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- *New markets, new segments, and new players are redrawing the battle lines in the passenger car market*
- *Over the next ten years, two-thirds of all incremental growth in passenger car sales will come from developing countries, where the demand will be for small, entry-level cars priced below \$5,000*
- *A number of new players from emerging markets are fine-tuning their business models for success on a foundation of low factor costs and innovation*
- *OEMs that can spot emerging shifts and trigger appropriate strategic responses ahead of their competitors will go on to win; those that can't will be left frozen in the headlights*

Shifting Battlegrounds in the Passenger Car Market

The competitive landscape is shifting in the passenger car industry—and that shift is rewriting the established rules of the game and reshaping the prospects of players around the globe.

Back in 2000, industry experts and observers saw consolidation as both desirable and inevitable. The economic rationale for it was compelling. Demand, which was largely concentrated in the Triad markets (Japan, North America, and Western Europe), was facing declining growth. For volume players, creating a full line of offerings that used the fewest possible platforms seemed key to driving profits, and building scale through consolidation appeared inescapable. From 1960 to 2000, the number of independent industry-size manufacturers of light passenger vehicles had fallen from more than 40 to just 11. Little wonder, then, that the march toward an oligopolistic endgame seemed unstoppable at the time.

Today, however, the same experts are more circumspect in their predictions of the industry's future. New markets, new segments, and new players are challenging the conventional rules, demanding the creation of new business models and capabilities.

New Markets: Riding the Wave

That developing markets would constitute an increasing share of demand for cars was well known even in 2000. However, the rapid growth of that share has taken many by surprise. In 1996, developing markets represented just 11 percent of sales of light passenger vehicles. By 2000, their share had grown to 14 percent, and by 2005 to 22 percent. We expect that by 2015, developing markets will account for more than 30 percent of new-car sales.

This shift in itself is quite remarkable. It emerges from the confluence of two trends: rising incomes and shrinking price tags. Our analysis reveals that the best predictor of the size of passenger car markets is affordability—in this case, the

ratio of per capita income to the price of an entry-level car. The economic boom in emerging markets has led to rising incomes and greater prosperity. At the same time, a number of new players in these countries have successfully built and launched low-cost, entry-level cars by harnessing local engineering and manufacturing talent. Together, these two trends have catalyzed demand for passenger cars in the growing middle- and high-income segments.

The dramatic rise in the affordability of automobiles portends a change in the old order. We expect that over the next ten years, 67 percent of all incremental growth in passenger car markets will come not from the Triad but from countries that ten years ago were peripheral markets, such as China, India, Brazil, Russia, and Iran (listed in order of their anticipated incremental new-car sales over the next decade). By 2015, India, Brazil, and Russia (listed in order of the anticipated size of their car markets) will all have annual sales of more than 2 million cars. Moreover, several countries with smaller markets will attain volumes that can support investment in local assembly and manufacturing to serve their domestic markets. For example, by 2015, Malaysia and Indonesia will each have annual car sales of more than 500,000 units, and sales in Thailand, Poland, and Pakistan will exceed 250,000 units apiece.

New Segments: Small Is Big

As might be expected, the vehicles that are being sold in these developing markets are not midsize sedans, which make up the largest segment in developed markets, but small, entry-level cars. Remarkably, these vehicles carry price tags of around \$4,500, whereas small, entry-level cars in developed markets tend to sell for more than \$7,000. Customers in developing markets have shown a willingness to trade what they see as inessential features, such as electric windows and power steering, for a lower total cost of ownership over a car's lifetime. However, they are unwilling to settle for models that seat fewer than five people, and they place a premium on additional storage space in the trunk.

Clearly, to succeed in these markets, companies must design and build cars on the basis of a deep familiarity with local preferences. Merely transplanting product concepts from Triad markets will not be enough. Some OEMs, such as Renault, are attempting to com-

bine global scale, low cost, and local preferences in ways that have not been tried before. For starters, Renault is using its Logan platform to create several low-cost offerings across segments and markets, each adapted to local needs and demand. The company also recently announced a plan to develop a new small-car platform targeted for the \$2,000-to-\$3,000 price range.

The emergence of such low-cost offerings is a potential game changer in the global industry. Although developing markets have provided the initial impetus for small-car sales, the growth in demand for small cars will not be restricted to those markets. The small-car segment is also gaining prominence in developed markets, albeit in response to different forces. One is stricter emission standards, which are finally being imposed in several countries after years of resistance from business interests. In Europe, for example, emission standards for all OEMs, in terms of average grams of carbon dioxide per kilometer across the range of cars each sells, tightened from 186 in 1995 to 165 in 2003—and are slated to tighten further, to 120 in 2012.

This development makes it imperative for OEMs to rebalance their portfolios by aggressively increasing the percentage of small, low-emission cars in their fleets. At the same time, growing environmental awareness is prompting consumers in developed markets to opt for smaller cars with greater fuel efficiency and lower emissions, further accentuating the importance of the small-car segment over the next decade.

New Players: The Regional Attackers

A bevy of new players from emerging markets are preparing to storm the automotive bastion. These regional attackers, such as Tata Motors in India, and Chery Automobile Company and Geely Group in China, have fine-tuned their business models to achieve success in these markets on a foundation of low factor costs and innovation.

Regional attackers have access to a highly skilled, low-cost labor pool with extensive engineering talent. The cost of developing a new platform in India, for example, can be as little as one-quarter the cost of developing one in Western markets. Manufacturing labor, too, costs only a small fraction of what it costs in Germany and the United States and is also highly productive.

The supplier base for automotive components in these markets is maturing rapidly and can offer world-class quality and service in addition to the expected cost advantage. Capital to fund investments is cheap and abundantly available. Taking advantage of the slowdown in developed markets, these players have acquired underutilized assets (such as assembly lines and paint shops) from OEMs in high-cost markets and relocated them to their home markets, giving themselves a capital cost advantage. We estimate that best-in-class OEMs from developing markets, drawing on these advantages, can manufacture small cars at approximately 40 percent of the cost of manufacturing comparable cars in Western Europe.

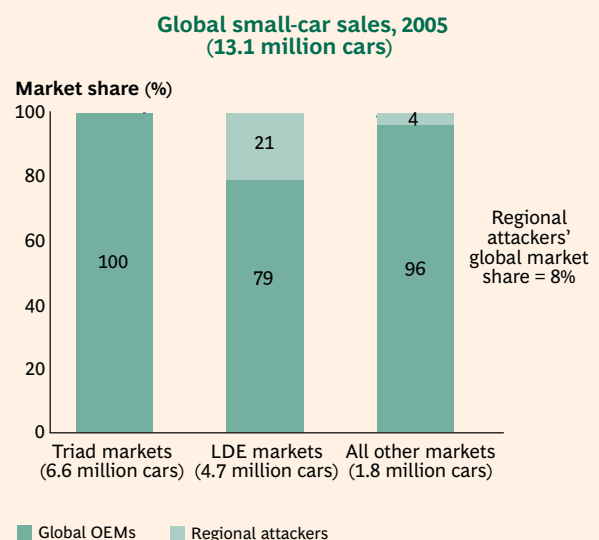
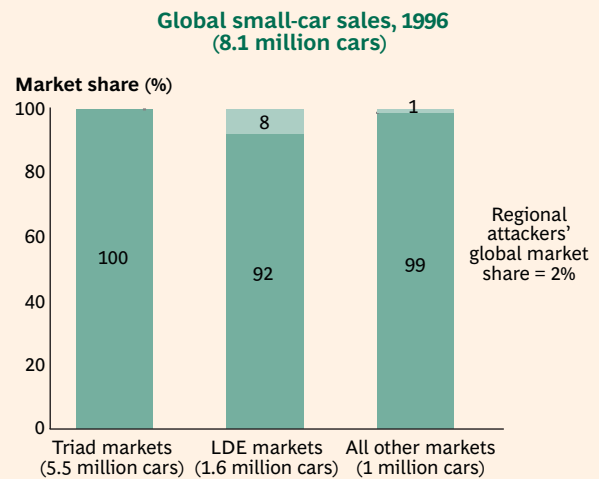
Moreover, it would be simplistic to consider regional attackers merely low-cost players. They also represent the leading edge of innovation. Tata Motors, for example, is attempting to develop an ultra-low-cost car priced at \$2,500 and targeting the large vacant space between the motorcycle and entry-level-car segments. The company believes that such an offering would open up a large untapped market. Tata Motors has assembled a team of engineers from both within and outside the passenger car industry and encouraged them to challenge all the theories in use in order to create an entirely new product concept and business model. Freed of historical baggage, this team is believed to have evaluated options as diverse as prepainted plastic body panels, adhesives in place of conventional fasteners, and distributed small-scale assembly units. Large vendors have joined with Tata Motors, willingly taking on part of the development cost and some of the risks in return for a seat at the table for what could be one of the most disruptive innovations since the Model T. Although not much is known about the final specs of the so-called one-lakh (100,000-rupee) car, prototypes are reportedly in testing, with a launch targeted for mid-2008.

As of 2005, regional attackers had already captured an 8 percent share of the global small-car market. (See the exhibit “Regional Attackers Are Gaining Share in Small-Car Markets.”) By way of comparison, from 1965 to 1975 the leading Japanese OEMs’ share of the U.S. car market grew from 2 percent to 10 percent, and these companies have since gone on to attain global market leadership.

Having established themselves in their home markets, regional attackers are now setting their sights overseas. As a first step, they are rapidly entering a slew of small and fast-growing emerging markets. With their

low-fixed-cost manufacturing model, they are able to build a sustainable presence in these low-volume markets—something the high-fixed-cost global OEMs cannot do. For example, Chery has set itself the target of selling 120,000 cars in overseas markets by 2008. It has built an international footprint spanning Central and Eastern Europe, Latin America, the Middle East, Southeast Asia, and West and North Africa. Like its markets, Chery’s mode of entry is varied: in some countries it employs local assembly of semi-knocked-down (SKD) and completely-knocked-down (CKD) kits imported from China; in others it engages in joint ventures with local players or acquires existing car plants.

Regional Attackers Are Gaining Share in Small-Car Markets



Source: DRI Global Insight sales database, August 2006.
 Note: Triad = Japan, North America, and Western Europe; LDE = large developing economy (Brazil, China, India, Indonesia, Iran, Malaysia, Mexico, Russia, South Africa, Taiwan, Thailand, and Turkey).

Strategic Responses for Traditional OEMs

Traditional OEMs have responded to these developments in three ways. First, they have expanded their sourcing and manufacturing activities in low-cost countries such as China, India, Turkey, the Czech Republic, Poland, Ukraine, and Romania (listed in order of the total number of cars produced in 2005). Second, many OEMs have set up both international purchasing offices and large-scale, export-oriented manufacturing facilities in these locations. Simultaneously, some have established sales and marketing activities, competing head-on with local regional attackers in the hope of accelerating their experience curves. Third, global OEMs are developing new products for these high-growth markets, building on existing platforms within their portfolios.

Through a combination of de-spec'ing, value engineering, and relocating sourcing and manufacturing to low-cost locations, global OEMs have been able to pare away as much as 49 percentage points from the 60 percent gap between their costs and those of the best-in-class regional attackers, reducing the cost gap to 11 percent of their former cost base—and close to 20 percent of their new, reduced cost base. Although some incumbents have chosen to confront these challenges on their own, others have adopted strategies involving acquisitions or have struck alliances with regional attackers in order to accelerate sourcing, manufacturing, market entry, and product development.

The stakes are high. In our view, the global passenger-car market, estimated at approximately 51 million cars in 2005, could grow to around 70 million cars by 2015. Developing markets (the home markets for the regional attackers) would account for some 25 million of these vehicles—up from only 11 million in 2005. The small-car segment (where the regional attackers' strength currently lies) would account for some 24 million cars globally—up from 13 million in 2005. If the regional attackers were to strengthen their home-market positions and also capture a sizable share of the growing small-car market in the Triad, they could rival the global OEMs in size and scale. However, if the global OEMs are successful in staving off the challenge, they could be the ones to benefit from all this growth.

These developments on the periphery of the established small-car markets are beginning to shape—and shake—the center. Recently, a senior executive at a leading global OEM told us, “We will soon see China and India prices across product segments in Europe and the U.S.” Global OEMs need to critically assess the likely impacts of these developments on their plans. How will the advent of the regional attackers—and of their platforms and models—affect each OEM's position in developing markets? What effects might there be in the Triad markets? And what can OEMs learn from the new concepts and business models that are being developed along this periphery? After all, Japan was on the periphery of the auto market in the 1960s—and we all know how developments there blind-sided the U.S. and European majors.

Taken individually, the new markets, new segments, and new competitors now emerging would each have a profound effect on the size and shape of the passenger car market. Together they will certainly determine the fortunes, and the very survival, of both established players and newcomers. OEMs that can spot emerging shifts and trigger appropriate strategic responses ahead of their competitors will go on to reap rich rewards. Those that can't will be left frozen in the headlights. For sure, the top ten car producers in 2015 will include some names that were unknown a mere ten years earlier.

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