

L.E.K.

CHINA'S AUTOMOTIVE
AFTERMARKET:
A STRATEGIC OPPORTUNITY



1. INTRODUCTION

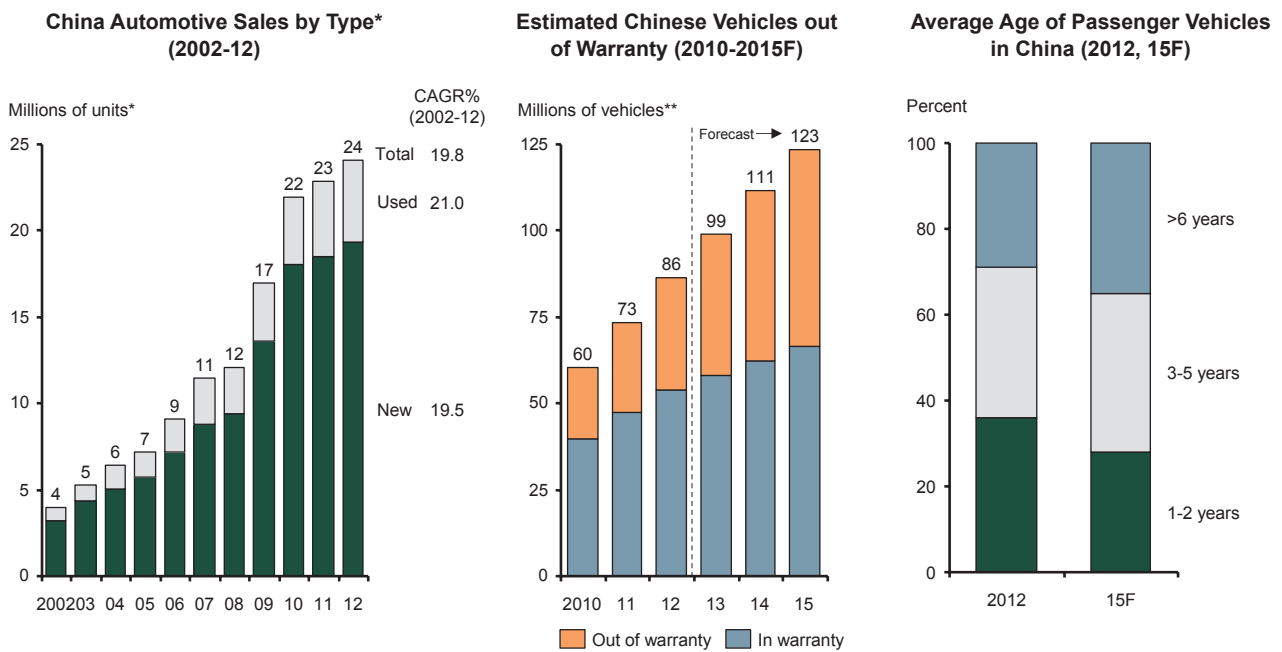
The explosive growth in China's automotive market has captured the imagination and focus of the world's automakers over the last decade. China is now the largest auto market in the world, and while the attention has previously been on new auto sales, there has lately been great interest in the development of China's automotive aftermarket. L.E.K. has undertaken several recent projects to help automotive companies develop the right strategies to successfully capture the China aftermarket opportunity. The domestic automotive aftermarket is in a relatively early stage of development and there are several characteristics unique to the China market. Drawing from case learnings, the following briefing paper details some of the major issues and opportunities of the Chinese automotive aftermarket.

2. WHAT IS THE SIZE OF THE PRIZE?

2.1. Driven by huge growth in car sales, China's stock of cars, especially older vehicles, is expanding dramatically

In 2009, China overtook the US to become the largest new auto sales market in the world. China has experienced annual growth of c.20% over the last ten years, and strong growth is forecast to continue. This is despite some cities, such as Shanghai, Beijing and Guangzhou, introducing monthly car plate quotas.

Figure 1



Note: *Includes commercial vehicle sales; **Includes light trucks and estimates based on average vehicle life spans (10-15 years)
Source: China Automotive Yearbook, J.D. Power and Associates; Technomic Asia, China-briefing.com, IBIS, L.E.K. research and analysis

The continued growth in new car sales is having the secondary effect of dramatically increasing the stock of cars in China. The number of cars on the road is growing fast as the rapid growth in annual new cars sales is boosting the cumulative car stock.

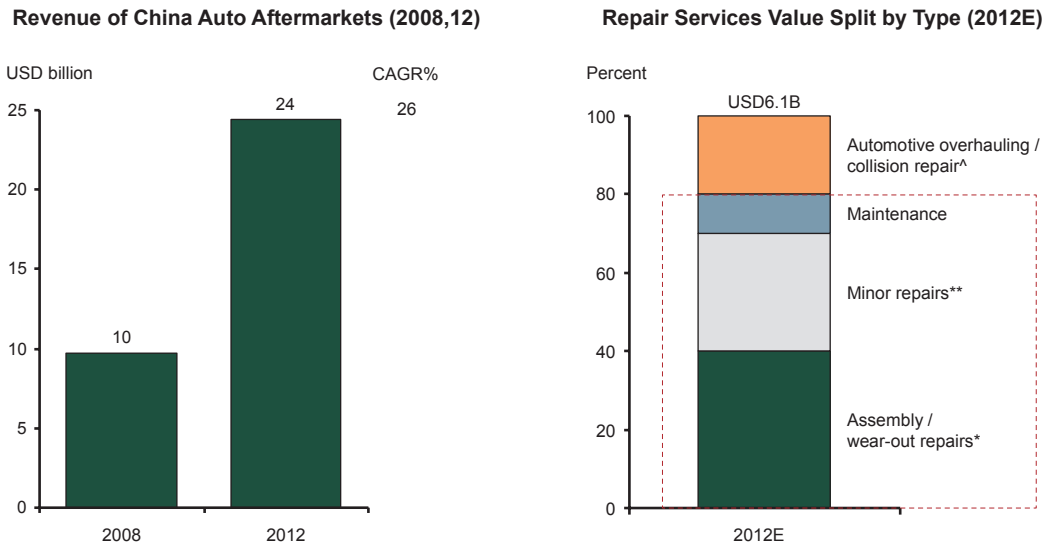
The average warranty period for vehicles in China is typically 3 years. Currently we estimate that by 2017 the average age of cars will increase from 3 years to 4.5 years, the age when spending on aftermarket parts and services typically peaks. At the same time, the number of 'out of warranty' cars will almost triple during the same period, further driving demand for aftermarket products and services.

2.2. Likely drivers point to a dramatically expanding automotive aftermarket

Based on prior case experience we know that these factors create substantial demand growth for aftermarket parts and services. The size of the market has already increased dramatically from US\$10 billion in 2008 to US\$24 billion in 2012. This trend can only be expected to continue as China's car fleet both increases and ages.

Assembly / wear-out repairs and minor repairs are the two largest segments of the repair services market (by value), and are expected to remain the largest segments for the foreseeable future.

Figure 2



Note: * Includes engine, frame, body, and transmission assemblies; ** Includes repairs to radiators, air conditioning, wheel alignment, etc.;
[^] Includes major repairs to automobiles severely damaged in accidents
 Source: Auto info, L.E.K. research and analysis

3. HOW ARE THE AFTERMARKET CHANNELS STRUCTURED?

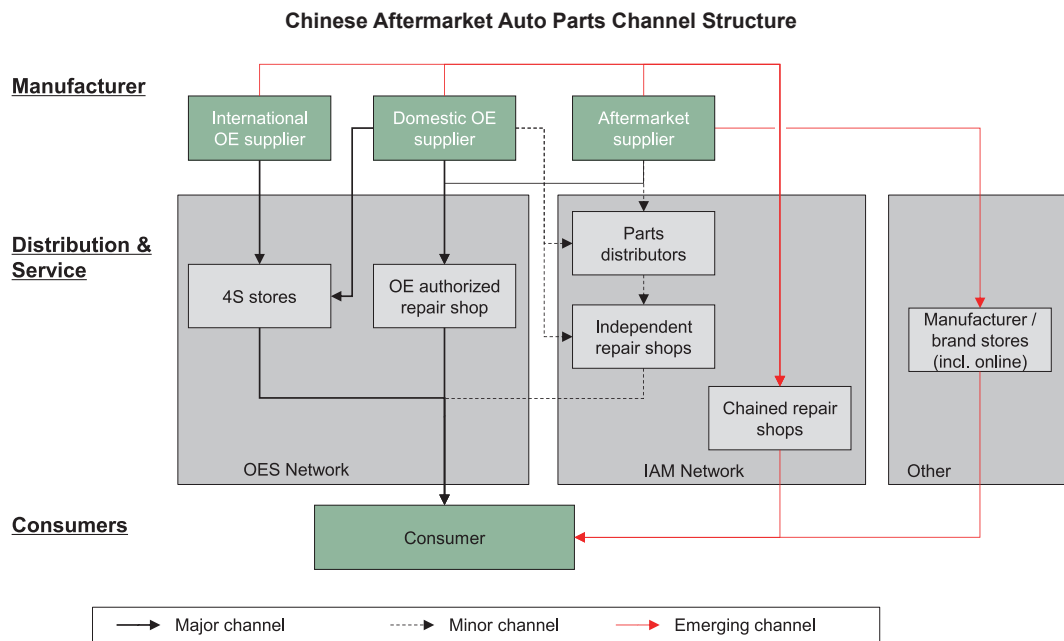
3.1. What is the structure of the automotive aftermarket?

A key area of focus in helping our clients develop winning strategies in China's automotive aftermarket is in accurately mapping the value chain, the key stakeholders and how suppliers can best reach the customers. These will fundamentally differ based on the product type and manufacturer's background, as well as by geographic region and development level of each city.

Manufacturing of auto parts is predominantly done by three types of companies: international OE (Original Equipment) suppliers, domestic OE suppliers and dedicated aftermarket suppliers. The distribution and service is typically done either by the OES (Original Equipment Supplier) network or the IAM (Independent Aftermarket) network.

As the development of a large Chinese automotive market is relatively recent, chained service and repair stations have yet to be established on a wide scale. In china, the bulk of servicing is done through the 4S stores controlled by the auto OEM's. In terms of the independent channel, aftermarket suppliers are mostly small, regional companies that sell parts through distributors that supply independent repair shops. Distribution in the independent channel is complex, and several layers of distributors may exist. Some distributors also have their own retail outlets and repair shops, adding further complexity to the channel structure.

Figure 3



Source: L.E.K. research, interviews and analysis

There is a new (currently small) direct channel emerging where component suppliers are opening self-owned and self-branded stores, or directly supplying products online. Bosch and Continental are examples of players moving down this path and many of our clients are studying if and how they should participate in this way. This is an exciting development as such channels are typically less common in other markets, but could be very effective in China as consumers are typically brand and price-sensitive, and increasingly require verification that the parts they are purchasing are genuine. Besides opening new and profitable revenue streams, these direct channels help strengthen the manufacturer brands which in turn can help their core business.

Going down the path of launching direct channels is naturally not without challenges and needs to be assessed carefully. Product mix, store economics and operational issues all need to be evaluated carefully before players sell products through this channel.

3.2. How is the industry expected to develop?

As part of a growth strategy project for a leading US automotive aftermarket supplier, L.E.K. defined the industry structure and identified attractive growth opportunities based on a robust understanding of China's market dynamics and the ability to leverage the client's core competencies. A requirement was to build a dynamic picture of how the industry is expected to develop in the coming years.

Currently, 4S stores hold the largest channel share in China, although chained repair shops are forecast to increase in relative importance over the coming years. Direct channels including self-owned / self-branded stores and online distribution may also be positioned for strong growth albeit from a small base.

Figure 4

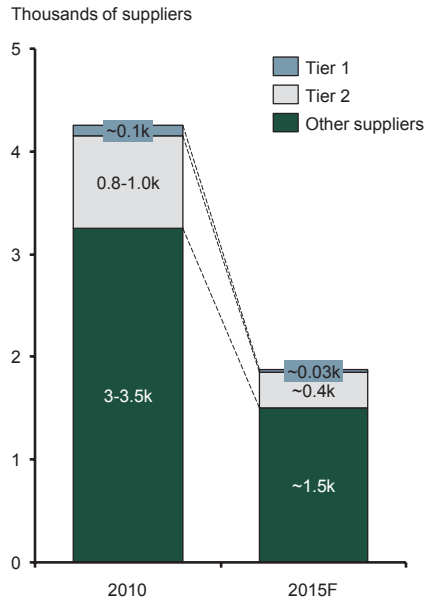
Automotive Aftermarket Sales and Repair Channels

	OES Network		IAM Network			Other		
	4S stores	OE authorized repair shop	General independent repair shop	Specialist independent repair workshop	Chained repair shop	Company in-house repair	Manufacturer / brand stores (incl. online)	
Description	<ul style="list-style-type: none"> Major channel for new car sales 4S stands for Sales, Spare parts, Service, Survey 	<ul style="list-style-type: none"> Repair shops authorized by OE Generally no car sales service 	<ul style="list-style-type: none"> Independent repair shops with more service and repair options 	<ul style="list-style-type: none"> Independent repair shops with limited service and repair options Service may be limited to tire replacement 	<ul style="list-style-type: none"> Emerging channel Mainly includes international suppliers and repair service providers 	<ul style="list-style-type: none"> Services for large company fleet vehicles, e.g., logistic companies, public transportation companies 	<ul style="list-style-type: none"> Self-owned and self-branded stores, including online offerings 	
Geographic presence	<ul style="list-style-type: none"> Mostly in tier 1 and tier 2 cities where mid- and high-end cars are sold 	<ul style="list-style-type: none"> Mostly in tier 2-, tier 3 and tier 4+ cities where 4S stores cannot reach 	<ul style="list-style-type: none"> Mostly in tier 4 cities and below or sub-urban areas in tier 1,2,3 cities 	<ul style="list-style-type: none"> Mostly in tier 4 cities and below or sub-urban areas in tier 1,2,3 cities 	<ul style="list-style-type: none"> Tier 1 and tier 2+ cities 	<ul style="list-style-type: none"> Company location 	<ul style="list-style-type: none"> Limited store coverage but can include an online presence 	
Source of spare parts	<ul style="list-style-type: none"> Only OE 	<ul style="list-style-type: none"> Majority OE May also source from other channels 	<ul style="list-style-type: none"> Other channels 	<ul style="list-style-type: none"> Other channels 	<ul style="list-style-type: none"> OEs or major parts distributors 	<ul style="list-style-type: none"> OEs or major parts distributors 	<ul style="list-style-type: none"> Aftermarket suppliers 	
Current presence in private car repair market	c.70 %		c.20%			c.10%	Less than 1%	Less than 1%
Future trend								

Source: TX Investment; L.E.K. research and analysis

Figure 5

Estimated Chinese Auto Parts Suppliers (2010, 2015F)



Source: L.E.K. research, interviews and analysis

Besides the changes in channel mix another important trend will be increasing levels of industry consolidation. Government policy directives have been issued in the last decade aimed at decreasing the number of auto-component suppliers as a means of increasing scale and competitive capabilities. The 11th Five Year Plan called for a reduction in the number of component suppliers while increasing the competence of supplier capabilities. A National Development and Reform Commission 2006 mandate encourages merger and acquisition activity in the sector. Every year we are seeing hundreds of domestic transactions in China's automotive sector suggesting the government's ambitions for a stronger home-grown automotive supplier base are gradually taking shape.

4. WHAT ARE THE CUSTOMER SEGMENTS AND BEHAVIOURS

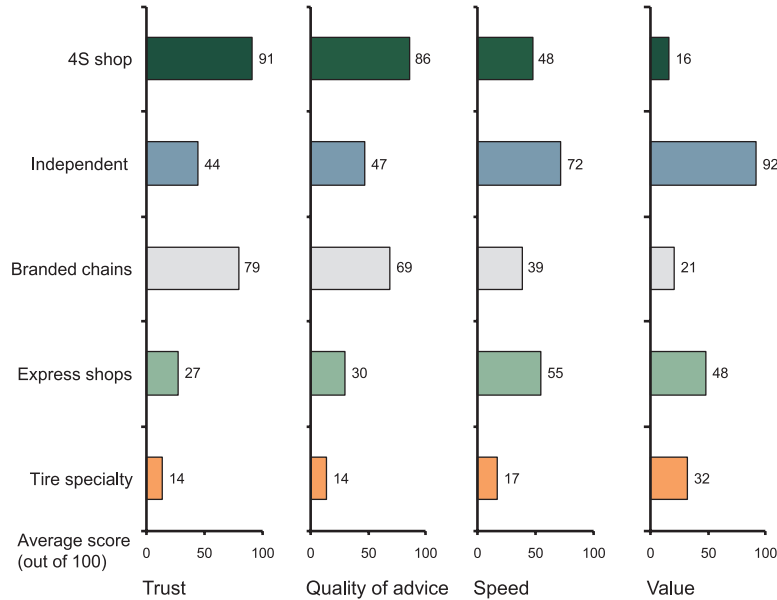
Understanding customer demand is always critical in order to be able to determine what is the right strategy to succeed. L.E.K. was recently engaged to conduct a product development and consumer survey program to help our client form a clear understanding of automotive accessories needs and leisure trends of Chinese car owners.

4.1. Where do car drivers go for aftermarket services?

Currently, most car owners use 4S stores for their aftermarket needs. Consumers that purchase their vehicles privately (as opposed to company cars, government cars, etc) are more likely to use non-4S service centres. These consumers are often more price sensitive and may have greater automotive knowledge. However the current presence of the OES network (i.e. 4S stores) is still dominant even in the private car repair market, and has been estimated at 70%.

Figure 6

Rating of Different Providers Along Key Selection Criterion



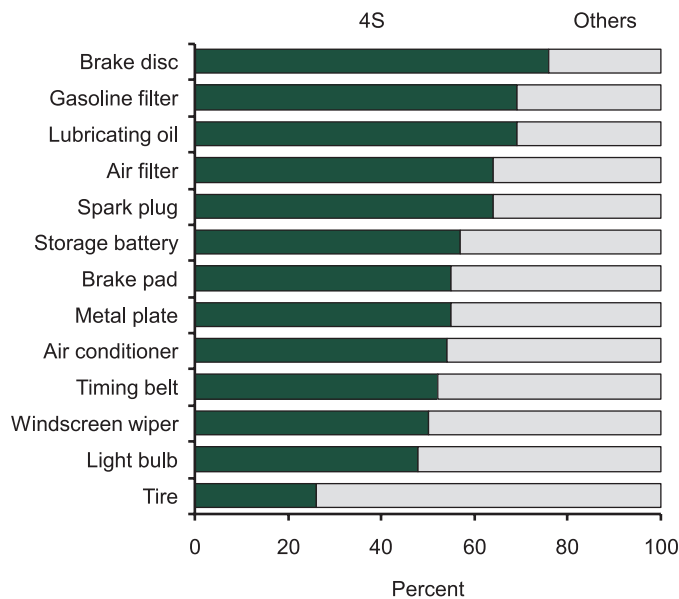
Source: GM

4.2. How does the service centre usage differ by required products / services?

There are differences in consumer behaviour depending on what service or product is required. Consumers who require more crucial mechanical repairs, or issues concerning safety may be more inclined to use a 4S centre. However other factors including price, convenience, product availability and technical expertise influence or determine the service centre selection.

Figure 7

Service Centre Usage by Required Aftermarket Service



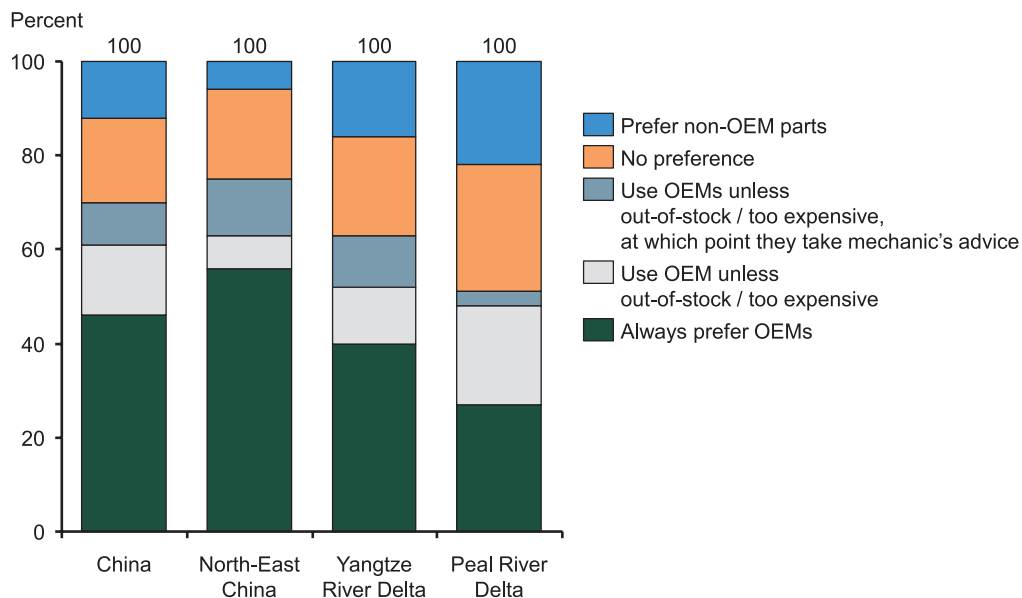
Source: GM

4.3. What drives consumers' selection of auto parts brands?

Typically consumers have a preference for OEM parts, with c.70% of consumers likely to choose 4S centers as their first choice. However there are regional differences in the propensity for consumers to consider non-OEM parts. There are also large differences between reported 4S auto part sales, and the estimated demand for 4S parts. This is likely due to a willingness to use other brands and the prevalence of counterfeit parts in the marketplace.

Figure 8

Preference Between OEM and Non-OEM Parts by Location



Source: GM

5. HOW DO YOU DEVELOP A WINNING STRATEGY?

5.1. What are the key success factors?

The dynamic nature of the Chinese market means there are several key factors that will determine success in the market. Consumers can be very price sensitive and there is generally low brand awareness. It is not uncommon for a BMW owner to shop around and save a few RMB on an oil change for instance – haggling for bargains is a key trait of the Chinese consumer and car-owners are no different in that respect. In such an environment it becomes critical to position the company correctly and align products, price and channel strategies accordingly.

Furthermore, the Chinese component supply chain is long and complicated, and there are typically many levels of distributors. Design and management of the go-to-market and supply chain assets will determine success or failure in the industry.

Figure 9

Key Success Factors in the Automotive Aftermarket Industry

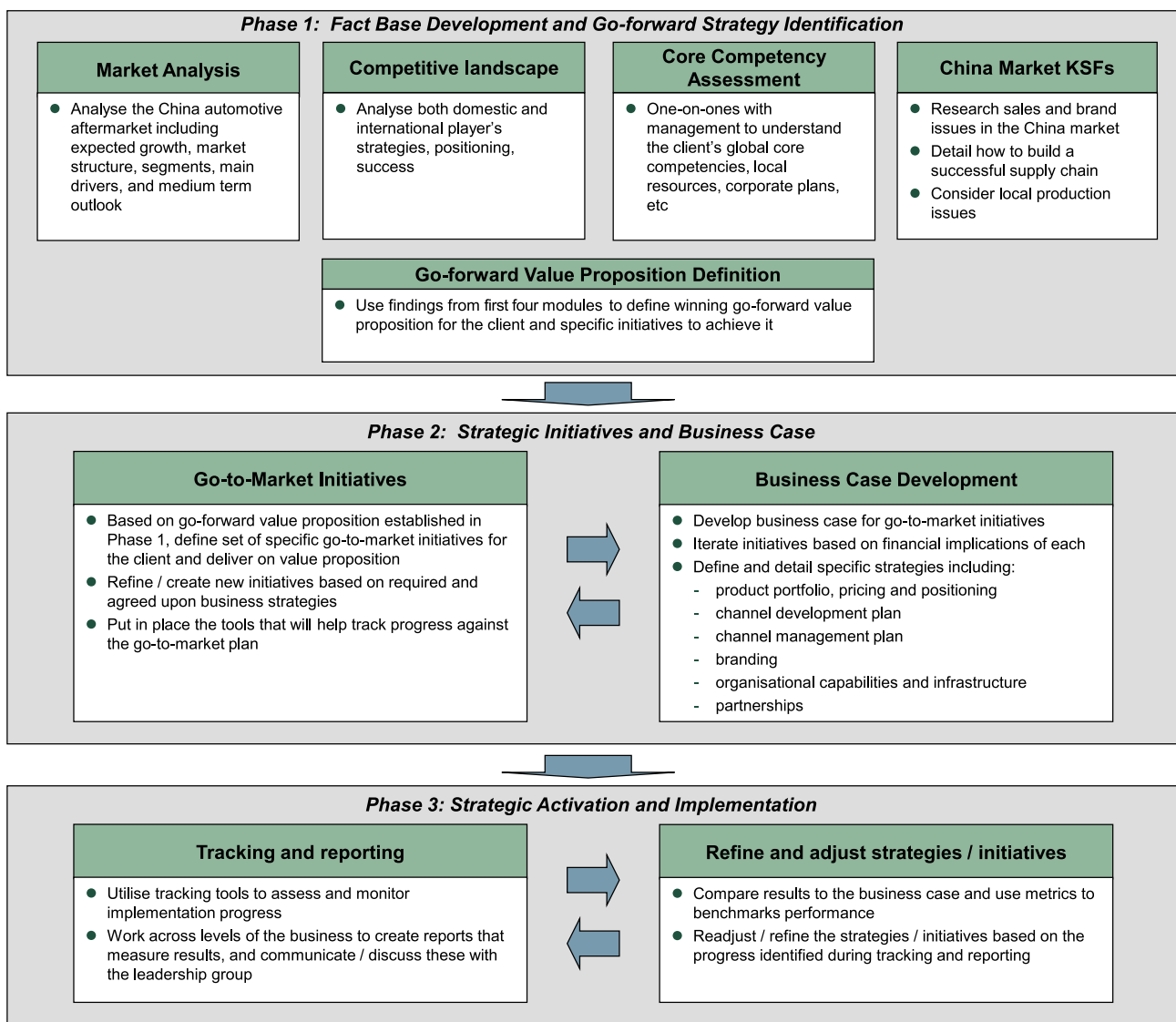
KSF	Description	Implication
Competitive price offering	<ul style="list-style-type: none"> ● Chinese car owners are typically very price sensitive when picking car parts for replacement <ul style="list-style-type: none"> - low levels of driver knowledge mean the decision is influenced by price and technicians' advice - domestic brands with less transparent pricing structures allow for a bigger mark up by retailers ● The price gap between foreign brands and domestic products can be significant ● Prices quoted in different channels can also vary greatly 	<ul style="list-style-type: none"> ● Ensure effective cost control practices which may include local procurement and / or local production, and improved manufacturing processes ● Offer economic versions of modules to the local market ● Differentiate the aftermarket brands from the OEM brand
Brand recognition	<ul style="list-style-type: none"> ● There are c.5.8k domestic auto part manufacturers with few recognized brands, who compete largely on price. China's aftermarket is also flooded with fake products <ul style="list-style-type: none"> - consumers are price sensitive and unable to differentiate genuine products - fake products are much cheaper and allow dealers to generate a better profit margin 	<ul style="list-style-type: none"> ● Premium brands need to invest in dealer relationships and reinforce brand awareness among dealers, repair shops and end users ● Provide authentication methods ● Form associations and work with authorities to shut down counterfeiters' factories ● Develop direct channels
Efficient supply chain	<ul style="list-style-type: none"> ● A highly efficient and reliable logistics management system is key to ensuring business success <ul style="list-style-type: none"> - the vast variety of product types and the multi-level distribution increases the complexity of supply chain management - availability of products upon request and prompt delivery is a critical 	<ul style="list-style-type: none"> ● Enhance supply chain efficiency by adopting information technology systems, optimizing location of warehouses and forecasting end market demand to manage inventory ● Invest in state-of-the art IT and supply chain systems
Channel relationship	<ul style="list-style-type: none"> ● Most suppliers need to reach local markets through multiple layers of dealers and distributors while local distributors are key to winning local repair shops' business <ul style="list-style-type: none"> - dealers can help educate repair shops and technicians to understand increasingly complicated products and communicate their needs to auto part suppliers 	<ul style="list-style-type: none"> ● Build strong relationships with dealers ● Offer regular training for dealers and technicians in repair shops on product knowledge, car diagnosis, authentication, etc ● Identify the right partners ● Define clear distributor protocols and develop in-house distributor management capabilities
Penetrate chained repair shops	<ul style="list-style-type: none"> ● National / regional repair chains are a small but emerging segment in the car aftermarket; they typically have better pricing than 4S stores and have more reliable quality than local repair shops 	<ul style="list-style-type: none"> ● Cooperate with chain repair service providers as their market share is expected to grow significantly ● Consider building self-owned service centres

5.2. Approach to Designing a Winning Aftermarket Strategy

L.E.K. has developed the following approach to review, synthesise and recommend strategy initiatives and we have used this successfully to develop winning strategies for our clients in China. Equally importantly, we provide the expertise and manpower to activate these strategies and to ensure we realise the desired outcomes and deliver tangible results.

Figure 10

L.E.K. Approach to Develop and Implement Successful Automotive Aftermarket Strategic Initiatives



Typically in Phase 1 we help our clients in creating clarity and insight into the China automotive aftermarket opportunity, including demand / supply drivers and the client's position in the market at the individual product level. It would look at customer behaviour and channel dynamics by city tier and understand the economics of supplying through different channels. It will examine the core competencies of the client and identify the key success factors and capabilities the company needs to build in order to be successful. We will build consensus within the client team based on a fact-base of market, customer, competitor and industry data which then forms the basis for defining the value proposition of the client and the strategy objectives for the business.

Phase 2 builds the business case and details the specific strategic initiatives. This is typically an iterative process where L.E.K. works alongside the client-team to 'co-create' the strategies that will allow the company to realise its ambitions in China.

Phase 3 focuses on strategy activation and implementation of specific initiatives. No strategy is finished until it is activated. To do so we need to translate the business plan into a series of concrete 'execution projects', each including a very specific blue-print of objectives, activities, task-owners and milestones to operationalize the project. It is not uncommon for up to 20 of these strategy activation projects to be defined in parallel. Furthermore, it is also not uncommon that key elements of the original strategy are revised during this stage of the projects as new insights are developed and improvements are embedded in the organisation.

6. L.E.K. CAN HELP YOUR BUSINESS IN CHINA

L.E.K. is a global management consulting firm that uses deep industry and consulting expertise and analytical rigor to help clients solve their most critical business problems.

L.E.K. works closely with senior executives in the automotive industry to create winning strategies and the operational and organisational capabilities required to deliver long term value and exceptional results for their business in China.

Strategy, Marketing & Sales	Operations and Organization	M&A Transactions
<ul style="list-style-type: none"> ● Market assessment, segmentation and positioning ● Evaluation of growth and investment opportunities ● Competitor benchmarking and costs effectiveness programs ● Business plan development ● Sales and distribution strategy ● Portfolio optimisation ● Strategy Activation 	<ul style="list-style-type: none"> ● Evaluation of manufacturing options and locations ● Supply chain strategy ● Performance measurement and improvement ● Business process redesign ● Sales force effectiveness ● Organization structure ● Capability development 	<ul style="list-style-type: none"> ● Identification and screening of partners/ acquisition targets ● Commercial due diligence on partners/acquisitions ● Negotiation strategy and advisory services ● Post-Merger Integration and 100-day planning ● Distributor evaluation and assessment

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7. L.E.K. CHINA AUTOMOTIVE PRACTICE LEADERS

Michel Brekelmans, Partner, L.E.K. Shanghai



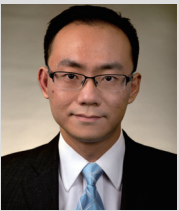
- Michel Brekelmans is a Partner at L.E.K. Consulting and co-head of L.E.K.'s China practice based in Shanghai
- He has nearly 17 years experience in strategy consulting with L.E.K. of which over 11 years in Asia
- Michel has worked on nearly 200 strategy, M&A and performance improvement projects and specializes in projects in the industrial products and automotive sectors

Ken Chen, Partner, L.E.K. Shanghai



- Ken Chen is a Partner in L.E.K.'s Shanghai office
- Ken has been in the consulting industry for 16 years, with the last 10 being based in Shanghai
- Ken has experience in a wide range of industrial sectors including the automotive industry assisting companies with market entry, growth strategies and commercial due diligence

Justin Wang, Principal, L.E.K. Shanghai



- Justin Wang is a Principal at L.E.K. Consulting in Shanghai
- He has extensive experience in providing strategic, management, and investment advisory to corporates and investors, covering a variety of industry sectors including industrial transportation, products, as well as life sciences

Lane Chen, Manager, L.E.K. Shanghai



- Lane Chen is a Manager at L.E.K. Consulting in Shanghai
- He has been engaged in various strategy and M&A transaction support projects covering a variety of industrial products including projects in the automotive industry

For further information about the article or details on how L.E.K. can assist, please contact LEKCHINA@LEK.COM

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded 30 years ago, L.E.K. employs more than 1,000 professionals in 22 offices across Europe, the Americas and Asia-Pacific. L.E.K. has been on the ground serving clients in China since 1998. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

For further information contact:

Bangkok

Suite 26/F Capital Towers
All Seasons Place 87/1
Wireless Road
Bangkok 10330
Thailand
Telephone: 66.2.654.3500
Facsimile: 66.2.654.3510

Beijing

Unit 1026, Floor 15
Yintai Office Tower No. 2
Jianguomenwai Avenue
Beijing 100022
China
Telephone: 86.10.6510.1075
Facsimile: 86.10.6510.1078

Seoul

10FL, Kyobo Securities Building
26-4, Youido-dong
Yongdungpo-gu
Seoul, 150-737
South Korea
Telephone: 82.2.6336.6813
Facsimile: 82.2.6336.6710

Shanghai

Floor 34, CITIC Square
1168 Nanjing Road West
Shanghai 200041
China
Telephone: 86.21.6122.3900
Facsimile: 86.21.6122.3988

Singapore

50 Raffles Place
Singapore Land Tower #32-01
Singapore 048623
Singapore
Telephone: 65.9241.3847

Tokyo

7th Floor, Glass City Shibuya
16-28 Nanpeidai-cho,
Shibuya-ku
Tokyo 150-0036
Japan
Telephone: 81.3.4550.2640
Facsimile: 81.3.4550.2641

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