The Insight Bureau

From the Desk of…

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Most firms see China as an opportunity. It is not. Worse, it threatens to undermine their whole business.

I recently gave a presentation in Hong Kong on the outlook for Asia's economies. I happened to talk briefly about a trip I'd made to a car plant about two hours outside Shanghai. The factory, operated by Shanghai Maple, a subsidiary of Geely, turns out a variety of mid-sized cars for around US$6,500. It already ships them overseas, where it offers them with air conditioning, leather seats, ABS and a two year warranty for exactly the same price. As part of my talk, I also explained how many of the world's biggest carmakers were struggling, how some of the biggest names were selling off the family silver in an effort to stave off bankruptcy.

During question time, a member of the audience put his hand. He was the CEO for Asia of a big pharmaceutical company. "Er, I don't quite understand," he said and paused. "If Shanghai Maple can sell cars for $6,500, which is half the price of a similarly-specified car made in the US or Europe, and companies like Ford and GM are in such trouble, er", he paused again, seemingly slightly unsure of the wisdom of the question, "why don't Ford and GM simply outsource their manufacturing of cars to Chinese firms".

A brilliant idea, seemingly, entirely obvious to anyone without any knowledge of the automotive industry. Pharmaceuticals are highly specific, single-function products. They are at the end of the long chain that runs from oil through bulk and fine chemicals. Successive levels of the chain are linked by market interfaces. R&D can take place in one region and manufacturing in another, wherever makes most sense. Cars are highly integrated, multi-functional products. To be competitive, a vehicle manufacturer must also achieve or access optimal scale and unit cost at each level of the chain.

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The different levels and functions must also be perfectly linked together and synchronised. China superficially looks like a low cost Eldorado. Today, however, making cars in China remains hopelessly uncompetitive, as there are insufficient economies of scale. This has got worse, as every car maker in the world has piled in, looking for growth, thereby fragmenting the market and reducing economies of scale in both vehicles and components. Logistics costs are high as soon as one goes beyond the seaboard, 20% or more above those in other regions. Staff turnover can be 300%. There's no protection of IP. Prices are falling, while costs, especially raw material costs are rising, so already thin margins are evaporating.

As usual, the industry sticks to its lemming-like believe that growth will cure all ills. There may be 1.3 billion people in China but most of them won't be able to afford a toaster, let alone a car for another generation. There's not going to be enough growth for everyone within China. The low wages (which will not last indefinitely) can't make up for the lack of scale, especially in the Chinese components industry, and the logistical disadvantages. Sub-contracting to China the final assembly of vehicles from imported components won't solve the problem. Maple claims to break even at 8,000 cars a year sold at $6,500 each. Perhaps they have found a magic formula that will beat even Toyota at manufacturing. Perhaps they don't understand their own economics.

Although there is little concrete evidence, the most likely explanation is that they are being heavily subsidised, as part of the launch phase of China's national automotive industry. They are not competitive on cost, performance or safety – yet. But a very few survivors will be. The automotive industry requires scale but also huge amounts of know-how, because of the complexity of its products and of its manufacturing structures.

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But that know-how can be acquired. The Japanese were scoffed at during the 1960s, as were the Koreans until quite recently. Who are the two most profitable volume car manufacturers in the world today? Why, Toyota and Hyundai. It took them decades of persistent investment, sheltered by a closed domestic market and subsidised in more or less visible ways. The tied dealership distribution system in their export markets was a barrier for a long time. But, once the attractiveness of their products became clear, the dealers came to them.

So the Chinese have no magic formula. They are not changing the rules of the game or the industry's economics. They are simply repeating the old formula for new entrants: protect, invest, subsidise, and build scale through exports. Looking forward, there is good reason to think that these upstarts will win the battle. Since 1994 there has been a legislated plan for China to control its own automotive industry. With a trillion dollars in the bank, China can well afford to continue this subsidised build-up. China will not, therefore, meet the wishful expectations of foreign firms. With the lack of effective IP protection, the foreign investments and joint ventures simply help fuel this strategy. It's the same effect as in consumer electronics or clothing – just slower, because of the complexity of the products and the industry. Like the Japanese and the Koreans before them, they will capture the lower end of the developed country markets and crash the whole price structure. We can't join them. We can't beat them at our own game -- indeed we mostly don't make a decent profit playing it. There's only one answer: change the game! Abandon the fantasy of globalisation. Raise our environmental and safety standards and the technology stakes. Get off the treadmill of product proliferation, repackaging and zero sum brand competition in a commodity business. Shift the huge R&D expenditures from predominantly 'D' to predominantly 'R'. Create truly innovative and sustainable transportation systems for the 21st century.

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In answer to that somewhat naive question, the pharmaceutical industry does not make its profits through low-cost manufacturing but through increasingly targeted and challenging science-based innovation. Noticed much Chinese competition in that sector?

About Graeme Maxton and John Wormald

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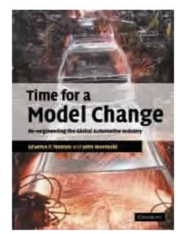

Mr. Graeme Maxton and Dr. John Wormald are two of the world's best respected independent automotive strategists. They are the co-founders of *auto*POLIS and have co-authored two globally acclaimed books. Most recently *Time for a model change* has done much to provoke the industry to rethink its strategies.

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