Opportunities for Action in the Automotive Industry

Winning in Today's Chinese Automotive Market

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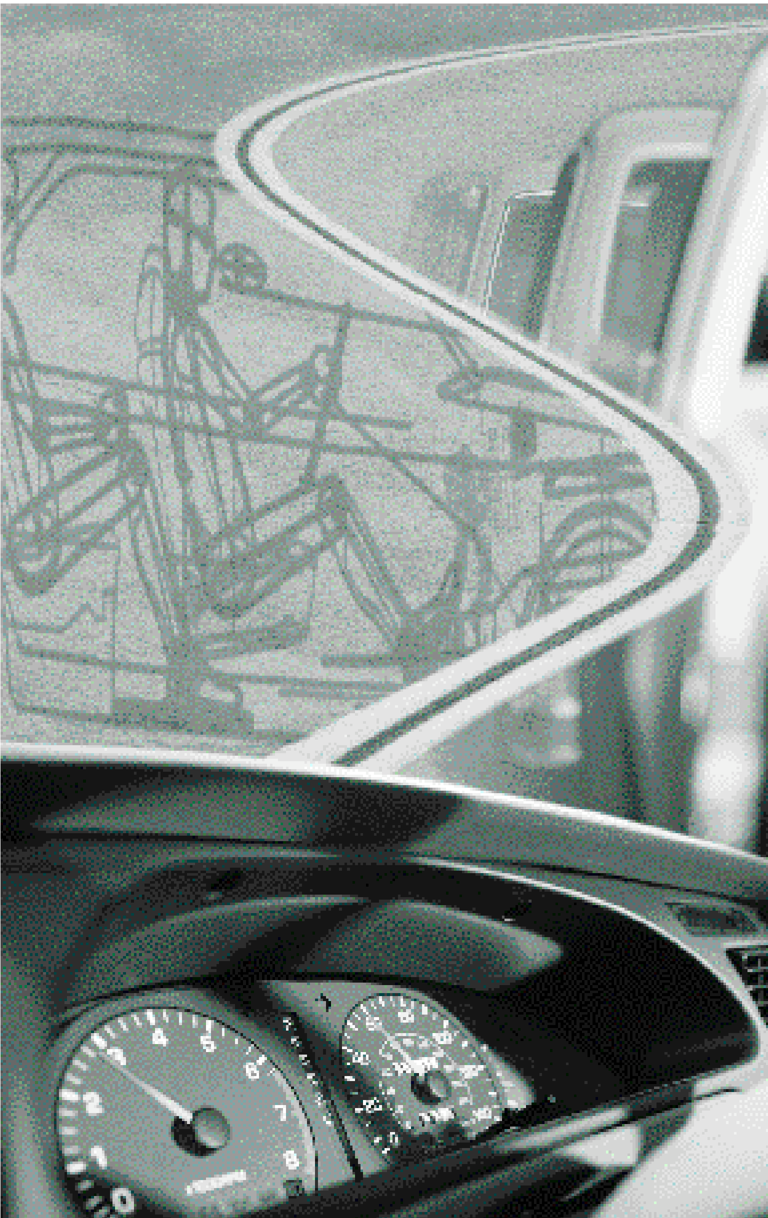

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These are challenging times for executives in China's automotive market. In 2002 and 2003, China had experienced phenomenal growth in auto demand, following the country's entry into the World Trade Organization in December 2001. From the end of 2001 to the end of 2003, passenger car sales grew at a compound annual rate of 64 percent. In 2003, China became the third-largest automotive market in the world, after the United States and Japan, with total commercial and passenger sales of 4.4 million vehicles.

However, this red-hot market cooled dramatically in 2004, when passenger car sales increased only 13 percent over 2003, to 2.24 million vehicles—sharply down from the 74 percent rise to 1.98 million vehicles in 2003. This deceleration continues in 2005. Moreover, slowing growth combined with falling prices, significant increases in capacity, and a proliferation of new-model launches has turned China into a fiercely competitive auto market—one that is rapidly separating the winners from the losers. What's going on? And what can participants do to position themselves for success?

Why the Slowdown?

China's recent automotive "bear" market has been driven by a vicious cycle of high inventories, frequent price cuts, and consumers' wait-and-see mentality. That cycle, in turn, is propelled by a fundamental imbalance between supply and demand, exacerbated by a savage price war.

From the supply perspective, auto OEMs as a group were too optimistic in their production planning for 2004, basing their forecasts on the market's rapid growth in 2002 and 2003. Their sales targets for 2004, announced early that year, anticipated 40 percent growth over 2003. These upbeat forecasts, coupled with launches of more than 50 new models, led to substantial oversupply.

From the demand perspective, meanwhile, the central government's "economic soft landing" policies had the effect of tightening auto financing and boosting both interest rates and car insurance premiums, inevitably curbing demand. When industry participants responded to dampened demand with price cuts in an effort to gain share, the market quickly spiraled into an all-out price war. To remain competitive, OEMs vied to announce massive price cuts. In response, savvy customers postponed their purchases, anticipating the next wave of discounts. As demand has stalled, OEMs have continued to cut prices to push sales and reduce mounting inventories—and consumers have become conditioned to wait for the next round of price cuts before buying.

These three forces—excess capacity, national economic policies, and price cuts—have combined to slow growth. And this slower growth, in turn, is separating the weak from the strong—revealing clearly who is winning and why.

Key Success Factors in China's Challenging Market

Despite the manifest challenges posed by last year's painful market turn, some companies are succeeding.

Our observations of the industry, together with our firsthand work with OEMs in China, suggest that the winners are those that focus on four key success factors: developing cars Chinese consumers want, delivering a superior brand experience, creating capable dealer networks, and driving down costs.

Developing Cars Chinese Consumers Want. The real battle in China's car markets today is not among OEMs, or even among brands, but among individual models. Our analysis of new-vehicle launches shows a clear pattern: within each price segment, two to four models account for all the growth. So just a few models in each segment are winning at the expense of all the others. Why? Fundamentally, these models deliver a value proposition designed for the Chinese consumer.

Hitting the consumer's sweet spot is increasingly important because Chinese buyers are becoming more sophisticated. Even today, however, not all OEMs seem to understand this. We continue to see OEMs trying to sell cars in China that have been designed in Europe or the United States to meet the needs of European or American consumers. In such cars, for example, the rear seat and compartment have not been modified to account for the fact that many Chinese car owners do not drive themselves but employ drivers. Therefore, Chinese consumers place disproportionate value on features of the rear seating area—including leg room, head room, climate control, suspension, and the entertainment system—along with the fit and finish.

Equally important is attention to value. Chinese consumers' keen appreciation of good value has been reinforced by the ongoing price discounts. All the successful car models in China have one thing in common: a high performance-price ratio. For example, the soaring sales of Hyundai's Elantra in the mid-level segment can be explained by its strong performance-price ratio. At a Chinese premium of merely 2 percent over its U.S. price, Elantra stands out clearly against other brands, whose Chinese price premiums can be as high as 40 to 50 percent.

OEMs need to understand that it is no longer enough to bring models to China because they happen to be in their portfolios, or because they fit whatever platforms the OEMs are already making in China, or because they are successful in other markets. The bar has now been raised: vehicles for China must either start with the Chinese consumer or at least meticulously meet the Chinese consumer's needs.

Delivering a Superior Brand Experience. Chinese car buyers are becoming increasingly knowledgeable, sophisticated, and demanding. Information is widely available, and the media continue to devote extensive coverage to the automotive sector. Numerous rating organizations now also provide useful discussions of new models, including detailed comparisons of features. The proliferation of online auto-club communities has created further opportunities for car owners and potential car buyers to share driving experiences, bargaining tactics, maintenance tips, and perspectives on market trends.

As consumers become more sophisticated, automotive branding must advance to meet them. Already, the auto companies that are most adept at branding are taking a holistic approach, orchestrating activities along the entire purchase-ownership-repurchase continuum. While cars themselves remain at the core of the brand experience, the brand war is increasingly being fought in customers' pre-sales, sales, and after-sales experiences. Best practices include GM's offer to let customers trade in their existing cars for an Excelle; careful attention to functional and emotional messages, such as those used to market Honda's Fit—a name that refers to both "fitting into limited space" and "fit for a new generation"; and creative use of PR events such as Hyundai's nationwide name-the-car-in-Chinese competition for the Elantra.

Among the many models recently launched in the Chinese market, the most successful—including Corolla, Elantra, Excelle, and Fit—are clearly linked to strong value propositions. However, it is instructive to note that the customer service ratings of the respective OEMs, as measured by third parties, are also among the highest in the industry. Consumers are choosing good products, but those choices are profoundly influenced by their purchasing and service experiences. The superior brand experience is not just about innovative marketing campaigns. The key to cultivating customer loyalty—and withstanding price erosion in the long run—is providing a consistently superior brand experience throughout the customer's product-ownership life cycle.

Creating Capable Dealer Networks. In China today there is a significant difference between two kinds of dealers and their related service networks: on the one hand, high-performing dealers and networks focused on selling and providing service to individual consumers and, on the other, those stuck in the mindset of dealing with institutional buyers. What's more, the gap between the two groups is widening. The successes of GM, Honda, and Hyundai are closely related to the high quality of their sales and service networks.

Three recent changes have intensified the pressure on OEMs to upgrade their dealers' capabilities. First, the combination of slowing market growth and excess capacity has fundamentally transformed the Chinese auto market from a seller's to a buyer's market. Second, the market has shifted from cutting deals with institutional buyers to selling to individual consumers. And third, some OEMs have made sizable investments to develop their dealers' selling and customer-care skills and processes, whereas others have not. As a result, skillful selling and customer care are now more important than ever—but only a few OEMs have dealers that can deliver.

The differences between top-notch sales and service and mediocre performance in this area are apparent at each step in the selling process. Effective dealers start by drawing customers into the showroom through advertising, promotional events, customer loyalty programs, and lead-generation activities. Next, they provide a positive showroom experience that includes not only an attractive physical space and accessible information, but also positive interactions between customers and sales and service representatives. Effective dealers clearly communicate product and brand benefits—something many dealers in China simply do not know how to do. Moreover, having invested time and effort with customers, too many dealers fail to follow up with them, leaving many customers to drift away to competitors. Even dealers who successfully close sales often fail to use after-sales service as an opportunity to create loyalty and thus increase the probability that customers will repurchase the brand.

Driving Down Costs. As automobile prices continue to fall, it is critical for OEMs to build competitive cost positions. Key to this effort is reducing costs in the supply base.

Across China's automotive market, there are important differences among suppliers. For many components, China's lowest-cost suppliers already offer the lowest prices in the world—which is why OEMs such as Ford and GM have established major sourcing offices in China to buy parts for global assembly in the United States and Europe.

Despite the availability of low-cost parts, however, the cost of many vehicles produced in China remains stubbornly high. This is because many OEMs are still captive to certain suppliers with ties to their respective Chinese joint-venture partners and are not free to pursue lowest-cost sourcing. Also, some parts produced in China are high in cost or low in quality, while other parts simply are not yet available there. However, as the supply base develops, the cost, quality, and availability of components should improve. The key therefore is to continuously seek new competitive suppliers while investing to develop existing ones. OEMs that find, develop, and "lock in" the best suppliers will build increasing advantage.

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While China represents one of the world's largest automotive markets, conditions will remain challenging for at least the next several years. We anticipate that customers will become even more sophisticated, supply will continue to exceed demand, price pressure will ease but remain downward, and further rationalization will take place. These conditions will continue to reward companies that get the four key success factors right: building high-quality cars designed for China's consumers, delivering a positive brand experience, creating strong dealer networks, and driving down costs. The important thing is to get on with it before it's too late.

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