China Economic Update
by NAB Group Economics

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National Australia Bank

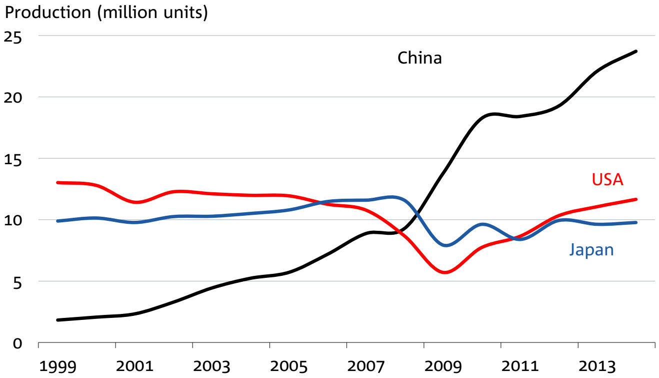
China's auto industry may be reaching its domestic limit, but is not yet ready to take on the world

China's motor vehicle industry has experienced spectacular growth over the last decade – reflecting in part a broader evolution in China's industrial sector over this period. At a national level, China is no longer the global factory for low value added, labour intensive manufacturing – having lost competitiveness to a range of emerging economies in Asia – while production of more complicated, higher value goods (such as motor vehicles) has expanded. That said, China's auto manufacturing industry is still in its infancy, with producers still some way from having a foothold in global markets.

China's rise to become a major motor vehicle manufacturer is a recent phenomenon

Although motor vehicle manufacturing has a reasonably long history in China – there was some limited production in the 1950s and China's production had overtaken Australia's by the mid 1980s – China's emergence as a major motor vehicle producer has been a far more recent phenomenon. The spectacular growth emerged in the 2000s – at the turn of the century, China was the eighth largest motor vehicle manufacturer but became the largest in 2009, as producers in the advanced economies suffered weak demand following the Global Financial Crisis.

China's emergence as a major auto manufacturer commenced this century



Sources: OICA, NAB Economics

In 2014, China's automotive industry produced almost 24 million vehicles, more than twice the output of the United States (the second largest producer). Production is split between domestic firms and joint-ventures between major foreign producers and their domestic partners (regulations prevent foreign manufacturers from controlling a share in excess of 50%). China's motor vehicle buyers are quite brand conscious – with a preference towards multinational brands (reflecting in part the perception of higher quality). According to the China Association of Automobile Manufacturers (CAAM), the market share of domestic branded vehicles was around 41.5% over the first half of 2015. The largest sales over this period were recorded by Volkswagen, Hyundai-KIA and General Motors, while China's largest sellers among domestic brands were SAIC and Chang'an (ranked fourth and fifth respectively in the first half of 2015).

Foreign branded vehicles dominated China's motor vehicle sales in the first half of 2015

Rank	Brand	Domestic partner(s)	Sales ('000)
1	Volkswagen	SAIC, FAW	1742.9
2	Hyundai-KIA	BAIC, Dongfeng	813.4
3	General Motors	SAIC	789.1
4	SAIC		588.0
5	Chang'an		522.4
6	Toyota	FAW, GAC	463.7
7	Nissan	Dongfeng	457.8
8	Ford	Chang'an	429.7
9	Honda	Dongfeng, GAC	420.6
10	PSA Peugeot Citroën	Dongfeng, Chang'an	368.5

Source: CAAM, CEIC, NAB Economics

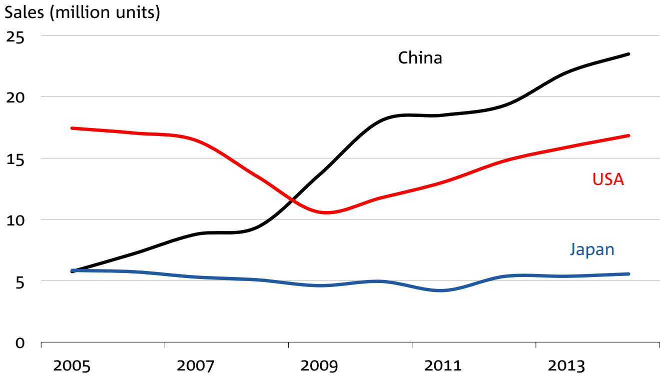
Domestic automotive brands not only suffer from perceptions of lower quality than their international competitors, they also suffer from the tyranny of choice. China's auto industry is highly fragmented, with CAAM data showing that there were over 170 domestic manufacturers in 2012, and production capacity is continuing to be added – supported by local governments (through subsidies and favourable procurement policies) keen to develop the industry in their regions. According to research by IHS, production capacity in China's auto sector is likely to exceed domestic sales by almost 11 million units in 2015 – with this surplus increasing by around 83 per cent over the past two years.

In comparison, the production capacity of the Japanese and South Korean auto industries is just over 8 million units larger than domestic sales – however these two countries are major exporters (unlike China), meaning that producers can operate their factories at a high level of utilisation to support profitability. China's capacity utilisation is expected to fall below 70% in 2015 (compared with a benchmark breakeven level of 75%) (IHS).

Congestion and pollution may constrain the prospects of China's domestic automotive market

China's motor vehicle production has been predominantly focussed on its domestic market – with limited exports of vehicles despite the spectacular growth in output over the past decade. China is already the largest market for new sales, but longer term growth is far from assured.

China has been the largest market for new vehicles since 2009



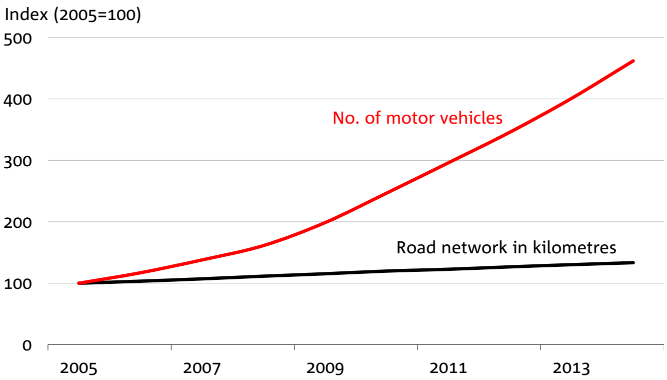
Sources: OICA, NAB Economics

Sales of new motor vehicles have slowed significantly in 2015 – with the total over the first half of the year only around 1.4% higher, and year-on-year sales between April and June falling. A slowing economy may have contributed, along with tightening regulations.

A range of major Chinese cities have introduced restrictions around the registration of motor vehicles. These include tier one cities Beijing, Shanghai, Guangzhou and Shenzhen as well as major tier two cities such as Tianjin, Guiyang and Hangzhou, with new licence plates issued either via an auction or a lottery system. These restrictions limit the potential sales growth for new vehicles, particularly for domestically branded ones – with evidence suggesting the increasing cost of registering vehicles has resulted in an increase in the share of higher-end foreign brands in these cities.

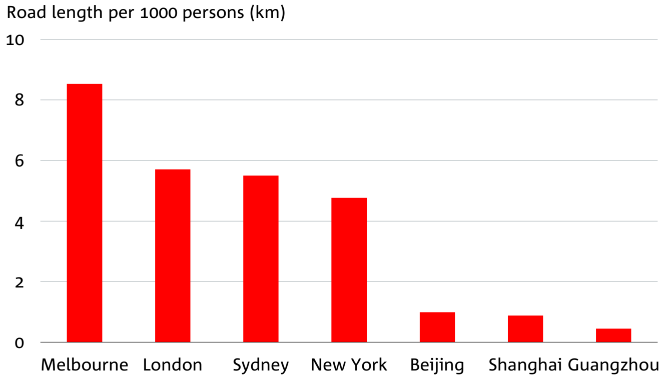
These policies are in response to concerns around air pollution and congestion. According to data produced by navigation and mapping firm TomTom, China has seven of the twenty-five most congested cities worldwide. In a large part this reflects population density, as well as the slow rate of growth of road construction, compared with the number of motor vehicles. Between 2005 and 2014, the length of China's road network expanded at an annual average rate of 3.3%, while the total number of motor vehicles grew by almost 19% a year over the same period (CEIC).

Congestion has increased in China's cities as road construction has lagged vehicle growth



Sources: CEIC, NAB Economics

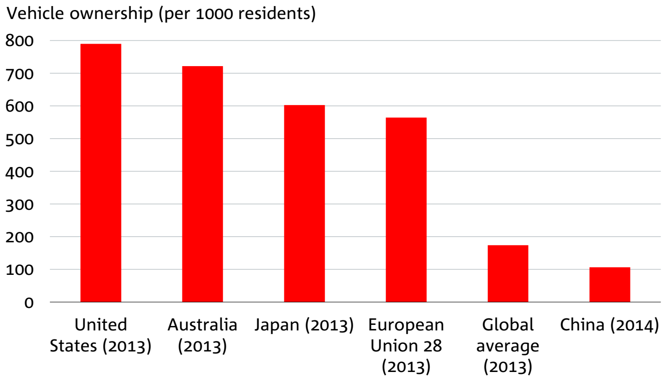
China's major cities have extremely limited road networks when compared with global peers



Sources: TomTom, Bloomberg, NAB Economics

These restrictions may also limit the penetration rate of motor vehicles into China's population. In 2014, China had 107 vehicles for every 1000 residents – a rate the United States exceeded in 1922 (US DOE). Bloomberg Intelligence expect China's ownership to reach 280 vehicles per 1000 residents by 2025 as policy restrictions increase – well short of the typical levels of advanced economies.

Despite the strength in sales, China's vehicle ownership remains comparatively low



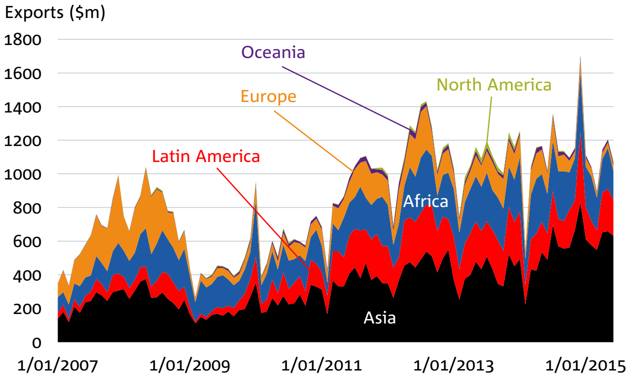
Sources: OICA, CEIC, NAB Economics

New vehicles may also face growing competition from an emerging used car market. Used cars have typically been unpopular with Chinese consumers, with many vehicle owners yet to trade in their first car, but this view is gradually starting to change. China's Automotive Dealers Association forecasts the used car market to double in 2015 to 11 million sales. Even so, this would result in the ratio of used car sales to new sales remaining below 0.5 – compared with 3.3 in the United States and 3.0 in the United Kingdom (Bloomberg) – indicating there is still considerable development potential for this market.

China's export potential limited until it can close the quality and perception gaps

As the domestic market matures, Chinese manufacturers are likely to seek opportunities in foreign markets – following the development path of the Japanese and South Korean motor industry – although the standard of production is currently too low to succeed in mature, Western markets. At present, China's limited exports are concentrated in emerging Asian markets, as well as Africa and Latin America.

China's motor vehicle exports largely directed towards emerging market economies



Sources: Bloomberg, NAB Economics

It takes a considerable amount of time to become a competitive power in global markets. While it takes some time (often decades) to meet the acceptable quality standards of mature markets, it can take even longer to overcome what famed auto executive Bob Lutz described as the 'perception gap' – the difference between actual quality and the perception that consumers have of the product. For example, South Korean manufacturers – most notably Hyundai – have been exporting their vehicles since the 1980s, yet despite considerable improvement over three decades they still arguably suffer from a perception of inferior quality, when compared with Japanese or European vehicles. It may take a similar amount of time for Chinese vehicles to overcome the perception gap.

In Australia, there are a range of Chinese vehicles currently available for sale– particularly focussed on the light commercial segment. Firms such as Foton, ZX Auto, Great Wall, JMC and LDV (formerly a British manufacturer) sell utilities and commercial vans, while Chery currently sells two passenger vehicles. Data from the Federal Chamber of Automotive Industries shows that sales of Chinese vehicles have fallen sharply, down from a peak of over 12000 vehicles in 2012, to just over 4200 in 2014 – with currency movements and safety concerns contributing to this trend (the latter largely related to a recall of Great Wall and Chery vehicles due to asbestos parts). Sales of Chinese vehicles totalled 593 vehicles in the first quarter of 2015 – just 0.21% of new vehicles sold over the period (FCAI).

Conclusions

China's domestic motor vehicle manufacturers are likely to face challenging conditions in coming years, as the rate of growth for new vehicle sales slows and additional production capacity is brought on line. Consolidation (both in terms of capacity and the number of producers) is likely to be necessary to improve the profitability of the industry as a whole, before Chinese producers can realistically compete in global markets over the long term.

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