Managing the Dragon Blog Post

Q1 2015: A Watershed For China Autos?

By: Jack Perkowski | April 30, 2015

Inevitably, price becomes a major factor in every industry in China. The vast numbers of Chinese whose per capita incomes remain well below what is considered to be middle class puts downward pressure on pricing. At the same time, intense competition among a large universe of local and international players eager to gain their fair share of the huge China market ensures that consumers get what they want at ever cheaper prices. Against this backdrop, it is remarkable that China's auto market has become the largest in the world, all the while defying economic gravity and avoiding the costly price wars that have plagued most other industries in the country.

Ever since the loosening of government restrictions that followed China's entry into the World Trade Organization in late 2001 touched off a tenfold increase in vehicle sales to 24 million units annually, international car companies, have had their way with pricing, enjoying large profits from their China operations. Despite high prices, the international original equipment manufacturers (OEMs) still account for approximately 75 percent of all passenger cars sold in China. Evidence is mounting, however, that this phase in the development of China's auto industry may have finally run its course. During the first quarter, the international car companies not only showed little growth, but also began cutting prices to remain competitive with their local counterparts.

First, the raw numbers. During the first three months of 2015, sales of passenger cars rose by 9 percent year on year to about 5.3 million units. While sales of sedans were essentially flat at 3.1 million units; Multi-purpose vehicles (MPVs) rose an impressive 19.3 percent during the quarter to 582,000, and sport utility vehicles (SUVs) rose an even more impressive 48.8 percent to 1.3 million units. That's the good news. Behind the headline numbers, the news only gets worse for the international auto assemblers, but better for the local car companies.

After falling to a 22.4 percent share of the domestic sedan market according to the China Association of Automobile Manufacturers ("CAAM"), Chinese brands staged an impressive comeback during the quarter, taking most of the industry growth. Bernstein, a well-regarded equity research firm that covers the global auto industry and closely follows China autos, said in a recent report that the Chinese brands now account for 25.5 percent of China's passenger car market, picking up over three market share points as a result of their recent performance. The clear losers last quarter were the international car companies that grew, as a group, by just over one percent. The Japanese brands continued their slide, declining by almost 5 percent year on year; the Koreans and Volkswagen were flat; and the American brands grew by 3.2 percent, according to Bernstein.

Moreover, the Chinese auto companies are hitting the international players where it hurts most — in the highly profitable SUV segment. According to the Bernstein report, many Chinese brands launched new SUV models during the quarter that are priced at RMB 120,000 ($19,300), undercutting the foreign SUVs that start at higher price points. Bernstein estimates that sales of low priced SUVs more than doubled during the quarter. In reaction, the foreign car companies have begun cutting prices.

More threatening over the longer term is that the gains made by the Chinese companies may not be due solely to price. In its "2014 China Initial Quality Study," J.D. Power, the US automotive industry consultancy, said that "Chinese automakers have narrowed the gap with international brands in producing reliable vehicles." According to the annual survey, which examined mechanical and design problems experienced by more than 21,000 Chinese buyers of new cars within the first two to six months of ownership in 51 Chinese cities, "the performance of some Chinese brands, including GAC Motor, Venucia, Roewe, and Luxgen, bettered the industry average." J.D. Power predicts that the domestic and global brands will be on parity in terms of quality before the end of 2018.

"Innovation for Upgrading," the theme of the 2015 China Auto Show which just closed in Shanghai, was meant to highlight the progress made by the Chinese brands over the past few years. Among the Chinese participants in the Shanghai Show, which is now the largest auto show in the world, Dongfeng Motors, Geely Automobile, Guangzhou Automobile and Great Wall all showcased impressive new models. While it is still too early to predict the long term winners among the local players, these four companies cannot be ruled out.

As the largest automotive market in the world, developments in China's auto industry have far reaching implications for the global industry. Only time will tell whether Q1 2015 will be seen as a true watershed in the development of the auto industry in China, or merely another bump in the road for foreign companies operating in the country.

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