

strategy&

Formerly Booz & Company

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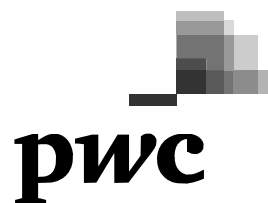
Detroit, MI

Autofacts

China's Economy and Automotive Market



Industry Outlook Seminar



The latest headlines about China's economy and equity markets have been overwhelmingly negative

The Economist

World politics

Business & finance

THE WALL STREET JOURNAL. | OPINION

The Twilight of China's Communist Party

President Xi Jinping may be gathering unprecedented power in China—but perhaps it is more the flaring of a candle before it gutters.

Open the door to green

China's stockmarket crashes—again

ESSAY

The End of China's Economic Miracle?

Debt and corruption are hobbling the Asian giant.

Harvard Business Review

FINANCIAL MARKETS

Why China's Market Crash Is So Unsurprising

by Linda Yueh

JANUARY 12, 2016

China stock trading abruptly halted after 7% plunge



In reality, China's equity markets are largely disconnected from the real economy and a poor leading indicator

China's Stock Market and the Rise of the “Pyjama Traders”

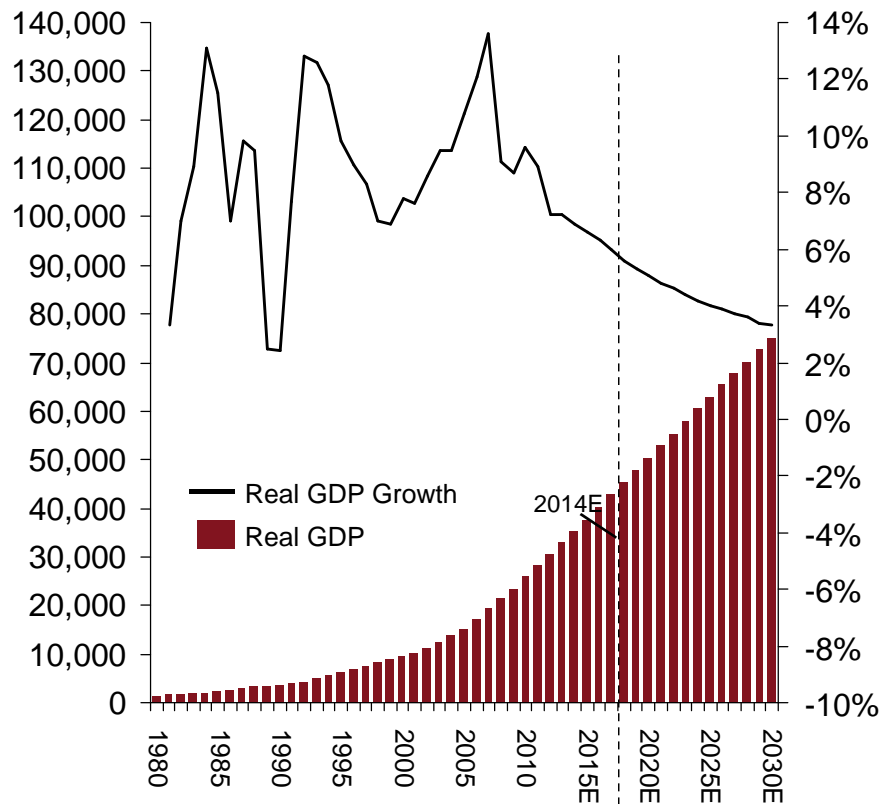


- Total market value represents only ~40% of GDP
- Individual retail investors account for as much as 90% of daily transactions
- Traded stocks are heavily skewed towards the manufacturing and construction industries
- Chinese firms rely far more on the banking system to raise capital

Source: “What Really Ails China’s Economy”, Jullens, Strategy+Business, Jan 2016, BBC News

Nevertheless, all is obviously not well, as China faces significant economic, social, and political challenges

Chinese Real GDP, 1980 – 2030E, RMB, bn

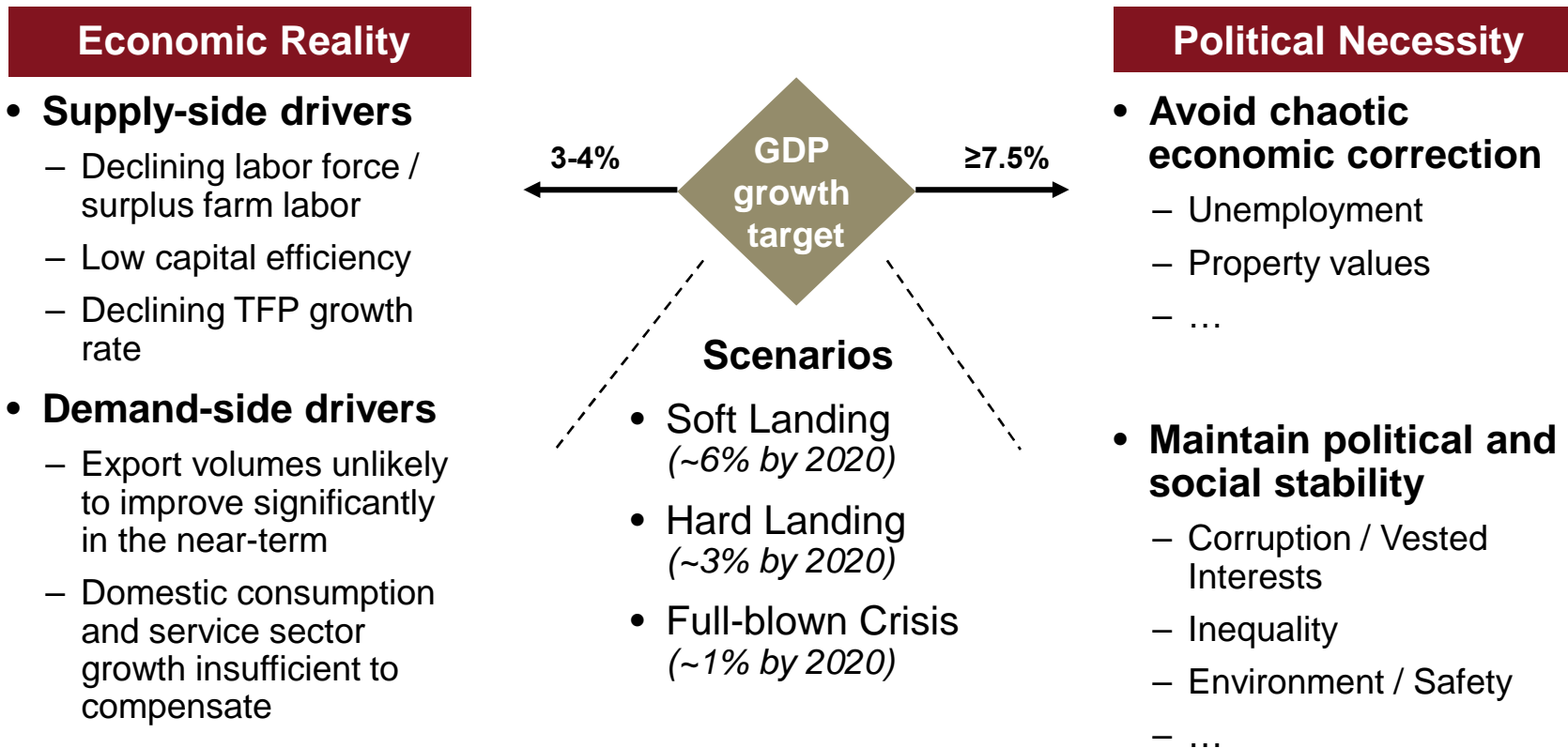


Source: The Economist Intelligence Unit, Strategy& analysis

Major Challenges

- **Economic**
 - Potential GDP growth rate declining
 - Increasing structural imbalance
 - Slow recovery elsewhere (e.g., EU)
- **Social**
 - Rising inequality (Gini coefficient)
 - Pollution / Environmental degradation
 - Safety issues (e.g., food)
- **Political**
 - Endemic corruption at all levels
 - Domestic unrest (e.g., HK, Xinjiang, Tibet)
 - Geopolitical tensions (e.g., Taiwan, Senkaku / Diaoyu islands, South China Sea)

Beijing's dilemma is how to balance the political necessity of high growth with the economic reality of low(er) growth



Source: "Will China's New Leaders Step Up to the Plate?", Jullens, Strategy+Business, Nov 2013
"Avoiding the Blind Alley" – Rosen, Asia Society Policy Institute / Rhodium Group, Oct 2014

In truth, there is little consensus on how to best solve these economic and political challenges – even in China itself

Schools of Thought Within the Chinese Elite

Economics

New Left - challenge neoliberal economics and call for a return of the state (e.g., Cui Zhiyuan)

vs.

New Right - Pioneered gradualist reforms of the '80s and '90s and favor restarting pro-market reforms (e.g., Justin Yifu Lin)

Politics

Neocons - Feel that limiting the state leads to collective government, unable to take tough decisions or challenge vested interests (e.g., Pan Wei)

vs.

Liberals - Want to place limits on the power of the state, either through elections, the rule of law, or public participation (e.g., Sun Liping)

Foreign Policy

Internationalists - Want China to merely play a role in existing global institutions and emphasize prudence (e.g., Wang Yizhou)

vs.

Nationalists - Want China to (re-)assert itself on the global stage (e.g., Yan Xuetong)

Source: "What Does the New China Think?", Leonard, ECFR Policy Report, Nov 2012

Ultimately, much will ride on the political courage and business acumen of President Xi Jinping himself



Source: "Will China's New Leaders Step Up to the Plate?", Jullens, *Strategy+Business*, Nov 2013

Either way, MNCs will face a much more challenging environment – for many, the easy phase is mostly over

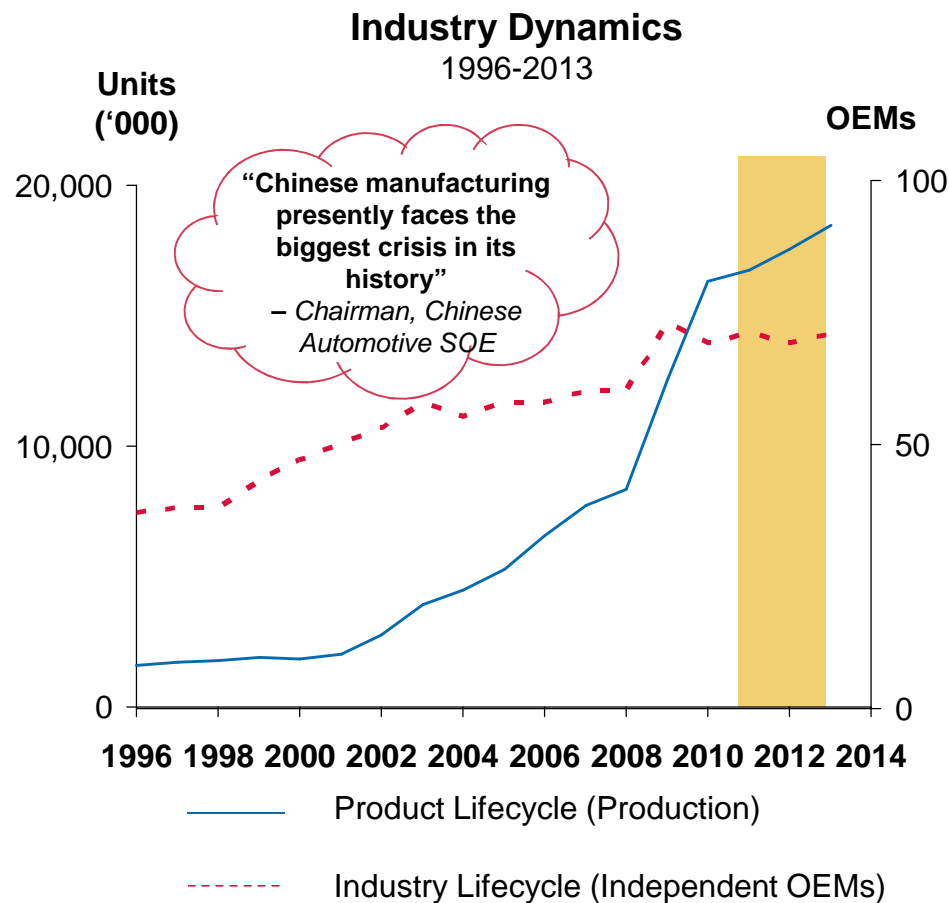
Reform Impact

- **Slower growth**
 - Greater competitive intensity among both foreign and domestic firms
 - More heterogeneous customer demand
 - Significant supply-side cost pressure and resulting need to improve productivity and efficiency levels
 - Lower demand for natural resources from other countries (e.g., Australia, Brazil, Russia)
- **Closer scrutiny**
 - Much tighter operational control in response to anti-corruption, anti-monopoly, and other government initiatives
- **New opportunities**
 - Financial services
 - Green technology
 - ...

Other Trends

- **Shifting demographics**
 - China's population is aging; under-40 segment is shrinking
 - New growth opportunities to serve the unique needs of older consumers
 - However, much tougher competitive dynamics in under-forty consumer segment, including head-to-head competition and price/margin pressure
 - Need for domestic and foreign firms to optimize operations and re-think strategy and investment plans
- **New technologies**
 - China is at the cutting edge of the digital era with the largest online population
 - Digitization helps increase connectivity between urban and rural markets with exponential growth of consumer choice
 - Foreign multinationals not necessarily advantaged

At the same time, the Chinese automotive industry has arrived at a similar inflection point in its development



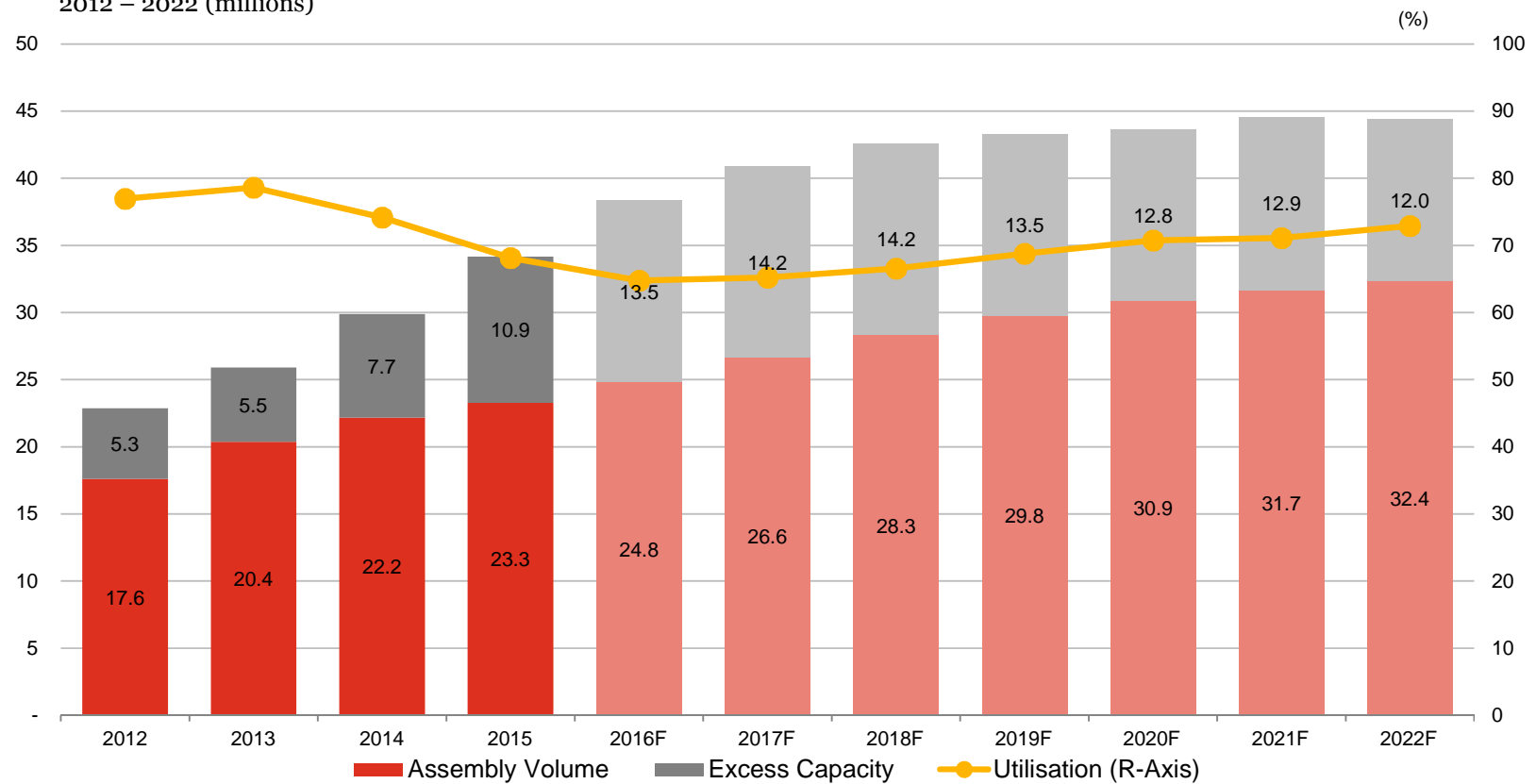
Major Trends

- The product and industry lifecycles are decoupling
 - High levels of overcapacity
 - Price and margin pressure

- Industry and competitive dynamics are evolving
 - Repeat vs first-time buyers
 - Emergence of used vehicle segment and independent aftermarket
 - Greater acceptance of lease/finance products

Nevertheless, China remains on track to reach annual volumes in excess of 30 million units by 2020

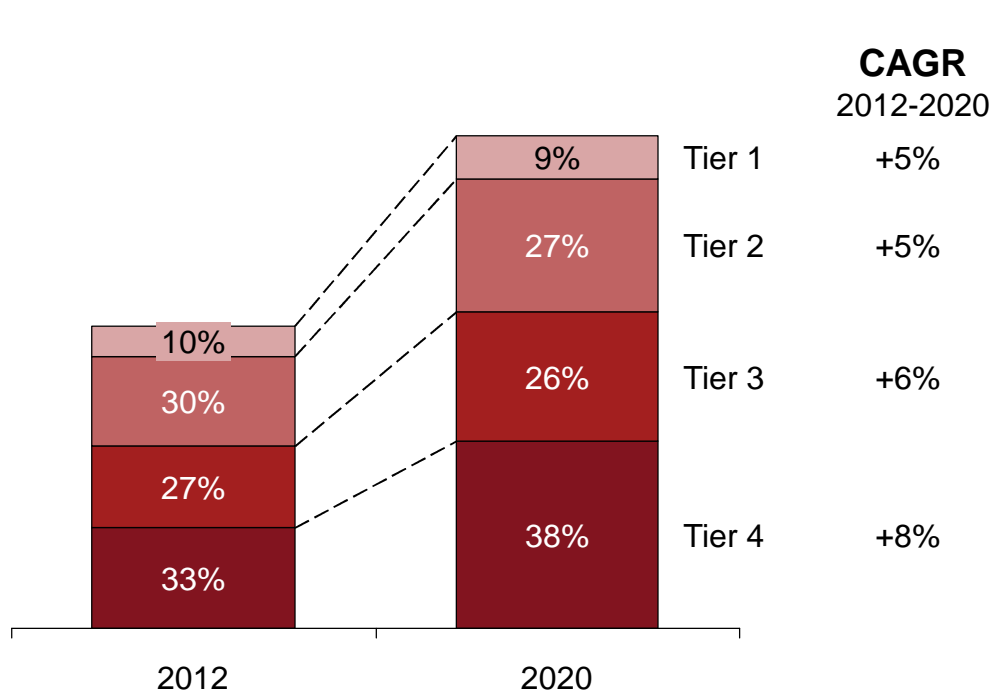
China: Light Vehicle Assembly
2012 – 2022 (millions)



Source: Autofacts 2016 Q2 Forecast Release

For example, the emerging budget segment represents a major volume opportunity in China's lower tier cities

Total Budget Segment
Breakdown by city tier (conservative case)



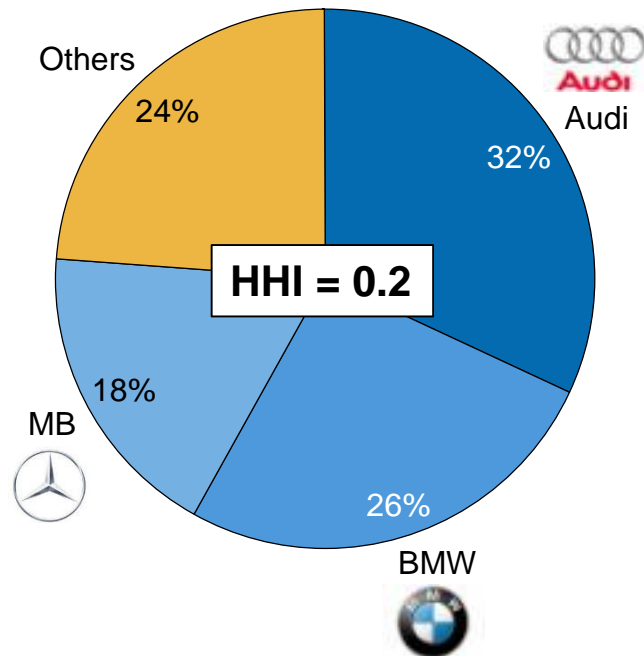
Primary Growth Drivers

- Lower Tier/ inland consumers crossing the mobility threshold
- Continued urbanization / lifestyle changes
- Improved rural infrastructure

Source: WebMIS, Policy registration data, PwC Strategy& analysis
Strategy&

Similarly, China's premium segment still offers significant growth potential despite the dominance of the German 3

Chinese Luxury Car Market
(Market Share, Unit Sales, 2012)



- **Changing customer preferences**
 - From back seat to front seat drivers
 - Younger and more demanding customers
 - Low loyalty levels to existing brands
- **Changing market dynamics**
 - Shift from C/D sedans to SUVs and smaller cars
 - Repeat purchasers vs. first-time buyers
 - Emerging used vehicle market and potentially lease/finance
- **Leading competitors vulnerable**
 - Audi ubiquitous and associated with government officials
 - BMW too polarizing
 - MB trying to recover share
 - Lexus and Infinity still struggling

The major challenge in the volume segment is that the underlying business model itself will need to change

TODAY

Hunter-Gatherer Business Model

- Distribute new cars

Basic OEM/Dealer Capabilities

TOMORROW

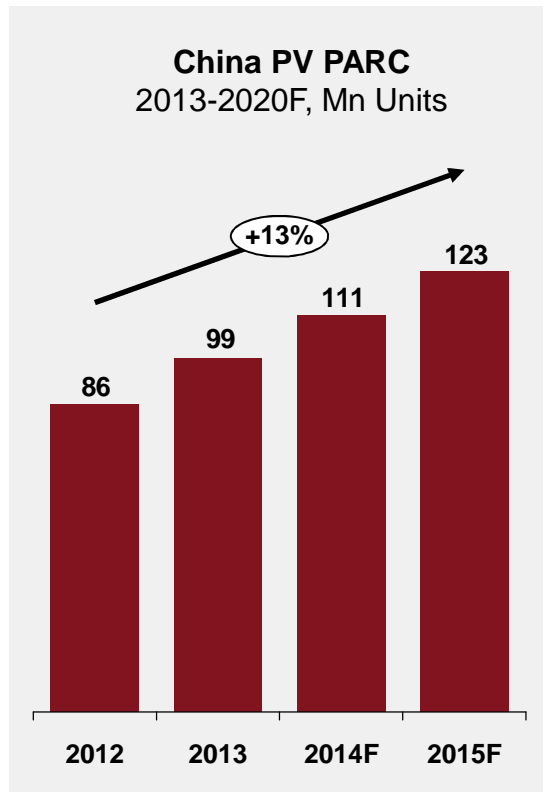
Seed-Harvest Business Model

- Market and sell new cars
- +
• Cross-sell complementary products
- +
• Sell trade-ins used vehicles
- +
• Sell aftermarket parts and services

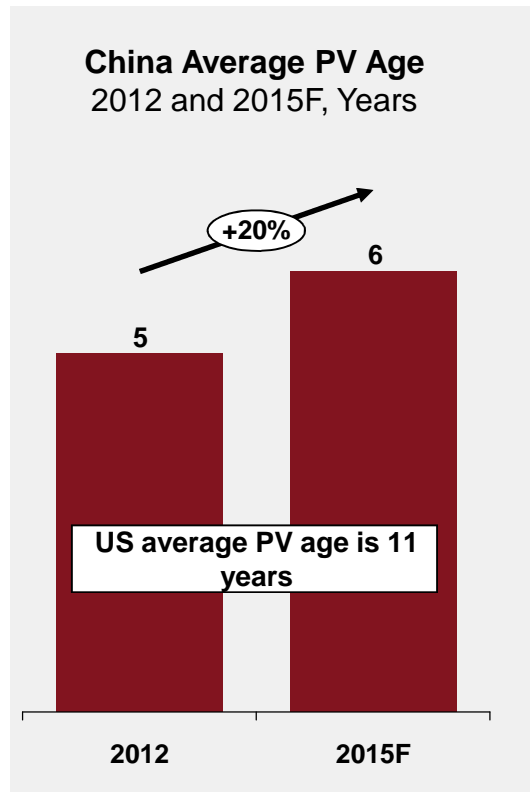
Advanced OEM/Dealer Capabilities

For example, as China's automotive industry matures, the used car and independent aftermarket are gaining share

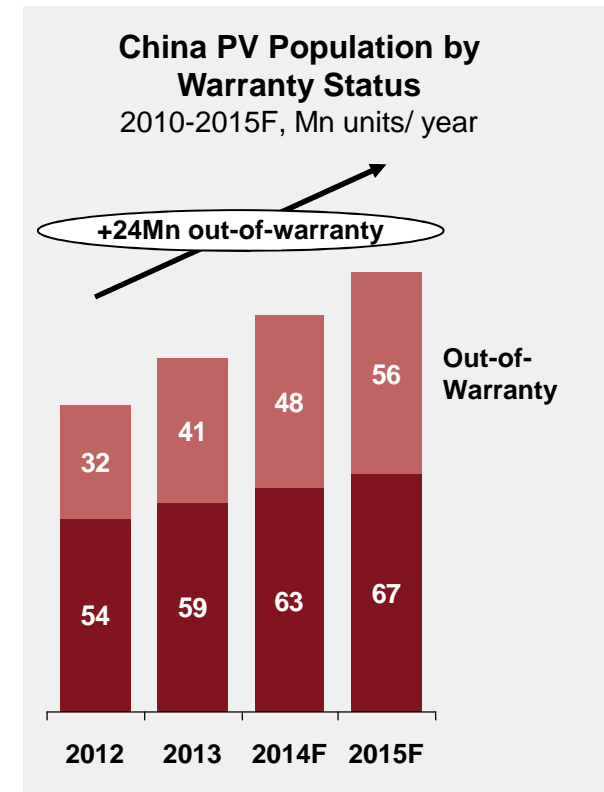
China's PARC is expected to exceed 120Mn in 2015...



.. while vehicle population is expected to age...



... leading to an increase in of out-of-warranty vehicles

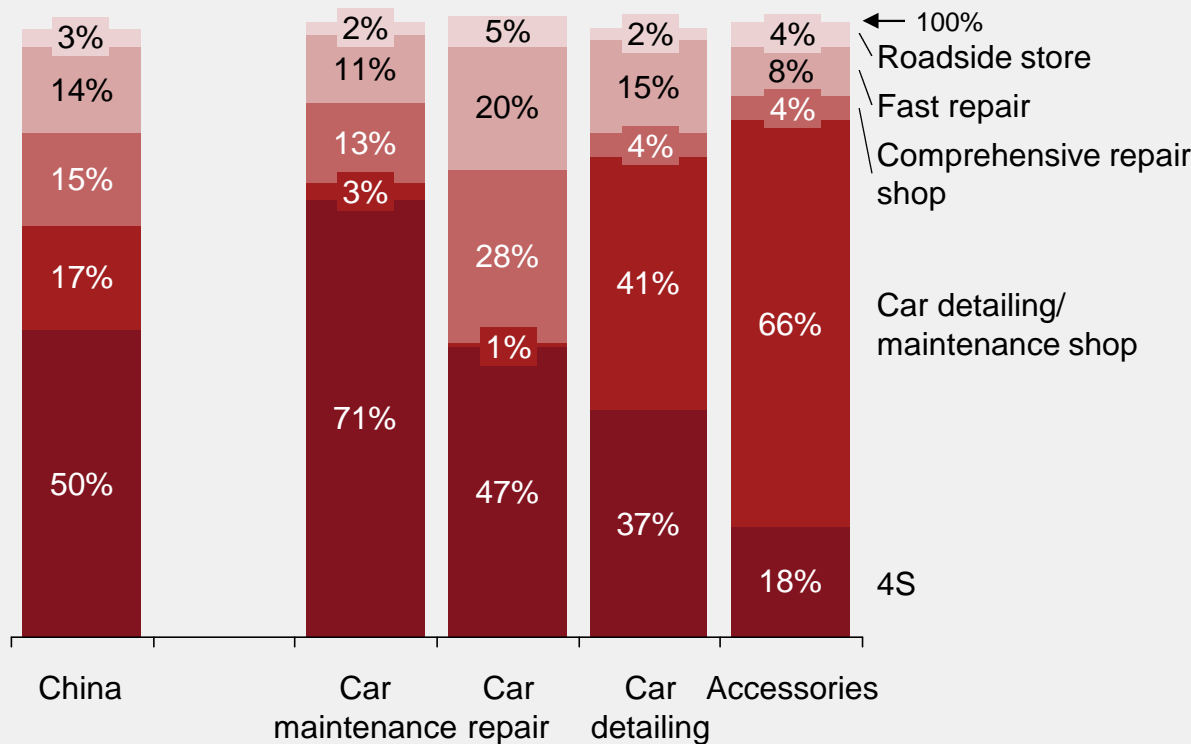


Source: JD Power, PwC Research Literature Research, PwC Strategy& Analysis

As a result, customers are increasingly migrating from the traditional OEM 4S stores to independent channels

China Aftermarket Channel Preference of Car Owners

2011, by Repair Type



While most car owners prefer to use 4S outlets for maintenance, there is a shift in preference towards independent centers for car repairs. As such aftermarket products offered through different channels should reflect the purchasing criteria of the car owners

Source: PwC Strategy& Analysis

In this context, OEMs and their suppliers have to navigate a wide range of strategic challenges over the next few years

PwC Strategy& - Recent Automotive Assignments in China (sample)

- 1** R&D / Product Development
 - New product development and localization strategy
 - Low-cost car strategy
 - Alternative fuels and powertrains
- 2** SCM / Manufacturing
 - Factory productivity improvement and quality management
 - Core process benchmarking (versus Toyota Production System)
 - Optimal manufacturing / logistics footprint
- 3** Marketing & Sales
 - New customer acquisition and loyalty programs (capabilities-driven approach)
 - Optimal dealer network footprint, configuration, and process management
 - Marketing innovation to retain industry leadership position
- 4** Strategy
 - China growth strategy (OEMs, Suppliers)
 - Premium brand upgrade strategy (OEM) / Multi-brand management (OEM)
 - Car sharing growth strategy (OEM) / Rental car growth Strategy
 - JV/Alliance Management (OEM, Supplier)

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Relevant Publications

Harvard Business Review

- *“How Emerging Giants Can Take on the World”*-- Harvard Business Review, Dec 2013
- *“Is China the World’s Next Rust Belt?”* -- Harvard Business Review China, Apr 2013

CEIBS Business Review

- *“Choose Your Capability Path”* -- CEIBS Business Review, Mar 2014
- *“Modern Zorro is Out”* - CEIBS Business Review, Feb 2014

Strategy+Business

- *“It’s No More BRICs as Usual”* – Strategy+Business, Mar 2016
- *“What Really Ails China’s Economy”* – Strategy+Business, Jan 2016
- *“Why China’s Stock Market Crisis Spread”* – Nov 2015
- *It’s a Race to the Bottom in China’s Auto Market’* – Strategy+Business, Sep 2014
- *“China’s Mid-Market: Where “Good Enough” Just Isn’t”*– Strategy+Business, Jul 2013