The Role (and Impact) of the PRC Government in the Auto Industry in China

Inside China: Understanding China’s Current and Future Auto Industry
Introduction

- State of the Industry
- Regulatory Efforts 2008-09
  - Specific to Auto Industry
  - Related to FDI Generally
- (Cause) Promoting Consolidation (and Protectionism) and High Tech
- (Effect) Reemergence of Joint Ventures
State of the PRC Auto Industry

- Prior to 2008, China had enjoyed double-digit sales gains for more than a decade
- Three straight 20% increases (’05-’07)
- 2008 sales growth in China = 6.7%
- 2008 sales growth in US = -18%
State of the PRC Auto Industry

- Jan. ’09 China sales surpass US for 1st time
- Despite 14% sales drop, sales exceeded 736,000 units; US sales plummeted 37%
- Feb. ’09 sales up 25% from 2008, mostly due to lower sales tax and other incentives
- Mar. ’09 sales up 5%; US declines by 37%
State of the PRC Auto Industry

- Still hundreds of auto makers, and thousands of suppliers (over capacity)
- Remains very regional in terms of production and sales, although changing
- Overcapacity under control – production in Mar. ’09 of 1.1m vehicles to sales of 1.11m
Regulatory Update (Auto)

- Auto Industry Revitalization Program (2009)
  - 50% cut in sales tax for cars with engines of 1.6 liters and smaller
  - RMB5000 ($730) subsidy to farmers to buy pick-ups and mini-vans
  - Sales growth targets of 10, 12 and 15% for 2009, 2010 and 2011, respectively
Regulatory Update (Auto)

- Auto Industry Revitalization Program (2009)
  - Subsidies for new energy vehicles
  - Incentives for replacing high-emission vehicles ahead of schedule with more efficient models
  - Restrictions on local governments to prevent unfavorable regulations towards sales, while at same time promoting government procurement of local brands
Regulatory Update (Auto)

- RMB10 billion fund created to promote new technology vehicles (2009) over next 3 years
- Gov’t pushing consolidation (2009)
- New Anti-Monopoly Law (2008) to permit dealers to set pricing and sell outside of their geographic regions
- $586 billion stimulus package focuses on expanding transportation networks and infrastructure, among other things (2008)
Regulatory Update (Auto)

- PRC government to focus on 4 major development areas over the next few years
  - Increase R&D spending on hybrid technology
  - Speed up commercialization of fuel efficient and new energy vehicles
  - Provide tax incentives for fuel efficient and new energy vehicles
  - Build technology alliance among business, academia and R&D institutions
Regulatory Update (FDI)

- 2008 a banner year for major legislation affecting FDI:
  - Labor Contract Law
  - Unified corporate income tax system
  - Bankruptcy Law
  - Antimonopoly Law
Promoting Consolidation

- Globally competitive “Big 10” (from 14), led by SAIC and FAW
  - Split into 2 groups: 1 with 4 OEMs with annual sales of at least 2 million and 1 with the other 6 companies, each with annual capacity of about 1 million units

- Seeking to increase market share of Chinese OEMs from 34% to 40%

- Exports growing, but still lacking right mix of good design, high quality, safety, low emissions and fuel efficiency necessary to become real global competitors
Promoting Consolidation

- Challenges Caused by Local Ownership
  - Most OEMs are state-owned, many at a local level
  - Selling off locally-owned OEM causes loss of revenues and jobs

- Success Stories
  - SAIC acquires Nanjing Automotive
  - Beijing Automotive looking to buy Fujian Motor
Promoting High Tech

- Current 5 year plan (scientific and sustainable development)
  - “Green” and energy conserving technologies favored
- Catalog Guiding Foreign Investment in Industry
  - Revised effective 12/1/2007
  - Overall, continued liberalization of FDI
Promoting High Tech

- Historically, JVs were only investment option
- Trend toward permitting WFOEs
  - Assembly operations only remaining investment required to be JV (general cap at 50% equity)
  - Honda (Guangzhou) JV only exception
  - Some recent discussion in government to remove this cap
Promoting High Tech

- **Counter trend may be starting**
  - Gov’t supporting development of new fuel tech under long term science and technology plan
  - New Rules on Approval of Manufacturing New Energy Automobiles (11/107)
    - Approval needed before commence production
    - Likely need to form JV
Creeping Protectionism (M&A Activity)

- 1st 3 quarters of 2008 were slow for cross-border M&A investors in China
  - 70% drop
- FDI, however, continued to surge, mostly in form of “Green Field” investments
  - $72 billion in “green field”
  - $10 billion in M&A
Creeping Protectionism (M&A Activity)

- Few “control” acquisitions closed
  - Mostly minority stake deals in companies needing growth capital
- PRC gov’t emphasizing global competitiveness
  - Pushing industry consolidation
  - Concentration on “core” businesses
  - Resulting in increased “protectionism” in M&A deal approvals
Creeping Protectionism

- All investments require some level of government approval
- M&A approvals under New M&A Provisions / Antimonopoly Law
  - All M&A deals involving FIEs subject to “national” or “economic” security review
  - Protecting “famous trademarks” (Coke/Huiyuan)
  - Protecting future Chinese multinationals (Carlyle Group/Xugong)
Creeping Protectionism

- Long Arm of the New Anti-Monopoly Law’s Reporting Requirements
  - Reporting thresholds based on deal size and aggregate turnover/assets in China
    - Even if unrelated to the present transaction
    - Onerous (now like the EU/US)
  - End result: Non-China deals may have to report in China because of other China holdings
Creeping Protectionism

- China Created Antitrust Commission
  - Branch of State Council
  - “Insure control of SOEs in important industries and key sectors”
  - Provide equal protection for foreign investors, **BUT** “prevent malicious foreign takeovers and protect national economic security”
  - MofCom’s InBev Ruling (Re: Anheuser-Busch)
Reemergence of Joint Ventures (JVs)

- One possibility to resolve these pressures operating against foreign investors is to reconsider JVs
  - Faster way to establish larger footprint
  - Helpful to maneuver through regulatory jungle
  - Access to Chinese partner’s market share
  - Difficulties of achieving organic growth
Reemergence of JVs

- Traditional Disadvantages of JVs Include:
  - IP Theft and Unauthorized Production
  - Sharing of Profits
  - Management Deadlocks ("Same Bed, Different Dreams")
  - "Marriage in a No Divorce Jurisdiction"
Reemergence of JVs

- **New Risks in JVs**
  - Industry consolidation being driven by PRC government makes it difficult to know if making the right choice of partner
  - Tax and other Investment Incentives + Market opportunity + Consumer preferences are requiring high technology so prospect of IP theft is enhanced
Mitigating Risks Associated with JVs

- Complete and Thorough Due Diligence
  - Treat as an Acquisition
    - Full Legal and Financial Review
  - Reputational Diligence
    - US “Gold Key” Service Reports
    - Consult with target’s other JV Partners

- Does the JV make the most strategic sense?
  - WFOE or other structure
  - Investment in different region or country
  - American Axle (50-50 JV w/ Anhui Jianghuai)
  - Yanfeng Visteon
What does the Future of the Auto Market in China look like?

- **High Growth**
  - Currently, only 20 per 1,000 market penetration (as compared to roughly 500 per 1,000 in EU and US)

- **High Tech**
  - Safety enhancing and “green” technology “encouraged” by China’s industrial policy
  - Alternative fuel technologies supported (Beijing mandates 10% of cars must run on alternative fuel by 2012)
QUESTIONS?

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