KPMG

AUTOMOTIVE

China Automotive and Components Market 2005

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Preface

China's automotive sector has been on a rollercoaster ride. From heady growth in 2003 to handwringing over sluggish growth and price wars in 2004, the market has been anything but predictable. To date 2005 has been a relatively positive year for the industry, yet views on the long-term development of the market cover a wide range of opinions. The auto sector in China is still developing and is far from becoming one single, seamless and integrated market — providing plenty of ammunition to support the positions of both market optimists and pessimists.

It is against this backdrop that KPMG in China launches the third annual review of the automotive and components market in China. For this 2005 report, KPMG in China has chosen to focus on three topics that are critical to the future development of the sector in China, and which are felt may present opportunities for existing market participants as well those who have yet to enter the market:

- Passenger car exports
- Component and aftermarket sector
- Car-related services

In conducting the study KPMG in China drew on a number of industry sources and literature, as well as discussions with industry participants in China in August and September 2005 to capture a practical "bottom-up" view of market developments. Key findings arising from the analysis include:

- Overall a positive outlook for China's long term growth, but a challenging environment for some as the fragmented and crowded market matures and consolidates
- Exports should not be seen as an instant cure for the over-investment that has taken place in China — exports are coming, but significant hurdles must be overcome
- OEMs are focusing increasingly on improving local component sourcing and the aftermarket, and component exports may rise as a result
- Demand for automotive related services is set to grow as China embraces the car culture

KPMG in China hopes that this report provides insights and clarity in a market that is changing rapidly.

Paul Brough
Head of Financial Advisory Services
KPMG in China and Hong Kong SAR

November 2005

- The information in this report is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

- KPMG does not accept responsibility to any party that relies on information or views expressed in this report; companies should seek professional advice and conduct a thorough assessment of the particular situation prior to making any business decision.

- Our report is based on information available to us at the end of September 2005. Our information and analysis is based on research conducted from July to September 2005.

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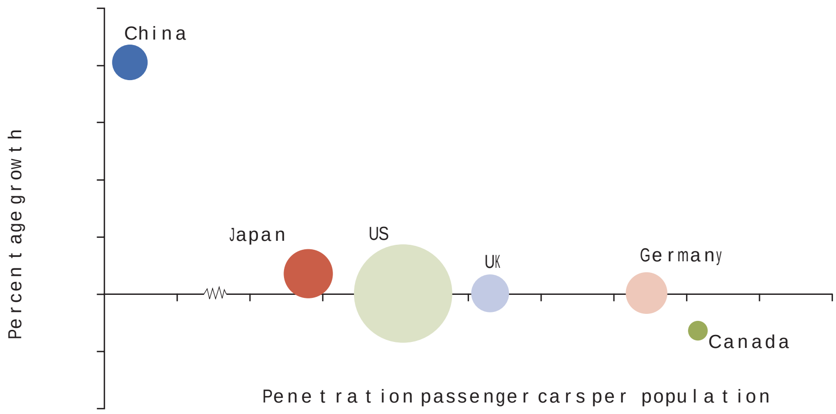
Market development

China, still a growth market

In recent years, China's automotive industry has experienced tremendous growth to become one of the leading automotive markets globally with sales and production of passenger cars reaching 2.3 million in 2004. China is now the fifth largest market in terms of sales, and is expected to overtake Japan by 2010 to take the number two position[1].

Compared to other major automotive markets, however, China still has ample room for growth. China's car penetration is one of the lowest in the world, fuelling optimism from local and foreign investors alike over the attractiveness of the sector in the long run.

Growth vs. penetration of global passenger car markets (2004)

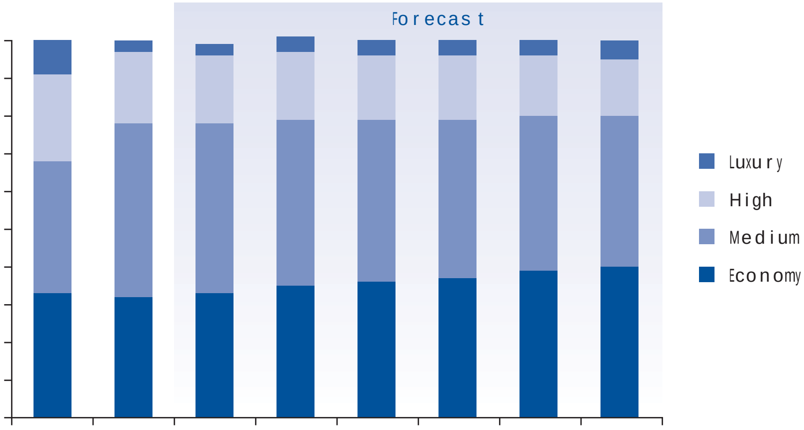


Note: Size depicts sales units of market (millions)
Source: Euromonitor reports, 2004; EIU Viewswire; KPMG analysis

After doubling sales in 2003, passenger car sales slowed in 2004, due in part to government measures to cool the market. Though growth in China has slowed down, it is still relatively robust at an estimated 14 percent per year in the long term, compared to marginal growth in other mature markets. Growth will continue to be driven by the robust sales of the small car segments.

1 EIU Viewswire, "World automotive outlook: Pressures remain" 9 March 2005; OICA Web site

Passenger car sales by segment, 2003-2010



Sources: China Car Passenger Association; JP Morgan estimates; CSFB "China Auto Sector — Buy ahead of 2006 recovery?" 26 May 2005; KPMG analysis

Do sales equate to profits?

Despite the relatively high growth rates, margins for automotive manufacturers have come under pressure due to falling prices and increases in raw material costs, in particular steel, with manufacturers' profits decreasing by approximately 19 percent in 2004[2]. Nevertheless, the ability to pass on some of the pricing pressures to autoparts manufacturers should help many automotive manufacturers to continue to enjoy above average margins in China.

In addition, the Chinese automotive market is non-homogeneous with many smaller and separate "markets". For example, Buicks and VWs dominate their "home turf" in Shanghai, yet one sees a very different market mix in Guangzhou or Beijing. This is partly due to differences in customer preferences across the country but mostly, regional protectionism. Automotive manufacturers are able to enjoy more "advantages", in regions or cities where their plants are located. The existence of separate markets mean manufacturers can still expect above average margins as China is still not a fully competitive playing field.

Much of the competition in China's automotive market has been domestic, as imported cars still only account for a small proportion of sales despite increasing by approximately 13 percent in 2004. Imported cars are likely to pose even less of a threat to the market in the near term, as more and more vehicles are locally manufactured, prices in China fall and the government creates additional hurdles for imports such as new rules prohibiting bonded zones storing vehicles targeted at the domestic market.

2 China Association of Automobile Manufacturers; KPMG analysis

The effects of over-investment

The basic strategy of most OEMs seems to have been straightforward: grow the top line and increase sales to establish a significant position in the market. However, as foreshadowed by our 2003 report, with a large number of new car plants coming on line, the inevitable result has been lower prices. In an effort to gain market share, automotive manufacturers have been cutting prices aggressively over the past two years. Monthly car prices decreased from an index of 100 in January 2003 to approximately 70 in April 2005[3]; for example, the price of a BMW 3 Series sedan decreased by more than 10 percent in 2004.

To cope with the above issue, automotive manufacturers recently formed a tacit agreement to stabilise output[4]. Therefore, car prices are still falling but at a much steadier rate; many industry experts expect price competition to be more "rational" in the future.

Fragmentation or consolidation?

At the end of 2004 there were approximately 130 automotive manufacturers in China, with the top five producers controlling approximately 60 percent of the market. The top producers' market share has weakened compared to five years ago; the government intends to strengthen the industry by encouraging further industry consolidation, though a detailed plan has yet to be issued[5]. It should be noted that foreign vehicle assemblers are still required to operate via a joint venture, with a 50 percent ceiling on their interest. Component manufacturers, on the other hand, are not subject to this restriction.

China's automotive manufacturers can be categorised into three groups:

- Group 1: major automotive JVs. These will be able to develop a national presence and maintain a technical and scale advantage
- Group 2: these are niche producers that focus on the small car segment, which are expected to enjoy much higher growth; when fully developed, these producers would have a lean cost structure as well as relatively robust brands
- Group 3: the last group comprises a large number of automotive manufacturers that lack economies of scale and strong competitive advantage. Companies in this group are likely to become victim to industry consolidation as they will either become insolvent or be acquired

3 Automotive Resources Asia Ltd "China Automotive Report" July and August 2005
4 Deutsche Bank "China Autos — Dealer survey: cautiously optimistic" 8 April 2005
5 Xinhua's China Economic Information Service "Profile of China's automotive industry" 2003-2005

Table: Segmentation of OEMs

	Description	Representative companies	Estimated number of companies
Group 1 – the "mainstream"	Major JV OEMs that have partnerships with foreign OEMs and enjoy large sales volumes	FAW-VW, Shanghai GM	Around 10
Group 2 – the "challengers"	Niche local OEMs that focus on producing economy cars and developing their own brands	Geely, Chery	More than 20
Group 3 – the "remainder"	Smaller local OEMs that lack scale and competitive advantage		Many

Source: China Automotive Press "Overcapacity is not the biggest worry of the automotive industry" 19 August 2005; KPMG analysis

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Passenger car export segment

Still early days

In developed automotive markets, exports can represent a relatively large proportion of total sales. In China, however, the export market is still in its infancy. Chinese exports are only a fraction of exports from such countries as Japan, South Korea, Thailand, and India. Although China's exports of vehicles[6] have been growing steadily in recent years (by a CAGR of 34 percent between 2000 and 2004), it is still a very small segment and only accounts for approximately two percent of China's total car production.

Countries	Exports ('000)	Production (million)	Exports as % of production
Japan	4,224	8.8	48%
South Korea	2,108	3.1	68%
Thailand	240	0.8	30%
India	100	1.0	10%
Indonesia	32	0.4	8%
Malaysia	16	1.4	4%
China	11	2.3	2%

Source: OICA, "Production of passenger cars" 2004; United Nations Commodity Trade Statistics Database 2005; KPMG analysis

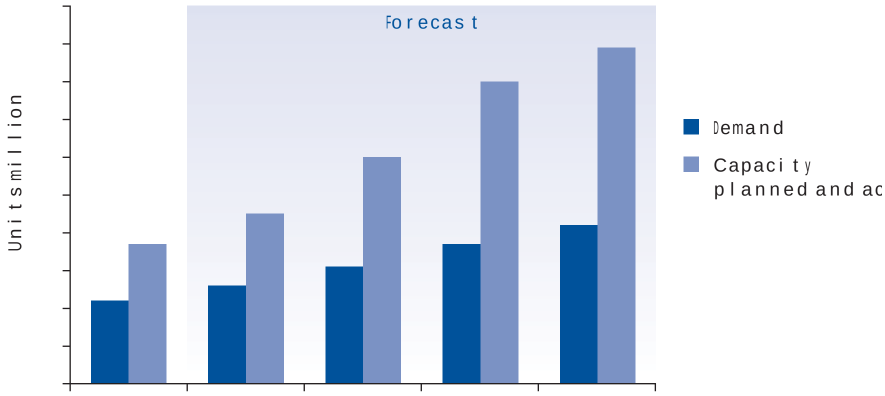
Nevertheless, in face of fierce competition and over-investment in the domestic market, some automotive manufacturers have started exploring overseas markets. For example, Chery is partnering with a U.S. entrepreneur to introduce 250,000 vehicles in the U.S. starting in 2007, and a million units a year within another five years. Though China has yet to be recognised as an attractive export production base, some global manufacturers have started investing in facilities in China for export purposes; for example, Honda established a facility in Guangzhou in mid 2003 to target European and Asian markets, and began exporting cars to Germany in mid 2005.

Exports — a solution for overinvestment and overcapacity?

Concerns about overinvestment have been around for some time and it appears that domestic demand may not be able to absorb planned production capacity in the near future. It is believed by some that exports could be a potential but partial solution to the issue.

6 "Vehicles" are defined as trucks, buses and passenger cars

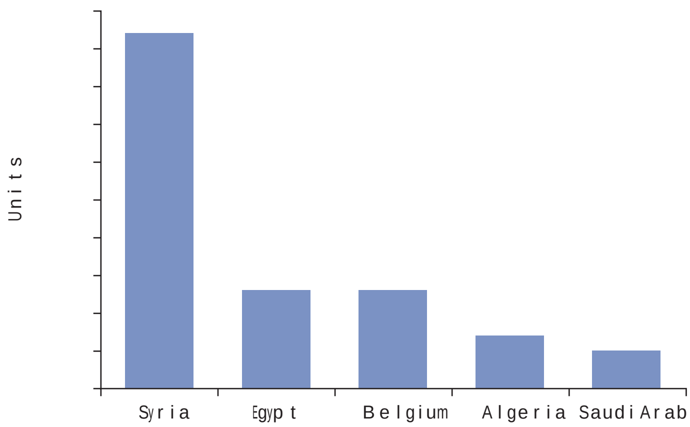
Capacity and demand forecast of passenger cars in China



Note: KPMG estimates
Source: CSFB "China Auto Sector — Buy ahead of 2006 recovery" 26 May 2005

The reality, however, is that it may take time for exports to materialise. Chinese manufactured cars face various challenges in entering major overseas markets. Currently, the major destinations of vehicle exports have predominantly been to small emerging countries in the Middle East, Africa and Southeast Asia, despite manufacturers' ambitions to enter other developed and larger export markets. Chinese passenger car exports are not expected to pose any significant threat to developed countries in the near term. Manufacturers face a number of constraints on their ability to export, but as we set out below these challenges are quite different for foreign OEMs than for local manufacturers.

Top 5 export destinations for Chinese passenger cars (Jan-July 2005)



Source: Automotive Resources Asia "China Automotive Report" August 2005

Foreign OEMs are cautious about exporting Chinese cars to developed markets, mainly for strategic reasons:

- Chinese cars may cannibalise their production bases in overseas markets
- Labour unions (and possibly consumers) in overseas markets may oppose a large influx of Chinese imports
- Currently it is potentially more expensive to assemble cars in China as some high-quality parts are not available in the local market and need to be imported

Chinese OEMs also face a different set of challenges when entering overseas markets:

- Chinese cars must improve technology and quality to meet international standards, in particular safety and emission standards
- Chinese OEMs need to convince international customers that Chinese cars are not another "Yugo" and develop a strong overseas sales and service network
- Intellectual property rights remain a key issue, especially for Group 2 OEM manufacturers
- Lack of Free Trade Agreements with overseas countries make it difficult for Chinese cars to compete effectively

Challenge 1: Technology and quality

Although Chinese manufacturers have improved their designs and manufacturing processes, they have yet to acquire strong technology and quality control capabilities, in particular safety and emission standards, which are key to entering developed markets. For instance, The JiangLing Landwind displayed at the Frankfurt Motor Show in September 2005 scored zero in safety tests conducted by Allgemeiner Deutscher Automobil-Club e V (ADAC), a German automobile club. ADAC, which carries out tests for Euro New Car Assessment Programme (NCAP), calculated that a driver would be unlikely to survive a head-on collision at 40mph[7]; however, the car performed well in a later test conducted by German certifying laboratory TUV, after a number of engineering improvements were made.[8]

Clearly, to become major challengers in the global arena, Chinese manufacturers still need to invest significantly in safety and emission technologies.

"The Chinese are probably five or six years away from being able to sell a competent low-end car"

commented an investment analyst

7 The Sunday Times, Chinese 4X4 gets zero in safety test, 18 September 2005
8 The Sunday Times, Chinese alter cars after crash test, 23 October 2005

Challenge 2: Marketing and sales network

"Made in China" has been associated in the minds of many with the perception of "competitively priced" but "low-quality", and this also applies to passenger cars from China. In addition to enhancing the quality of cars, Chinese manufacturers also need to invest significantly in marketing to build up their image and brand in key overseas markets. This strategy has been successfully implemented before, by Japanese manufacturers in the 1970's and 1980's, and more recently by Korean manufacturers. Chinese manufacturers may also adopt a "lift and shift" approach, where they buy an overseas brand (e.g. Nanjing Auto's acquisition of the Rover brand) and then leverage this sales network and platform to export Chinese made cars.

"In addition to tariffs and other policy restrictions in overseas markets, the most critical challenge for domestic OEMs is to gain trust and recognition from foreign consumers."

marketing manager of a major JV auto manufacturer[9]

Besides, developing a strong overseas distribution and support network will also prove to be critical for Chinese manufacturers.

Challenge 3: Intellectual Property Rights (IPR)

Infringement of IPR has increasingly come to the attention of the global automotive market, not only in trademark and autopart areas, but also in car design and manufacturing technology. Already, there are many IPR cases in China's automotive industry of concern to the international market, in particular those related to Group 2 manufacturers. For example, GM sued Chery for allegedly copying elements of the GM-designed Chevrolet Spark in its QQ model[10]. Chinese manufacturers may therefore find it difficult to export their cars to developed markets.

Challenge 4: Free Trade Agreements (FTA)

Countries with which Chinese has signed Free Trade Agreements represent relatively accessible markets for Chinese manufacturers, by allowing them to export Chinese-made vehicles without tariff and quotas. Aware of the importance of FTAs, China has participated actively in establishing trade relations, especially with Asian countries[11]. For example, the China-ASEAN FTA is expected to bring long-term benefits to the China automotive industry by 2010[12]. However, China still needs to work hard to finalise FTAs with target countries, and it will take some time before agreements are finalised and fully implemented. In the near term, without FTAs, Chinese manufacturers may find it difficult to compete effectively on price in some overseas markets.

9 KPMG interview, September 2005
10 Knight Ridder Newspapers "China eyes U.S. auto market" 19 May 2005
11 Bilaterals.org website, 2005
12 National Development and Reform Commission "Automotive Industry Development Policy" June 2004

The government's role

The Chinese government has identified the automotive sector as a priority industry and is looking at ways to boost the sector's international competitiveness. For example, in 2004 the government introduced the "Automotive Industry Development Policy" and other related regulations to strengthen the industry and increase its competitiveness in the international market[13]:

- Introduce market competition to help strengthen domestic capabilities, with a focus on brand, quality and technology, rather than just price
- Encourage local auto enterprises to draw on existing competitive advantages to target international markets

The new automotive policies are aimed at nurturing the industry to maturity, but it will take time before results can be clearly observed.

Highlights of Automotive Industry Development Policy

Section	Highlights
Policy objectives	• Aim at making China a main player in the world's auto market, with export quality products • Develop a few internationally competitive major automobile groups, which could become "Global 500" enterprises by 2010
Technology innovation	• Provide tax incentives for enterprises that develop their own IPR on new technologies • Promote the development of environmentally-friendly and fuel efficient cars, as well as new fuel technologies • Reduce average fuel consumption for new passenger cars by more than 15 percent of the 2003 level
Branding	• Promote brand marketing and strengthen brand consciousness for all OEMs and autoparts makers

Source: National Development and Reform Commission, 2004

The manufacturers' approach to challenges facing auto exports

Domestic manufacturers have been dedicating significant resources to improving technology, quality and product innovation in order to compete on the international stage. These efforts include looking overseas. For example, SAIC acquired a 49 percent stake in Ssangyong for US$500 million in October 2004[14], with the aim of acquiring technology from the Korean auto manufacturer; it also acquired the technology of MG Rover for £67 million in May 2005[15].

As a result, although China currently has a small automotive export market, it has the potential to become a major exporting industry in the long-term, by following the footsteps of Korean and Japanese manufacturers. It may be some time before Chinese branded cars are driven throughout Europe and the U.S., but global OEMs should not underestimate this long-term threat.

13 Business Daily Update "SAIC, Ssangyong sign MOU" 3 August 2005
14 Business Daily Update "SAIC, Ssangyong sign MOU" 3 August 2005
15 SinoCast China Transportation Watch "SAIC Pays GBP67m for a MG Rover Technology Platform" 16 May 2005

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Autoparts and aftermarket segment

Autoparts manufacturers under pressure

The fragmented autoparts industry has enjoyed significant sales growth over the past few years, with a CAGR of 17.8 percent from 2000 to 2004. However, autoparts manufacturers are facing intensifying competition from new entrants and pricing pressure from downstream automotive manufacturers. Some industry experts expect the autoparts sector to grow at a relatively steady CAGR of about 10 percent between 2004 and 2007.

Until recently, most Chinese autoparts manufacturers focused exclusively on the OEM segment. Why? Because the aftermarket was seen as too small and in China the sector is bedevilled by knock-off parts. However, this situation is changing quickly. To diversify earnings, improve margins, and sustain sales growth, autoparts manufacturers have begun to consider the relatively unexplored aftermarket and accessories sector, which offer huge potential. In addition, autoparts manufacturers are also starting to venture into other countries' aftermarkets to tap into the global trend of outsourcing.

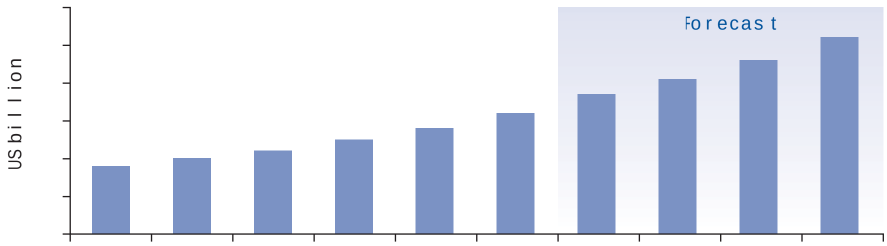
"Four years ago we did not even consider developing the aftermarket business in China...However, we believe we have to reassess China's aftermarket after 2005 and our dedicated team is already working on this."

vice president and general manager of
Visteon Corporation's Asian Customer Business Group, in press reports[16]

How big is China's aftermarket?

China's aftermarket and accessories segment is small, compared to that of other overseas markets. By 2004, China's aftermarket had a sales value of US$3.2 billion, which accounted for less than ten percent of the total autoparts segment, whereas aftermarkets in the U.S. and Germany account for around 60 percent and 40 percent of total autoparts manufacturing, respectively[17].

China Auto Aftermarket sales value (1999-2008)



Source: Euromonitor "Automotive Aftermarket in China" August 2004

16 China Business Press "By entering the aftermarket, foreign autopart JVs are venturing into new territory" 15 August 2005
17 Datamonitor and Euromonitor reports, 2004; GK Goh "Autoparts Sector — Parts worth more than the whole" 9 June 2005; KPMG analysis

China's aftermarket has been viewed as unattractive for various reasons:

- China's automobile market is still in its infancy with a "car parc" of 11 million in 2004, compared to 215 million in the U.S. and 72.7 million in Japan[18]
- Retail outlets for aftermarket parts are scarce in China as most parts are distributed via small repair shops that provide basic service and often use non-original or copy parts

Growth drivers for the aftermarket

The aftermarket and accessories segment is poised to experience strong growth in the coming years, with an estimated CAGR of 17.6 percent from 2004 to 2008, compared to the estimated CAGR of nine percent for OEM parts.

"The aftermarket is a rapidly and steadily growing segment while the OEM segment has too much competition and uncertainty. Many autoparts manufacturers that used to focus on the OEM segment only, have started exploring the aftermarket"

general manager of a local automotive industry consulting company[19]

The growth of the aftermarket will be driven by the following factors:

- Rapidly expanding car parc
- Strong sales of small cars, which have a higher demand for accessories
- The emergence of the used car market
- Improved quality and reliability of distribution channels

Sales of new vehicles, in particular passenger cars, have been registering double digit growth over the past few years with growth accelerating since 2002. The car parc is expected to increase from 11 million in 2004 to 24 million in 2008. This huge and aging car population will create strong demand for aftermarket parts and accessories[20].

Though China's used car market is still tiny and facing some development challenges, it is expected to grow with an estimated CAGR of more than 20 percent from 2004 to 2010. The rapidly growing used car market is likely to further fuel the replacement demand for aftermarket parts[21].

Distribution of aftermarket parts will also improve as many foreign players have been entering the aftermarket. For example:

- Bosch, a leading autoparts manufacturer, has already established 300-500 outlets across China

18 China Securities Press "Automotive trade policy is becoming more refined" August 2005; Manheim auctions Web site; China Automotive Press "Traffic accidents are due to multiple reasons" August 2004; PC Auto "China 2004-2020 vehicle population forecast" 30 June 2005
19 China Business Press "By entering the aftermarket, foreign autopart JVs are venturing into new territory" 15 August 2005
20 PC Auto "China 2004-2020 vehicle population forecast" 30 June 2005
21 Xinhua Press "Second-hand car market will experience a break-through this winter" December 2004

- AC Delco, a U.S. based chain of repair stores, also plans to open more than 200 service centres in the next three years
- U.S. based Ashland group opened its first maintenance centre in Shanghai in June 2005, the first of its kind operated by a foreign company. It has reportedly set up a US$3 million joint venture with a local partner to operate workshops throughout the country.
- Royal Dutch/Shell has also announced plan to open 600 outlets over the next few years, providing services such as oil changes and filter replacement.

The entrance of foreign participants is expected to help improve the quality and reliability of distribution channels and boost the long-term development of the aftermarket.

The potential of overseas aftermarkets

In addition to the local aftermarket, autoparts manufacturers in China are also exploring the large aftermarket overseas.

"In face of falling prices and intensifying competition in the domestic market, we will now focus more on exports."

manager of a major local autoparts manufacturer[22]

Global outsourcing to low cost locations has become one of the hottest topics and trends for OEM and autoparts manufacturers. Autoparts manufacturers in China are therefore looking to take advantage of China's cost structure to become part of the global supply chain for OEMs and autoparts manufacturers.

"We are considering establishing a wholly-owned subsidiary in China. It is for export purposes only and will supply products to our European and U.S. markets."

vice president and general manager of Visteon Corporation's Asian Customer Business Group[23]

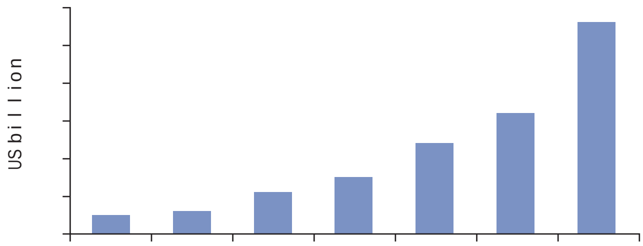
China is already an important autoparts exporting country. Currently, China is the fifth largest exporter of auto parts to the United States, after Mexico, Canada, Japan, and Germany. Although China's autoparts export volume is still relatively small compared to some developed markets, it has been growing at an exceptional rate of more than 30 percent per annum over the past few years. This strong growth, in particular for aftermarket parts, is expected to continue as global autoparts manufacturers face mounting pricing and cost pressures. For example, Delphi's facilities in China are increasingly supplying parts to other overseas markets.

22 KPMG Interview, September 2005
23 China Business Press "By entering the aftermarket, foreign autopart JVs are venturing into new territory" 15 August 2005

For global autoparts manufacturers, focusing on R&D and branding while outsourcing low-tech and labour intensive autoparts manufacturing to China can be a tempting proposition, as the potential savings of such a model may be significant.

ThyssenKrupp Automotive expects China to yield a tenth of global vehicle parts sales by 2010 versus less then one percent now[24].

Growth of China's autoparts exports (1998-2004)



Source: GK Goh "Autoparts Sector — Parts worth more than the whole" 9 June 2005; KPMG analysis

Like the auto manufacturing segment, China's autoparts manufacturers are facing challenges in improving quality to meet international standards. China's autoparts manufacturers' current competitive advantage is on low tech parts, but they have been investing significantly to enhance technology and quality. Over time, with support from the government and investments from global parts manufacturers, domestic manufacturers are likely to start competing in the more sophisticated autopart segment.

"We expect overseas demand for auto components in China to start with basic and low-end parts and move towards more sophisticated parts over time."

an investment analyst at GK Goh[25]

24 HK Standard 26 April 2005
25 GK Goh — Autoparts Sector — Parts worth more than the whole, June 2005

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Car-related services

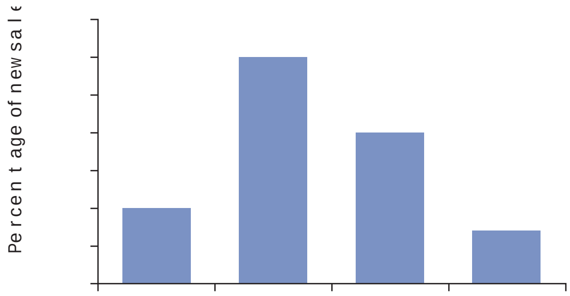
Introduction to car-related services

Given the rapid growth in its auto sector, China is striving to develop its supporting infrastructure. There is a wide range of auxiliary areas to be developed, some more pressing than others. We have chosen to focus on auto-financing, the secondary car market and urban parking.

Auto-finance: entrance of foreign OEMs to kick-start the industry

Penetration of auto financing in China (i.e. the ratio of auto finance on new vehicle sales) is low, less than 10 percent in 2005, compared to around 70 percent in overseas markets. High bad debt ratios (up to 50 percent) have forced banks and insurers to tighten credit by applying stricter criteria and loan investigation procedures, dropping penetration from 30 percent in 2003 to seven percent in 2005. In overseas markets, auto financing is mainly provided by OEM manufacturers; however, the majority of outstanding credit in China (around US$20 billion) has been provided by banks and insurers as OEM manufacturers were only recently allowed to provide auto finance in China.

Penetration of auto-financing in China (2002-2005)



Source: Sinofile Information Services "Interest rates limit auto financing" 12 January 2004; Deutsche Bank "China Autos — Dealer survey: cautiously optimistic" 8 April 2005

Auto-financing is expected to offer huge potential — in the long-term. Since the introduction of the "Administrative Methods on Automobile Financing" in mid-2004, the finance arms of several global auto manufacturers, including GM, VW, Daimler-Chrysler and Toyota, have already established their own auto financing companies in light of what they see as China's long-term potential and as a way to drive or support their own-brand car sales.

Some industry analysts are optimistic about the development of the auto-financing industry in China. They point out that global OEM manufacturers may adopt practices similar to those used in their overseas activities by providing auto financing to boost new car sales. Recently, the Ministry of Commerce has issued policies to support the development of auto-financing providers.

"We expect that up to half of China's car purchasing will be financed by loans by 2015."

senior executive of Volkswagen Financial Services[26]

However, the industry is still facing some structural problems. Risk management has been one of the key issues holding back the penetration of auto financing: China lacks a nationwide credit system, though some industry experts have been calling for the establishment of a nationwide credit bureau. In addition, OEM manufacturers may need to deal with other potential issues, such as sources of funding and regulated interest rates, lack of regulation to allow repossession of cars when buyers default and the absence of a national car registry.

In summary, while there is much optimism about the potential of the auto-financing market, practical issues such as credit data availability mean that the market may take longer than expected to develop.

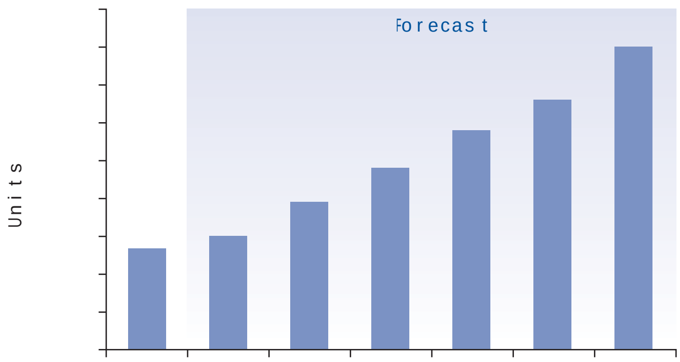
A small secondary car market, but growing

China's secondary car market is still a fledgling market, with around 460,000 used cars traded in 2004, equivalent to less than 20 percent of the total number of new cars. This percentage is very low compared to international norms of 70 percent and up to 200-300 percent in more developed markets such as the U.S. and Germany.

Driven by a growing car parc and the start of a replacement cycle since the boom of the automotive market in 2001, the secondary car market is expected to continue growing at a CAGR of around 20-30 percent, while transaction volumes are expected to equal that of new vehicles by 2008[27].

26 China Daily "Volkswagen Places Bets on Auto Finance" 22 October 2004
27 Auto263 website "Second-hand car market — Auto manufacturers' new landscape?" 2004

Growth of China's secondary vehicle market — including passenger cars and commercial vehicles (2004-2010)



Sources: Mercer Management Consulting; Auto Industry Report; Economic Observer; KPMG estimates

Future market drivers

The current used car market is characterised by several structural issues, which hinder its long-term development:

- Lack of a transparent market and asymmetric information that favours car sellers
- Unscrupulous practices of some second-hand car dealers
- Complex and unclear regulatory environment
- Lack of second-hand car evaluation standards and residual value management system

All these issues lead to a lack of trust and confidence from potential customers, but the situation is expected to change.

First, some major OEM manufacturers, such as Shanghai-GM and FAW-VW, have entered this growing and higher-margin market, by offering trade-in and valuation services for their own brands to stimulate replacement demand. This may help introduce more rigorous practices and standards for the secondary car market.

Second, the long-awaited "Administration Procedures for Circulation of Second-hand Vehicles" was issued in September 2005. These procedures supersede those issued in 1998 and provide updated regulatory guidelines on used car trading.

In addition, the new procedures allow new car dealers to sell used cars, enable private sales of second-hand car between individuals and most importantly, allow private used-car dealer businesses to be established. With the liberalisation of the used car regulations, some international participants, such as U.S.-based Manheim and Japanese-based USS, have been preparing to enter the Chinese market. The entrance of international players is expected to help introduce leading business practices and more sophisticated service levels to the market.

Shortage of car parks

The shortage of parking space in urban areas is fast becoming a major issue threatening the long-term development of the automotive industry. The number of legal parking spaces has simply not kept pace with the number of cars on the road. The situation is so severe in some city centres that it is starting to undermine potential buying interest.

"Finding a convenient and 'legal' parking space is more difficult than buying a car"
a potential car buyer in Beijing[28]

In the U.S., car parking is a US$26 billion industry, which has created one million jobs. Car parking is still a small and very under-developed industry in China, and it is estimated that there is only one legal parking space for every 4.8 vehicles in China. There are many small parking lots across China but most of them are operated by the local governments and not efficiently run[29].

Attractive market potential

The parking industry in China is poised for strong growth. It is estimated that from now until 2010 China will need an additional 4.8 million parking spaces.

However, there are a number of factors holding back the development of the car parking industry and they are mostly government related, including:

- Lack of government planning on vehicle parking
- Unclear and changing regulatory framework, including government regulated parking charges and investment restrictions on parking lots
- Weak enforcement, including illegal parking and parking lots

28 China Economic Times "Difficulty in car-parking: the great distress of car owners" August 2005
29 Zhejiang Business website "'Car parking economy' is still waiting for opportunities" August 2005

The government is aware of the severity of the issue and is responding to it. For example, the Beijing government passed a series of regulations on parking in order to solve the parking issue ahead of the 2008 Olympics. Industry experts have also been calling for the industrialisation of vehicle parking which will help solve this social issue and develop other supporting industries, such as car park equipment.

Some foreign players have already spotted an opening and are beginning to enter the market. For example, Hindmarsh, an Australian parking-lot operator, plans to open offices in Beijing and Shanghai, and has recently taken a 40 percent stake in a JV with Kingdy, Beijing's only private car-park operator, which controls about six percent of the market.

Car parking development and management is likely to offer an attractive potential for both domestic and international players, particularly once new government policies are issued.

Contact us

Please contact KPMG for more information

KPMG's Transaction Services in China:

Paul Brough
Partner
Head of Financial Advisory Services, China
Hong Kong office
Tel: +852 3121 9800
e-Mail: paul.brough@kpmg.com.hk

Warren Phillips
Partner
Head of Transaction Services, China
Hong Kong office
Tel: +852 3121 9809
e-Mail: warren.phillips@kpmg.com.hk

Thomas Stanley
Director
Strategic & Commercial Intelligence, China
Shanghai office
Tel: +86 (21) 5359 4666 Ext 3884
e-Mail: thomas.stanley@kpmg.com.cn

Honson To
Partner
Transaction Services
Shanghai office
Tel: +86 (21) 5359 4666 Ext 2708
e-Mail: honson.to@kpmg.com.cn

Ryan Reynoldson
Partner
Transaction Services
Beijing office
Tel: +86 (10) 8518 9225
e-Mail: ryan.reynoldson@kpmg.com.cn

KPMG offices in China:

KPMG Financial Advisory Services
27th Floor, Alexandra House
16-20 Chater Road
Central
Hong Kong
Tel: +852 3121 9888
Fax: +852 2973 6616

KPMG Financial Advisory Services
50th Floor, Plaza 66
1266 Nanjing Xi Lu
Shanghai 200040
China
Tel: +86 (21) 5359 4666
Fax: +86 (21) 6288 1889

KPMG Financial Advisory Services
8th Floor, Tower E2
Oriental Plaza
No.1 East Chang An Avenue
Beijing 100738
China
Tel: +86 (10) 8518 5000
Fax: +86 (10) 8518 5111

KPMG Financial Advisory Services
29th Floor, Guangzhou International
Electronics Tower
403 Huanshi Dong Road
Guangzhou 510095
China
Tel: +86 (20) 8732 2832
Fax: +86 (20) 8732 2883

KPMG's Global Automotive contacts:

Harald von Heynitz
Global Chair,
Industrial & Automotive Products
KPMG Deutsche Treuhand-Ges. AG
D-80339 München
Germany
Tel: +49 (89) 9282 1201
e-Mail: hheynitz@kpmg.com

Oliver Gross
Global Executive,
Industrial & Automotive Products
KPMG Deutsche Treuhand-Ges. AG
Klingelhoeferstraße 18
10785 Berlin
Germany
Tel: +49 (30) 2068 4254
e-Mail: olivergross@kpmg.com

kpmg.com

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