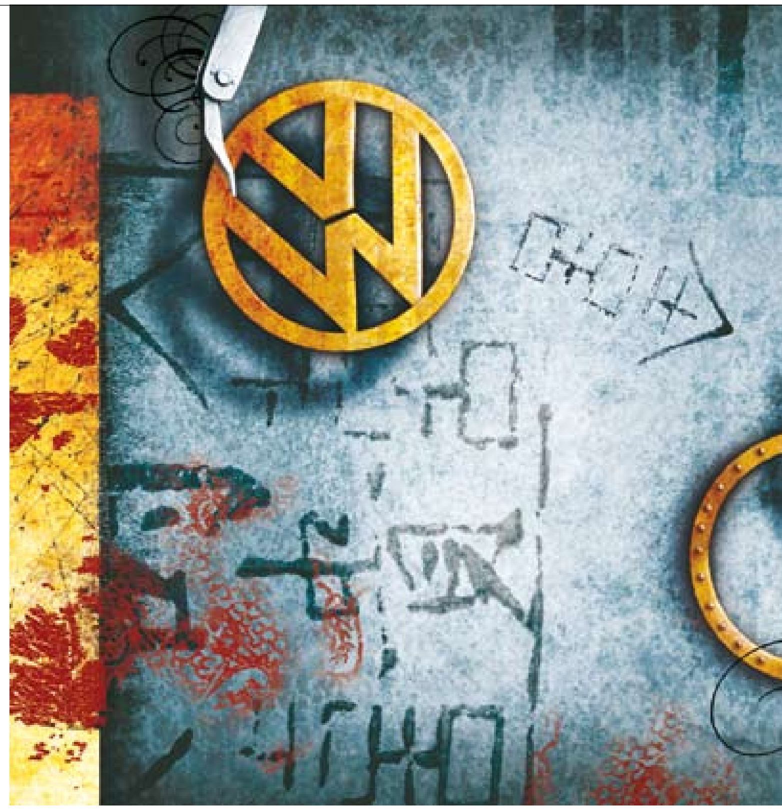
Volkswagen in China: Running the Olympic Marathon



Will VW's "Olympic" programme help it reassert its advantage in China?

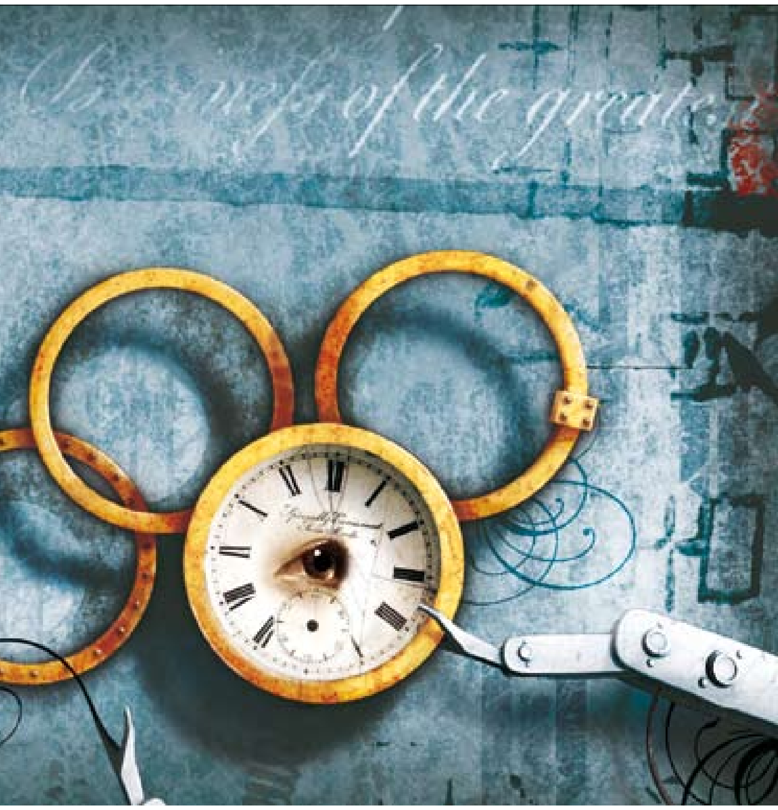
Bernd Pischetrieder, CEO of Volkswagen, took a few minutes from his busy agenda to reflect on the group's position. Although VW was still the largest carmaker in Europe, times were difficult. There had been losses in North America and there were serious productivity problems in Germany. And worse still, General Motors had replaced Volkswagen as the leading carmaker in China. This was a personal blow, for China had been one market that he was proud of. When most of his competitors had failed or had marginal success, VW had enjoyed leadership right from the time of market entry in 1985.

But that was history. In 2000, VW enjoyed more than 50 per cent of the Chinese passenger car market, but this had slumped to 15 per cent by 2005. Winfried Vahland, who was responsible for the Chinese operations, had launched an "Olympic programme" to restore VW's position of leadership by 2008, the year of the Olympic Games in Beijing. Pischetrieder had faith in Vahland, but he remained concerned. Would Vahland be able to roll out this marathon programme and succeed in restoring the company's position in China?

The Volkswagen stable

Founded in 1937 during the Nazi dictatorship in Germany, Volkswagen literally means "the car of the people". The company is based in Wolfsburg, Germany. In the 1950s and 1960s, the famous Beetle and the Volkswagen Bus helped turn the company into an international success story. Another iconic brand, the Golf, was launched in 1974. Other successful products followed: the Scirocco, the Golf GTI, the Lupo and the Touareg.

Organisationally, Volkswagen evolved into the Volkswagen Group, which also included Audi and Seat, which joined the Group in 1986, and Škoda, which VW acquired in 1991. It also included some exclusive elite brands such as Bentley, Bugatti and Lamborghini, in 1998. Services such as leasing, insurance and fleet business were also developed along with Europcar, one of the largest car rental companies in Europe. Within the group, sales revenue and operating profits were broken down into four geographic regions: North America, South America/South Africa, Asia and Europe/Rest of the World. The group's passenger car business was divided into two divisions, one under the leadership



of Audi and the other Volkswagen. These two divisions were responsible for the results for their respective clusters worldwide.

VW had about 11.5 per cent of the car market worldwide. Its strongest position was historically Western Europe, where its market share was 18.1 per cent. Its lowest market share was in North America with 5.7 percent. VW was much more international than other German carmakers. Although it still described itself as a "European-oriented company", in 1990 VW sold two-thirds of its cars outside Germany, and produced 40 per cent of its units overseas. But while BMW sold more than half its cars outside Germany, less than four per cent of its production sites were abroad.

Of Volkswagen's 343,000 workers, about 179,000 were based in Germany, including 103,000 in Wolfsburg. But Germany had become the most expensive place in the world to manufacture cars. The group needed to cut thousands of jobs and increase efficiency among those who remained. VW's sales were also suffering around the world. Between 2003 and 2004, VW lost market share in all regions except South America.

Volkswagen in China

The first Western auto manufacturer to enter China, VW opened its first office in Beijing in 1985. There followed a successful joint-venture partnership and a near monopoly in government and taxi sales for nearly 20 years. VW was the undisputed leader of the Chinese passenger car market until 2005.

The strategy of targeting taxi and official car fleets enabled VW to sell high volumes and thus harness economies of scale. The taxis become a permanent showroom for the brand, allowing VW to become well known and acquire credibility in China. Third, in time, the taxi fleets were renewed and new VW brands were introduced. From 1988 the taxi service in Shanghai was largely made up of the famous red VW Santanas, as iconic in their own way as the black cabs of London. In 2000, the Shanghai taxi fleet underwent its third upgrade, this time switching to the Passat B5.

Until 2004, it was compulsory in China for multinationals to enter the market through a joint venture with a local company. VW relied on two major joint ventures for vehicle production: Shanghai Automotive International Company (SAIC), founded in 1985, and First Automotive Works (FAW), established in 1987. SAIC was based in Shanghai, while FAW was in the north-eastern city of Changchun. VW also built a network of joint ventures to supply accessory products. The ability of VW to manage and build long-term relationships with its joint ventures was one of the key factors behind its success in China for many years.

By the end of 2000, VW had 53 per cent of the Chinese passenger car market. But that market share then collapsed, falling to 24 per cent in 2004 and finally to 15 per cent. Volkswagen China faced a crisis.

The Chinese car market

Total car sales in China in 2006 reached 2.25 million units. In 2002 and 2003, there had been double-digit growth (25 per cent growth in passenger car sales in 2003) and carmakers made substantial profits. In 2005, all carmakers except VW had posted an increase in sales, but overall profits declined by 40 per cent compared with 2004. Although demand has slowed, China remains one of the world's fastest growing car markets.

The emergence of a middle class in China began in the 1990s, and the luxury car market soared in this decade. As in many other countries, the car in China was considered a symbol of one's social status.

A class of noveau riche had emerged – a small percentage of the population, but still numbering about 60 million. These were eager to show off their newly acquired social

When most of its rivals had **failed** or had marginal success, VW had enjoyed **leadership** since its market entry in 1985

Illustration: Christopher Gibbs

status. They had a preference for luxury foreign cars, particularly Italian or German brands, such as Ferrari, Lamborghini, Porsche, BMW, Mercedes or Audi.

Many carmakers expected to go on and tap into China's middle-class market, estimated to be around 300 million people. But only a few middle-class car buyers have emerged and then only in a few big cities. These buyers are more price-sensitive, in part due to tighter conditions imposed by the Chinese government to rein in high rates of economic growth. Measures were introduced to toughen the criteria for approving car loans from banks. Moreover, the government has maintained high taxes on luxury brands, despite its WTO commitment to reduce taxes.

In response, carmakers introduced price cuts to boost demand. Price seemed to be an important selling point for middle-class Chinese buyers. However, technology was beginning to play an increasingly significant role in product differentiation. In the 1990s, VW and the other early entrants sent outdated factory equipment to China to produce older models that were no longer saleable in the West.

Price was an important selling point for China's middle-class consumers, but **technology** was becoming more significant

But this practice was increasingly unsustainable. Honda introduced its latest version of the Civic only several months after it went on sale elsewhere, and Toyota was assembling its Prius gasoline-electric sedan in China as well as in Japan.

Backed by price cuts from carmakers, volumes rose once again, but prices and profits suffered. More importantly, overcapacity was becoming a factor. Both Asian and Western firms were investing more than $13bn in China to triple annual production to about 10 million cars by the end of the decade. This would make China the world's largest, or second-largest, producer. This oversupply must in turn drive China to search for foreign markets for its cars.

The fight for market share

First established in China in 1997, GM was a late entrant. Its subsidiary, Shanghai General Motor, showed a profit in its first year of sales. GM also quickly acquired shares in other Chinese carmakers. Its Buick brand became popular at once. Cadillac and Chevrolet models, introduced later, also did well. Nearly all GM cars sold in China were made domestically. The company opened a second plant in Shanghai and added three new Chevrolet models in 2005. That pushed sales in China for the brand past the 100,000 mark for the first time, establishing China as Chevrolet's fourth-largest global market. These results were a breath of fresh air for GM, which had encountered shrinking market shares and depleting profits in its domestic market. In China, GM was unburdened by high costs that bottlenecked its US operations, including generous health care for its more than one million US workers and dependents.

Asian carmakers were already stepping up production and several analysts predicted they would prevail in the Chinese market, replacing Volkswagen or GM. Honda was the first Japanese automaker to expand into China in a big way and now controls nine per cent of market share in China. Toyota has also announced plans to invest more heavily in China, and Nissan reports rising sales. Japanese brands together had a 27.4 per cent share of the market in 2006, and have won a reputation based on the same factors that have helped them in other markets, namely, quality and reliability. The traditional enmity between China and Japan scarcely matters when it came to Japanese nameplates. Chinese consumers "say they hate [Japan] but then their next car will be either a Toyota or Honda", commented one analyst. Finally, Hyundai has seen sales growth in recent years and has announced plans to increase production.

Apart from VW, European carmakers have not succeeded in China. PSA Peugeot Citroën was an early entrant, with a co-operation agreement signed with a Chinese partner in 1992. Citroën has a 3.5 per cent share of the market, while

Peugeot's presence is miniscule. Among the German carmakers, BMW and Mercedes appealed to the top-end of the market and most of their business was imports, though BMW opened a production facility in China in 1994.

Chinese brands have won market share by doing what Chinese manufacturers had done successfully in other sectors: competing on price. Three of the main Chinese brands are Geely, Chery and Lifan. The most successful model has been Chery's QQ micro-car, which increased sales by 136 per cent in 2006, and which is priced at about $4,000. Such models make car ownership accessible to many new Chinese consumers. Automotive Resources Asia, a consulting firm in Shanghai, reported that: "Chinese brands overtook their Japanese counterparts to become the top selling passenger vehicles in China in January [2006], with total sales of 92,630 units."

Altogether, Chinese brands (as distinct from Western brands made by Chinese companies such as SAIC and FAW) captured 28.7 per cent of the market in January 2006, coming in ahead of brands from Japan (27.8 per cent) and Europe (19 per cent). One reason could be a change in regulations by the Chinese government, which had restricted the use of small cars in Chinese cities. This regulation was progressively abolished by March 2006. Most Chinese companies had already become proficient at making small, low-cost cars.

Gaining knowledge from joint ventures with Western partners, Chinese carmakers were catching up fast in terms of technology. Technology transfer meant that sophisticated Chinese brands could not only target the Chinese market, but could also be aimed at the export market.

The woes of Volkswagen

Apart from sluggish demand and the price wars of 2005, market observers believe that VW's offer has been growing old and losing appeal. The old favourite, the Santana, is now seen as dated. There are also co-ordination issues between the two joint ventures. Car models launched by the two ventures sometimes target the same consumer, meaning VW is in effect competing with itself. One analyst commented:

"Volkswagen, which 20 years before ventured into China was the first Western auto manufacturer, got rewarded for its vision with years of near monopoly on government and taxi sales. But as China's growing passenger car market picked up speed in the late 1990s with the growth of a middle class, Volkswagen found itself the envy of all foreign rivals… That made the company forget some of the good habits of a multinational company that it practiced. But instead it learnt bad habits from China's state-owed enterprises, such as having no desire to make progress and [failing to react to] challenges. Now if there is no restructuring of its two joint ventures, one will die."

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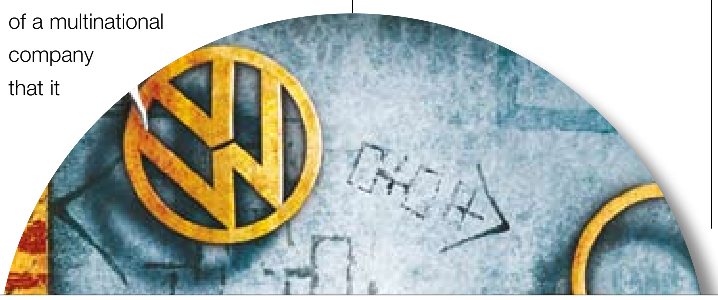

In October 2005, VW China announced its "Olympic" programme to restructure the group in China. Its targets were:

- a stronger differentiation between the products of the two joint ventures to prevent Volkswagen competing with itself;
- the introduction of 10-12 new models catering specifically to Chinese customers by 2009;
- a programme of cost reduction, including centralised purchasing;
- more co-operation between the two joint ventures in order to achieve synergy;
- a restructuring of the sales organisation and development of more customer-centred sales channels;
- a "revitalising" of the partnership with the two main partners, SAIC and FAW, with the aim of "generating a definite win-win situation for all".

This was an ambitious programme, and Winfried Vahland hoped that he would be able to run this particular Olympic marathon. For Bernd Pischetrieder would be waiting for him at the finish line.

Ashok Som is associate professor and co-chair of the management department at ESSEC Business School, Paris. This case was written with the help of Emeline Nicolas. A full version is available at www.ecch.com