

China overhauls its new energy vehicle manufacturing regulations

As an observer of market behaviour over the last decade and industry consultant, I have frequently heard complaints by Western clients regarding unfair subsidies granted by the Chinese government to prop up non-performing entities. The common theme is that western firms believe that many Chinese producers will be able to operate at a loss ad infinitum and that China is not concerned with competitiveness and profit, just growth.

While I do not profess to be an expert in Chinese business policy or practices what I have come to understand from my analyses of various sectors and from engaging with Chinese clients, is that China, unlike western firms, focus first on revenue. "Increase revenue and eventually profits will follow, even if profits on a per-unit-basis, are nominal." If one has sufficient revenue, then even a low margin becomes significant. It is only recently with the growth in the hi-tech/ disruptive technology sectors, that western firms have earnestly started to play a low-margin, high volume game, seeing the benefits of acquiring market share and growing revenue, sometimes without profit. China in contrast has played this game as a matter of policy for years.

Having said this, once China seems to reach a critical mass, government tends to refocus its policies on profits, regulations, sustainability and competitiveness. We have seen this with a number of industries in China, most recently in China's rare earth sector, whereby the China's Ministry of Industry and Information Technology (MIIT) forced consolidation of larger companies with smaller firms to end up with six mega suppliers. In 2011, China's magnesium industry

went through a similar phase, whereby the MIIT mandated that producers needed to have a certain minimum capacity, thereby forcing suppliers to either close or merge.

China has now turned its attention to new energy vehicles. In terms of output, the number of new energy vehicles (NEV's) is on the rise, up 93% y.o.y in July. In the first seven months sales reached 207,000 units, up 123% y.o.y and the government is still targeting a goal of 700,000 units by the end of the year.

Whilst China should be able to realise at least the majority of this target, with over 200 manufacturers of new energy vehicles, the quality of these vehicles is coming into question. China lags behind in terms of quality, reliability and key technologies. As such, China's central government is tightening its regulations as regards who may be granted a manufacturing license with the aim of insuring an improvement in competitiveness.

China's Ministry of Industry and Information Technology (MIIT) released a new draft of regulations for the new energy vehicle sector, for public comment. The draft proposal is far more stringent with respect to the types of products and manufacturers as the overall aim is to increase the quality of vehicles that China is able to produce.

The new reform aims to accomplish this goal by preventing manufacturers from applying for production licenses unless they can demonstrate capabilities in developing the control system and coordinating the power and drive systems. This is a contrast to the current policy in force since 2009 whereby knowledge of only one of these systems was sufficient, which opened the doors to modifiers of vehicles as well. As a result today modifiers represent around 30% of cars sold and manufactured in 2015. In 2015 there were over 277 new energy vehicle models but only 43 had an annual production of more than 1,000 units, rendering the Chinese vehicle market

inefficient with respect to its global competitiveness.

Furthermore, all these smaller outfits were recipients of government subsidies which amounted to over \$4.25bn from 2013-2015. Elimination of these producers is expected to assist in deployment of subsidies to more efficient producers which should help see China realise its ambitions of 5m new energy vehicles on the roads by 2020. If successful, the new policy would encourage mergers of firms that do not meet all the required attributes, resulting in a rationalisation of the industry to around ten competitive manufacturers.