

# InterChina Insight



## The Auto Components Sector In China: Lessons to be learned

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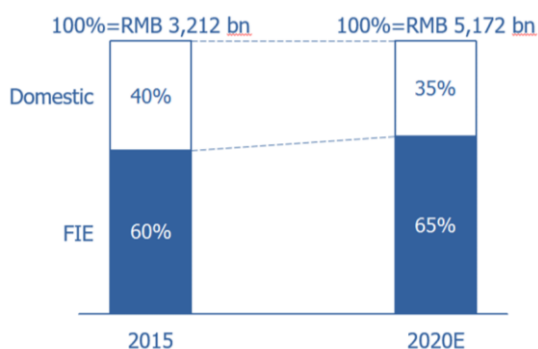
Around the start of 2017, InterChina interviewed close to 20 APAC and China CEO's of large auto component companies (global sales between 2 and 20 Billion US\$) in order to understand their views on the current situation and the future of their companies in China. The auto component sector presents a bright spot amidst the China gloom projected in the international press. For most auto component companies, China represents one of their largest, fastest growing and most profitable markets. The future will be one of further growth, although there are important challenges to deal with, such as increasing costs, local competition and possible disruption from new technologies. The automotive sector in general, and the auto components sector in particular, is in our view one of the most 'advanced' sectors in China in terms of foreign presence. How foreign auto component companies have achieved their current position, and how they deal with the new challenges ahead, brings valuable lessons for foreign companies in other sectors.

*(Note: all quotations in this article come from our interviews – we do not attribute quotes for confidentiality reasons)*

## 1.1 Continued Growth

The auto component sector in China is currently dominated by international suppliers, and this dominance is expected to continue.

*FIE vs. Domestic Suppliers – Shares of the Automotive Component Market in China*



Source: CAAM, InterChina interviews and analysis

The auto component sector not only benefits from the growth of its clients – OEM car producers – but also from a general shift to 'quality', which is particularly beneficial to international producers.

Growth in the passenger car market is expected to hit 6-7%, which will mirror GDP in the next few years. The growth will be driven by the continued rise of the middle class, lower costs for better quality vehicles and further government consumption and tax subsidies.

*"The car market will follow the GDP evolution, so we expect the "new normal economy" to mean slower growth rates than in the past. However, the Chinese car industry still has a lot of room to grow, so we do not expect as big an impact as there may be in other markets - growth will continue for a long time."*

*"We are reflecting growth between 6-8% in our 3 year plan... the only short-term risk we see is a drop in government incentives, especially if incentives for cars with <1.6 liter engines ends in 2017."*

The coinciding shift to 'quality' will favor international component suppliers. As consumers increasingly value quality, OEM producers, including Chinese ones, will expect higher quality components produced at scale.

Considering these two factors, component producer CEOs are optimistic about their businesses and are budgeting higher growth than OEMs are - 5 to 15% - for the coming 5 years. While organic growth may hit 6-8%, many companies are implementing inorganic growth strategies to allow for an extra 4-6% YoY growth. This implies a continuation of the double-digit growth pattern until at least 2020.

*"Our 5-year plan forecasts 12-13% YoY growth. Compared to the past, this goal can now only be achieved through a combination of organic and inorganic growth... without inorganic initiatives, we are planning for only 7% growth."*

## 1.2 Margin and Cost Pressure

Generally speaking, component producers in China are profitable, and for many companies, more profitable than in other large global markets. The end of the 'good margins' era in China has been predicted for many years, but that prediction has been only partially realized. Yes, costs have increased substantially over the last 5 years, and prices are under some pressure, but this has been largely compensated by scale and efficiency improvements. However, future price pressure is expected to increase considerably, while costs may still increase to some degree.

*"China today represents 8% of total company sales and contributes a slightly lower percentage of profit. In 4-5 years, we should exceed 10% in both."*

*"China represents 10% of global sales and 15% of global profits... we see clear growth potential, but profits will gradually fall in line with those in Western countries."*

*"China is 20% of our sales and 30% of our global profits. We expect this to continue for a number of years given the competitiveness of our product segment, but in the longer run, pricing pressure will increase."*

There will be increasing pressure on OEM car prices (20-30% decreases in the mid-term), which will be passed onto tier-1 and 2 suppliers. Some suppliers are clearly seeing this trend already in several key components, such as dies, where OEMs are putting added pressure on manufacturers to absorb investments and costs.

In terms of costs, labor and other expenses should be more stable than in the past. However, some key costs, such as raw materials, energy/utilities and land, will bring added pressure. Specifically, we expect the following increases in these cost drivers:

- Inflation at +2%.
- Salary increases between 4-6% (except direct labor, which is a fixed number based on regional minimum wages set by the local governments)
- RMB depreciation of 3-4% YoY.

## 1.3 Changes in Client Structure – the Surge of Local OEM's

The client landscape is changing dramatically. Local OEMs will continue to grow and quickly win market share.

- In 2016, local brands' market volume was over 34%. By 2018/2019, this could reach 40%. Key players will be Geely, followed by BYD and Great Wall. Some of the SOEs (SAIC, Dongfeng, BAIC and FAW) may also become more important.
- Overcapacity may become a problem in the mid-term, but not now. OEM's have grown their capacity too quickly (today's CAPEX investments assume double-digit growth, which will not be met in the reality).
- At the same time there will be further consolidation among the OEM's. The merger of Dong Feng and FAW may happen, although opinions here diverge. If it goes through, it may trigger other SOE consolidations. Consolidation of private companies is unlikely in the mid-term.

## 1.4 Disruptive Technologies

New Energy Vehicles and high-tech, connected vehicles will reshape the industry at the China and global levels in the years to come.

*"In the car market, the main trends worldwide (and even more so in China) are electric vehicles and connectivity. China is heavily subsidizing R&D in these areas in hopes of becoming a technological leader."*

*For the Chinese government, it is not just the incentive of reducing pollution and having more control over energy efficiency, but also that Chinese companies can take a strong position in this new market."*

*"Geely aims to expand its capacity from 400K units/year to 2-3 times that by 2020, and to have 80% of its production focused on electric vehicles by 2018."*

*"The development of electric vehicles and the connectivity market will have big impacts on the auto market, since it means incorporating, at the same time, both new technologies and new players. However, the pace of growth in the China market remains unclear (current sales size is insignificant)."*

The impact of these new technologies in China is likely to be biggest on the OEM side, where China will make efforts to skew the car industry more towards local brands. However, for component producers, new technologies are also an important long-term challenge, both because of the potential impact on their business in China and globally and because of the uncertainty of the outcome. This uncertainty is way bigger than in other major markets, where it is more an issue of competitive development and changes in client structure. In China, however, there is the additional factor of government interference.

For China, these new technologies are actually considered potential game changers, which might allow the country to not only decrease its dependence on international component suppliers and OEMs, but also to achieve industrial leadership in the sector locally and globally. The government commitment to the new technologies (as stated in the China 2025 policy and several related documents) clearly shows the strategic importance China attaches to the EV and connectivity trends. We can expect a continued push by both the government and Chinese

players to achieve the maximum level of control over this industry within China, while at the same time creating the global standards for products.

This balancing act between market access and technology transfer – with its unclear and uncertain outcome – will determine the structure of the industry in the mid-to-long term in China, and possibly globally, too. In any case, at this moment there seems to still be considerable room for international component suppliers as China brings state of the art technology into the country. Acquisitions of smaller technology players in the space is one of the options being considered.

## 1.5 Local Competition

Foreign players are dominant in the car component sector, and in the short and medium term, this dominance seems endangered only at the margins, with some specific Chinese companies (e.g. Wanxiang, Huaxiang, Minth) threatening global suppliers in China and – through international acquisitions – abroad. Other local producers in the market are clearly overinvesting, as they follow their OEM customers without critical / professional planning.

*"One of our local competitors has already doubled our capacity, but we know most of these lines are not yet running....they make the CAPEX first, then offer the capacity to their customers, taking on all the risks without closing contracts in advance... this cannot be sustained."*

At the same time, supplier consolidation is now occurring, driven by MNC acquisitions of local players, domestic-to-domestic acquisitions and natural attrition – elimination of smaller low-quality Chinese players due to their lack of scale, quality or technology.



## 1.6 Action

Asia is one of the global priorities for most tier-1 auto component producers, and China is the top market in Asia. The key to success in the China market is local decision making, speed and flexibility. While global supply chains are important, Chinese clients are a big part of this chain, as even 'international OEM's' are 50% Chinese, given the legal requirement for a 50% or more Chinese share in any car or truck OEM. Therefore, much attention is being given to China, and many companies are starting to see the benefits of granting more decision making flexibility to China-based leadership.

*"China is a hot topic for our global board. Along with the USA, we are one of the top two countries in terms of new investment plans; our board has finally decided to go for inorganic growth in China, which represents a big change from their traditional approach."*

*"After a restructuring brought about more flexibility, I report directly to the global CEO, who always listens to ideas that allow us to adapt to the changes in China... we are becoming more and more of a 'local' player in terms of speed and risk assessment."*

*"Our China entity has always been, and will always be, more independent than our American or European offices because we operate many business through Joint Ventures where we must respect our Chinese partners' ways of doing business. However, we can say that our Chinese organization is moving towards more standardized procedures, which is in the core interest of an industrial company."*

*"Our China entity has full decision making power, as the global CEO is frequently in China. Decision making speed is increasingly important because of the increased importance of Chinese clients,*

*and because of more and more foreign JV OEM's behaving like Chinese companies. Decision making speed has become a key competitive advantage for us, and this cannot be achieved without local decision making authority."*

In term of the management priorities for the short and medium term, the focus is on continued growth (both organic and inorganic) and efficiency.

Since pricing pressures are bound to increase, efficiency is taking on a more prominent role:

- Plant efficiency via CAPEX and automation. Most MNCs' China plants still have technological gaps compared to their EU and USA counterparts. Closing these gaps should increase efficiencies and protect profits over the next 2-4 years.
- Further localization, including fewer expats in factories and more local production equipment.
- Localize raw material procurement and decrease imports.
- Consider rentals in lieu of purchases (for instance for new factories).

On the growth side, both organic and inorganic paths are being followed. In terms of organic growth, it is all about growing market share, in particular to the Chinese client segment through the strengthening of relations with local OEMs. This is done via M&A or JV and building ad hoc factories for each OEM. In addition, some companies are considering introducing adjacent product categories that have not been present in China. This is driven by new areas like aftersales and services and greater quality requirements.

Along with organic growth in the traditional segments, there is a need for inorganic growth projects focused on Chinese OEMs. This is a very different market, where many FIEs lack the right product/price/relationship positioning.

*"Around 32% of the market is made up of local OEMs, which FIEs have a difficult time accessing due to prices. Other JV OEMs such as DPCA, SVW, FAW-VW are also very price sensitive and not open to innovative or high-tech solutions. For 75% of the market, the customer still remains highly price sensitive and not entirely ready to pay for added value solutions."*

The outcome is that many companies consider M&A and JVs as key to their growth paths. In terms of M&A, the typical target company has 0.5 to 1 billion RMB in revenue, is privately owned or part of an SOE that is considering a carve-out. These companies should have strong relationships with Chinese OEMs (even cases where a single OEM represents more than 50% of revenue would be considered). In addition, the targets should own local technologies that have price advantages, be profitable and well managed in a local Chinese way. A key success factor is to assess whether or not the commercial and sales practices that made the company successful can be retained after integration. Lastly, EBITDA multiples should not exceed 10, depending on growth and synergies.

A second inorganic growth trend is to develop JVs OEM-by-OEM. This has been quite normal in the past with the large SOE's, like FAW, SAIC, etc., but now there are new opportunities with POEs. Greenfield or brownfield JVs are the best model, preferably with a local player that both knows the OEM well and is motivated by constraints in terms of scale, efficiency or technology (as Chinese OEM's are increasing their efficiency and technological requirements).

Some companies are also looking at investing in start-ups or early stage companies in the EV and connectivity fields. Although the rules of the game are different here – with different valuation expectations for instance – there seem to be many opportunities for international component suppliers who bring the technological experience and OEM access.

## 1.7 Conclusion

The car component sector is typical of other sectors in China, where global companies have established an entrenched leadership position, which is now further enhanced by the increasing quality requirements of clients, higher costs and stricter compliance enforcement. However, as China upgrades the industry, this position is under threat, first from market changes and stronger local competition, and secondly from government policies favoring local companies in the long run. Further localization, with a stronger and more empowered local management team, closer relationships with clients and fast decision making are key to maintaining and strengthening China market positions. In terms of strategy, it is about efficiency (lowering costs and improving processes) and organic and inorganic growth. For inorganic growth, acquisitions and JV's with suppliers to the Chinese segment of the market and with companies active in the emerging EV and connectivity segments is key.



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