Auto industry competitiveness

Fat profits, fat failures

by G. E. Anderson

In January 2012, violent protests erupted at Changhe Automobile's factory in Jiangxi province. Two thousand workers downed tools and raised fists in an attempt to block plans by Chang'an Automotive, Changhe's much larger parent company, to move all production of Suzuki-branded cars from Jiangxi to its main car factory in Chongqing, 1,000 km away. The protest came just two years after the National Development and Reform Commission (NDRC) hailed Chang'an's acquisition of Changhe as a successful example of auto industry consolidation. Yet, rather than pressing for more consolidation, NDRC publicly supported the demands of Changhe's protesting workers, thereby forcing Chang'an to back away from its consolidation plans. For the government's economic planning body, saving local jobs and maintaining social stability trumped economic logic.

Chang'an's failure to consolidate production in Chongqing is one recent example of the problems that beset China's auto industry, which remains highly fragmented and inefficient. It also illustrates a much broader problem that affects competitiveness in all Chinese industries: conflicting central government objectives. State planners have long wanted to create a handful of national auto champions capable of competing with foreign giants like Volkswagen, GM and Honda—even Suzuki. Yet they have proved reluctant to force through necessary mergers to consolidate the industry, fearing the social unrest provoked by mass layoffs. In addition, the government's attempt to create a stable of national auto champions by marrying off the biggest state-owned players to foreign partners has spectacularly backfired. By failing to force through meaningful consolidation and allowing bloated SOEs to make easy profits, policy makers have ensured that the world's largest car market remains dominated by foreign brands.

Foreign invasion

China's top light vehicle brands (2011)*

		Sales, '000	Yoy change, %
1	Volkswagen	1,778	18
2	Toyota	848	5
3	Nissan	835	23
4	Hyundai	770	4
5	Buick	646	17
6	Chevrolet	618	13
7	Honda	593	-8
8	Chery	556	3
9	Kia	460	30
10	BYD	448	-14
11	Great Wall	365	24
12	Ford	323	6
13	Audi	306	29
14	Suzuki	302	6
15	FAW	274	-9
16	BMW	234	56
17	Citroen	231	3
18	Mazda	225	-10
19	Skoda	220	16
20	JAC	217	9

*Chinese brands in red.
Note: Geely sells cars under four different brand names. Together they would put Geely at ninth place, making it China's top private car-maker.
Source: LMC Automotive

Playing the numbers game

China's auto industry has been fragmented since the mid-1980s, when more than 100 companies had already begun to assemble vehicles. In 1988, state leaders agreed at their summer retreat in the northeast seaside resort of Beidaihe to consolidate the industry around three big state-owned enterprises (Shanghai Auto, First Auto Works, Dongfeng Motor) and three small state-owned enterprises (Beijing Auto, Guangzhou Auto, Tianjin Auto). The plan was known, imaginatively enough, as "big three, small three." With the exception of Dongfeng, all the companies had joint ventures with foreign automakers, from whom they hoped to copy technology. The idea was to create half a dozen competitive domestic brands that could eventually go head-to-head with the major global automakers.

China's auto history is littered with failed attempts to achieve consolidation

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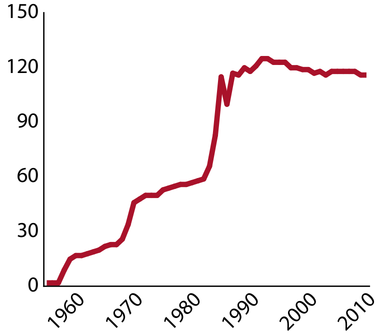
Unconsolidated

Number of vehicle assemblers in China



Source: China Automobile Industry Yearbooks

But the government did little to follow through on its rhetoric, and the industry remained as fragmented as ever.

Policies formulated in the 1990s were marginally more successful. The first comprehensive auto plan, introduced in 1994, announced a moratorium on the formation of new vehicle enterprises and raised the barriers to entry. The number of auto assemblers, which had already increased to 124, remained steady for a few years. But, to planners' dismay, the industry did not consolidate: not only were China's larger state-owned automakers uninterested in merging with each other, but for every small automaker that went out of business in the late 1990s and early 2000s, another new player would pop up to take its place. These newly formed automakers, some of them privately owned, were typically established under the radar of central planners, and often with the aid of local governments.

In the early 2000s, Beijing closed a loophole that had allowed ambitious upstarts to enter the industry through the back door—including two of China's biggest privately owned car makers, Geely and BYD. Geely, based in Zhejiang province, made an international splash in 2010 when it bought Volvo from Ford. But before turning to auto manufacturing in the late 1990s, Geely was better known for making refrigerators and motorcycles. It entered the car business by purchasing the auto production license of a bankrupt, prison-owned vehicle factory in Deyang, Sichuan. Similarly, BYD began life making batteries for laptops and mobile phones. It only started making cars in 2003, when it bought a bankrupt, state-owned auto factory in Xi'an. Today BYD is probably best known for convincing Warren Buffett that its electric-vehicle technology showed enough promise to merit a US$200m investment. Four years on, that investment has singularly failed to deliver.

The number of China's car makers has remained largely unchanged since the mid-1980s

The government's latest attempt to force through consolidation came in 2009, when it announced a new policy called "big four, small four." Under the plan, China's four largest automakers (Shanghai Auto, First Auto Works, Dongfeng Motor and Chang'an) would be encouraged to conduct nationwide mergers, and the four "small" automakers (Beijing Auto, Guangzhou Auto, Chery and Sinotruk) encouraged to conduct regional mergers. Since even the four "small" automakers are in China's top 10, the idea was to create eight heavyweight domestic car makers. Despite stating that mergers should be "market-driven," the plan also stipulated that automakers could not form new foreign joint ventures without first acquiring an existing domestic automaker. So far, there have been few specific government actions to bring about consolidation—and the market has largely failed to do Beijing's bidding. The overall number of car makers in China remains roughly at the same level as it was in the mid-1980s.

Fiat mergers

Yet a few substantial mergers did take place over the past decade, even as new private players continued to pop up. Most of them occurred with government involvement. In 2002, First Auto Works (FAW)—a stodgy central state-owned enterprise located in China's Manchurian rust belt—

bought the local state-owned Tianjin Xiali in what amounted to a rescue. Tianjin Xiali had relied for too long on outdated technology, yet it had a partnership with Toyota that made it attractive to FAW. Then, in 2007, Shanghai Auto (SAIC) and Nanjing Auto (NAC) were ordered by the central government to merge after they fought over the carcass of the UK's bankrupt MG Rover Group. SAIC wanted the parts of MG Rover owned by NAC, but it was uninterested in buying NAC itself. Beijing made sure it ended up with both.

Government-stipulated mergers have done nothing to make domestic car makers more efficient

In 2009, Guangzhou Auto bought Changfeng Auto, based in neighboring Hunan province in south-central China. According to industry insiders, the merger was "encouraged" by the central government as part of the requirement that Guangzhou Auto complete a domestic merger before forming a new joint venture with Italian carmaker Fiat. The government also required Changfeng to merge with a larger domestic partner before it could sell a new mid-sized sedan it had designed. Later that year, centrally owned Chang'an Auto, based in the smoggy Yangtze city of Chongqing,

Swallowing failure

Guangzhou Auto (GAC) was among China's earliest experimenters with foreign joint ventures. Its joint venture with Peugeot, launched in the 1980s, was a miserable failure. But GAC redeemed itself in the 1990s through successful partnerships with Japanese automakers Honda and Toyota. Keen to boost profits further, GAC pressed on with plans to form a new foreign partnership, eventually picking Italy's reinvigorated Fiat. Yet GAC ran up against an unexpected bureaucratic wall: regulators would only allow the joint venture if GAC first acquired Changfeng Auto, a failing domestic brand based in neighboring Hunan province.

The last thing GAC wanted was to absorb a provincial minnow. But under regulations introduced in 2009 to prod China's fragmented auto sector toward consolidation, it had little choice. Changfeng, controlled by Hunan's State-owned Assets Supervision and Administration Commission, was founded in 1950 to build vehicles for the People's Liberation Army. In the 1980s, it formed a partnership with Mitsubishi to produce four-wheel drive vehicles for civilians and a military version for the army. But by 2008, the joint venture was floundering: that year it sold just 13,000 Mitsubishi vehicles and 27,000 of its own-brand vehicles. Profits dived by 23%. Changfeng was on a trajectory that was likely to end in bankruptcy.

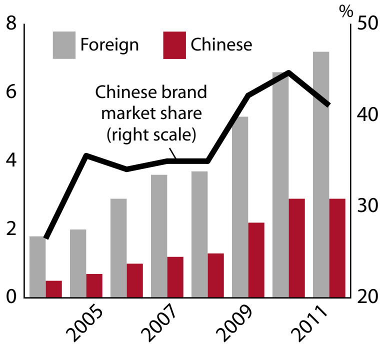
For its part, Changfeng believed it could turn its dire position around by offering a wider portfolio of models. It developed a mid-size sedan and sought permission from the central government to sell it in the domestic market. But when central regulators withheld their approval, Changfeng found that it had little choice but to accept the terms dictated to it in Beijing, which wanted to push the company into the arms of a larger firm. After a fairly extensive process of elimination that included discussions with at least nine different automakers (three of them foreign) Changfeng narrowed its discussions to two local state-owned companies—GAC and Beijing Auto (BAIC). In the end, central planners made the decision: Changfeng would merge with GAC.

The central government ultimately favored GAC over BAIC as a partner for Changfeng for two reasons. First, as two of the designated "small four" champions, policy makers had encouraged GAC and BAIC to conduct regional rather than national mergers. In this case, Changfeng's hometown of Changsha was much closer to Guangzhou than Beijing. Second, Guangzhou desperately wanted to gain permission to form its joint venture with Fiat, and was prepared to do almost anything to make that happen. The central government, spying an opportunity to enforce its new rule that all foreign joint ventures be preceded by a domestic merger, told GAC to begin talks with Changfeng.

This raises the question of whether approval for all future joint ventures will also depend on a prior domestic merger. Chery, a local state-owned automaker from Anhui province, recently agreed to form a partnership with Jaguar Land Rover, a stable of venerable UK brands now owned by Tata of India. Approval depends on a decision from Beijing. Will Chery also be forced to swallow a zombie enterprise as its price for future growth?

Puttering along

Passenger car sales by brand type, m units



Source: China Auto Blue Books, CAAM

bought the automotive-related subsidiaries of AVIC, China's centrally state-owned aircraft manufacturer. Included in this purchase were two assemblers, Hafei Auto of Heilongjiang and Jiangxi's Changhe Auto.

Despite planners' stated wish that consolidation should be "market-driven," none of these mergers involved the sort of corporate restructuring typical of genuinely commercial deals. For one thing, no assets were sold; for another, no workers were laid off. While staffing initially declined slightly at Tianjin Xiali, within two years the workforce exceeded its size at the time of the merger. The SAIC-NAC merger even included an explicit agreement that staff and operations in Nanjing would not decrease for at least three years. Chang'an may own Changhe, but the two companies essentially operate as separate entities. Consolidation in this sense has little to do with improving efficiency and everything to do with maintaining social stability. The government's policies have succeeded in creating bigger companies—but they are also flabbier, and not necessarily more competitive.

Consolidation, with Chinese characteristics

What these mergers show is that the central government is quite capable of forcing through mergers if it really wants to, but it is rarely willing to force enterprise or factory closures. And this explains why China is still home to 100 or so small, inefficient local producers. Local governments continue to prop up socially useful enterprises, even if they are barely profitable. Local and central government officials alike share the same primary concerns—to keep the economy running while also ensuring that social stability is maintained. In the auto industry, the 100-plus small automakers collectively employ over 200,000 people. This is not a great number by China's standards, but the figures are similar for any number of other industries. Add these together and you can begin to see why the central government is happy to put up with local industrial and corporate protectionism.

China's car industry is bifurcated between a few giants at the top and a fragmented multitude everywhere else

The result is a bifurcated auto industry that is increasingly consolidated at the top, but highly fragmented everywhere else. China's industrial policy has helped to create a number of genuinely large state-owned players, but has protected laggards from going under. China's top five automakers (72%) actually have a greater market share than the top five players in the United States (68%). But they also have many more, smaller competitors. Although central policy makers would prefer not to have so many inefficient players in the market, it essentially views their survival as a form of industrial welfare. This is not necessarily a bad arrangement, assuming that local governments can afford the misallocation of resources.

In fact, consolidation is not really the prime issue: much more important is Chinese auto brands' lack of competitiveness. Policy makers viewed greater consolidation as the first step to creating national champions with their own strong brands. But the impressive market share enjoyed today by China's Big Four automakers—SAIC, Dongfeng, FAW and Chang'an—is almost entirely based on building cars for foreign brands. SAIC, for example, has long dreamed of designing its own cars to compete with its partners, GM and Volkswagen. But its own-branded models, while improving in quality, have not sold well and are mainly derived from models SAIC acquired from MG Rover. Among the top-20 light vehicle brands sold in China in 2011, more than 80% were foreign. And by far the most popular domestic brands are built by private players such as Geely and BYD, not by the big state-owned champions backed by Beijing.

Four fat mosquitoes

The crux of the problem is that the Big Four state-owned automakers are effectively living off the easy earnings of their joint-venture partners. They benefit from their partners' technology and know-how, which allows them to spend less on R&D than they would need to if they had no foreign partners. And since Chinese consumers still overwhelmingly favor foreign brands, the Big Four have been reluctant to invest heavily in their own brands. For Chang'an, it is much easier to get rich quick selling Fords than it is to spend years and billions of dollars hoping to beat Ford at its own game. This is why foreign brands continue to dominate China's passenger car market. China's Big Four may assemble most of the cars on China's roads, but they are not competitive in their own right.

The Big Four state-owned automakers live off the easy earnings of their joint-venture partners

Far more impressive are the smaller, often privately owned, automakers who have found success through hard work (and, admittedly on occasions, some brazen copying). Geely, BYD and Great Wall all rank in China's top dozen car companies. Until recently, these nimbler, more entrepreneurial companies had not benefited from partnerships with foreign heavyweights; instead they had to develop their own brands and technology. And while Chinese consumers still consider domestic brands to be inferior to foreign brands, surveys by auto analysts at JD Power indicate that private Chinese automakers are quietly closing the gap in terms of real quality. Yet these genuine home-grown champions will struggle to win over more consumers so long as the government continues to favor the Big Four, whose own profits depend on supporting the continued dominance of foreign brands.