"Costs a catalyst for shake-up in car parts"
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By Jin Jing

Surging cost for raw materials have hit many Chinese manufacturers of auto parts, which are suffering declining profit and tougher competition.

However, it's not all bad news for suppliers. Although they face up to 10-percent profit cuts, it has prompted a flurry of consolidation among China's 5,000 registered auto parts companies.

More than 80 percent of executives are considering mergers and acquisitions, according to a survey from industry analyst AlixPartner. And more than half of them plan to look overseas.

"Auto parts manufacturers are much more influenced by the price hike because of their position in the forward part of the production chain," said Jane Ye, auto and infrastructure research analyst from consulting firm Cazenove Asia Limited.

"They are also pressured by auto makers to shoulder the additional cost to maintain vehicles' price competitiveness," Ye added.

The auto parts industry has traditionally enjoyed high profits as it has benefited from the global trend of outsourcing.

Galaxy Securities Co reported that China's auto parts industry had a compound annual growth of 31 percent in sales between 2004 and 2007.

But steel prices, which have increased from 5,000 yuan (US$725) per ton to 8,000 yuan per ton over the past few months, have left domestic makers deep in the red.

The rising yuan and lower tax rebates on exports are another two factors estimated to cut industry profit by 10 percent this year.

AlixPartner said in a separate research report China's top 12 auto parts makers have reported their profit declined significantly in 2007 from three years ago.

About 67 percent of senior executives surveyed estimated profit will fall further in the next three years.

The Chinese government is encouraging consolidation, realizing that the auto parts industry is much more fragmented than the complete vehicle segment. Many domestic car makers are still involved in low-tech content and low-value-added segments.

Small parts makers are more vulnerable to rising costs because of their small scale production. That means market leaders have more opportunities to take over smaller rivals.

"Industrial consolidation will enable industry leaders to gain more market share through the takeover, thus they are able to achieve higher growth," Cazenove's Ye noted.

In the big picture, it will help China's industry to improve its global competitiveness and management expertise, with the side effect of saving resources.

For example, Huaxiang Group announced it will invest 500 million yuan to gain a stake in Fawer Automotive Parts Co Ltd. This will boost its business with China's second-largest auto maker FAW Group.

Shanghai Automobile Gear Works, a subsidiary of China's largest auto maker SAIC, also signed an agreement with Brilliance Auto to collaborate on the development of core spare parts and transmissions at the beginning of this year. Annual production capacity is designed at 500,000 units.

Henan Province-based Aeolus Tyre Co Ltd just completed its purchase of a powertrain maker with 81.79 million yuan. And it also plans to take over another smaller tire maker in Henan.

"We like companies with scale, technology, alliance or cooperation with foreign auto makers and suppliers," Ye commented.

As rising commodity prices spread across the world, the consolidation will also give Chinese companies the chance to step up overseas mergers and acquisitions.

And the appreciation of the yuan will make it cheaper for them to buy overseas, especially in the United States.

Domestic makers see technology and engineering capability as their top priority in overseas integration, in addition to overseas distribution and clients.

Following Wanxiang Group's attempt to buy struggling US company Delphi, Ningbo-based Huaxiang Group bought UK luxury interior supplier Lawrence Automotive Interiors for 3.4 million pounds, or about 51.95 million yuan.

Through the deal, Huaxiang will become an OEM supplier to globally famed car makers such as PSA.

"Except for Wanxiang, the amount of deals is still very small and limited," said Ken Duck, attorney at Foley & Lardner LLP.

"However, given the situation of US auto makers, many Chinese auto suppliers and auto makers are studying the market and doing some due diligence."

But the path to consolidation is fraught with problems. Many M&A deals are finally dropped because it may hurt the interests of related governments in areas such as tax income.

Some companies are also hit with financial bottlenecks while fund-raising channels are narrowed, according to Teng Bole, official from China Association of Automobile Manufacturers.

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