumers through better sales and service networks are becoming essential for building brand loyalty. As in other sectors of the Chinese economy, service has struggled to keep up with product, and the ability to close this gap could be decisive in the auto market. ❖