The Future of Auto JVs in China

By: Jack Perkowski | November 1, 2018

In June, China's National Development and Reform Commission (NDRC) and its Ministry of Commerce (MOC) announced that, as of July 28, the country's "Negative List" of industries where foreign ownership is prohibited or restricted would be reduced from 63 to 48. Despite the fact that China formally opened to the outside world in 1978, foreign investors and companies were not permitted to own more than 50 percent in any Chinese entity until 15 years later in 1993. In that year, China opened its automotive components industry to majority ownership by foreigners as a way to encourage investment and bring technology to the sector.

Since then, ownership restrictions in one industry after another have been lifted. In recent years, China has reduced the number of restricted measures on foreign investment by nearly two-thirds. Under the latest changes, ownership restrictions in the finance, transportation, professional services, auto, ship, and aircraft manufacturing industries will be phased in over the next few years or ended immediately.

In addition to a number of key industries where greater foreign ownership is now permitted, the new regulations announced by the NDRC and the MOC dramatically change the ownership rules in autos. Except for special purpose and new energy vehicles, foreign ownership in automobile manufacturing companies has been limited to 50 percent under the old regulations. Moreover, foreign companies have not been permitted to have more than two joint ventures producing similar vehicle products in China.

Under the new rules that became effective on July 28, restrictions on the foreign-invested shares of Chinese companies that manufacture commercial vehicles will be eliminated in 2020. The restrictions on the foreign-invested shares of passenger vehicle manufacturers will be eliminated in 2022, as well as restrictions on the number of joint ventures which a foreign company may have in the country.

Bayerische Motoren Werke AG, more commonly known as BMW, is the first company to take advantage of the new regulations. In October, the German luxury car maker announced it would pay 3.6 billion euros ($4.2 billion) to take control of its main joint venture in China.

In its announcement, BMW said that it would increase its stake in its venture with Brilliance China Automotive Holdings Ltd. (Brilliance Auto) to 75 percent from 50 percent, with the deal closing in 2022. While talks between the Ford Motor Company and Changan Motor, its Chinese partner, regarding the possibility of Ford raising its stake in their joint venture have been rumored, Ford has since denied the existence of such talks.

The move by BMW, as well as the rumors surrounding Ford and Changan, raise the broader question as to the future of automobile joint ventures in China. Will the move by BMW be a trend, or will the trend be for Chinese automakers to buy out their foreign partners? Will foreign companies begin to establish wholly-owned car assembly facilities in China and forego the joint venture route? Whatever happens, the landscape of China's auto industry is likely to change in the years ahead.

In one sense, the relaxation of the JV rules for auto manufacturing has come along about 15 years too late for them to have any significant impact on car manufacturing in China in the short term. From 2003 to 2018, China's auto industry grew almost sevenfold, from 4.2 million to 29 million units. With such dramatic growth, strong relationships have already been formed in most auto JVs; substantial dealership organizations have been established; and a great deal of capital has been invested to build capacity.

To unravel these arrangements, and to replicate the infrastructure that has been built, would be a significant undertaking for either the foreign or the Chinese partner. Moreover, most of the JVs are very profitable, and it is questionable whether either the foreign or the Chinese partner would be willing to sell its stake in order to turn the company into a majority or wholly-owned Chinese or foreign company.

Complicating matters further is that the joint venture contracts at many of the major auto joint ventures in China are due to end in 2030. There has always been a question as to what happens when these contracts expire, which, among other issues, creates uncertainties as to valuation. The profitability of the existing JVs; the

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contract overhang; and the general difficulties of obtaining the necessary approvals and establishing a greenfield operation in China make it unlikely that much happens in the short term.

In this sense, the case of BMW may be a bit of an anomaly. Since its formation in 2003, the joint venture, whose partners include BMW (50 percent), Brilliance Auto (40.5 percent) and the Shenyang Municipal Government (9.5 percent), has been one of the most successful in China.

Approximately 600,000 BMWs are sold every year in the country, and BMW has emerged as China's top-selling luxury brand. Globally, BMW is a strong company whose global sales grew by 4.2 percent to 2.09 million passenger cars and SUVs in 2017. Asia in general, and China in particular, continues to be a significant growth driver for BMW Group sales.

On a relative basis, BMW's partners in China are not as strong. Brilliance Auto is not in the same category as First Auto Works, SAIC, Dongfeng, Changan, and other major Chinese car makers, and the city of Shenyang undoubtedly has other ways it can use the capital it has invested in the BMW joint venture. Given this imbalance in the relative strengths of the joint venture partners, it is not surprising that BMW made its move. Most of the other major auto joint ventures in China involve partners of more or less equal strength, so the same dynamics would not apply.

Over the longer term, however, there are likely to be more wholly-owned foreign and Chinese companies formed to make vehicles as a result of this policy change. This is particularly true given that the electrical vehicle (EV) industry is at an early stage of development and threatens to disrupt the entire industry. The fact that EV technology is completely different from internal combustion engine technology provides a convenient rationale for manufacturing EVs in a completely new entity rather than the existing JV. Since EV technology is evolving, companies that have spent a considerable amount of research and development are less likely to want to share that technology.

Absent the requirement to have a Chinese partner, foreign OEMs that believe they have an edge in EV technology will be more likely to form a wholly owned foreign enterprise to commercialize that technology in China.

A prime example is Tesla, which plans to go it alone in the country. Similarly, Chinese companies that believe they have an edge in EV technology or connectivity are unlikely to want a foreign partner. Most of the new companies formed in China to make EVs do not have a foreign partner or rely on foreign capital.

While the recently announced ownership changes are unlikely to have a significant impact on the structure of China's auto industry in the short term, they promise to inalterably change the country's auto landscape over the longer term.

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