

Automotive & Assembly Practice



Upward Mobility: The Future of China's Premium Car Market

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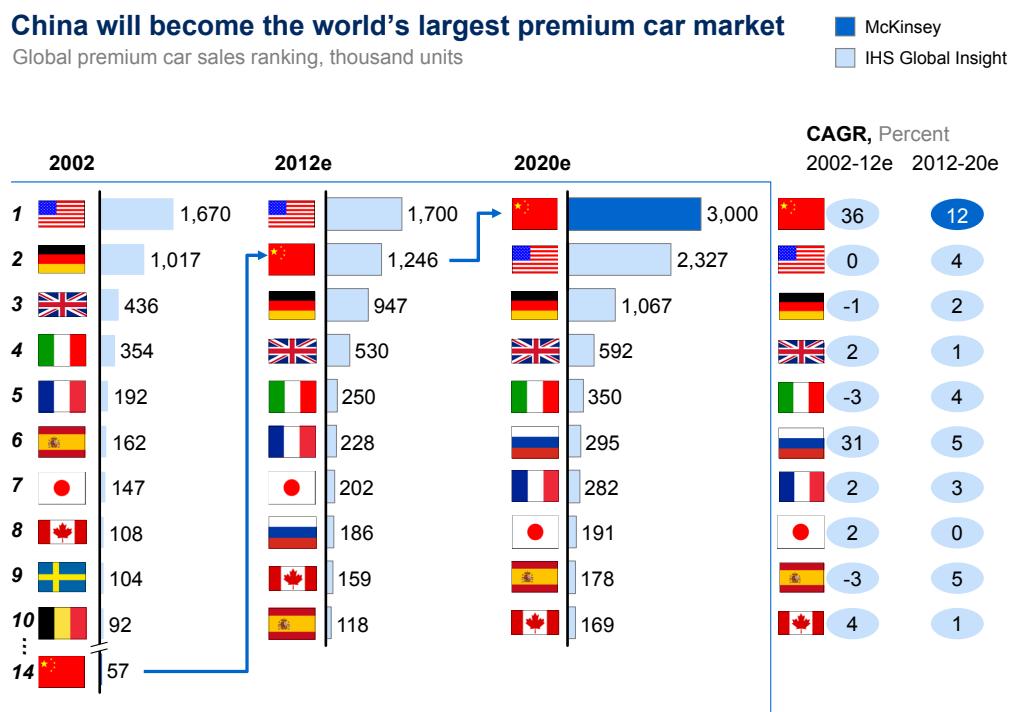
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The market for premium cars¹ in China has increased at an impressive rate of 36 percent a year in the last decade, faster than the 26 percent annual growth in the overall Chinese passenger vehicle market during the same period.² Sales of premium cars in China reached 1.25 million vehicles in 2012, making it the second biggest market in the world after the United States. The premium car market in China represented 9 percent of all passenger car sales in 2012, surpassing Japan (4 percent) and South Korea (6 percent).

McKinsey forecasts that China's premium car market will grow at an annual rate of 12 percent through 2020, compared with 8 percent for the overall passenger car market. We forecast that sales of premium cars in China will reach three million by 2020, equaling those of Western Europe, and surpassing the 2.3 million sales expected in the US market. In fact, China may overtake the United States as the largest premium car market as early as 2016, when sales could reach 2.25 million units. (Exhibit 1)

Exhibit 1



Along with the sales increases comes a rapidly changing market landscape. The older generation of premium car owners purchased vehicles mainly to reflect their social status, but the increasingly sophisticated new generation of buyers is expressing other reasons for buying premium autos. This is one of several important findings from a 2012 McKinsey survey of 1,200 Chinese premium car consumers in 12 of the country's biggest cities that examined brand sentiment, key buying factors, and touch points along the consumer decision journey.³

1 For the purposes of this report, the premium car market comprises Acura, Aston Martin, Audi, Bentley, BMW, Cadillac, Ferrari, Infiniti, Jaguar, Land Rover, Lamborghini, Lexus, Lincoln, Lotus, Maserati, Mercedes, Mini, Porsche, Rolls-Royce, Smart, Volkswagen Phaeton, Volkswagen Touareg, and Volvo.

2 The percentages cited are compound annual growth rates.

3 McKinsey's consumer decision journey is a novel way to look at the consumer decision-making process that goes beyond the traditional marketing funnel. The circular, iterative journey comprises four steps, from initial consideration to active evaluation to moment of purchase to the post-purchase experience that drives loyalty and future impressions. Digital and social media are integrated into the traditional funnel approach to best understand consumer touch points today.

The survey sheds light on consumers' evolving needs in the premium car market, including the increasing importance to them of value-added services.

Multinationals dominate China's premium car market, with German automakers (e.g. Audi, BMW, Mercedes, and the Volkswagen Group premium cars) accounting for 80 percent of market share; other European, Japanese, and US brands make up the remainder. However, competition is heating up, putting pressure on profit margins.

How should automakers address this fast-growing but increasingly complicated market? To seek answers, McKinsey conducted not only the survey noted above, but also a series of focus groups to zoom in on consumer preferences and purchasing habits as well as interviews with about 60 automotive executives, dealership general managers, and industry experts. In addition, we carried out in-depth home and drive-along visits with individual buyers and analyzed more than 6 million Internet and microblog postings for insight into customer perceptions of the premium car market in 2012. Then, we compared our results in China with those of a 2010 McKinsey survey of premium car customers in Germany.

In this report, we synthesize our findings, reviewing the state of the Chinese premium car market, identifying the most important trends, and suggesting what they mean for multinational premium automakers. We don't claim to offer a complete picture of the premium car market in China but rather provide an overview of the trends and consumer preferences that will likely influence automaker responses to the big changes ahead in the market.

THE NEW FRONTIERS OF GROWTH

Over 60 percent of survey respondents regarded "buying a car" as much a priority as "buying an apartment" and "paying for children's education". McKinsey's consumer research has shown that 80 percent of Chinese premium car owners have annual disposable household income of more than RMB 200,000⁴. The weighted average of annual household disposable income of all surveyed families was RMB 450,000. We expect this affluent segment to grow at a compound annual rate of 16 percent between now and 2020, offering underlying support for the premium car market. By 2020, we forecast that there will be 23 million affluent urban households in China – 7 percent of the population and roughly equal to the total number of households in Great Britain today (Exhibit 2). In particular, our analysis shows that 300 cities in China will have consumers with sufficient household income to buy premium vehicles by 2020. (Exhibit 3)

Exhibit 2

Number of urban households by annual disposable income bracket

Million households



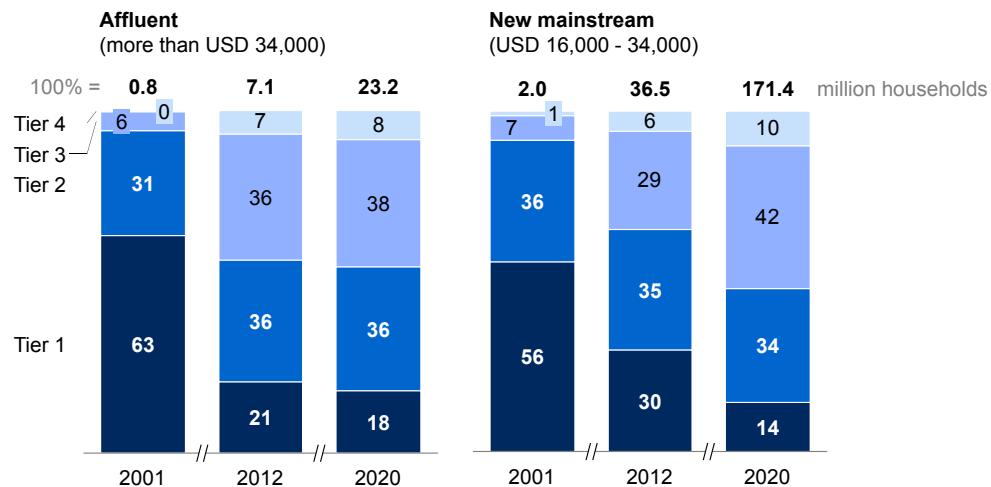
SOURCE: McKinsey Insights China – Macroeconomic model update (2012) ; Canback Dangel

⁴ In our research, we focused on car owners/potential buyers of premium cars of up to RMB 1.25M, which represents 85 percent of the premium market in China.

Exhibit 3

More than half of the incremental growth in affluent and new mainstream households will come from lower-tier cities

Household distribution by city tier, percent



300 cities in China will have consumers with sufficient household income to buy premium cars by 2020

1 Based on McKinsey city definition: 4 tier-1 cities, 46 tier-2 cities, 211 tier-3 cities, and 554 tier-4 cities
SOURCE: Team analysis; McKinsey Insights China – macroeconomic model update (2012)

In general, premium car buyers are optimistic about their future. A quarter of those surveyed said they have a high degree of confidence in their career and business prospects and therefore spend more lavishly. For example, their willingness to pay for premium cars was 30 percent higher than car buyers with similar household disposable income.

Our research also points to the emergence of an “entry-level” group of potential premium car consumers. This segment, which we call “new mainstream” households (with annual disposable incomes of RMB 100,000-200,000), has confidence that its incomes will continue to grow, opening the way for them to at least consider purchasing a premium car. The new mainstream households care more about body style, brand, and exterior than more affluent consumers, who tend to value functional factors such as powertrain technology and vehicle performance.

We identified several other important trends:

- What motivates the Chinese middle class to upgrade to premium cars? The first generation of premium buyers sought status and the ability to show-off. But there are more reasons in play now. In our survey, 30 percent cited “reflection of social status” as the top reason to upgrade to a premium car, while 27 percent cited “self-indulgence”. More nuanced responses include: the “car as my ‘business card’ for credibility,” “attracted by sophisticated functions and innovative designs,” “the car as a source of fun in life,” and “demanding excellent service.” These responses all obtained 20 to 25 percent agreement among the premium car consumers that we surveyed.
- Most Chinese families replace their cars every six to eight years. In our research, premium owners and those intending to buy premium cars said they would replace their cars two to three years faster than the average. Only about 30 percent of the premium segment was first-time buyers, the survey found, compared with 70 percent in the overall passenger car market. A quarter of families that owned a premium vehicle later bought an additional car for various reasons, including providing a car for the spouse, family usage, or suitability for different business circles, but only 20 percent traded down to mass branded cars.

- Women are playing an increasingly important role in the premium car market in China. In our survey, we found that when choosing a vehicle model, women value exterior styling, safety features, and comfort, over the attributes favored by their male counterparts, such as powertrain technology, socially recognized premium brands, and bigger models.
- Given the unsettled macroeconomic environment across the globe, there is increasing concern in the auto industry about the volatility of demand for premium cars in China and what that means for continued market growth. We assessed what we call premium sentiment, which focuses on three critical drivers: confidence in the growth of the Chinese economy and expected household income growth; willingness to pay for premium cars; and the influence of societal attitudes on displays of wealth. Our analysis found that despite some uncertainty about the direction of the economy, and shifting social attitudes about public displays of wealth, 80 to 85 percent of Chinese consumers surveyed are confident in future growth and will stick with premium cars.

In the last three years, the premium car market undoubtedly has grown more competitive because of the entrance of additional premium car makers, a large number of localized models and model launches, and higher sales targets set by leading premium brands. These moves reflect a clear strategic decision by leading automakers to embrace “new mainstream” consumers as potential customers. We also see that premium-segment prices are declining 4 to 5 percent a year in nominal terms, resulting in declining profitability for both premium automakers and dealership groups. In the battle for premium car market share it is increasingly important to offer more value to customers, differentiate models along key emotional attributes, and prepare to ramp up market presence in China’s fast-growing lower-tier cities.

PROFILING THE UNIQUE CHINESE PREMIUM CAR BUYER

Our survey identified important behavioral characteristics of Chinese premium car buyers. We also derived a detailed consumer segmentation from our survey. This level of granularity is now essential for automakers hoping to understand this evolving market.

Key buying factors – what truly matters?

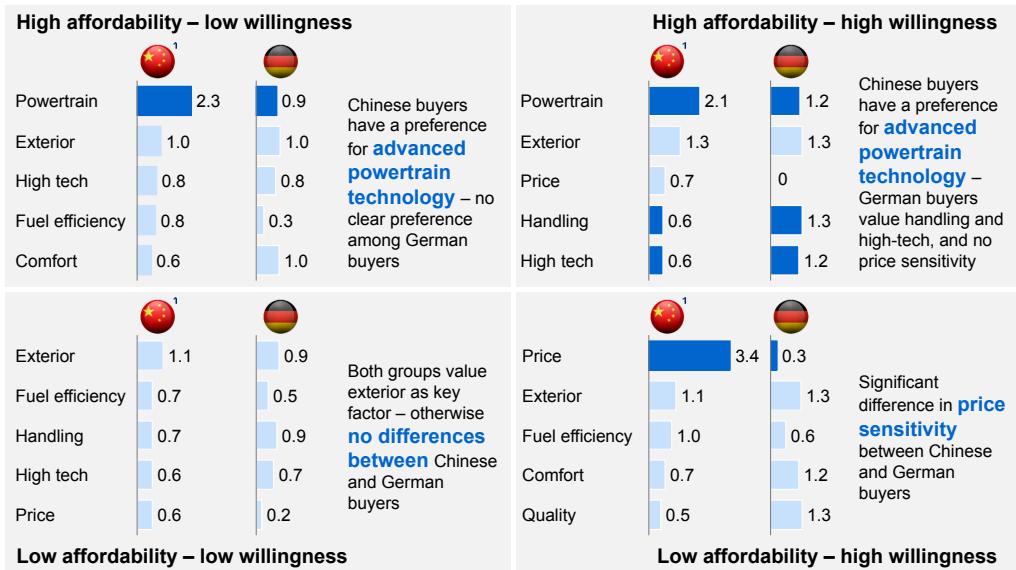
Premium car owners prioritize five key buying factors out of 22 possibilities we offered in our survey. Overall, they rate safety as their number one concern, perhaps in response to the media attention that has been devoted in recent years to a spate of traffic accidents associated with premium cars. This may also be due increased consumer awareness of active and passive safety systems.

Other key factors cited by respondents include brand, reputation, powertrain technology, and exterior. Quality and handling were not differentiating factors for Chinese premium car buyers as much as they were for German buyers who participated in our 2010 survey. Automakers need to be careful when interpreting this finding. Chinese consumers may believe “quality is a given” because of the premium they pay for the vehicles. High expectations for quality and craftsmanship usually surface only after they’ve purchased their vehicle and have had a chance to drive it. When Chinese premium auto owners discover defects in their vehicles, they sometimes react emotionally.

In another comparison of Chinese and German consumers, we found a linear relationship between affordability and powertrain technology in the Chinese market. This implies that affluent car owners in China are more attracted to powerful, high-tech cars with advanced powertrain systems. In both markets, consumers place a high value on car exteriors. (Exhibit 4)

Exhibit 4

Chinese and German premium auto buyers value exterior, but differ significantly in preference for powertrain technology and price sensitivity



1 Indicates ranking of the top 5 most important attributes, from most important (5) to least important (1)

SOURCE: Team analysis; McKinsey China Premium Car Research (2012); Germany Premium Car Research (2010)

Breaking down the premium market

We identified eight consumer segments based on the distinctive needs we observed in our survey, including how likely consumers are to afford premium cars, how willing they are to pay a premium for these cars, and how they associate premium cars with personal identity. Two examples follow:

“Business cards.” This segment (11 percent of the premium market) comprises business owners or people holding senior management positions. They consider a premium car a business necessity but don’t see it as a source of fun or a pleasurable indulgence. Their attitude might be characterized by statements like these: “I need the car for credibility in business circles... I have to fit in ...The car is like a business card for me.” They would pay a premium for advanced powertrain technology, favor VIP services such as 24-hour roadside assistance, and are comfortable buying niche premium models, as long as they fit their business circle.

“Deal hunters.” Consumers in this segment agreed with the statement, “A car may be just a means of transportation, but I wouldn’t want to drive a cheap model...Brand is important to me...I would only purchase a premium car if I can find a deal.” In general, while deal hunters say they love premium brands, they do not exhibit a preference for a particular brand, and they do not seem to care much for the driving experience. They are interested in trade-ins, and value heavily discounted premium cars. The segment (13 percent of the premium market) is not as large as we originally thought, which might mean that discounting may be less necessary than automakers expect.

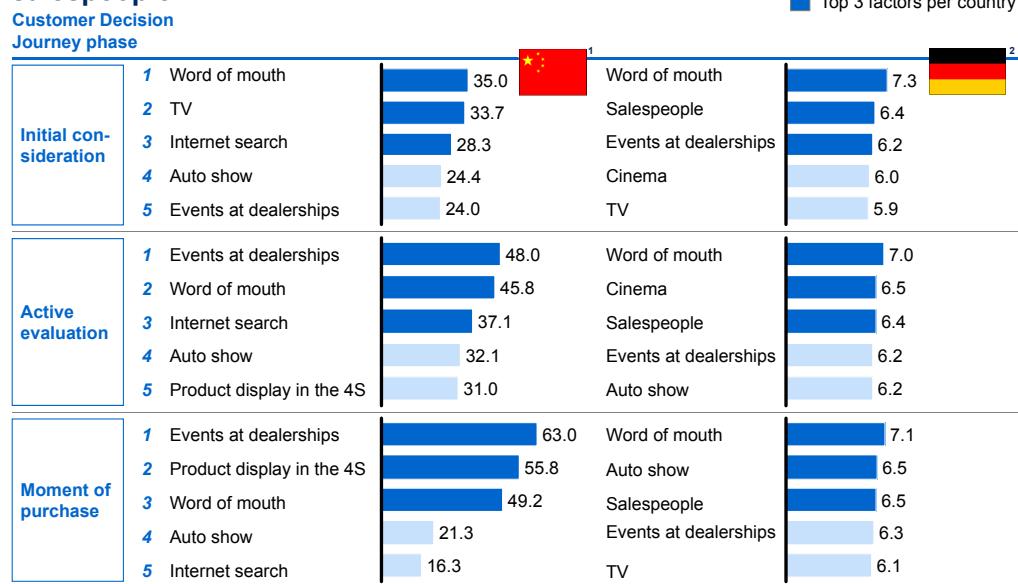
China's increasingly sophisticated premium car market will require automakers to adopt a segment-based approach to serving their customers. For example, value-added services such as car financing and used-car sales are less appreciated in China than in more developed car markets. From our survey, only 14 percent of premium car consumers favor financing options. However, our segmentation showed that attitudinal-based segments such as "performance/high-tech" and "joy seeker", and needs-based segments such as "social climber" and "young and individualistic" are more open to car financing. These four segments combined account for half of premium car owners and potential buyers. Moreover, only 12 percent of owners in our survey expressed interest in driving pre-owned premium cars. This finding suggests an opportunity for automakers to source and refurbish higher quality used cars, and implement measures to resolve customer concerns regarding quality and maintenance. It may also suggest that most used car buyers do not belong to one of the core segments of today's premium car buyers. Instead, automakers should identify consumers that are seeking affordability and value.

Influencing the premium buyer

Our surveys found that both Chinese and European premium car consumers highly value word of mouth across different stages of the decision journey. In addition, Chinese buyers are strongly influenced by Internet search results, special events, and product displays at stores when actively evaluating two to three models, while German consumers are more influenced by sales people. (Exhibit 5)

Exhibit 5

Word of mouth highly influential in China and Germany; Chinese buyers rely on Internet search and events; German buyers more influenced by salespeople



1 Percentage of responses based on the question: "Please pick 3 channels that affected you the most"

2 Average points based on the question: "How does [channel] make you feel about the car? (1 = significantly negative, 9 = significantly positive)"

SOURCE: McKinsey China Premium Car Research (2012); McKinsey Germany Premium Car Research (2010)

In China, "circles of influence" play an important role in building word of mouth awareness of particular brands and models of premium cars. Positioned at the center of these circles are family members who are primarily concerned with basic features such as safety and size. Friends influence 40 percent of premium car buyers by helping them establish a shortlist of compelling models and by providing feedback and suggestions gained through their personal experience. Business colleagues and clients play an equally important role through

the application of peer pressure. And finally, premium car buyers often carefully observe the purchasing behavior of their bosses, who often put an implicit “ceiling” on the brand and price range they are willing to consider.

Regional differences in consumer behavior

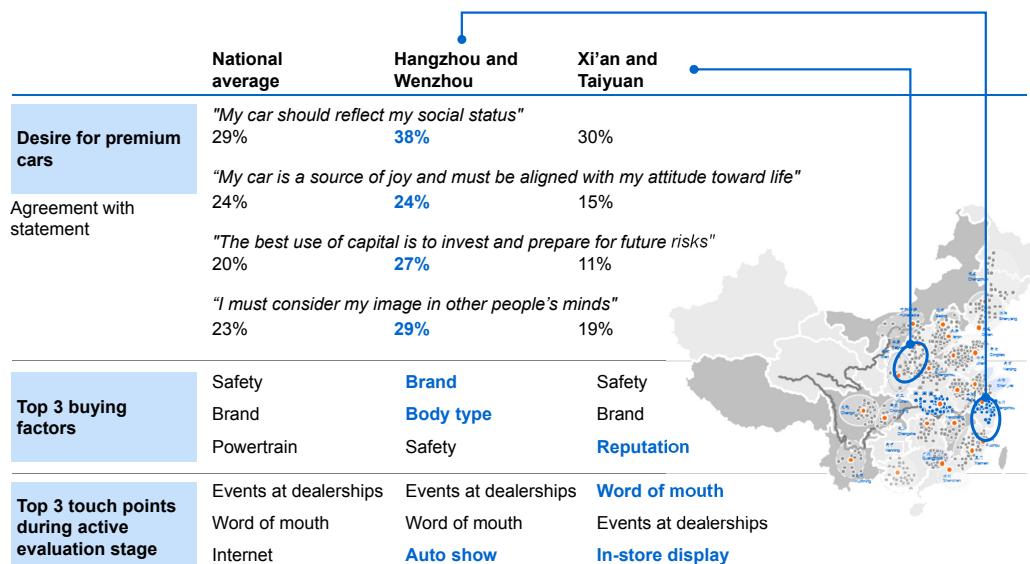
Chinese auto buyers exhibit different attitudes about their desire for premium cars, buying factors, and touch points depending on where they live. For example, those living in the coastal cities of Hangzhou and Wenzhou have had exposure to the premium car market for several years. As a result, they are more sophisticated about the market and expect a premium car to reflect their social status and lifestyle needs: 38 percent of respondents in these cities agreed with the statement “My car should reflect my social status”, compared with just 30 percent of respondents in the inland cities of Taiyuan and Xi’An. Such status-consciousness translates into a preference for brand and body type when buying a premium car (Exhibit 6).

By contrast, premium car buyers in Taiyuan and Xi’An, where penetration of premium vehicles is lower, need the reassurance of a strong brand and good reputation, and therefore rely heavily on word-of-mouth and the in-store experience when deciding which model to buy. They also appear to be more impulsive when it comes making the decision to purchase a vehicle, elevating the importance of the in-store experience and the availability of knowledgeable and approachable sales people.

Exhibit 6

Consumer patterns also differ across regional clusters

SELECTED EXAMPLE



SOURCE: McKinsey China Premium Car Research (2012)

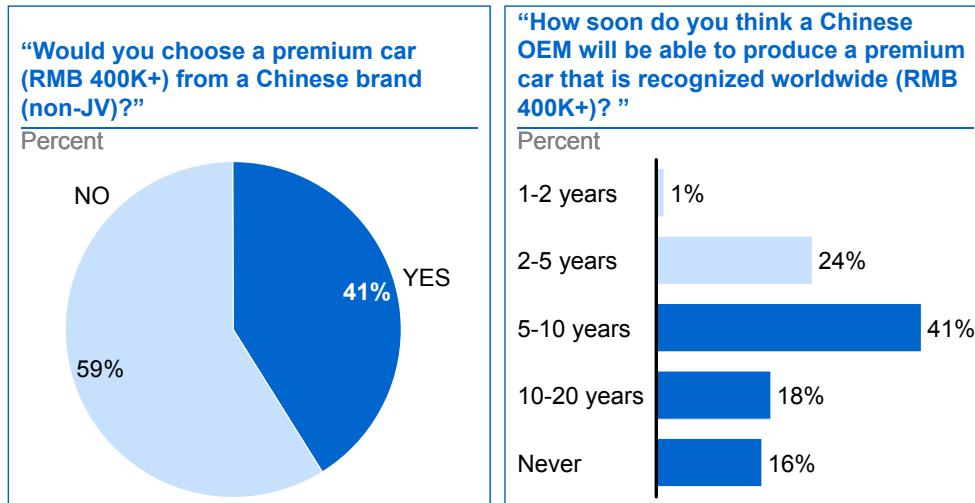
How local Chinese automakers stack up

Many car manufacturers in China today dream of developing a premium auto brand, and many Chinese auto buyers today believe that such a goal is within reach. In our survey, 41 percent of respondents said that Chinese automakers would build a globally recognized premium car priced higher than 400,000 RMB in the next 5 to 10 years; 18 percent said that it would take 10 to 20 years. The excitement of building a domestic premium brand is fueled by national pride and the large demand for premium cars. However, successfully launching a premium auto

brand will be a long journey for the handful of Chinese automakers with the aspirations and resources required for such an effort. (Exhibit 7)

Exhibit 7

40 percent of buyers claim that they are open to considering a premium car from a local Chinese (non-JV) OEM; they only expect local OEMs to be ready with such a car after 2020



SOURCE: McKinsey China Premium Car Research (2012)

KEYS TO SUCCEEDING IN CHINA'S NEW PREMIUM CAR MARKET

What are the implications of these findings for automakers hoping to capture the next wave of China's premium car market growth? Car manufacturers should consider three actions as they prepare their strategic plans for the rest of the decade.

Enrich China-specific product portfolio, features, and equipment

The fast rise of newly affluent middle class and two-car families presents an intriguing opportunity for premium automakers. SUVs are still popular on a national level. Of consumers surveyed, 26 percent expressed interest in green technology. What will be the next big hits with regard to body styles? As consumer preferences continue to diversify, premium automakers may need to further localize vehicle portfolios, and even nurture indigenous Chinese premium brands with their joint venture partners to offer China-specific car models at appropriate prices.

China is also shifting to a new generation of drivers. In addition to the chauffeur-based segment, the premium market will increasingly include cars driven by their actual owners. These drivers care not only about what their car stands for, but what it can actually do for them, both at an emotional and functional level. In our survey, 75 percent of premium car buyers in China have smartphones that are increasingly equipped with powerful interactive apps, such as "Autonavi," which features navigation services, location-based information, and voice-driven queries with a level of accuracy that often exceeds that of systems that come pre-installed on many premium auto brands. Telematics systems installed by automakers today have difficulty matching these apps when it comes to user-friendliness and frequency of data updates. In a market such as China, where smartphone penetration is exploding and

mobile internet use is becoming so pervasive, automakers will need to rethink their telematics offerings.

The survey also found that an increasing number of premium car purchasers are spending less time alone in their cars, and have started using their vehicles to take their family members and business partners on trips more frequently. Automakers should closely observe driving behavior in the densely populated cities of China, a seemingly chaotic world of endless traffic jams, inexperienced drivers, and careless pedestrians. This might give their research and development engineers a better appreciation for why Chinese premium drivers favor panoramic sunroofs, the latest infotainment systems, and active safety systems such as night vision aids and attention warning systems. They might offer special features or add-ons for the Chinese market, such as interiors with customized leather cockpits or seat ventilation.

Female buyers are also increasingly present in the premium market, and automakers should keep in mind the importance they attach to exterior styling, safety features, and comfort. Our research shows that Chinese women are open to trying new and niche products, and willing to pay a premium for them. In addition, they are willing to exchange larger-sized vehicles for smaller ones equipped with more sophisticated functions. That might suggest significant new demand for A-segment (smaller) premium car models and their derivatives, such as coupes. Premium automakers might attract more female consumers through green-technology products such as hybrids; others might consider appealing to them with trendy exterior designs or personalized services.

Strengthen emotional differentiation and increase customer loyalty

Many automakers are introducing innovative features and equipment on all types of cars, not simply those in the premium category. It is now harder than ever to distinguish a car purely through advanced technology. What is more difficult to commoditize, however, is the “premium personality” or brand DNA, particularly whether the car reflects the owner’s sense of individuality and emotional needs. Indeed, as China’s affluent middle class has become more sophisticated and assertive, it has also learned to define, and choose, the premium car brands that best fit their values and personality.

In our research, we experimented with a way to test the emotional connections between Chinese premium owners and their chosen vehicles. From a set of about 30 pre-defined emotional characteristics, our research converged on ten interesting “premium personalities” rooted in Chinese society.

In our test, while two German auto brands displayed completely different traits, each is successful in the market. One of the automakers based its appeal on a careful translation to the Chinese market of its global brand DNA of ambition, dynamism, and stylish prosperity. The other pursued a more understated brand personality marked by attributes consistent with traditional Confucian values, such as reliability, quality, sophistication, and heritage. Curiously, while some Japanese auto brands also projected a similar set of Confucian-based values, they have been overshadowed or marginalized by the incumbent German brands. This suggests that Japanese automakers might benefit by making a stronger emotional appeal to Chinese car buyers by touting the well-regarded interior and exterior features of their vehicles.

At the other end of the spectrum, while some American premium automakers have established a distinctive brand personality around the concepts of excitement and individualism, they may have defined themselves too narrowly. What can they do to break through? They may take inspiration from companies such as Apple, Google, and Pixar, which model simplicity, innovation, and imagination. And they might work on improving aspects of styling and craftsmanship that appeal to Chinese buyers.

Drilling down into the regions

Network expansion should be high on automakers' agendas if they want to maintain double-digit growth. For leading premium car makers in China, this implies both improving their consumer insight capabilities as well as ramping up dealerships to capture demand in the 300 tier three and four cities where consumers are expected to reach the threshold for household income by 2020 that will enable them to buy premium vehicles. This will represent an enormous leap from the approximately 100 cities today where consumers can currently afford to purchase such cars. Automakers that aspire to tap into the coming wave of new premium car buyers from smaller cities will need to innovate their dealer formats and sharpen their digital marketing skills.

Before expanding into these small but fast-growing regional markets in China, automakers must first secure a significant share in the regional markets where they currently compete, or risk spreading their resources too thin and taking their eyes off quality and customer satisfaction. This will require devoting considerable resources on marketing, store construction, hiring and training of scores of new employees, and optimizing the dealer network.

The prospects for latecomers

Even now, China's premium car market presents a sizable opportunity for latecomers. For example, Japanese and US attackers still have a chance to create a market footprint as long as they identify an exclusive and definitive value positioning, and then carry out a well-planned channel rollout. Since major premium segments are overcrowded in terms of market positioning, players will need to deploy a more focused segment-based approach, such as addressing the sporty, younger premium personality, or catering to the entry-level premium consumer or exclusive luxury consumer. Incumbents have taken years to build a robust physical distribution network, an advantage that new entrants will have trouble replicating. Newcomers to the market should pursue creative distribution approaches, such as focusing on specific, fast-growing city clusters, or aggressively employing digital marketing and ecommerce tools and creating a vibrant social media community. This would help reach a broader consumer market in a more targeted and cost-effective way.



A bigger question for everyone relates to the direction in which the China premium market is headed. Will China become like Germany, where premium tastes are technology-driven? Or will it develop a US-style convenience-oriented premium? Or, will we see Chinese auto buyers develop their own unique preferences for premium vehicles? Whatever the answer may be, premium automakers seeking to win in China will need to sharpen their insight into consumer behavior, and fine-tune their skills in product development, sales, and marketing. It's going to be an interesting ride for all.

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The authors would like to acknowledge the contributions to the development of this report of [Hong Chen](#), [Vicky Chen](#), [Shu Hattori](#), [Fang Gong](#), [Paul Gao](#), [Hans-Werner Kaas](#), [Christian Malorny](#), [Detlev Mohr](#), [Andreas Tschiesner](#), [Alexander Wieser](#), [Cherie Zhang](#), [Tony Zhou](#), and [Andreas Zielke](#).

