Perspective

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The Eight Overarching China Automotive Trends That Are Revolutionizing the Auto Industry *Part 2*

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EXECUTIVE SUMMARY

In Part 1, we introduced the Eight Overarching China Automotive Trends That Are Revolutionizing the Auto Industry, and provided an in-depth look into the first four trends. The eight trends are again summarized here:

1. *Policy-driven Consolidation of Chinese Vehicle Manufacturers*
2. *Global Redistribution of Assets by Non-Chinese Companies to Capture China Market Growth*
3. *Acquisition of Foreign Assets and Key Development Competencies by Chinese Companies*
4. *China's Investment in New Energy Vehicles and Related Infrastructure*
5. *Utilization of China's Automotive Capacities for Global Expansion*
6. *Hyper-Competition Across the China Automotive Market Segments*
7. *China Vehicle Manufacturer's Push to Build Brand Equity*
8. *China's Rapidly Changing Demographics and Growing Demand in Lower Tier Cities*

In our judgment, we believe China is the catalyst for the restructuring of the global automotive industry, and that the trends described here act as the driving force behind the many of the changes that are occurring.

As an economic bellwether, the automotive industry captures a great deal of interest. Many auto industry observers view recent events on a shorter time horizon and see the auto industry restructuring of 2009 as having been precipitated by the global financial crisis. In our view, we are witnessing the early stages of an economic revolution: a shift of the global center of gravity of economic strength towards the east, which will result in fundamental and irreversible changes in numerous industries. In this context, the global financial crisis was a triggering event that accelerated the structural changes that were ultimately unavoidable.

In Part 2, we will look in depth at Trends 4–8 and summarize how the eight trends are revolutionizing the global automotive industry.

TREND #5: UTILIZATION OF CHINA'S AUTOMOTIVE CAPACITIES FOR GLOBAL EXPANSION

The growth and development of China's automotive market is transforming the automotive business model for the entire global auto industry. While it is obvious that China already has become the world's factory for "everyday low price" merchandise, the ramifications of the rapid development of the Chinese automotive base on the global auto industry are less intuitively obvious. While we call this trend the "Utilization of China's Automotive Capacities for Global Expansion", it is not simply about exporting finished vehicles from China. Rather, the more significant trend is how other elements of the automotive value chain are impacted by the development of China's automotive capacities and capabilities.

China has rapidly become the largest car market in the world. For 2009, China posted sales of 13 million units versus 9.7 million vehicles sold in the U.S. market. It now seems like all the ingredients are there for the "Chinese automotive factory" to expand to the global markets. In fact, much of the content in cars sold in the U.S. and elsewhere today already does come from China. Because a significant percentage of the total cost of a car is in the manufactured components, there has already been a significant movement of the production of supplied parts to China. A great many of the components used in cars today either are or can quickly be manufactured in China. This is purely driven by the efficiencies gained from sourcing in China. Most consumers are unaware of how much Chinese content may already be in their current car. However, our focus here is on the globalization of China's automotive capacities.

Despite the rally in China's domestic sales, China's largest car exporters reported fewer export sales in 2009 when compared with last year. China auto insiders have pointed to the overall decline in worldwide demand as the reason, particularly in such key markets as Russia where protectionist measures have had a direct impact on vehicles entering the market. But this is not a complete explanation. The challenges faced by China's domestic companies in their efforts to go global were covered in detail in our previous Viewpoint entitled The Path to Globalization of China's Automotive Industry.

As a result of the unprecedented restructuring of the global automotive industry, several OEMs and suppliers have filed for Chapter 11 bankruptcy protection, and are in the process of restructuring and selling assets. Going forward, global automotive companies have been forced to radically and often involuntarily rethink their global footprint. Several examples have already been noted in Trend #2: Global Redistribution of Assets by Non-Chinese Companies to Capture China Market Growth. Clearly, the global center of gravity of automotive strength is shifting east.

If we look out over the next decade, we can with confidence anticipate a resumption of global auto market growth, particularly fueled by economic recovery and robust demand from emerging markets. This will create many opportunities for the reconfigured industry with its new "Asia-centric" footprint.

Leveraging Regional Automotive Capacities and Capabilities

The reality of the 21st century globalized auto industry is that businesses models must be redesigned to fully leverage the capabilities that are now accessible in newly emerging markets. Unfortunately, in order to become global, most automotive OEMs have attempted to export a business model optimized for their home market to their international locations. Migrating development capacities to markets that lack the competency to perform the work misses the entire point of globalization. Pursuing cheap parts or cheap labor is ultimately self-defeating when doing so robs an organization of its core competencies, thereby accelerating their demise. Similarly, exporting a business model designed for the home market to foreign markets only serves to limit the ability of the organization to embrace the capabilities of the foreign market.

Automotive manufacturers in concert with their key stakeholders must redefine their business models for the new reality of 21st century competition. Going global is not a simple transplant of the current business model to a foreign location. This implies a transformation of the entire automotive value chain to leverage the opportunities made possible by globalized capabilities. It involves redesigning business processes across the value chain in order to deliver to the customer a brand with a Unique Selling Proposition (USP) relevant to the local consumer. This will require that 21st century global auto companies fundamentally rethink their entire value chain from the consumer back through sales and service, production, supply and R&D. Key stakeholder groups, including the national governments with an interest in the global competitiveness of their domestic auto industry, must contribute to this development.

Businesses capable of leveraging global capabilities will ultimately be able to deliver a relevant USP at much lower cost. The Logan produced by

Renault in India is one good example. Through engine re-engineering and parts simplification, Renault successfully adapted this car to be more cost efficient and easy to repair for Indian customers.

International OEMs are doing two types of differentiation in overseas markets, such as China. The first practice is the local adaptation on top of existing platforms. This is represented as changes to styling, functions and features to meet local regulatory requirement and market tastes. Recent examples are extended wheelbase luxury cars such as Volvo S80L and Audi A4L, the refreshed Buick Regal and LaCrosse, and the Hyundai Elantra Yuedong. Excellent sales have resulted from delivering products tailored to the local consumer taste—delivered at a cost made possible from the cost efficiencies and scale achievable in the China market.

The second type of differentiation is development of a brand new vehicle "top hat" (uniquely styled upper body with common chassis and powertrain). Products such as the Lavida by Shanghai VW are excellent examples of low-cost derivatives from a global VW platform tailored to the taste of the local consumer.

China's Emerging Role in the Global Auto Industry

Over the next 5–10 years, China will be the world largest auto market, and for reasons noted in Trend #4: China's Investment in New Energy Vehicles and Associated Infrastructure it will also the strive to become most fuel-efficient market. China's sales growth will be also fueled by small displacement cars demand from those first time buyers from lower-tier cities. This has a profound impact on China's capacity to leverage the scale and competencies that accrue from becoming the largest production base for energy efficient vehicles.

From the supply side, we can foresee the trend of consolidation of vehicle makers, growth of local brands, and development of New Energy Vehicles. The future belongs to those who can extend their capabilities beyond low-cost production and supply to areas of world-class R&D and brand management—essential steps on the path to globalization. It is important to note that opportunities to integrate these capabilities into the business system are available to both local firms as well as multi-national companies. One of the poorest assumptions made by industry analysts when observing the China auto market is they often assume that only Chinese firms will ultimately benefit from the growth of the Chinese market—and they must therefore eventually dominate the global industry. This is a simplistic view, particularly when one considers that foreign brands still hold about two-thirds of the share of the Chinese domestic market.

However, Chinese auto companies are developing rapidly and aspire to become global companies. SAIC and FAW already possess significant scale advantages as a result of their successful JVs. FAW's own brand B50, B70 and Xiali products are well received by market. Chang'An group has recently demonstrated market leadership and capability in the small car segment. Chery has developed full range of products with their own platforms, transmissions, and engines.

One must also take note of the astonishing rise of independent companies such as BYD, Great Wall and Geely. BYD—a cell phone and battery maker aspiring to become a leader in electric vehicles has clearly startled the world by delivering the first mass-produced plug-in EV. Several of these independent companies can become successful global car companies.

Several Chinese companies may prove capable of becoming icons of the 21st century global auto industry. However, they must also learn the lessons from the failure of the 20th century industry icons, who ultimately became "healthcare and insurance providers backed by vehicle sales".

TREND #6: HYPER-COMPETITION ACROSS THE CHINA AUTOMOTIVE MARKET SEGMENTS

The rapidly changing structure of the China automotive market is having a dramatic impact on the product portfolio and brand strategies for the industry both inside and outside of China. While many Vehicle Manufacturers have reported robust China sales in 2009, industry watchers often overlook an important point: China is a market where quantity of sales should not be confused with quality of sales. The China market is now experiencing what many companies doing business in the United States have come to understand for many years: hyper-competition.

With Tremendous Growth Comes Hyper-Competition
As described in detail in Trend #2: Global Redistribution of Assets by Non-Chinese Companies to Capture China Market Growth, China's vehicle market has more than doubled in size from 4.56 million units (in 2003) to 9.67 million units (in 2008). Global Insight has forecasted that the Asian markets represent the largest growth potential in the global auto industry—with a combined 4.7% compound annual growth rate over the next 10 years (compared with 2.9% in NAFTA). Within Asia, 54% of that growth is expected to come from China. With the promise of tremendous growth, many international firms as well as Chinese firms are encouraged to allocate resources to seize the opportunities presented by the Chinese market.

The high popularity of the April 2009 Shanghai Motor Show further illustrated the attraction of the Chinese market. The show stand covering 170,000 meters attracted over 660,000 visitors with over 900 models on display, over 300 of which were imports. Over 1,500 exhibitors were present at this year's show.

Early-movers in the China market such as Volkswagen and General Motors have enjoyed significant profit margins by occupying mid-size, full-size and MPV segments without a great deal of competition. In such a market environment, profits could be made on products such as the VW Santana and the Buick GL8 minivan—older technologies that dominated their segments with good margins. However, today's China market no longer offers such an easy road to profitability. Virtually every major vehicle manufacturer is now present in the China market. A recent J.D. Power & Associates study has reported that many of the cars sold in 2009 were in low-end segments that are eligible for tax incentives and that many of these cars earn the manufacturers as little as $100 each.

However, hyper-competition actually began several years ago, with the onset of a phenomenon called "net negative pricing". In fact, Global Insight reported the following net segment price declines over a four-year period (starting 2004):

1. Micro (A-segment): 20.4%
2. Small (B-segment): 27%
3. Compact (C-segment): 32.5%
4. Standard (D-segment): 26.3%
5. Luxury (E/F-segment): 12.1%

The outlook is that local brands and international brands will install more capacity in China, placing even more pressure on pricing in order to increase capacity utilization. Weak brands and older models will become the first casualties as market and competitive forces squeeze them out. The competitive battle can only be won with strong brands and contemporary models that can be delivered profitably to savvy Chinese consumers with choices that demand a competitive price.

The Problem of Overcapacity

Chen Bin of the National Development and Reform Commission has recently encouraged automakers to "keep their heads cool" to prevent overcapacity. With an expectation of a 28% jump in vehicle sales in 2009, many automakers are announcing aggressive expansion plans. With sales now expected to surpass 13 million units this year, there is every cause to be bullish about China's future automotive market. However, China's industry planning agency has good cause for concern as there are already many weak vehicle manufacturers in the market today.

Beyond simply adding capacity to produce more of the same type of cars, there is evidence that the competitive structure of the market will take on a new dimension in the near future. For the early stages of the development of the China market, the multi-national brands and Chinese brands were for the most part not competing directly with each other. Foreign brands enjoyed a tremendously high share of the passenger vehicle market, with overall share of more than 70% as recently as last year. Until recently, the more affluent Chinese consumers who tended to shop for foreign branded products largely drove China's automotive market. However, this year's sales jump has been largely driven by first-time consumers entering the market to buy the low-displacement micro-and small-segment cars that are supported by the tax policies. These segments are for the most part served by the Chinese local brand manufacturers.

This is about to change. Attracted by the tremendous growth of these segments, many multi-national brands are expanding their product portfolio into these smaller segments. Examples include the Ford Focus Hatchback, Chevrolet Cruze, PSA 207 Hatchback, Hyundai i30, VW Polo Sport, Toyota Yaris, smart Fortwo, and Kia Soul.

Attracted by the desire to raise their brand image, and achieve higher margins, the Chinese carmakers are also expanding their product portfolio—into larger segments. Examples include Chery's Rely V5, Riich G6, Dongfeng's S30, BYD's S8 and M6, Geely's Dihao and Yinglun and the Brilliance Zunchi.

While top-down advice to cool things down may be helpful, it is rare to see any organization unilaterally opt for conservatism in the face of optimistic market forecasts. Since China has become the most attractive area to invest for growth, it seems that Chinese consumers will be enjoying even more choices and even more attractive pricing as a result of hyper-competition.

These developments will have significant implications on the global auto industry, as the installed capacity in China will increasingly be used to serve demand beyond China's borders. Structurally, many vehicle manufacturers will either learn to profit in this hyper-competitive market, or will find their ability to compete here, and thereby elsewhere, compromised.

TREND #7: LOCAL VEHICLE MANUFACTURER'S PUSH TO BUILD BRAND EQUITY

China opened its domestic market to foreign vehicle manufacturers in the 1980's, starting with the first sino-foreign automotive joint venture between American Motors Corporation (AMC) and Beijing Automotive Industry Corporation (BAIC). Through the use of the joint venture form of cooperation, the government then hoped a domestic industry would emerge where the Chinese domestic companies would learn from their partners and eventually emerge as successful automotive companies.

In theory, the domestic companies would learn from their foreign counterparts the skills needed to manage a complex business, establish manufacturing and supply bases to produce vehicles and ultimately transfer critical technological development capacities in order build their own-branded products. While the China automotive market has indeed developed rapidly, it is very clear that the 25-year journey toward establishing independent automotive capabilities is still a work in process.

In fact, the model for development of China's domestic automotive industry was also designed to facilitate development of China's industrial base. Provincial governments, with the support of the central government, were encouraged to develop industrial bases to create investment opportunities and jobs in order to accelerate China's economic development. However, as was noted in Trend #1: Policy-driven Consolidation of Chinese Vehicle Manufacturers, there are numerous structural problems in the China automotive industry that result from the highly fragmented landscape of licensed car manufacturers. The fact that that there are over 150 registered manufacturers is an outgrowth of a start-up phase for China's auto sector. However, the highly fragmented industry that results from this creates enormous inefficiency for the management of critical assets.

This fragmentation also makes it very difficult to focus and allocate resources to the development of critical technologies as well as brands. This is an area of particular weakness for Chinese OEMs who have relied on their foreign partners to take the lead in the development and integration of key technologies. Foreign vehicle manufacturers, through their JVs have also lead the establishment of branded vehicle distribution networks. Chinese-branded vehicles have largely played the role of "bottom feeder" by selling a cheaper form of transportation to first-time consumers who are not as concerned over whether their product meets world-class standards.

The majority of Chinese consumers understand this quite well—which is the reason why foreign brands held a 66% share of the China market in 2008. The China government understands that in order to create a healthy industry, they must first raise the perception of "Made in China" cars in the minds of Chinese consumers. This is why there is a goal for Chinese OEMs to achieve a 50% share of domestic sales in 2010. The stated expectation is for the domestic manufacturer to introduce vehicles with their own brand trademark either through their existing joint ventures or other subsidiaries. We can therefore anticipate the following trends:

1. The government will likely require a foreign partner seeking to form a new JV to provide the support needed to introduce a Chinese local brand.
2. Domestic vehicle manufacturers will seek to improve brand image, enhance quality and target international expansion. Having enjoying rapid growth the China domestic market, several Chinese car companies including Chery, Great Wall and others have already started to export Chinese-manufactured vehicles to Australia, Latin America, the Middle East, Africa, and Southeast Asian countries. It stands to reason that less mature markets have demographics that lend themselves to new market entrants who compete primarily on price.
3. Foreign vehicle manufacturers may actively participate in local brand development in order to expand their market reach and receive preferential treatment. Honda is in fact taking this approach and is investing RMB 2 billion to develop a local brand with Guangzhou Automotive through their joint venture.

To support the growth of local brands, the government in 2009 has reduced tax rates by 5% on the purchase of vehicles below 1.6L engine displacement, as well as fiscal subsidies to rural customers for vehicle replacement. These policies clearly favor the local brand manufacturers who tend to build small, compact cars with smaller engine displacements. Such policies have helped companies like BYD and Geely become the shining stars of China's domestic market by offering competitively priced small cars which meet the quality requirements of Chinese consumers, many of whom are entering the market for the first time.

Brand Equity—With Chinese Characteristics

The capabilities of local Chinese OEMs have come a long way in a short time. Chinese firms will learn quickly as they grow their share of the domestic market. However, much work needs to be done to gain acceptance of the Chinese consumer of Chinese manufactured goods. This must be the first priority as it stands to reason that if it is difficult to convince a Chinese consumer, it will be even harder to convince a foreign consumer to accept a "Made in China" car. The fact is that with the proper attention to quality management discipline and with the transfer of critical know-how in the area of vehicle synthesis and development, it is indeed possible for Chinese firms to capture greater share of the domestic market, and eventually of the global markets.

While building equity in Chinese domestic brands is a tremendous challenge, there is a significant benefit of the joint venture approach taken in the development of the Chinese domestic auto industry. While learning from their global partners how to become global players is easier in theory than in practice, this approach has helped China establish a global supply base, with virtually all international auto parts companies now represented in China. By building and leveraging the capacities of such suppliers, and by selectively acquiring the assets of such suppliers, Chinese automakers are striving to build a more upscale image. Several examples were previously noted in Trend #3: Acquisition of Foreign Assets and Key Development Competencies by Chinese Companies.

Using this approach, Zhejiang Geely Holding Group has introduced several products and uniquely positioned brands, including Gleagle, London Taxi, Shanghai Maple, and Emgrand. New models such as the EC718 will be introduced under their new Emgrand brand at price points (starting at RMB 82,300) not previously achieved using the Geely brand. Convincing consumers to pay more for a relatively unknown brand will require a clear value proposition. Geely intends to increase their brand equity by sourcing from the world's leading auto parts suppliers, and in the process upgrade their image from a maker of "affordably priced cars" to one that delivers "safe, fuel efficient, and environmentally-friendly cars".

This year, Chery Automobile Company has taken a similar approach with the expansion of their brand portfolio to four brands: Riich, Rely, Karry and Chery. Such an approach carries significant risk, as the investment and resources needed to develop unique products and market separate brands is quite significant. Alfred Sloan's pioneering concept of "different cars for different buyers" was the centerpiece of GM's early 20th century expansion—and this was perfect for an American industry in its infancy. However, the cost of engineering unique products for as many brands as GM had in its portfolio became too great. GM's reluctance to give up brands because of their historic value became a major financial burden. After GM's sale of Hummer, Saab, Opel, Vauxhall and the wind-down of Pontiac, only 4 brands will remain: Chevrolet, Buick, Cadillac and GMC Truck.

Geely's Chairman Li Shufu apparently understands the brand equity challenge. He was recently quoted as saying "A brand is closely related to its cultural background. Isolated from that background, it is worthless," stressing that it would not be very easy for Geely or any other Chinese carmaker to grow its brand portfolio. He noted: "A brand is like a person's name. Even if I change my name to Hu Jintao, I am not Hu Jintao."

A significant part of addressing this challenge will be to overcome the perception that "Made in China" is equivalent to "Cheap and Poor Quality". However, great rewards accrue to those firms who understand how to adapt their positioning to the unmet needs of the local consumer. Successful firms find a way to take their brand value proposition and uniquely position it relative to competition in their target markets—creating a unique selling proposition (USP).

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TREND #8: CHINA'S RAPIDLY CHANGING DEMOGRAPHICS AND GROWING DEMAND IN LOWER TIER CITIES

The dramatic rise of China's automotive industry, in terms of both consumer demand and production supply, is truly unprecedented in the history of the industrialized world. No country has risen from a nearly standing start to the size and scale that China has achieved in such a compressed time frame. It was, after all, just 17 years ago when Deng Xiaoping made his now-famous visit to Shenzhen where he announced the creation of Special Economic Zones and thereby sparked China's wave of economic momentum. The logical question to ask is whether this momentum is sustainable, particularly as it relates to the most iconic of consumer goods: the automobile.

The last of the Eight Overarching China Automotive Trends That Are Revolutionizing the Auto Industry addresses the underlying socio-demographic forces that are driving the recent economic developments in China: and why there is every reason to believe that, barring unforeseen geo-political instability, China has a very bright automotive future.

China's Multi-Tiered Cities

Since the early 1990s, China's economic development has been centered the metropolitan areas of China's coastal regions and surrounding areas. Shanghai, Beijing, Guangzhou and Shenzhen are typically identified as Tier 1 cities with the highest income, largest population base and largest GDP. This is followed by a group of 21 Tier 2 cities. Chongqing is the largest municipality with a total population of 32 million residents, however only 6 million are considered urban. Other Tier 2 cities include Dongguan, Nanjing, Wuhan, Hangzhou, Shenyang, and Harbin. Smaller cities such as Zongshan, Xiamen, Changzhou and Zhuhai are also included because of their higher per capita GDP.

Over the last decade, a set of third-tier "emerging middle class" cities have also emerged, including cities like Dalian, Qingdao, Shantou, Kunming, Zibo, Huizhou, Zibo, Shijiazhuang.

A fourth-tier "next wave" group of cities is also beginning to emerge as economic development begins in earnest in yet another group of mostly interior Chinese cities. And finally "rural" and "remote" population groups complete the classification of the Chinese population of over 1.3 billion people.

In fact, the emergence of this multi-tiered structure is a result of the economic development path that was initiated by Deng Xiaoping. Prior to this, over its history of nearly 5,000 years, China had been a rural and agricultural economy. In the space of just few decades, a significant percentage of the population of our planet has migrated to the cities of "new China", and in the process these people are moving from poverty to prosperity.

Urbanization Trends
At the start of the reform era, 82% of China's population was considered rural. By 1990, this percentage had declined to 74%. By 2000, the percentage was 64%. In 2008 this had further declined to 55%, or approximately 720 million people. Clearly, these shifts represent a migration of population towards the areas of economic development and concentration of wealth. The creation of new wealth has had a profound impact on the development of the cities across all of the previously described "tiers". This has also impacted the development of rural areas as urban wealth has a positive impact on extended family members who remain in the rural population.

While China possesses a migrant workforce of over 200 million people, there is no mistaking the trend of permanent migration of rural population to existing urban areas. Looking forward, it is expected that nearly two-thirds of China's population will be in urban areas by 2020. This represents a whopping rise in urban population of nearly 200 million people in just over 10 years. Essentially, China creates the population-equivalent of a city of between 1.5–2 million people each month! It is no wonder why China's cities are continually under construction.

Income Growth
A growing middle-class is emerging in these urban areas. If we define "middle class" as people with annual income greater than RMB 150,000 (USD 22,000), this number has increased from 1.5 million to 4.8 million individuals from 2000 through 2008. This number is expected to increase to over 40.3 million individuals by 2020.

The China government estimates that there are over 45 million families that have reached the threshold of RMB 30,000 (USD 4,400) of expendable money, which is considered a threshold for entry into the car buying population. Urban wealth accumulation is undoubtedly fueling the growth in automotive sales. The fact that 85% of all vehicles are sold to urban residents is a clear sign of the relationship.

Ageing and Increasingly Affluent Population
The growth of a more affluent urban middle class, combined with a generation that has lived under a one-child policy is creating yet another consequence: wealth accumulation for an increasing number of middle and older age groups. By 2020, it is estimated that China's population will grow by approximately 110 million, yet the number of individuals over 45 will increase by 118 million. It is also expected that the population of individuals between 25–44 will shrink by 22 million. This has significant implications for product preference, as middle-aged and older consumers tend to seek more luxurious products.

Automotive Implications
The statistics on urbanization, income growth and population demographics point to very favorable conditions for the continued robust growth of the automotive market. However, many people question whether China has sufficient infrastructure to handle the increased volume of cars and whether resource constraints (people, energy, investment capital) may eventually limit the growth of the market. While these are all legitimate issues, it is useful to first view China's automotive development in contrast with that of other developed countries.

A commonly used benchmark to compare the development of the car industry across markets is cars per 1,000 of population. On this measure, China is tied with Belize in 107th place at 10 cars per 1,000 (source: www.nationmaster.com). The U.S. leads with 765 cars per 1000. Of course, the U.S. market may not be a fair comparison as it is a mature market with a historically large car population. A fairer comparison would be a market like Mexico with 138, Russia with 124, and Brazil with 81. Clearly, there appears to be upside growth potential for China.

Forecasts of the China market over the next decade anticipate that the passenger vehicle population will grow from 100–200%. Global Insight's base forecast anticipates growth in the passenger vehicle population from 10–153 million units from 2005 to 2030. The high forecast places the number at 327 million units. The bottom line here is that it is hard to be pessimistic China's future automotive prospects.

The Growth of the Lower-Tier Cities

A key reason for optimism is the anticipated development of China's lower tier cities. While China's economic revolution has been clustered around the Tier 1 and 2 cities, it is important to understand the real impact that the lower-tier cities will have on the future development of the market. Interestingly, most multi-national corporations had focused their businesses and sales activities around the Tier 1 and Tier 2 cities. For example, Toyota has derived 20% of its sales in 2009 from Guangdong province, and 5 of China's 31 provinces account for 49% of their sales. Similarly, VW generates 40% of its sales from its top 5 provinces.

The Chinese local manufacturers, by contrast, are more focused on the lower tier cities. Local brands offer a better fit to the purchasing power of the consumers residing in these lower tier cities. Driven by the onset of the global financial crisis, the Automotive Industry Stimulus Plan published in early 2009 took specific measures designed to spark the growth of consumer demand in these lower income cities. Measures including the reduction of sales tax for cars below 1.6L engine displacement, along with subsidies for new minibus or light truck sales for rural residents have accelerated the auto market expansion in these markets, helping to boost the performance of the Chinese local manufacturers. Recognizing this, multi-national companies are placing more focus on the development products suited for the tastes and preferences of consumers in these lower tier markets.

Lower tier cities are capturing an increasing share of the market and are experiencing the highest year-over-year growth. Recent data from China's National Statistics Bureau highlight this trend *(See Exhibit 1)*.

As a result, we can expect to see even more intense competition among the foreign and domestic brand vehicle manufacturers as they attempt to capture this growth opportunity (see Trend #6: Hyper-competition Across The China Auto Market Segments). As this is happening, the local manufacturers are striving to upgrade their brands and product portfolios to meet the more upscale image aspirations of Chinese consumers (see Trend #7: Local VM Push To Build Brand Equity).

Clearly any growth strategy in China requires an understanding of the rapidly changing demographics and a plan to capture the growth in China's lower tier cities.

Exhibit 1
Recent data from China's National Statistics Bureau

City Classification	Market Share	Growth Rate
Tier 1	13.9%	+8.1%
Tier 2	47.2%	+27.6%
Tier 3	21.3%	+33.7%
Tier 4	17.7%	+36.0%

Source: Booz & Company analysis

SUMMARY

This article brings us to the conclusion of this in-depth look into the Eight Overarching China Automotive Trends That Are Revolutionizing the Auto Industry.

Taken collectively, it is clear that these trends signal a shift in the global center of gravity towards the east. The dramatic shifts that have occurred over the past year in the structure and brand portfolios of the vehicle manufacturers are simply the early stages of a process of asset reallocation and global realignment that will unfold over many years. These trends are reshaping the brands, products and global footprint of those who hope to prosper in the 21st century automotive industry.

Indeed, China has taken center stage in the battle for global auto industry dominance.

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