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AUTOMOTIVE

Overcapacity: A Potential 'Speed Bump' in the World's Largest Automotive Market

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Introduction

China continues to maintain its position as the world's largest producer and consumer of automobiles. As a result, most global automakers have increasingly focused their businesses and expansion plans on this exciting market. For example, China now represents around 30 percent of Volkswagen's global sales, a significant number.¹

However, the automotive industry in China is now reaching a critical juncture, with overcapacity emerging as one of the greatest development risks it faces. KPMG's recent Global Automotive Executive Survey 2012, which interviewed over 200 senior executives from the world's leading automotive companies, found that 68.5 percent of survey participants believe that China will build up the most capacity by 2016.

The survey also found that China was already estimated to have 6 million units of unutilised capacity, as at the end of 2011. This is twice the size of the current car market in Germany. Moreover, this figure is expected to rise to more than 9 million units by the end of 2016. Based on estimates made in the survey, this may be up to 35 percent more manufacturing capacity than the Chinese market can actually absorb.

This dynamic represents a significant risk to the automotive industry in China and is one which automakers should take seriously as they formulate and launch their capacity expansion plans. Considering the striking contrast between the recent 'glitzy' Beijing Auto Show and the reality of weakening sales growth over the last 12-15 months, our concern is that structural overcapacity is not getting enough priority in the minds of policy makers and industry executives.

Similarly, many automakers appear to be engaged in a head-long rush to expand in China, and competition is certain to intensify. Already, there are more than 90 brands and 475 models present in the China market² — and as the Beijing Auto Show demonstrated, more are on the way!

¹ <http://www.bloomberg.com/news/2012-01-13/vw-s-2011-china-h-k-sales-rise-18-to-record.html>

² JD Power & Associates, Presentation to Automotive News Conference, Beijing, April 2012



The overcapacity issue



Industry structure

The automobile industry in China is largely decentralised and features OEMs with a diverse range of manufacturing capacities and capabilities. There are over 130 automakers in the country, the highest number in any auto producing nation. However, 87 percent of sales in 2011 was contributed by the top 10 large original equipment manufacturers (OEMs), while the remaining 13 percent was shared by more than 100 small, local OEMs.³

These small automakers generally have limited capabilities, deploying outdated technologies and facing numerous quality challenges. As a result, they tend to focus on bottom-tier markets. This means that, typically, sales volumes and profitability are extremely low.

Ambitious outlook based on China's 12th Five-Year Plan

According to auto industry statistics originally quoted in the 12th Five-Year Plan, it was estimated that manufacturing capacity would exceed 37 million vehicles by the end of 2015. At the time, planned capacity amongst the major OEMs added up to around 31 million vehicles. In 2011, however, a number of large OEMs increased their planned capacity targets for 2015: SAIC - 6 million units; FAW, Dongfeng Motor and Chang'an Automobile - 5 million units each; BAIC - 3.5 million units; GAIC - 3 million units; Chery and Great Wall - 2 million units each; and, 1.5 million units each for Brilliance and JAC.⁴

Such increases, together with the plans announced by second-tier automakers, mean that it is probable that the total manufacturing capacity could actually exceed the 12th Five-Year Plan figure, and even top 40 million units by 2015, which would be more than double the total sales volume in 2011.⁵

Additionally, whilst OEM plans grew more and more aggressive, auto sales growth rates slowed. According to statistics released by the China Association of Automobile Manufacturers (CAAM), production and sales volumes in 2011 were actually 18.4 million vehicles and 18.5 million vehicles respectively — increases of just 0.84 percent and 2.45 percent, the lowest for 13 years.⁶ The sales growth surge

³ China Daily (03/01/2012) & China Association of Automobile Manufacturers (CAAM) (12/01/2012)
⁴ 中国新闻网 <http://news.China.com.cn> (18/05/2011)
⁵ 中国新闻网 <http://news.China.com.cn> (18/05/2011)
⁶ China Association of Automobile Manufacturers (CAAM) (12/01/2012)



of prior years looked to be over, and sales volumes in the first three months of 2012 actually declined by 3.4 percent compared to 2011, according to the CAAM.

In recent weeks, forecasters have been revising their forward projections for the auto industry downwards, and most now believe that growth in 2012 will be in the high single-digits. Double-digit growth rates were always going to be difficult to maintain given the increasing size of the China sales base. The problem is that such double-digit growth would seem to be required to sustain the OEMs' planned capacity increases. A certain level of overcapacity is always needed to maintain manufacturing flexibility, but China's overcapacity position does seem to be getting well beyond this level (which would usually be around 15 percent).

The good news, however, is that from a macro perspective, car penetration rates are still very low in China (around 65 cars per thousand people, compared to more than 850 per thousand in the United States and 454 per thousand in Japan). This is why China remains such an attractive proposition.

The emergence of new technologies

In recent years, the Chinese government, through the provision of various incentives, has encouraged automakers and local governments to develop new-energy vehicles (NEVs), especially electric vehicles (EVs). This has driven OEMs to build specific, NEV-orientated manufacturing capacity. According to targets originally outlined in the 12th Five-Year Plan, the production and sales volumes of NEVs should exceed 1 million units by 2015. However, statistics show that local governments and OEMs have targeted the installation of up to 5.5 million units of capacity within this time frame, far exceeding both current production and sales volumes and the 12th Five-Year Plan target.

Whilst government policy has recently been re-stated to create less emphasis on EVs and allow for more attention to be devoted towards hybrids and plug-in hybrid EVs (PHEVs) in the short to medium term, the fact remains that the number of NEVs produced and sold in China last year was less than 10,000 units. At this stage, there is limited market demand, infrastructure support and consumer acceptance for NEVs. Large-scale investment in building production capacity seems like a potential waste of resources and money.

“ SUVs and luxury cars were a prominent feature at the Beijing Auto Show, with almost every carmaker trying to capitalise on the booming demand for vehicles in these segments. ”

Even more ambitious plans ...

Although manufacturing overcapacity has become increasingly apparent, and the Chinese government, industry experts and analysts have all warned automakers of a potential problem, capacity expansions by OEMs continue. In recent months, the industry has seen the following announcements:

- DFAC Nissan, GAIC Honda and GAIC Toyota, the top three OEMs in Guangzhou, will expand their manufacturing capacity this year and total manufacturing capacity will rise by 45 percent to 2.12 million vehicles by 2015.⁷
- The third phase of FAW Volkswagen's Chengdu plant, as well as its fourth plant in Foshan, will be ready for use in 2013. This will increase its total manufacturing capacity to 1.65 million vehicles. Volkswagen Group will also embark on a China-driven, USD18.2 billion global investment plan, aiming to expand capacity and increase its production of new models between 2012 and 2016.⁸
- FAW's plant in Tianjin will be on line in 2014, doubling its current manufacturing capacity of 0.75 million vehicles in Tianjin to 1.5 million vehicles by 2015.⁹
- Beijing Hyundai's third plant will be completed this year, increasing the automaker's total manufacturing capacity to 1 million vehicles.¹⁰
- The second phase of SGMW's OEM plant was completed at the end of last year, increasing its total manufacturing capacity to 1.21 million vehicles.¹¹
- The second plant of Chang'an Ford Mazda, with a capital injection of USD 490 million, will soon be ready for use, increasing the manufacturing capacity of Mazda to 0.6 million vehicles.¹²
- Ford Motor Group will undertake a USD 600 million expansion of its Chongqing Assembly Plant, raising annual capacity by 350,000 vehicles, and also plans to build a USD 760 million assembly plant in Hangzhou with an annual capacity of 250,000 vehicles.¹³

⁷ Special Commissioner's office in Guangzhou of Ministry of Commerce (16/02/2012)

⁸ China Business Times 中华工商时报 (22/01/2012) & Nanfang Daily 南方日报 (21/10/2011)

⁹ Xinhua news (27/02/2012)

¹⁰ Xinhua news (19/10/2011)

¹¹ Xinhua news (03/11/2011)

¹² Xinhua news (28/02/2012)

¹³ Ford news release (05/04/2012) & China Automotive Information Net (20/04/2012)

It seems that even in an environment of reduced sales growth, and despite potentially challenging issues on the horizon, almost every OEM is betting on itself to be a winner.

The Beijing Auto Show - more players and more competition on the way

The Beijing Auto Show, held in April 2012, clearly showcased an expression of confidence in the Chinese auto market, despite the recent slowdown in growth. Almost every major foreign automaker presented their newest vehicles at the show, highlighting the central place China occupies in their global strategies. Volkswagen filled almost a third of the floor space, reflecting its huge investment in Chinese joint ventures (seven existing plants, with three more in development).

Other foreign players also used the show to help launch capacity expansions in China. Ford, which has joint ventures with JAC, Mazda and China's Chang'an Group, exhibited several new vehicles, and Fiat showcased the Viaggio, the first model produced by its joint venture with Guangzhou Automobile Group.

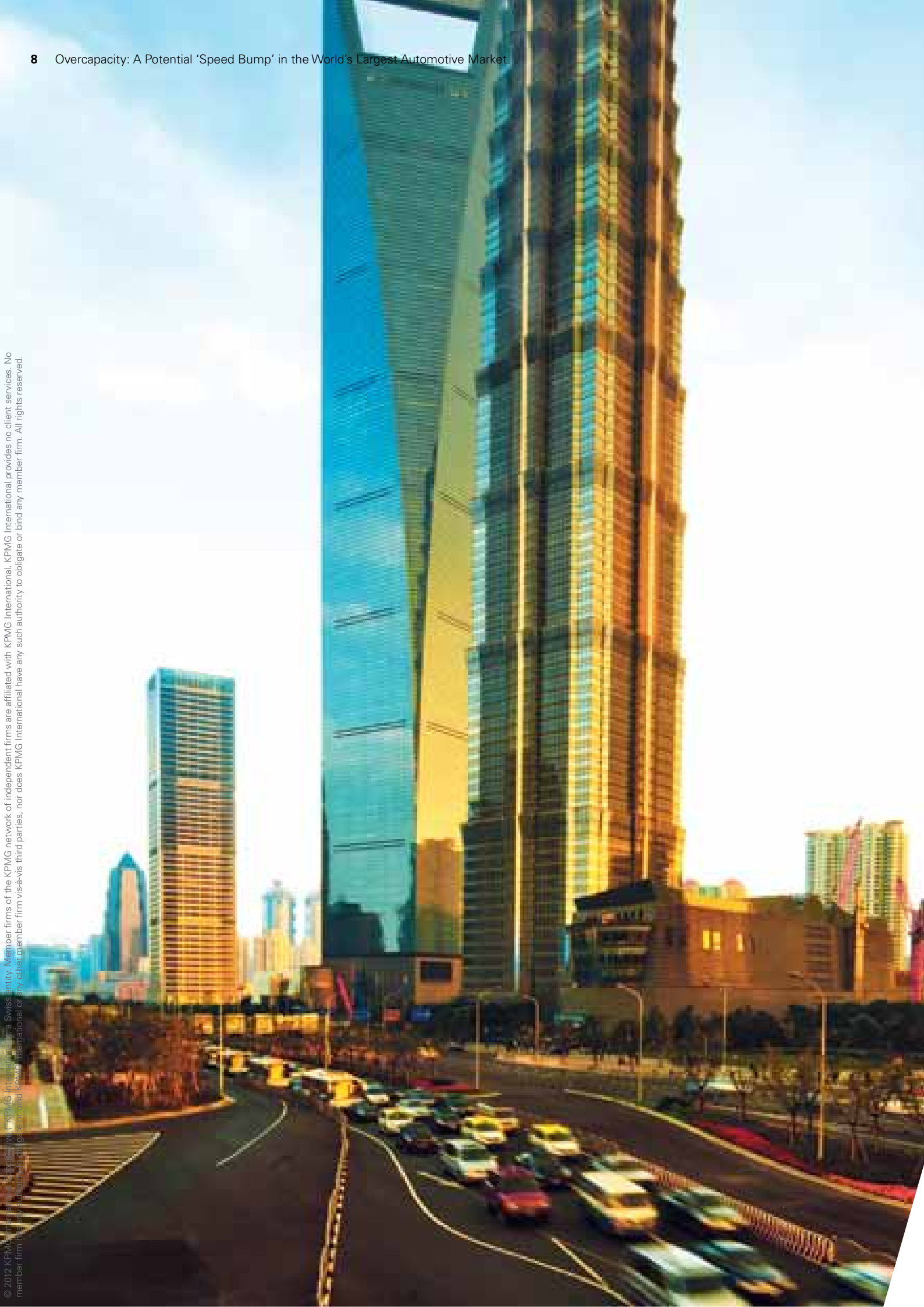
The large range of Chinese cars that were on show suggests that China's domestic car industry is responding to its recent difficulties. Faced with declining sales and strong foreign competition, many Chinese carmakers are making concerted efforts to adjust their strategies and improve quality.

Chery showcased 20 models at the show, including innovative concept models and SUVs, while BAIC introduced a mid-sized sedan from its wholly-owned Beijing brand. Chinese brands are likely to continue expanding aggressively over the next few years.

The show also provided other reasons for optimism for automakers and industry stakeholders alike. SUVs and luxury cars were a prominent feature at the Beijing Auto Show, with almost every carmaker trying to capitalise on the booming demand for vehicles in these segments. According to the CAAM, for example, SUV sales in China totalled almost 1.6 million units in 2011, a 20 percent increase over 2010.¹⁴ The Chinese government's focus on NEVs was also apparent, with around 88 NEV models on display. Toyota and Honda are the leading players in the NEV field, but a number of domestic car makers, including SAIC and BYD, displayed both pure electric and hybrid vehicles.

¹⁴ China Association of Automobile Manufacturers (CAAM) (12/01/2012)





However, one size does not fit all ...

A closer look at China's auto industry players suggests that overcapacity is not necessarily an industry-wide problem. Large Western OEMs, such as VW and GM, as well as luxury carmakers, including BMW and Mercedes-Benz, are in a much better position to expand production levels and have considerable room for growth. Furthermore, the urgency of the issue varies across different vehicle segments. While sales of small cars may be declining, the market for SUVs, NEVs and other innovative models is robust. This suggests considerable diversity in the market — while for some sectors capacity building may bring considerable benefits, for others it could lead to serious trouble.

Based on an analysis of annual sales rankings and the development of OEM capabilities in China, we conclude that overcapacity in China is a complex matter - 'ineffective' capacity may well be too high, while 'effective' capacity may be just sufficient, or even under-developed.

For OEMs producing top-selling models, demand is high and extra production is needed to meet market requirements. Insufficient capacity may be a development bottleneck for these OEMs. Conversely, the ineffective capacity of the hundreds of mid or small-scale automakers crowding the market contributes disproportionately to the overall manufacturing overcapacity problem in the Chinese automotive industry.

The role of local governments in China

Ineffective capacity is sometimes defended by local governments, usually to ensure ambitious targets are met, or to protect fiscal and tax interests. GDP is one of the key performance indices for measuring the achievements of local governments. As large automobile groups contribute significantly to local GDP growth and employment, local governments tend to support their expansion. Moreover, the OEMs contribute significant tax income to local governments.

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Responding to overcapacity – government policy measures



Policy on capacity expansion

While discussing government priorities at the recent National People's Congress and Chinese People's Political Consultative Conference (NPC & CPPCC), China's policy makers pointed out that industries facing overcapacity, such as automotive, iron and steel, shipbuilding and cement, should address the problem by focusing on better inventory management, production optimisation, reducing industry fragmentation (via mergers and acquisitions) and creating economies of scale.

Overcapacity was the main reason why the automotive industry was identified as an industry requiring reform.

It is expected that, in future, the entry threshold for automobile production in China will be raised. As any policy measures aimed at curbing production capacity are implemented, global automakers 'waiting at the gate' to enter the Chinese market may find it hard to set up production, while those who have already crossed the threshold, but are still waiting for joint-venture approval, will most likely also be subject to additional scrutiny and the need to get over a higher 'investment bar'.

Restraining foreign investment in OEMs

Approved by the State Council, the Catalogue for the Guidance of Foreign Investment Industries (Amended in 2011) (the 'New Catalogue') issued by the State Development and Reform Commission and the Ministry of Commerce, took effect on 30 January 2011. The New Catalogue re-classified automotive OEMs from the 'encouraged' to the 'allowed' category, and upgraded key components for NEVs to the 'encouraged' category.

The State Development and Reform Commission pointed out that the changes were necessary for the development of China's automobile industry, re-directing foreign investment towards manufacturing and R&D for new technologies, rather than tightening the rules regarding foreign investment across the entire automotive industry.

Foreign automakers, such as GM, Volkswagen and Ford, have stated that their current investments will not be seriously affected by these policies. However, the



termination of preferential tax rates, which have applied for seven years, means that foreign investors who have not yet entered the Chinese market can no longer rely on previously applied investment models. What they now need to consider is how to introduce their R&D capabilities and advanced technologies into China.

Discontinuation of incentives and allowances for car purchases

To soften the impact of the 2008/2009 global financial crisis, the Chinese government launched a series of incentive programs, such as a purchase allowance for rural consumers, a trade-in allowance, and a preferential purchase tax on low emission vehicles.¹⁵ These three measures stimulated car sales very effectively, but the termination of the initiative at the end of 2010 had a strong negative impact on the industry in 2011. Policymakers said that unchecked growth was leading to overheating. As a result, the Chinese government decided against continuing with the incentives, stressing that future vehicle purchase allowances would only be granted in fields related to energy conservation and environmental protection.

In addition to scrapping the incentives, passenger vehicle purchases were further cut back in 2011 through the restriction of new vehicle registrations in some cities. The total number of vehicle registrations issued in Beijing last year was set at 0.24 million, with allocations being decided by lottery. In July 2011, Guiyang, the capital city of Guizhou province in western China, also introduced the lottery system for allocating vehicle registrations. Some have suggested that this system may be applied nationwide in due course.

Growth and flexibility

Vehicle penetration rates per capita in China remain well below global levels and there is still considerable potential for strong, long-term demand in the automotive market. Tier 2 and tier 3 cities, central and western China and rural areas are all 'hotspots' for increased domestic consumption, due to rapid urbanisation and growing demand.

We also note that some segments and OEMs are likely to perform better than others, as consumer tastes change, brand perceptions develop and vehicle quality and functionality is improved (by some automakers, but maybe not by others). Our conclusion is that it is beneficial for automakers to maintain a 15 percent surplus capacity to deal with market volatility and development. However, large-scale total overcapacity still has real potential to harm the development of the auto industry.

¹⁵ Xinhua news (24/12/2010)

Joint efforts are needed to address overcapacity issues



Encouraging a mature market

By setting fixed targets and tasks for automakers, local governments often act as an 'invisible hand', pushing a boom in manufacturing capacity. However, the automakers themselves usually have a better understanding of capacity requirements. Automakers tend to make decisions according to market trends, funding availability and expected returns and, fundamentally, are prudent about committing their cash and resources. To solve the problem of structural overcapacity in the automobile industry in China, it is crucial that automakers are allowed to play the main role in market forecasting and industry planning. Automakers should bear investment and operating risks themselves and learn to survive on their own.

In addition, it may be necessary to reconsider taxation of the industry. Some have suggested that taxes might shift from the manufacturer to the consumer over time. If this plan was implemented, local governments would most likely transfer their enthusiasm from building plants and expanding capacity to market promotion, which would help to alleviate the problem of structural overcapacity and encourage the overall development of the industry.

The auto industry – enhancing capability

Many domestic OEMs have struggled to deal with overcapacity issues, due to limitations in key areas of their businesses. One particular issue is product quality, but other areas such as strategic positioning, brand management, core technologies, product planning, operational management, and human resource development need to be properly considered and invested in. Some domestic OEMs also need to tailor their brands more effectively to the needs of potential consumers; achieve better safety and emissions standards; explore more high-tech and high-value products that match market trends; standardise their operations to improve efficiency and, attract talented employees. These changes will help Chinese automakers improve their competitiveness and win a larger share of the market.

For those local players focusing on low-end and mid-tier models, attractive overseas markets in Africa, the Middle East, and Central and South America, offer a potential channel for absorbing domestic overcapacity. Last year, we saw many OEMs employing this strategy and the number of Chinese vehicles exported overseas grew considerably, reaching a total of nearly 850,000 units, almost 50 percent up on 2010.¹⁶

¹⁶ China Securities Journal 中国证券报 (22/03/2012)



A shift in foreign investment?

The Chinese government has re-considered previous fiscal and tax incentives relating to vehicle manufacturing. These have been replaced by strong efforts to guide foreign capital towards the production of key components and investment in R&D for core technologies. Foreign investors do not lack opportunities in the Chinese automobile market; on the contrary, if they are able to add their global R&D capabilities to their competitive position in the Chinese market, they will find fresh opportunities and potentially generate even greater profits.

GM, for example, has seized the initiative by setting up a global R&D centre for advanced technologies in Shanghai, which will be operational in the second half of 2012. The centre will focus on the development of promising new technologies, with initial R&D projects on the application of lightweight materials, such as magnesium alloy in engines, as well as new battery technologies in electric cars.

For the domestic OEMs, a legitimate strategy may be to form alliances and co-development partnerships with international players. They may also consider undertaking acquisitions to gain know-how, technologies, key skills and intellectual property assets. Sixty-eight percent of the respondents in KPMG's 2012 Global Automotive Executive Survey see 'corporate partnerships' as the best way to move forward in the currently uncertain business environment. Seventy percent see China as being the most likely driver of M&A, JVs and alliances in the industry.

Dealer networks – there is no point building cars if you can't sell them!

Rapid expansion in automobile manufacturing capacity leads to over-supply, which subsequently results in inventory management pressures and potentially harmful price competition. This, in turn, impacts cash flow, which can then drive further price reductions and the introduction of other incentive programmes – this is a vicious cycle.

Currently, dealer capabilities and sales distribution networks in China are largely immature and somewhat out of balance. 4S (and now 5S) shops are generally concentrated in tier 1 cities, which means that purchasing or repairing cars in tier 2 and tier 3 cities, as well as rural areas, can be difficult. In addition, car ownership

in large cities is reaching saturation point, with sales volumes lagging behind manufacturing capacity, while the rapid urbanisation of rural areas is creating huge new potential markets for the industry. OEMs and dealers need to adapt their strategies and businesses to cater for a new wave of increasingly sophisticated consumers, often in new and challenging environments.

A comment on the development of NEVs and new technologies

To deal with global commodity and resource availability challenges, as well as climate change problems, the China has already adopted a range of energy saving and emission reduction strategies. The development of NEVs was a key part of the 12th Five-Year Plan. Local governments and automakers have been motivated by incentives to buy land and build plants for NEVs, and this has fueled capacity development.

However, the current reality in this arena means that China is introducing 'hot' policies for a 'cool' market. Ambitions and plans may need to be scaled back.

The further development of key components and systems, as well as power-train and engine/system control technologies, and particularly battery technologies, is critical for the development of NEVs and should be a main priority. The current focus of particular OEMs on capital allocation towards capacity expansion ignores some important issues. It is worth noting that although new energy vehicles have been added to the 'encouraged' category in the updated Catalogue of Industries for Guiding Foreign Investment, the incentive policies it outlines are limited to the R&D and manufacturing of key components, not production of the whole car.

Consolidation?

Like the U.S. in the early 1900s, China has dozens of small but spirited car makers that have grown out of the country's burgeoning sales growth over the last decade. They have been welcomed as local engines of economic growth. Now, many will struggle as a result of reduced sales growth. Consolidation could result in a more streamlined industry that is better positioned to take on bigger, foreign rivals – and many commentators think that this is not only required, but inevitable.

China's central government has long said it wants to see consolidation in the auto industry, to create a handful of home-grown national champions. However, the industry has seen very little structural change over recent years, leaving aside some notable exceptions, such as the coming together of SAIC and Nanjing Auto in early 2008. Perhaps now is finally the time for structural issues in the industry to be addressed?

Final words

The automotive industry in China is currently facing serious overcapacity issues, which will potentially worsen. Although this problem is not necessarily industry-wide, and does not apply to every vehicle segment, a number of OEMs seem determined to continue with their expansion plans regardless. Some new entrants and existing players also have very ambitious plans. Our view is that all stakeholders need to examine their roles and take decisive action. There needs to be a critical shift 'from quantity to quality' if the Chinese automobile industry is to continue flourishing.

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Publication number: HK-ASPAC12-0002

Publication date: June 2012