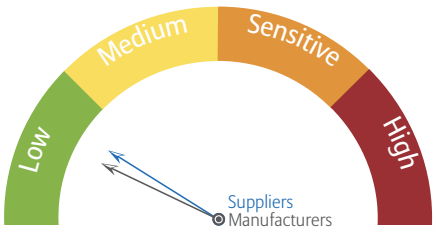
Automotive in China

New Technologies, Old Challenges



Automotive Non-Payment Risk
(Q2 2017)

- **30 million new vehicles to be sold in 2019, despite decelerating momentum**
- **Overcapacity persists, while moving from volumes to value-based growth**
- **Active industrial policy and high subsidies (23% of the EV retail price is subsidized) to drive growth**

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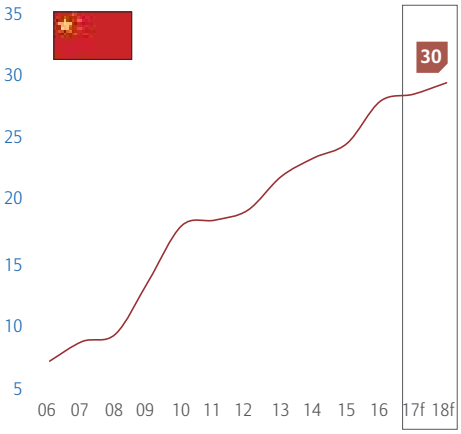
In January 2017, the tax on pollutant emissions was raised from 5% to 7.5% for small-engine vehicles and restrictions on used-car trading were lifted. The Chinese authorities aim to reduce demand further by raising the same tax to 10% by the end of 2017. Anticipating the hike, consumers brought forward new car purchases to 2016. For 2017 and 2018, we expect the market to expand +2.0% and +3.2% respectively. This stems to a large extent from lower-tier cities and rural areas. At the same time, there are signs of an emerging used-car market in China, which is set to expand at a rapid pace in subsequent years (from 12 million in 2017 to 24 million in 2020), with medium-term risks for manufacturers, who have invested in the Chinese automotive market.

New portfolios and consolidation will drive profitability

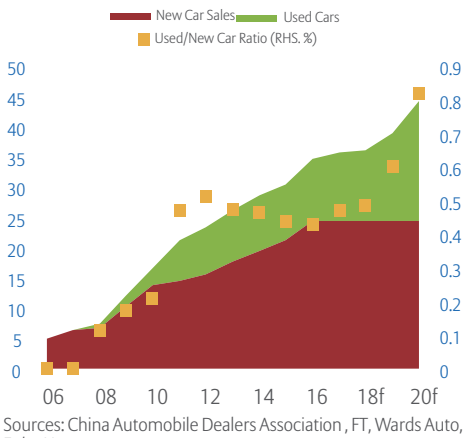
Financial performance of Chinese suppliers is excellent relative to their global counterparts. In 2016, they earned an average EBIT margin of 7.3%, whereas manufacturers achieved a margin of 3.2%, well below the average of the countries reviewed. Some manufacturers have started producing SUVs and crossovers, moving from volume-based to value-added manufacturing, which could drive up margins. This also happens in the context of structural overcapacity, especially in the commercial vehicles and battery segments, which will be corrected through a (state-induced) wave of consolidation.

Chart 1 New Vehicle Registrations
(in million)



Sources: OICA, IHS, Euler Hermes forecasts

Chart 2 The Used-Car Market in China
(in million)



Sources: China Automobile Dealers Association , FT, Wards Auto, Euler Hermes

World leaders in M&A, weak domestic innovation

Despite China's active industrial policy, R&D spending and granted patents lag behind most advanced countries. Only in the field of battery technology, the Chinese automotive sector managed to raise its share of worldwide patents from 7% between 2005-2009 to 14% between 2010-2015. Independent innovation remains weak, as manufacturers rely on foreign automotive technology via joint ventures. In contrast, between 2012 and 2017, companies spent USD 6.2bn on ICT M&A (Uber China deal for USD 1.2bn in 2016), making them worldwide leaders, followed by Germany with USD 4.5bn. In August 2017, Great Wall Motors expressed interest in buying Fiat Chrysler Automobiles' Jeep unit.

Leading the electric wave

China has today the world's largest electric vehicle fleet, amounting to over 1 million cars by the end of 2017. It will remain the fastest growing market, with high double-digit growth rates. This has been supported by a rapidly expanding network of fast chargers (136 per thousand EV in 2016) and one of the highest subsidies worldwide amounting to 23% of the price of an electric vehicle. High registration fees in top-tier cities for cars with internal combustion engines also make EV adoption more attractive. Medium-term risk could emerge from the shift towards non-monetary incentives. Despite the gradual phasing out of production subsidies until 2020, China's industrial policy is tilted towards electrification. Under a zero-emission vehicle mandate, the government requires that 8% of new car sales by producers be electric in 2018 and 12% in 2020. This represents a risk for foreign manufacturers, which have not yet launched production in China. ■

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