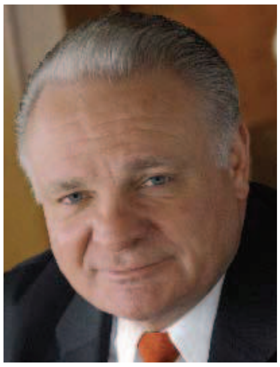
Why China's Industries Don't Consolidate

My company produces automotive parts, including piston rings. Several years ago, we analysed the market and counted a total of 140 piston ring manufacturing companies in China. That's an impressive number if you consider the fact that there are only a handful of producers of any significance in the world. Incredibly, five years later, that number has increased to over 400. How is that possible when all experts on China are predicting consolidation for fragmented industries?



By Jack Perkowski

With over 500 million tonnes of capacity, China's steel industry is the largest in the world. In car-making, the country is on track to produce more than ten million vehicles this year, making it the world's largest vehicle market. And so it goes. In product after product, and industry after industry, China's markets are rapidly becoming the largest in the world. Despite the large scale they are now reaching, industries in China remain extremely fragmented and are becoming even more so. This is in sharp contrast to more developed economies, where industries have consolidated over the years, enabling a small number of large players to gain economies of scale.

> "Companies that would go out of business in more developed economies live to fight another day because the extremely price-conscious, less demanding, purely local market continues to grow"

In steel, for example, there are somewhere between 300 and 1000 Chinese companies. No one really knows for sure. In 2007, Baosteel, China's largest, accounted for just five per cent of the China market, ranked only fifth in the world and was less than 25 per cent the size of ArcelorMital, the world's leading steelmaker. When I first came to China 15 years ago, there were approximately 130 vehicle-producing companies. Industry experts said that number was too high and that there was a need for consolidation. Paradoxically, the industry has only become more fragmented in subsequent years, with new car manufacturers setting up every year. Chery, Geeley, and BYD, three of China's largest car producers today, did not exist in 1994 when I moved to Beijing.

Recognising the ability of large enterprises to achieve economy of scale production, invest more aggressively in R&D, and compete globally, China's industrial policy has been to encourage consolidation and eliminate smaller, less competitive companies. Just this year, China announced a plan to consolidate its automotive industry. This will be done by forming two to three large group companies that produce over two million units a year, and four or five groups with annual sales exceeding one million units.

Will these consolidation plans work? If the past is any guide, it's going to be hard going. In the mid 1990s, China announced a plan to consolidate the car industry into three big, three medium, and three small companies. The fact that the current plan for cars sounds remarkably similar to the one proposed in the 1990s suggests that not much progress has been made. Why is consolidation so difficult to achieve in China? Because there are powerful forces at work that favour further fragmentation, not consolidation.

The first is China's vast disparity of incomes that creates two markets for any product: a foreign/local market and a purely local one. The former is characterised by high price, high technology and is served by the foreign invested enterprises and the best of the Chinese companies. The latter is characterised by low prices and low levels of technology. This second market is served primarily by local companies. The approximately 400 million people in China who have benefited most from the past thirty years of economic reform and whose average per capita incomes are above USD 8,000 shop in the foreign/local market. The much larger majority of 900 million people who have not benefited to the same degree and whose average per capita incomes are barely above USD 700 are confined to the latter.

Both markets continue to grow as China's economy expands, making room for new entrants. Because price, not quality or level of technology, is the primary consideration in the purely local market, barriers to entry are low and new local companies have ample opportunities to join the competition.

In developed markets, incomes are more uniform, so price, quality, and technology standards tend to be the same. That is the reason only a half dozen or so companies may make a relatively sophisticated product for the global economy. Conversely, literally hundreds of companies make a similar product for the market in China. Only relatively few Chinese companies may be able to compete in China's high price/high technology market, but there are scores that can make hay in the low price/low technology segment.

My experience in piston ring production provides a good illustration of how China's markets work in practice. When we analysed the market five years ago, we concluded that, along with its two largest competitors, our company accounted for approximately 60 per cent of the China market. But the proliferation of piston-ring-making companies led us to the conclusion that the industry had to consolidate. How wrong we were! Why is it that China's piston ring manufacturing industry is becoming more fragmented when the global industry has consolidated?

Due to their function within the combustion chamber of an internal combustion engine, piston rings are critical to achieving high emission standards. As technology and quality standards keep rising, companies that can't keep up fold, go bankrupt or are sold. That's why the number of piston ring manufacturing companies in the world has been decreasing over time. Fewer and fewer companies have been able to keep pace with the higher quality and technology demands of the market. It works the same way for virtually all industries where the manufacture of higher value-added products is involved.

Meanwhile, in China, companies that would have gone out of business in more developed economies live to fight another day. That is because the extremely price-conscious, less demanding, purely local market continues to grow. In addition to the ten million high technology gasoline and diesel engines that will be needed to power the trucks, buses, and passenger cars produced this year, another 40 million engines with only rudimentary technologies will be needed for the tens of millions of motorcycles, agricultural vehicles, and other vehicles that will be produced for China's local market. While they may serve different segments of the market and have vastly different technology standards, all 50 million engines require piston rings. Five years ago, the number of total engines produced might have been only 30 million. The growth to today's sales level, in combination with lower requirements in the local market, is why the number of piston ring manufacturing companies continues to expand, not contract.

The second major force driving industry fragmentation is the fact that local governments in China receive a share of the Value Added Tax (VAT) collected as products move through the production cycle. This gives each local government a strong incentive to have businesses locate and build factories in its own city. It is the reason why, for example, China's steel capacity went from 100 million tonnes early in this century to over 500 million tonnes today. As steel became a hot commodity, every city, town, and village in China decided that it needed to have its own steel mill so that it, too, could share in the growth of the market.

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Local economics also explain why it is so difficult to close factories and eliminate capacity in China; and why traditional merger and acquisition practices have not led to industry consolidation. What city mayor would willingly agree to a factory closing and give up his or her city's share of VAT receipts?

When will China's markets behave more like those in developed economies? In my opinion, not until income levels and prices, along with quality and technology standards, become uniform across the country. This will no doubt coincide with economic, not political, factors governing investment decisions. In the meantime, the marked income disparity in China, the continued growth of a vast local market where price is paramount and quality considerations are secondary, and the tendency of local governments to promote industrial development in their own locales, will cause markets to continue to fragment. ■

Jack Perkowski is a Wall Street veteran and the founder and Managing Director of JFP Holdings, a China merchant bank. He is also the founder and former CEO of ASIMCO Technologies. Jack is the author of Managing the Dragon and he writes China business commentary on his blog managingthedragon.com.