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MANAGEMENT SUMMARY

Oliver Wyman study “Automotive Suppliers in China”

China is key to the success of European automotive suppliers

- **European automotive suppliers need to maintain a strategic presence in China**
- **Positioning themselves as innovative first-tier suppliers will help them preserve their competitive advantages**
- **European automotive suppliers need to secure their own, low-cost production base**
- **Emerging Chinese competitors should be monitored very closely**

For the automotive suppliers, pursuing the right China strategy will be a critical success factor in helping them preserve their competitive advantages. That is because China is not only an important sales market, but also the home of emerging competitors, which fully intend, with the assistance of their government, to conquer the markets of the traditional triad countries. The recent Oliver Wyman study entitled “Automotive Suppliers in China” reveals that, for now, only few Chinese automotive suppliers pose a genuine threat to the established automotive suppliers. To keep it that way, European automotive suppliers need to enter the Chinese market aggressively, with the latest technologies. Cooperative ventures with Chinese automotive suppliers can also be a useful option.

For the European automotive suppliers, the Chinese market is important for three reasons: Not only does this market offer strong sales growth and low-cost production opportunities it is also home to potentially dangerous competitors. The Chinese domestic market for automotive suppliers is growing at an extremely fast rate of more than 30 percent per year. But the exports of automotive parts from China are growing at an even faster rate, averaging 70 per cent per year over the last few years, and reaching more than 15 billion euros in 2005. The purchasing departments of the international automobile manufacturers have discovered China as an attractive place to purchase manufactured parts and the big automotive suppliers have likewise been looking more intensively for new suppliers in that country. In fact, mass-model manufacturers like General Motors and Ford intend to increase their procurement volumes in China, which are already quite substantial, by an additional 50 percent to 70 percent by 2008. The premium manufacturers, which once purchased only a small percentage of their parts from low-wage countries, have set themselves even higher targets.They intend to boost their purchasing volumes in China by factors of anywhere from three to eight.

The Chinese market is served by a large number of small-scale domestic suppliers

In the Chinese market, a very large number of small domestic automotive suppliers are competing against much larger international suppliers, with average annual revenues that are four to six times higher than those of their Chinese competitors. Along with their joint ventures, the big suppliers from the Western industrialized countries, such as Bosch, Delphi, Denso and Johnson Controls, are responsible for about 40 percent of automotive revenues in China. They are also benefiting from booming exports of purchased automotive parts, manufacturing about 56 percent of Chinese auto part exports.

The approximately 2,500 domestic suppliers, most of them rather small, have until now supplied relatively simple mass-produced parts. Due to their strong growth rates, however, they are considered to be an important engine of the Chinese economy. The Chinese government has promoted and supported this growth through its deregulation policies. The overriding objective is to make the domestic companies internationally competitive. Until now, the Chinese automotive suppliers have focused their energy on manufacturing simple purchased parts. Such components, which include aluminum wheel rims, tires, universal joints, stereo speakers and compact cast iron parts, are already being exported from China in large quantities.

The Chinese market is maturing

Based on their findings, the authors of the Oliver Wyman study developed a medium-term scenario for the Chinese automotive supplier market. Under this outlook, the market prices of components manufactured in China will continue to decline substantially, as will the corresponding profit margins. Moreover, the Chinese automotive suppliers market will undergo increasing consolidation and suppliers will be grouped into hierarchies, as in the more developed automotive markets. In the last few years, the profitability of automotive suppliers in China has decreased by more than half, due to falling prices and the growing sophistication of automotive purchasing departments, which have learned how to analyze factor cost differences, as well as increased competition and rising quality demands.

The auto manufacturers are pursuing varied product development and purchasing strategies, depending on their respective product strategies. Those manufacturers which, like their Chinese counterparts, specialize in simpler, smaller vehicles, are currently strongly focused on achieving cost advantages. In the future, however, the innovation capacity of the automotive suppliers that supply this group of manufacturers will become increasingly important. Those international manufacturers that specialize in higher-end products, which still rely very much on the innovation capacities of their suppliers, will increasingly differentiate their product development and purchasing strategies in the coming years. Cost advantages will become increasingly important for simple purchased parts, while in the case of the more complex components, modules and systems, maintaining innovation capacities will continue to be the dominant factor.

To be internationally competitive as automotive suppliers, the Chinese companies will either need to develop more complex products and acquire specialized expertise in specific modules or systems, or they will have to focus instead on attaining the cost leadership position among second-tier suppliers. At the moment, however, their access to new customers is limited by their dependence on only a few customers and by the regionalized structure of the Chinese economy. Other significant factors hindering the international ascent of the Chinese automotive supplier industry today include their lack of innovation capacities, process expertise and internationally recognized brand names. Chinese automotive suppliers today invest less than two percent of their annual revenues in research and development. By contrast, the established international suppliers invest, on average, something like four to five percent of their annual revenues on R&D, while industry leaders such as Bosch, Denso and Delphi invest up to seven or eight percent of their revenues on R&D, well above the industry average.

For the time being, therefore, the Chinese automotive suppliers do not yet pose a serious threat to most of the module and system suppliers in the international market or even in China. On the other hand, component manufacturers, and especially the manufacturers of simpler components, will come under growing cost pressures in the coming years as more Chinese suppliers venture into the international market. Some Chinese suppliers, such as Wanxiang, for example, will eventually attain the status of internationally competitive automotive suppliers. The strategy pursued by Wanxiang is twofold. On the one hand, the company offers simple, labor-intensive parts such as universal joints at competitive prices; on the other hand, it is pursuing a strategy of foreign acquisitions in order to gain access to new customers and technologies for more complex chassis modules. This strategy is shaping up to be a successful, long-term strategy for the Chinese automotive suppliers.

The battle over market shares in Europe must be fought in China

To permanently counter the threat posed by the fast-developing Chinese automotive suppliers, the European automotive suppliers should aggressively target the Chinese market. Furthermore, they should offer the latest technologies and maintain adequate development capacities, notwithstanding their concerns about the protection of intellectual property. By leveraging the innovation advantages they still hold, the European automotive suppliers can position themselves as direct, first-tier suppliers in the Chinese market and so force their Chinese competitors into the role of second-tier suppliers. Such a strategy will also make it harder for the emerging Chinese competitors to gain access to international auto manufacturers. By pursuing an aggressive, innovation-driven strategy, the European suppliers will be able to position themselves as first-tier suppliers to the fast-growing Asian manufacturers and by that means capture an above-average portion of the industry growth that will occur in China.

Also, by entering the Chinese market or other markets with advantageous factor costs, the international automotive suppliers will be able to improve their own cost structures. They can achieve cost reductions either by purchasing components from the existing or developing supplier base, or by establishing their own production capacities. Yet another important advantage of maintaining a presence in China would be the ability to recognize, at an early stage, the emergence of competitive strategies among their Chinese competitors. Keeping a close eye on the Chinese supplier market for the product range in question is really a matter of survival for the European automotive suppliers, because it will enable them to respond quickly to emerging local, superregional and one day international supplier structures. In view of all these factors, the European automotive suppliers should rethink their China strategies, in order to protect their competitive advantages on a lasting basis and benefit from the further development of the Chinese automotive suppliers.

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Recommended actions for European automotive suppliers

1. Monitor the competition: This will enable the European automotive suppliers to respond quickly to the development of their Chinese competitors and will give rise to crucial competitive advantages.

2. Aggressive China strategies, based on the latest technologies: This will help the European automotive suppliers move against their Chinese competitors in their home market.

3. Production in low-wage countries: This will generate crucial cost advantages in the global production network.

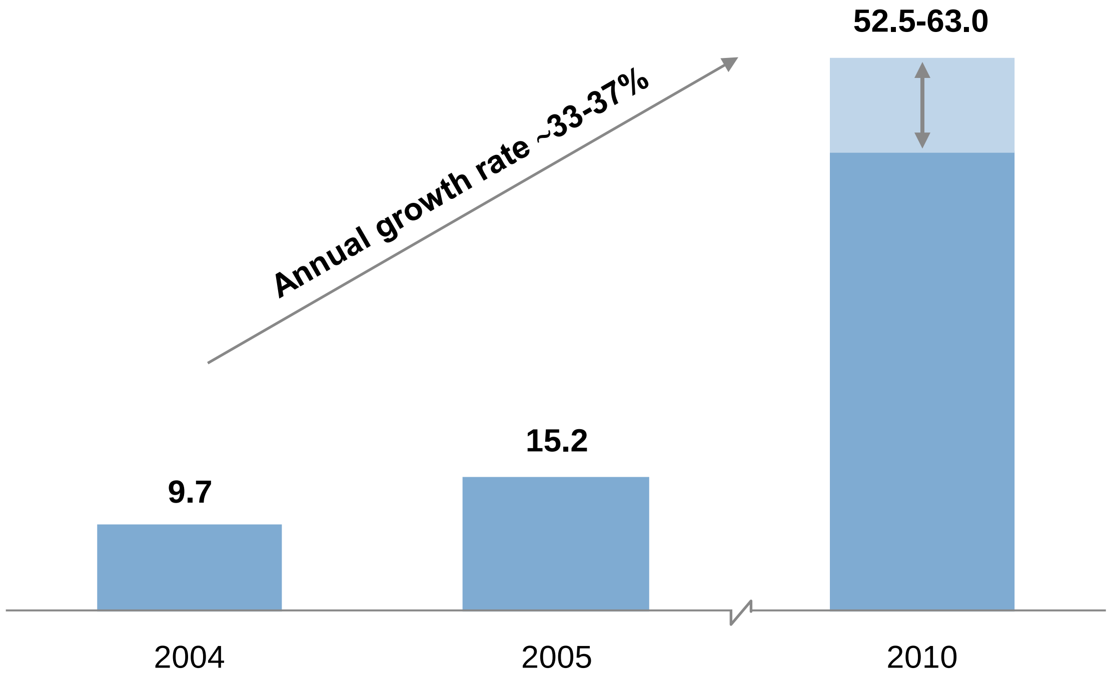
4. Seek to engage the Chinese automotive suppliers as second-tier suppliers: This will generate cost advantages and alleviate competition intensity.

Oliver Wyman study “Automotive Suppliers in China”

The Oliver Wyman study identifies current trends and developments in the Chinese automotive supplier industry and provides recommendations for actions to be taken by the European automotive suppliers. The study, which was prepared in 2007, incorporates the findings of more than 50 interviews with industry experts and with corporate executives of the first and second management levels. The study also incorporates the extensive experience that Oliver Wyman has accumulated in its numerous international consulting projects for automotive manufacturers and suppliers.

By the year 2010, the exports of auto parts from China will rise to more than 50 billion U.S. dollars

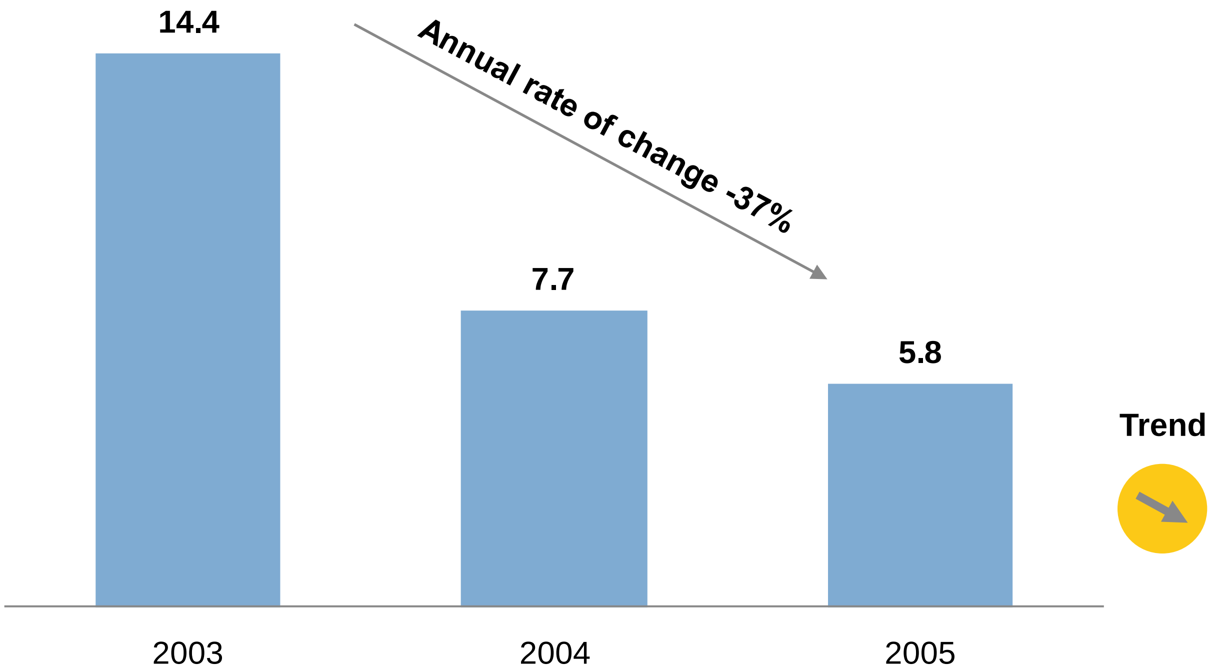
Exports of auto parts from China
In billions of U.S. dollars, 2004 to 2010



Source: Yearbook of the Chinese Automobile Industry, Oliver Wyman analysis

The profitability of the Chinese automotive supplier industry has declined substantially in the last few years

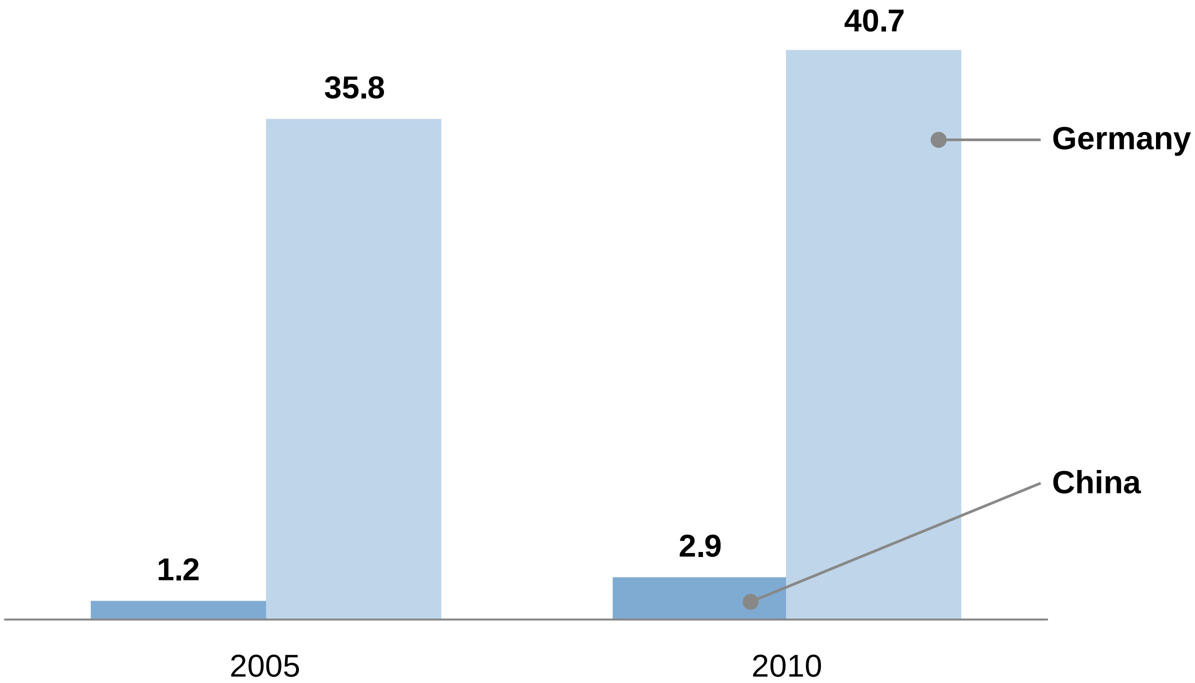
Profitability of the Chinese automotive supplier industry
In %, 2003 to 2005



Source: China Automobile and Parts, China Automotive Industry Research, Oliver Wyman analysis

Thanks to its low wage costs, China will continue to be an attractive production site for auto manufacturers and automotive suppliers in the future as well

Comparison of wage costs in China and Germany
In U.S. dollars per hour, 2005 to 2010



Source: The Economist Intelligence Unit, Oliver Wyman analysis