

Which do you think is more likely to emerge as a “national champion” in the Chinese auto industry, a private sector firm such as Wanxiang or a state-owned enterprise (SOE)? The purpose of this essay is for you to analyze the domestic competitive environment for this industry: what features are important for the success of private enterprises and SOEs in today’s China and what advantages/disadvantages do these features create for an auto sector firm?

In the early 1970’s Lu Guanqiu the Founder of Wanxiang Group was easily able to compete with State-owned Enterprises (SOEs), which were rife with agency conflicts, by focusing on human capital, research & development and political maneuvering. Nevertheless in the post reform era following the Eleventh Plenum of the CCCP and the recent establishment of SASAC, Wanxiang’s original competitive strengths are beginning to erode. In such an environment, Wanxiang’s designation as a “national champion” in the auto parts industry is far from assured.

Industry Overview

According to industry reports, at the end of 2006 the Chinese automotive parts industry was comprised of approximately 8,000 companies. Overall the industry was estimated to be worth \$46.1 billion in 2006, with the top 10 Chinese manufacturers accounting for roughly 20% of the total revenue.¹

At the assembly level, there are roughly 1500 registered auto manufacturers within China, however it is reported that fewer than 100 sold more than 10,000 vehicles in 2006.² For the past several years the auto parts industry in China has been consistently outperforming the indigenous auto manufacturing industry by significant measures. From 2004 to 2007 the industry grew at a rate of roughly 31% with net profit margins of almost 7%, versus only 4.5% margins for auto manufacturers.³

The oligopolistic nature of the international auto manufacturing industry is increasingly consolidating pricing power in the hands of a few powerful conglomerates. Subsequently pricing pressure within the parts industry is already starting to materialize as demonstrated by declining gross margins over the past several years (Figure 1) among the top listed auto parts players such as:

- Weifu High-Technology Co., Ltd
- Wei Chai Power Co., Ltd
- Wanxiang QianChao Co., Ltd
- Fu Yao Glass Group Industries Co., Ltd
- NingBo Huaxiang Electronic Co., Ltd

¹ Kong, Wilfred & Gwinn, Edward, *China Business Guide 2008*, pg. 152-157

² Ibid.

³ Liao, Whitman, Chinese Suppliers to Face Consolidation, *China Automotive Review*, March 2008, pg. 32

Along with consolidated pricing power, profit margins are under increasing pressure from factor conditions such as FOREX fluctuations, labor costs, raw material prices and energy/power demands.

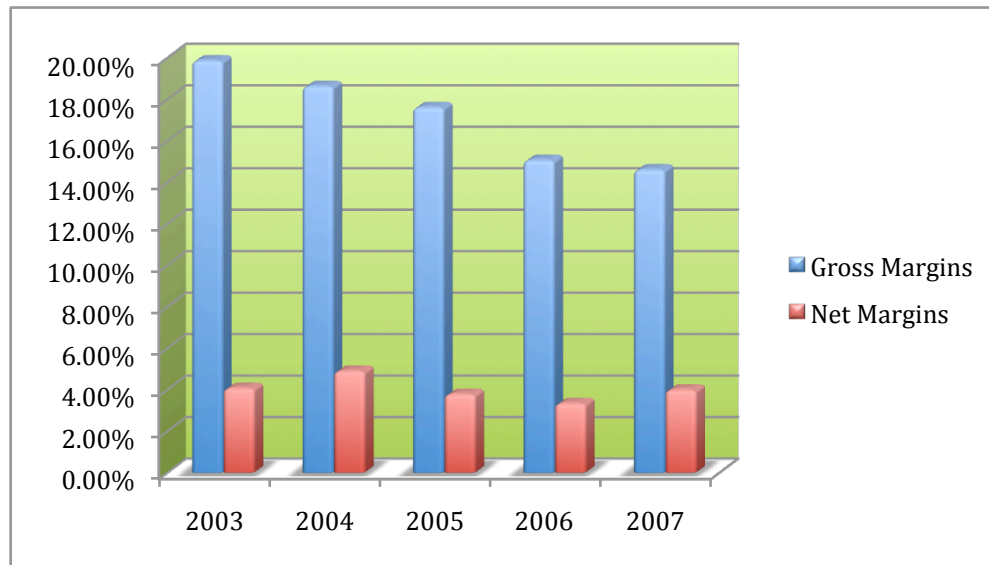


Figure 1 – Comparison of Margins for Listed top Auto Parts Manufacturers⁴

Indigenous parts manufacturers are responding to these pressures by beginning to shift their organizational integration strategies away from horizontal structures towards vertically integrated international parts platforms (Figure 2).

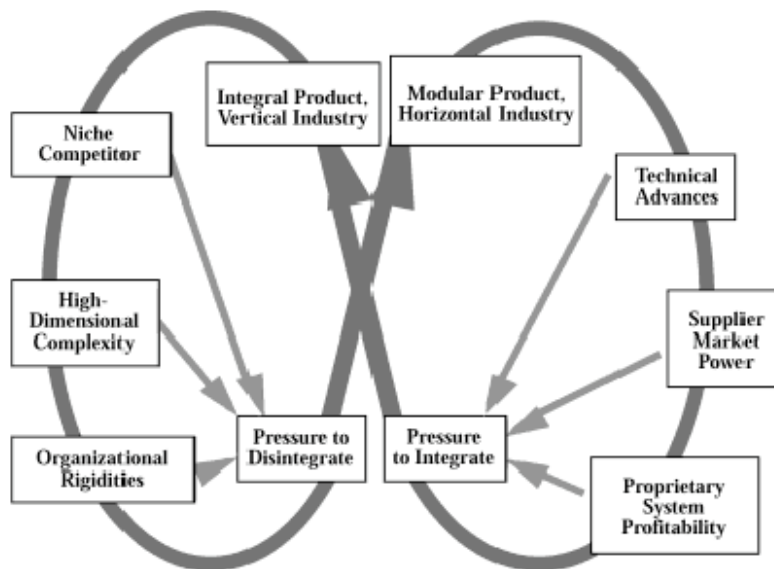


Figure 2: Double Helix⁵ of Industry Evolution

⁴ ISI Analytics, *China Industry Research Report – Auto Parts Industry*, Issue Q1 2008

⁵ Fine, Charles, *Clockspeed: Winning Industry Control in the Age of Temporary Advantage*, 1998

DRIVERS OF COMPONENT MANUFACTURING INDUSTRIAL SUCCESS:

Analysis of the industry dynamics suggests that there are three primary drivers of success that would lead to the ultimate designation of a “national champion” within the auto parts industry.

China was recently cited by the WTO for violating trade laws by requiring that imported parts contain at least 60% of locally sourced completely-built-unit characteristics. Undoubtedly they will appeal the ruling in an attempt to protect the indigenous auto parts industry from competition emerging within the region from the likes of Vietnam and Cambodia, however this is only a strategy to extend the inevitable.

Overseas competition means that in order for indigenous Chinese companies to succeed and prosper they must proactively engage with foreign markets, unencumbered by bureaucratic rules and regulations. It will become increasingly important for local corporations, regardless of structure (SOE or Private) to source management talent with considerable expertise in driving international M&A activities along with the requisite skills associated with post-transaction integration. Without a doubt this will be the primary component that will determine success in the global marketplace.

Secondly, many auto parts are more efficiently produced in proximity to the point of final assembly. Thus only specific ranges of parts are suitably manufactured in low cost centers (such as China, Vietnam & Cambodia). Dynamically shifting production results in significantly lower costs basis’, which can be passed along to the end customer or captured as pure profit. The ability of indigenous firms to dynamically shift manufacturing and production runs, in the process arbitraging market discrepancies by balancing differences in production costs along with the degree of required locality, will be a critical success factor.

Finally, the role of national pride, culture and protectionism must be considered. As possibly the most amorphous of all success factors it is the one that most indigenous firms will be least able to control. Recent history suggests unexpected societal responses to certain international expansion strategies by non-Anglo-Saxon firms (CNOOC & Unocal, Dubai Ports & P&O, PetroChina & Sudan Controversy). When and if these controversies emerge will be primarily a function of “how” Chinese firms choose to go abroad and secondly a more fluid function of how those strategies are interpreted by local stakeholders.

IMPLICATIONS OF SUCCESS DRIVERS

The State-Owned Assets Supervision & Administration Commission (SASAC) was established by the 10th National People’s Congress to resolve the agency issues plaguing SOEs. Since its creation SASAC has firmly established its base of power

within the government, in the process espousing clear ownership responsibilities and management accountability. Nevertheless at the same time the power of SOEs, driven by their economic importance, has also increased, possibly to a greater extent.

In order for SOEs to compete on the international stage major reforms of social security systems must be adopted. SOEs are currently saddled with the responsibility of maintaining a social safety net, thus they are unable to reallocate production to take advantage of cost/labor factors. As the industry evolves this issue will become an ever-greater impediment to SOEs looking to succeed in the global marketplace. Conversely their private corporation counterparts, who do not suffer these same kinds obligations, will be able to respond to changing market conditions with greater ease and flexibility.

Within the leadership structure of many SOEs, senior management assignments are still driven by party affiliations with assignments being made by both the Communist Party Organization Department as well as SASAC itself.⁶ While the expertise of such senior placements is not in doubt, it does highlight the simmering agency tensions between pure economically driven profit-motives and the greater social and political policy agenda of the CPC. The long-term implications of such a patronage arrangement are still unclear, however with these issues relatively absent within private corporations the theory of parsimony tells us this could impart a competitive advantage for private firms heading abroad. Furthermore membership in the CPC by private corporation senior management may instill all of the benefits of association without the related agency conflicts in SASAC administered SOEs.

Preconceived western notions of differing political systems are difficult to displace. Until that happens SOEs seeking to expand abroad are in danger of facing public and political backlashes against not only accelerating globalization but also perceptions with regards to “underlying motivations.” While it may or may not be ultimately true, private corporations may be less affected by such hostilities since in theory their only motivations are profit-oriented.

Despite the previously mentioned negative effects associated with the SOE structure there are strong mitigating positive benefits, which were clearly demonstrated in 2007-2008. When China Eastern airlines (an SOE) announced a partnership with Singapore Airlines, SASAC was one of the agencies that granted approval, citing the positive market benefits of increased competition⁷. Shortly afterwards Air China (another much larger SOE) raised concerns over the effects of foreign competition on the industry. In the end the transaction was aborted despite SASACs approval. Ultimately Air China sidestepped SASAC by bringing in higher-level “patrons” which

⁶ Naughton, Barry, *China Leadership Monitor*, 2008, No. 24

⁷ Ibid.

helped it maintain constrained competition in the indigenous market. National protectionism is a potential benefit of the SOE structure, however with increasing economic coupling and harmonization of trade standards, it is a fleeting competitive advantage for SOEs.

CONCLUSION

The global auto parts industry is entering a period of rapid transformation driven by not only macroeconomic trends but also technological innovations in both products and processes. Future auto supplier success is dependent upon the ability of indigenous players to proactively engage the global marketplace. The firm best able to manage this process, regardless of ownership structure, will be the beneficiary of the “National Champion” designation.

Within the operating environment described above, Wanxiang is well placed to capitalize on the shifting market structure. Within China the firm is very well respected for its expertise in utilizing “advanced management” techniques to build its business by successfully engaging the international marketplace⁸.

Going forward the critical component of Wanxiang’s success hinges upon its ability to further leverage management expertise in order to ensure successful integration of its global parts manufacturing platform into one cohesive unit. Any diversions in strategic direction run the risk of setting the company askew and in the process allowing fast moving seconds to capture significant market share.

⁸ ISI Analytics, *China Industry Research Report – Auto Parts Industry*, Issue Q1 2008

Wanxiang aspires to be a global firm, and it has asked you to develop its strategy both within China and abroad. Should it continue to focus on automotive components (and if so, should it supply foreign-invested assembly plants, domestic assembly plants, or the global aftermarket) or should it begin to develop the capabilities to produce a complete vehicle (such as an electric car)? This answer should build upon your previous answer: considering the strengths and weaknesses of Wanxiang, what value chains should it focus on and what should its place within them be?

Several years ago Detroit automakers would call up their U.S. suppliers asking how they were going to meet “the China price?”⁹ In the not too distant future, global automakers may be calling Wanxiang saying, “We want you to match the Vietnam/Cambodia/African/Eastern Europe price.” To prevent that from happening Wanxiang needs to radically reinvent its position in the global automotive value chain.

REINVENTING THE LINE

When Henry Ford invented the assembly line, he firmly established it as the dominant design with regards to automobile production. Virtually all of the subsequent innovations in the industry in some form or another revolved around this core component. At the time, limited distribution required supply and production facilities to be in close proximity. In due course, as the world expanded, political regimes opened and international shipping emerged as a viable and cost effective solution, geography become less of an impediment to the efficient functioning of the automobile assembly line.

The future of the automobile industry is distinctly global, in the absence of major geopolitical destabilizations. As the industry transforms, a scenario emerges where the current crop of automobile manufacturers refocuses 100% of their efforts on design and distribution, while increasing their reliance on the Original Design Manufacturing (ODM) model.

Under the ODM model, backwardly shifting complexity allows for the reallocation of assembly tasks to regions and personnel best positioned to add value through specialization and general factor conditions. This backward shift would allow a newly emerging crop of automotive ODMs to offer greater value-added services built upon a modular, internationally integrated assembly platform (Figure 3).

The industry is only now beginning to even consider the implications and opportunities associated with such a seismic shift in structure. Despite its radical nature, macroeconomic and competitive drivers are pushing the automobile manufacturers down a path which they may not be able to retreat from.

⁹ Auto Industry Consolidation: Is There a New Model on the Horizon?”

Knowledge@Wharton article published January 25, 2006. Accessed via Internet on June 10, 2008 at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1365>

The next 5-10 years will be the most important period of Wanxiang's history. As the firm considers its expansion and diversification strategy, the decisions it makes today will have profound long-term implications.



Figure 3 – Envisioned Wanxiang Group Automotive Platform Approach¹⁰

STRATEGIC RECOMMENDATIONS

Wanxiang is currently faced with three strategic questions:

1. Should it continue to focus on automotive components? If so, should it supply foreign-invested assembly plants, domestic assembly plants or the global aftermarket?
2. Should it begin to develop the capabilities to produce a complete vehicle?
3. What value chains should it focus on and what should its place be within them?

To begin with, the answer to the first part of question one is relatively straightforward. The dynamics of the global after market components business are such that while it only accounts for roughly 25% of corporate revenues, margins in

¹⁰ Adapted From: Xu Qingrui, Wang Yi, Chen Jin, Shen Shouqin, *Putting Core Competencies Into Market: Core Competence-Based Platform Approach*, Accessed via Internet on June 10, 2008 at:
<http://ieeexplore.ieee.org/iel5/7004/18885/00872496.pdf?arnumber=872496>

the segment are generally healthier than in the OE segment. Given global growth and automobile ownership trends it would be premature for Wanxiang to exit this segment.

The answers to the remaining questions are slightly more complicated. Modular assembly is not a new concept¹¹; however the prospect of automakers adopting a 100% ODM model is monumental. Whereas a full-scale strategic analysis is beyond the scope of this document, the proposed Wanxiang platform strategy (Figure 4) provides a high-level overview of how the firm could seize upon industry trends in order to maintain its relevance well into the 21st century.

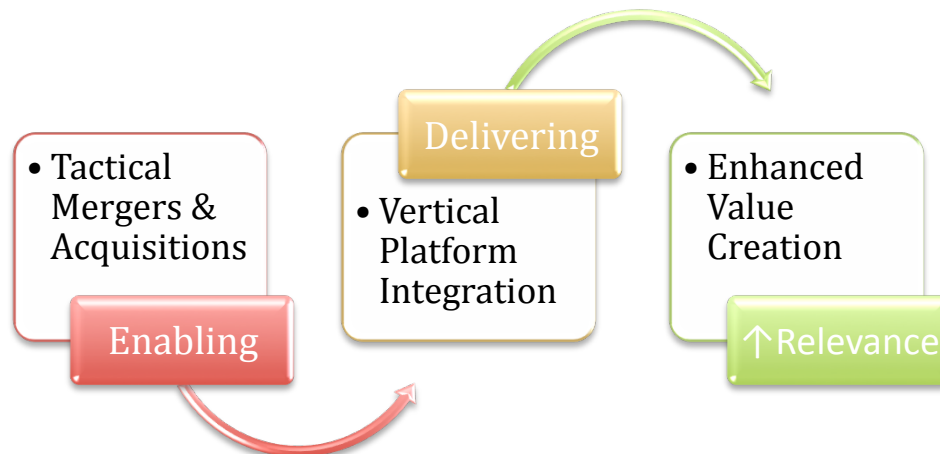


Figure 4 – Proposed Wanxiang Platform Strategy

Tactical M&A Transactions

Consolidation in the auto parts industry, brought about purely for the purpose of creating bigger diversified empires, will not in and of itself guarantee commercial success. Instead strategic consolidation and acquisitions to build a complimentary product portfolio that leverages a platform of modular sub-assemblies will ultimately be the most profitable model.

There are three critical areas where Wanxiang should consider either strategic investments or outright acquisitions:

- International Maritime Shipping Capacity
 - Delivering Reliability, Visibility and Supply Chain Optionality
- Advanced Business Intelligence, Supply Chain Management & Customer Relationship Management
 - Providing real-time end-to-end platform integration that is tightly coupled to the end-customer's business

¹¹ Helper S., MacDuffie J.P, Pil F., Sako M., Takeishi A., and Warburton M., *Project Report: Modularization and Outsourcing: Implications for the Future of Automotive Assembly*, paper prepared for the IMVP Annual Forum, MIT, Boston, October 1999

- Advanced Design and Development Capabilities
 - In order to provide end-customers increased value-added services

Vertical Platform Integration

Under this new automotive manufacturing model, Wanxiang should begin the process of integrating its operations and refocusing efforts around the modular assembly of complete automobiles. As it develops these capabilities it should NOT seek to roll out this vehicle directly to automobile consumers, lest it run into the same conflicts-of-interest that direct-to-consumer ODM laptop manufacturers experienced. Instead it should seek OEM/distribution partners willing to explore this new business model.

Fundamental Value-Creation

By combining the first and second phases of this strategy, the additive benefits of upgraded knowledge, capabilities and resources form the core of a durable competitive advantage in the assembly business. Furthermore high barriers to entry ensure that the early firms, who adopt this manufacturing model, will be the ones who dominate the industry for many years to come.

Wanxiang's original query asked what should be their Indigenous and International Strategy. However these two concepts are inextricably intertwined. In a global assembly marketplace firms must holistically balance the pressures of local competitive dynamics with international customer demands and shifting design requirements.

CONCLUSION

History has shown that a single product or supply chain decision (by a dominant producer) can set the stage for a momentous structural shift. Horizontal industry structures tend to be short-lived due to their tendency to create fierce commodity driven competition. Increasing consolidation and verticality in the global parts industry along with automobile manufacturer desperation has created a dynamic environment, which could overthrow the traditional industry structures and firmly entrench Wanxiang as the leading international assemblers.