Assessment of threats and growth opportunities for Indian manufacturers from the Chinese Automotive sector

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Executive Summary

No nation was ever ruined by trade. - Benjamin Franklin.

Recent trends in the global automotive industry has seen a paradigm shift in relationship between the various stakeholders of the automotive value chain and a growing need for consolidation and redefining business scopes for each firm. Given the happenings worldwide, this paper outlines the impact on two of the largest growth markets for the industry – India and China. The impact is all the more relevant in light of the liberalization policies followed by both the countries' governments in the sector.

China has always been a strong competitor to India in the world markets and of late there has been a growing sense of insecurity among Indian manufacturers about the penetration of inexpensive Chinese goods into the Indian markets. As David Ricardo, the 19th century English economist demonstrated that what matters in trade is not absolute cost advantage (which China undoubtedly has), but comparative advantage, this paper uses the same principle to provide certain strategies to the Indian automobile sector to counter the threat. The analysis involves firstly a true assessment of the threat to the different sectors of the auto industry and then provides an insight into opportunities available to them in light of their inherent strengths. Finally, it concludes by mentioning the strategic choices left with the firms (whether to consolidate, which product-market segment to target etc) and the imperatives for the industry to improve its global competitiveness.

Introduction: Global automotive trends and their implications

Being one of the most important engines driving world economies, the automotive industry has been subject to globalization in the Western world for a long time now. Need for high resource commitments, nature of the industry (scale sensitivity), the current stage in the industry's life cycle, increasing competition and declining unit profit margins have forced automobile manufacturers to merge, form alliances, or co-operate in the fields of R&D, production, marketing and distribution. The formation of global oligopolies first by regional consolidation and then on a global scale has been evident from the spate of mergers and strategic alliances. In the backdrop of the mega mergers, there has also been a change in the strategies of the global component suppliers. With the tierization of suppliers, the Tier 1 suppliers (those who directly supply to the OEMs) have increasingly taken on the role of module integrators and have come under severe cost pressures from the OEMs as a direct result. The OEM-vendor relationship has changed drastically over the last five years and it is now costs and not allegiances, which determine who carmakers, buy from. Thus they too have taken the consolidation route to survive in the times of intense cost competition. The above trends have prompted them to look at emerging countries for component and vehicle manufacture due to the inherent advantages in production and potentially large markets. As it makes less sense to focus on the geographical origins of the components or assemblage (as long as the brand guarantees as certain level of quality), there has been a gradual re-orientation in the perspectives of automobile manufacturers.

India and China: Overview of the Auto industry

China and India account for less than 1% of the cars in use today[1] with fewer than 10 cars per thousand people. These countries represent a huge potential market in the long term. There might have been evidences of rapid growth in the short term but the options are limited for potential entrants. The markets on the Pacific Rim alone cannot support the kind of volumes expected to run sustainable operations in these countries. Domestic car sales in China is expected to grow at 10% each year and is expected to account for over 15% of the global growth in car sales[2] (India's CAGR is expected to be 8% during the same period contributing to 9% of the global growth). The Auto industry contributes to nearly 4% of India's GDP[3] whereas a higher percentage is deployed in the case of China (where the manufacturing sector accounts for nearly 40% of the GDP[4]). Both countries had long followed strict FDI norms into these sectors and high import tariffs to support domestic players. With the accession to WTO and the liberalization of the two economies, a large number of global players have set up plants in India and China and in the process burnt their fingers in anticipation of the large volumes. Given the capacity-intensive nature of the industry, the logic of "cheap"-labor has not worked to be too profitable, as the auto majors have realized. In addition, these countries have one of the worst cost structures for the car industry, given the inefficient supply chains and fragmented distribution systems. Thus not too many car manufacturers have reached their economies of scale so far.

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[1] Source: Autopolis
[2] Source: DRI-WEFA (Data Resources Inc-Wharton Economic Forecasting Association)
[3] Source: Business Line
[4] Source: Accenture Study, "*Making Indian Manufacturing globally competitive*", 2002

Thus it can be seen that the new opportunities of globalization are most attractive for suppliers, who are to operate in multiple geographic locations simultaneously. A recent study[5] shows that 36% of the world's major suppliers are focusing on China as the target for strategic expansion.

Framework for the Analysis:

Assessment of the Chinese threat & Weaknesses of the Indian players

- Two wheelers: Imports of two wheelers into the Indian market is unlikely to pose a serious threat to the Indian players despite the low price tags mainly due to two reasons – low perceived quality levels of the Chinese vehicles and widespread availability of retail financing for two-wheelers in India which makes Indian bikes easily available to most households. Those low-end Indian models competing essentially on price might have to bear the marginal decrease in sales due to the imports. The government has also imposed strict emission norms, which act as non-tariff barriers to Chinese imports.
- Component exports: The area of major competition for the Indian auto industry is in the components sector. Firstly, global sourcing of components from China brings savings[6] of nearly 17-20% to the table (as against the 15-17% in the case of India) mainly due to their scale economies, lower power costs[7] (0.061 kWhr/USD in China as against 0.095 kWhr/USD in India), reduced freight, local government concessions, lower transactional costs[8] (30% lower for auto component

[5] Global Manufacturing Survey by Deloitte & Touche and Deloitte Consulting, 1998
[6] Source: Freemarkets
[7] Source: Accenture Study, 2002
[8] Business Today, *On the global highway*, Oct 2002.

manufacturers in China) etc. With the increasing competition for orders from global OEMs, Indian component exporters might lose out in the price wars if they start with a higher cost base.

- Component Imports: The structure of the component industry in India shows a largely fragmented industry (implying low scale operations) with just 28 players[9] with a turnover of greater than 30 million USD. Hence the Chinese dragon could eat away a diverse set of small and medium enterprises in India through low cost imports of components (primarily in low-end, low-technology parts).

Strengths of the Indian players & Opportunities to enter the dragon:

- Passenger Cars: in China have traditionally been sold at huge premiums (nearly 150% over the sticker price in the US) and despite this, not many carmakers have been profitable in China. The profit pool[10] in the Chinese passenger car industry shows higher margins for OEMs (46% in China as against 17% elsewhere in the world, while service accounts for only 14% of the profits of the industry in China as against 57% world over). Hence there is a potential for branded integrators, after sales service providers, spare parts providers and leasing companies to utilize this opportunity and make profits with low investments. Indian manufacturers like Tata Engineering and M&M, who have the requisite designs and technology with them could use an "*Asset light strategy*" and form JVs with local manufacturers for contract manufacturing their vehicles and leverage their brand marketing skills to market them in one of largest growth markets in the world. Use of proven JV

[9] Source: ACMA website
[10] McKinsey Quarterly, *Tune up for China's auto industry*, 2002.

facilities (say that of First Automotive Works or SAIC) reduces the financial risks involved but may involve transfer of technology and management skills to local JV partners. Their assembly plants in China could source critical components from India (also supports the off-take commitments of the Indian OEMs to the suppliers).

- Auto components: Following Ricardo's principle of comparative advantage, India, although starting off with a higher cost base, has a comparative advantage when it comes to high technology auto components as evident from the growing exports[11] (USD 417 million in 2000), increasing quality consciousness of the manufacturers (evident from 244 ISO 9000 suppliers, 11 ISO 14000 suppliers, 2 Deming Award winners and a "GM supplier of the year" award winner), and presence of a highly skilled and educated workforce. Hence it would be logical to outsource the low end products and raw materials (like say fastener grade steel) from China to avail the comparative cost advantage and market them through the already existing distribution channels in India. Strategic alliances could also be formed with Chinese vehicle manufacturers for supplying of high technology components on a long-term basis from India.

  Leading Indian component suppliers should set up production facilities in China and utilize their existing contacts with global players (Ford, GM, VW, already present in China) to develop startup businesses. This is a strategy to try and enter into the league of the global Tier 1 suppliers such as Delphi and Visteon.

- Leveraging IT skills in the automotive sector: The already existing strong IT based skills could be utilized in the automotive sector in primarily three areas – Telematics, CAD-CAM design and B2B exchanges.

- Telematics represents a huge market opportunity (estimated[12] to be anywhere between 13 and 100 billion USD by the year 2010)
- Global carmakers are looking to outsource all their backend operations (including design and development) from IT companies based in Asia – another opportunity in the automotive sector
- B2B exchanges (such as *Covisint* and *Freemarkets*) have lead to substantial cost gains and can help the Indian automotive industry face global competition. IT networks can aid auto companies operate efficiently with their subsidiaries and JV partners in China. Since most global supply chain standards are still in the formative stage, there is a unique window of opportunity for Indian firms to influence them.

Conclusions: Strategic choices and imperatives for Indian firms to counter the hidden dragon:

Disaggregation of the automotive value chain has led to increased competition, declining margins, increasing disadvantages of being subscale and emergence of a certain set of new opportunities for Indian firms.

There are certain choices that could decide the future existence of the Indian auto firms – choosing to ally or to stay alone and also choice of segment of the value chain to focus on (component suppliers or module suppliers etc).

[11] Source: ACMA website
[12] McKinsey Quarterly, *A Road map for Telematics,* 2002.

The imperatives for all the firms in the Indian auto industry are as follows–

- Increase scale of operation through Greenfield projects or M&As (to prevent subscale manufacturers from losing out to global majors),
- Increase the quality consciousness of workers through training programs (Utilize the Ministry of Industry's automotive cess fund for conducting training programs to boost productivity of SMEs in the component industry)
- Leverage IT to drive down transactions costs and time-to-market,
- Improve spending on R&D and employ flexible manufacturing to design and produce new products (and move up the value chain),
- Utilize existing relationships with MNC carmakers to achieve global recognition.
- Learn from strategic alliances formed with other firms worldwide – utilize the exposure to different companies with complementary capabilities and a mutual interest in cooperation.

It is a really humbling exercise to ascertain India's position in the global competitiveness league – far below that of China's. Hence it is time for the Indian manufacturing sector as a whole to hone its competitive edge. They would have to develop new competencies and radically overhaul existing ones if required and companies which view their international expansion, as an opportunity to learn would find it perfectly feasible to do so.

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