

AUTOMOTIVE

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- > Focus on Russia – A new promising market
- > A view on the markets in India, Brazil and CEE



Editorial



Dear reader,

Despite the glamour of automotive fairs, everyone knows that the global industry is under immense economic pressure. The vast majority of companies are busy tackling severe problems and a harsh climate. But a new promising market has emerged – Russia!

Although emerging automotive markets have not always lived up to their promise, this opportunity cannot be missed. In this second issue of Roland Berger Automotive Insights, we focus on the key challenges presented by Russia and other fast emerging automotive regions. Russia's automotive market is already the ninth-largest in the world and signs are strong that the market will continue to grow robustly at least until the end of this decade. Major players are entering the arena in droves. Significant investments in assembly plants have already been made, and many more are in the pipe line.

But the examples of South America and China show that the going won't be easy. Competition is tough and will become even more aggressive. Companies have to bear this in mind when they hammer out strategies for fast developing regions such as Russia, India and CEE. Sound information, a good understanding of the market and experience are key for achieving success.

I wish you insightful reading and welcome any feedback that further improves our services for you.

Sincerely,

Ralf Kalmbach

If you have any suggestions or questions, please do not hesitate to contact us:
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■ Cars: Pure fascination

Carmakers are serious about producing cleaner, more fuel-efficient vehicles. That was the clear message from this year's International Motor Show in Frankfurt. Professor Bernd Gottschalk, president of the German association of the automotive industry VDA, reports on his impression.



Professor Bernd Gottschalk provides his overall impression of the IAA

The International Motor Show has developed into one of the automotive industry's top international events. This year's motor show in Frankfurt was no exception. In terms of sheer quality, it is the best IAA that has ever been held. The record number of world premieres, exciting technological innovations, large media interest and number of visitors confirm this.

The motor show really lived up to its motto "Cars – Pure fascination" as there really were many fascinating vehicles on display. If there were any doubts that a car is "an emotional product of a special kind" then these have been completely erased.

The IAA 2005 was more professional and more international than in previous years. This barometer for the industry has become more reliable. The fact that one in four visitors intends to buy a new car within the next six months, is a positive signal in my view. The mood among exhibitors was also upbeat. Never before have there been so many intensive technical discussions – thanks partly to input from suppliers, which traditionally play a large role at this motor show.

The IAA has become an important forum for politicians and automotive industry specialists to exchange ideas. That was underscored by visits to the IAA from EU Commissioners, Gerhard Schröder and Angela Merkel, state premiers, members of parliament as well as numerous domestic and international delegations.

Because of the large number of impressive world premieres, the IAA did not need showy displays, music or glitter and glamour to draw crowds. Visitors were fascinated by the innovative solutions created by automotive companies for motors of the future. Displays of hybrid, and motors running on natural gas, hydrogen, flexfuel, fuel-cell, BTL and GTL fuels and the SCR technologies to reduce nitrous oxide emissions kept visitors riveted.

In light of increasing fuel costs, carmakers must be steadfast in their determination to "move away from oil". The sector is deliberately concentrating its efforts on a strategy that incorporates many technological possibilities with fuels and motors.

The IAA in 2005 clearly showed the world what steps the automotive sector is taking on the way to safe, clean and sustainable mobility.

THE TAKE-AWAY

- > Crowds fascinated by the motors of the future on display
- > One in four IAA visitors plans to buy a new car within six months



■ Russia's automotive market comes of age – Good prospects for international suppliers

Russia's car sector is growing at a breathtaking speed. But it won't be local players that benefit. Foreign OEMs have the most to gain – as long as they do their market entry homework.

The size of Russia's car market is impressive. It is the ninth-largest player in the world and 1.3 million vehicles were sold in the country last year. Just as importantly, its forecast growth figures are also impressive. With expected sales growth of around 7 percent annually until 2010, Russia places fourth worldwide in terms of growth. Fuelling this growth are rising incomes and strong demand for replacement vehicles. This is not surprising considering that the car park is on average 18 years old. But it will be exclusively foreign manufacturers that benefit from this growth. Russian OEMs in contrast can expect stagnation at best.

The development of the original equipment market is forecast to grow even more dynamically. This will be driven by heightened outsourcing of Russian OEMs, an increase in local content of foreign OEMs as well as higher environmental and safety standards. International suppliers will find developing production facilities increasingly attractive even if the time and form of market entry must be examined case by case.

Supplier market underdeveloped

The high level of vertical integration among Russian carmakers has hampered the development until now of a modern supplier market. That is why the Russian supplier market today is hardly competitive when compared internationally. Suppliers are seldom active in the development stage and OEMs use them mostly as an extended workbench. International suppliers have viewed Russia's local market as attractive only in exceptional cases. The production volumes of international OEMs remain too low and the share of locally engaged components for CKD fittings is too small.

Because of the high costs of international components, there is practically no demand from Russian OEMs. As a consequence, the critical mass required to manufacture economically has in many cases not been reached.

Checklist for potential investors

General:

- > Consider investment as future-oriented project
- > Define business case with detailed sales and production plan
- > Get local access to customers and administration – Check for selective co-operations to enhance local access
- > Introduce transparent management structures and systems
- > Understand and respect Russian culture
- > Avoid or prevent corrupt structures
- > Check for just-in-time requirements of customers and need for proximity to customer

Joint ventures:

- > Ensure quality by implementing own management in case of joint ventures
- > Claim industrial leadership and assure independence of local partner
- > Screen potential local partners as well as framework conditions intensively before signing agreements
- > Distribute roles in a clear and binding way

As a low-wage country, Russia has also not fallen within the radar screen of international suppliers. In past years, Europe's top 20 automotive suppliers have built more than 150 sites in Central and Eastern Europe.



They have chosen regions where they can benefit from cost advantages without exposing themselves to political and legal instability. In contrast, only eight production sites have been built in Russia. Further relocation from CEE to Russia has not occurred because the cost advantages are minor and transport costs are higher.

Growth opportunities open

The conditions that have hindered the creation of a competitive supplier industry in Russia are improving dramatically. According to a study conducted by Roland Berger Strategy Consultants together with the Committee on Eastern European Economic Relations, production of foreign OEMs in Russia will increase more than sixfold over the next ten years, standing at 125,000 units in 2004. Russian manufacturers' production levels in contrast will decrease slightly during the same period to around 800,000 units annually.

Spurred by rising incomes, greater desire for comfort and safety as well as sinking import duties on new vehicles, sales of foreign vehicles in Russia have jumped by almost 60 percent to 238,000 units alone in the first six months of this year. Hyundai alone, as market leader among the foreign manufacturers, plans to sell more than 100,000 units this year, approximately half of which will be assembled by their Russian partner TagAZ. Daewoo and Nissan are expecting unit sales of 60,000 and 40,000 respectively – sales of this magnitude would also justify local production. Ford, Renault, KIA and BMW already have production facilities or assembly partners in Russia. Toyota wants to produce around 100,000 vehicles locally by 2010. VW and DaimlerChrysler also have firm production plans for Russia.

But it is not just the upsurge in production among foreign manufacturers that is inciting the interest of international suppliers. Russian manufacturers too are giving their suppliers more responsibility. Based on the study, the share of work outsourced by Russian OEMs will climb

from 26 percent in 2004 to 43 percent in 2010. The share of locally made components in foreign vehicles will increase threefold to 36 percent during the same period. Russian OEMs are increasingly keen to purchase components produced by international suppliers because of greater environmental and safety standards. But customers' growing demands for comfort and safety also play a role. Components made by western companies already cover around 40 percent of Russian OEMs' purchasing volume needs, especially in drivetrain (around 22 percent) and interiors (around 10 percent). By 2010, the share of components meeting western standards in Russian vehicles will increase to around 37 percent from 13 percent. Because Russian suppliers rarely possess the technologies necessary to fulfill these requirements, the prospects are bright for international suppliers.

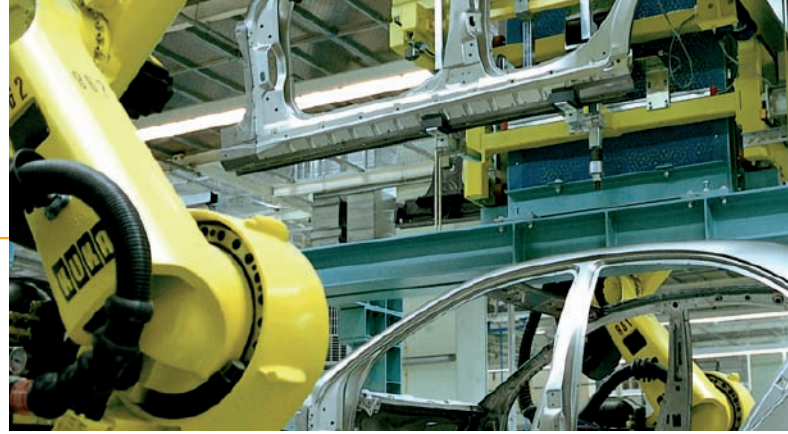
Based on these developments, the market for original equipment in Russia is expected to grow from EUR 0.9 billion to EUR 5.1 billion between 2004 and 2014. This translates into annual growth of almost 20 percent over the next ten years – an impressive feat.

THE TAKE-AWAY

- > Production of foreign OEMs is expected to increase eightfold over the next decade
- > Original equipment makers might see annual growth rates of almost 20 percent
- > Following some simple market entry rules could prevent disaster

Examine case by case

There is no one universally valid answer to the question, whether and how suppliers should set up facilities in Russia. Real life examples of successful but also failed business models show that there is no golden formula for success. Joint ventures, frequently the preferred option for setting up business, need to be examined case by case.



Without wishing to undermine the advantages garnered by better customer access to Russian OEMs, the use of the partner's local know-how and the availability of its qualified workforce, joint ventures carry specific risks. These structures can sometimes only be overcome with difficulty. Complying with corporate governance and compliance standards is difficult because of the extended but nontransparent networks, especially when these are linked with corruption.

Irrespective of the market entry chosen, some key success factors stand out. Production facilities should be viewed as a strategic investment that enables suppliers to secure a good standing with Russian but especially foreign OEMs as early as possible. Cultural differences need to be accommodated for just as much as specific legal and bureaucratic characteristics. Accordingly it is not just local access to customers that is of great importance but also gaining access to Russian administration. Corrupt structures should be avoided at all costs. If suppliers want to be successful, they should thoroughly examine the business model and plan. Introducing and implementing transparent management structures and systems is also critical for success.

There are a handful of additional factors that need to be taken into account when setting up a joint venture. Indispensable is a detailed check of the possible business partner that examines frequent non-transparent structures. Companies are also advised to clearly define the individual functions and roles of both parties. And finally, only the creation of a secure win-win situation safeguards the long-term success of the partnership.

Weighing up the needs and requirements of the target customers should be the starting point for all deliberations. What also needs to be considered is whether the Russian manufacturers should have their Russian suppliers develop parts with western partners, using

their technology and know-how, or whether the local manufacturer should build up further independent supply source. Foreign OEMs also need to consider what is the key issue – quality assurance or price minimization.

Growth potential

Without doubt, Russia's automotive sector offers international suppliers considerable growth potential. For sure the absolute market volume remains comparatively low, but a market entry in Russia today should be considered as a strategic investment – to get in quickly enough to create the conditions that will allow companies to participate successfully in the market growth. The time and manner in which companies settle in Russia needs to take into consideration both the company and the target customers.

Entering the market means taking on a calculable entrepreneurial risk. But it is worth it when weighed against the attractive growth and returns potential. Along with the local market dynamic, Russia may also become a considerable player in the global automotive sector when it comes to exports in the midterm and long term. Considering the lack of growth perspectives in many other parts of the world, the automotive and supplier industry should quickly grasp the opportunities offered in Russia.

*Jürgen Reers,
Partner at Roland Berger
Strategy Consultants, Munich*





■ Foreigners gear up investments in Russia

Russia is on track to become an especially attractive country for foreign direct investment. But foreign OEMs and suppliers will have to act quickly.

Russia's economy was put in a tailspin during the financial crisis of 1998. But since then the economy has been developing positively, with annual growth rates averaging around 6.5 percent. Also this year, the market is expected to grow by about 6 percent largely because of high oil and gas revenues. Business and investor confidence in Russia is flourishing as a result.

High oil prices and a relatively cheap ruble are important drivers of this economic rebound, which has been given an extra push by increased investment and a jump in consumer demand. Personal income has risen since 2000 by 12 percent on average and fixed capital investments have averaged gains of 10 percent.

Russia has made great strides in improving its international financial position. It has knocked down its foreign debt from 90 percent of GDP to 28 percent. Oil export earnings enabled the country to lift its foreign reserves from USD 12 billion to USD 120 billion in 2004.

Foreign trade is robust. Russia reported USD 136.2 billion foreign trade in the first quarter of 2005, a 35 percent increase from 2004. Germany is Russia's biggest trading partner with USD 25 billion in 2004. Other large business partners are the Netherlands, Italy and China.

Swelling FDI inflows

Gone are the days when foreign investors feared placing their money in Russia. With its undeveloped system of protecting intellectual property rights, a vulnerable financial system and a banking sector in desolate shape, investors' concerns were justified. Today confidence has increased and FDI inflows have picked up markedly as a result of reforms that the government introduced. Cyprus, the Netherlands, the US and Germany are the main investors. FDI of USD 37 billion made Russia Europe's fifth largest FDI recipient in 2004. This was the strongest growth in FDI to Russia recorded in four years.

Western Europe remains the most attractive destination for investment. But competition is emerging fast. The countries of Central and Eastern Europe have transformed themselves from low-cost workshops into markets with huge potential. Brazil, Russia, India and China are showing a similar development. Owing to its geographical position and its energy resources, Russia's starting position is strong. Once it manages to resolve such issues as WTO accession negotiations, international markets will quickly feel its presence.

Russia's automotive sector is proving especially attractive for foreign investors. It currently takes third place in Europe for drawing automotive manufacturing FDI. Russia is the thirteenth-largest vehicle producing country in the world. Considering its vibrant local market and GDP growth rate, it could soon enter the top ten. Production of passenger cars rose to 990,000 units last year. More telling still, Russia's car fleet per 1,000 inhabitants stands at 147, according to the World Bank. And the trend toward car ownership is growing.

All the leading automotive OEMs are present in this hugely promising market. More than 285,000 new cars were imported to Russia in 2004 and 130,000 foreign models were produced locally. In contrast, 860,000 Russian cars were produced domestically. Potential exists for all OEMs to strengthen their market position by ramping up local production. Despite recent positive progress, a handful of forces could still throw the economy off course. Political instability, a strong ruble, the privatization law, and administrative and tax barriers, could destabilize the economic situation. Further reforms are necessary.

*Dr. Klaus Mangold,
Executive Advisor to the Chairman
of DaimlerChrysler*





■ India's tempting but tricky auto market

India's economic progress pales when compared against China's stellar growth. But the crouching Indian tiger should not be ignored. India has already entered the big league of Asian carmakers. If global OEMs want to rule India's roads, they will have to build world-class cars with Indian cost structures.

Considering India's size and turbo-charged growth, comparison with China is inevitable. All too often, however, India draws the shorter straw. When it comes to automotive production, India is not in the same league as China. Whereas India sold 1.2 million units last year, China sold more than 2 million passenger cars.

Foreign direct investment provides a similar story. Although India's foreign direct investment policy has become more generous since 2000, FDI is minuscule compared to China. India's FDI inflows jumped 25 per cent during 2004 to USD 5.33 billion. But that's a trickle of the USD 60 billion FDI flowing into China, according to UNCTAD in its World Investment Report 2005.

when compared to other developed economies. Besides a strong four-wheeler market, India also has a sizeable two-wheeler, three-wheeler and commercial truck market. The country rolled-out a total of 8.5 million automobiles in 2004, of which 1.2 million were passenger cars and multiutility vehicles.

By 2010, India will be a 2 million passenger car market and will become a 3 million market by 2015. If only India had previously developed an adequate road infrastructure, these volumes could have already been reached. Purchasing power for such volumes already exists today, but the road development is moving at a far slower pace.

China and India take on the world

	Sales ¹⁾	FDI (USD) ²⁾	Share of global economy ³⁾	Economic growth ⁴⁾
China	2.0 m	60.00 bn	13%	868%
India	1.2 m	5.33 bn	6%	311%

1) passenger vehicle sales in units in 2004 2) in 2004 3) GDP in 2004;
4) GDP growth since 1980 (1980 = 0%)

Source: Deutsche Bank Research; OECD; UNESCAP; UNCTAD

Yet as attractive as China might be, European carmakers and suppliers would be wise to keep at least one eye pinned on India. They should also keep in mind that India's automotive market is not a cookie-cutter mold of China's car sector. The structure of India's auto industry is unique

Although the foundation for a strong passenger car industry was laid in the early 1990s, real momentum has only been building since 2000. That is when the government significantly changed its policies, taking steps to make manufacturing more internationally competitive by



creating export promotion zones and expanding infrastructure. It also freed industry from excessive regulations five years ago.

Its stance toward foreign direct investment also became less restrictive. Unlike in China where a joint venture is required for domestic production, India's auto foreign direct investment policy allows global OEMs to have 100 percent ownership, which has created a healthy industry from the start. The Indian market is thus full of real players and not "aspirers."

India's local heroes lose out

Given the potential of India's automotive market, it's worth taking a closer look at its structure. The future of the Indian market is in the hands of nine automakers, which command 98 percent of the total market. The Indian big three, Maruti, Tata and Mahindra & Mahindra, which boasted market share of 65 percent in 2004, are capable of designing, developing and producing indigenous vehicles. Of the global OEMs, Hyundai has the outright lead with its 18 percent market share, and hot on its heels is fast-growing Toyota.

Despite their clout, the big three Indian carmakers are losing market share. Their strengths primarily lie in the A and B segment. India however is experiencing considerable segment migration to C-segment vehicles (e.g. Honda City, Opel Corsa and Hyundai Accent). It's precisely in the C segment and above that global OEMs are strong. That's why we expect their market share to spike in coming years.

Ruling India's roads

To be successful in the Indian market, carmakers require a product that carries the highest customer value. In short: European quality cars at Asian prices. Price remains the crucial selling point in this market. But driving comfort and life-cycle costs, especially fuel economy, are becoming more important factors for potential car buyers in

THE TAKE-AWAY

- > India's big three carmakers are losing market share to C-segment carmakers
- > Price rules, but driving comfort and life-cycle costs are becoming selling points

India. Since local diesel prices are 30 percent lower than gasoline, the demand for efficient diesel engines should grow even more strongly, and European carmakers should hold a distinct advantage in this area.

Global OEMs must build world-class cars with the Indian cost structure if they want to be successful in India. India exported 130,000 passenger cars in 2004. To achieve the necessary economies of scale, Indian operations will need to be used as regional export hubs to supply other markets. Carmakers here can only achieve fixed and variable costs economies if they have a good balance of domestic sales and export sales.

Additionally, Indian operations should be leveraged in the global value chain of OEMs. Those companies that integrate India's strengths – such as engineering and software development – into their worldwide operations are seeing tremendous success. They are also benefiting from their local Indian subsidiaries.

India potentially is the next red-hot market. OEMs that have their finger on the local pulse and manage to globally integrate their Indian operations have good chances of seeing a profitable and sustainable operation develop.

*Dr. Thomas Sedran,
Partner at Roland Berger
Strategy Consultants, Munich*





■ Creating a sustainable car market in Brazil

After the boom and bust of the 1990s, the Brazilian market is growing again. But structural issues are threatening the future of OEMs and urgent actions needed.

Brazil's automotive market is no stranger to cyclical extremes. During the 1990s, all major OEMs and suppliers invested heavily there, and the country's production capacity jumped to more than 3 million units a year. OEMs, using several state-of-the-art plants and new manufacturing concepts, churned out vehicles at an unprecedented rate. But the automotive sector almost came to a standstill when production volume collapsed in 1999, down 35 percent since its peak in 1997. For a long time, the outlook for Brazil's automotive sector was bleak.

Over the past few years a moderate recovery has been unfolding and 2005 marks an important moment. Record high volumes of 2.2 million passenger cars and light commercial vehicles are expected to be reached in 2005. A boom in export flows and years of steady growth in the domestic market is behind this favorable situation.

Brazilian OEMs and suppliers, well equipped with modern plants, manufacturing processes and technology, have been tapping into new export markets. In 2005, 750,000 passenger and light commercial vehicles are expected to leave Brazil, up from 261,000 in 1999. "Made in Brazil" vehicles and components are being shipped both to emerging as well as mature markets.

Taking steps to avoid a fall

The sector must take steps to ensure that the current level of production develops into a sustainable platform for the future. If it fails to take measures now, the current high will become just another peak. Two main issues need to be addressed to ensure the sustainability of the industry for the next five years:

1. How to improve the distressed supply chain
2. How to develop a competitive cost base

Problems with the supply chain not only threaten the global competitiveness of the industry, the very sustainability of the domestic business is in question. In Brazil's automotive sector, tier 2 suppliers are the weakest link in the

THE TAKE-AWAY

- > Brazilian OEMs and suppliers are tapping into new export markets
- > Improve cost base and supply chain

automotive supply chain. In response to globalization, tier 1 suppliers restructured their business. Not so, tier 2 suppliers. They suffer from low profitability, high costs, meager investments, old processes and poor quality. Their difficulties could cripple the sector. OEMs can no longer afford to turn a blind eye toward them. Years of pushing through hard negotiations with them is now undermining their business. New approaches are needed.

Brazil is no longer a low-cost country. Car prices, measured in US dollars, are back to 1998 levels, but local costs are up by more than 30 percent. Years of currency devaluation hid the region's structural gaps and encouraged the "export campaigns" taken by OEMs and suppliers in the early years of the new millennium. Now that the exchange rate has recovered, the sector's competitive weakness is becoming more visible. Almost all players are stuck with their export commitments, characterized by high volumes and low margins.

Once again aggressive measures are required if Brazil's automotive market is to regain its competitiveness. If these are not taken the danger looms large that we are helping to create another economic bubble. Claiming import duty protection then will only be a measure of how many important decisions were not taken in 2005.

Corrado Capellano,
Principal at Roland Berger
Strategy Consultants, São Paulo



Committed to CEE

Roland Berger is concentrating its efforts in CEE countries – and for good reason. The regional markets are growing strongly, and lucrative business opportunities abound.

The Executive Committee of Roland Berger Strategy Consultants has defined Central and Eastern Europe (CEE) – along with China – as a focus region for the company's growth. Why? The bright light the media sheds on China might throw everything else into shadow, but CEE's impressive economic dynamic should not be ignored.

The diverse markets in Central and Eastern Europe are growing much stronger than their Western European counterparts. That makes them attractive for the top consulting groups and their clients. We have long been committed to this region, and thanks to our experience here we already command a strong position, which we are determined to defend and extend.

In CEE, the strengths of our company really come to light. Clients respect our pragmatic, get-it-done attitude, especially because it brings tangible results. Our ability to work across cultures, bringing in specialized international consultants from our worldwide network to create teams with local staff sets us apart from the competition. As the only global consultancy with European roots, we consider ourselves in some sense duty-bound to CEE countries – they represent in a way part of our home market.

Business is booming. We expect our business volume in CEE to grow by another 40 percent by the end of 2005. While our spectrum of clients is broad, we have built up especially good client relationships with companies in the automotive, transport and energy sectors as well as in consumer goods and financial services. Again, our ability to create teams from our pool of industry and functional specialists around the world and local consultants who truly understand the region helps us win projects.

This was the case recently when we developed a market entry strategy for an Austrian automotive supplier for Russia and the Commonwealth of Independent States.

THE TAKE-AWAY

- > Roland Berger Strategy Consultants has a wealth of experience and its reputation is strong
- > Consultants are hand-picked for their industry and regional know-how

The company, a leading supplier with worldwide activities, held a global niche position. Our team of consultants was commissioned to estimate the market potential in four target countries, exploit the growth opportunities in these CIS markets and to develop a market entry strategy.

Our business is equally divided in these markets between international and local companies. International companies call on our services when they are reconsidering their regional strategy or want to integrate acquisitions or optimize local production sites. For medium to large European companies as well as US and Asian specialists, we tend to develop market entry strategies, or create ways for them to boost growth in their regional activities by optimizing already existing companies or integrating recently acquired businesses.

We also advise national and regional market leaders. Our expertise has been used by railway companies, utilities, postal incumbents and telecommunication conglomerates. Industrial companies that have their sights set on a public listing are also among our clients. Our primary goal with these companies is to help them improve their competitiveness.

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