

AUTOMOTIVE

Automotive Dealerships in China: Accelerating Performance

ADVISORY

Contents

- 2 Message from Nelson Fung and Andrew Thomson
- 3 Acknowledgements
- 4 Introduction: The importance of the automotive dealer in a rapidly changing market
- 10 Consumers and the automotive dealership in China
- 22 Today's automotive dealership environment in China
- 31 Accelerating performance
- 36 The outlook for the automotive retail sector in China
- 38 About KPMG
- 39 About TNS
- 40 Contact us

Message from Nelson Fung and Andrew Thomson



Nelson Fung



Andrew Thomson

KPMG in China and Hong Kong SAR, together with the global market insight and information group TNS, is proud to be extending its thought leadership role in the automotive industry with the launch of this report *Automotive Dealerships in China: Accelerating Performance*.

This report aims to examine a segment of the automotive industry that will grow in importance in the coming years. Although levels of profitability for the Original Equipment Manufacturers (OEMs) in China in 2006 were generally good, and somewhat improved compared to 2004 and 2005, it is almost self-evident that the sustainability of these profits will come into question sooner or later, as China's automotive market develops to the point where it starts to look more like the mature environments of Japan, the United States, and Europe.

This development is already underway and proceeding rapidly. It was just a few years ago that one foreign brand dominated the passenger car sales market in China, with approximately 50 percent market share. By the end of 2006, 116 locally-manufactured car models were being marketed under 48 different brands, giving consumers an extensive range of products to choose from in order to satisfy demands that our research indicates are becoming more sophisticated every day.

Our view is that despite the rapid growth already witnessed and projected for the automotive industry in China, serious challenges will still emerge such as intense competition, new product proliferation, pricing pressures, declining profitability, and rapidly changing consumer needs and behaviours. For the OEMs, the key strategic questions going forward will relate to securing or consolidating profitable market share and differentiating themselves. Therefore, their future success will depend upon their ability to retain customers and manage effectively their distribution networks. In these tasks, automotive dealers will play a critical role, as they manage the greater part of the interaction with the customer and, to some extent, are the 'custodians' of the OEMs' brand promises and how they are delivered.

Bearing this in mind, this joint KPMG and TNS report identifies and comments upon the key trends in customer perceptions and behaviours relative to automotive dealerships, and how individual dealers can address these together with their other strategic, operational, management, and performance priorities in what is a highly dynamic and challenging environment. We believe that this report contains fresh and valuable insights both for OEMs and automotive dealers. As always, we will be delighted to receive comments on this research.

Nelson Fung
Partner in Charge, Industrial Markets
KPMG in China and Hong Kong SAR

Andrew Thomson
Director, Global Markets
KPMG in China and Hong Kong SAR
Member of KPMG's Global Automotive
Steering Group

Acknowledgements

This report was researched and written principally by Alexis Zirah from KPMG's Industrial Markets Group in China and Hong Kong SAR.

The automotive dealerships consumer research study on which part of this report was based, was conducted by Klaus Paur and his team from the global market insight and information group TNS. Klaus is the Head of Automotive Research at TNS China, and the team participating in this study included Melanie Stroehlein, Eric Tai, Colin Shi and Jessica Chen.

We would also like to thank those industry executives who so generously contributed their time, knowledge, and insights to this study.



Introduction: The importance of the automotive dealer in a rapidly changing market

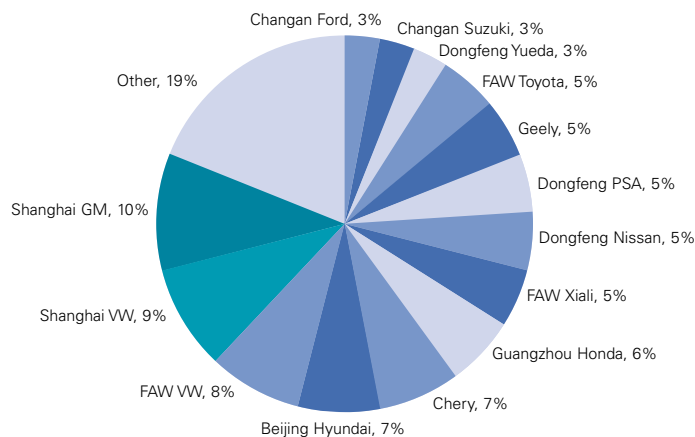
Automotive Dealerships in China: Accelerating Performance was compiled jointly by KPMG in China and Hong Kong SAR and TNS China's Automotive Group

An expanding market

China has now overtaken Japan to become the world's second-largest auto market after the United States. Total new vehicle sales (including trucks and buses) grew by 25 percent to 7.2 million in 2006.¹ New passenger car sales also reached 4.4 million units (including MPVs and SUVs), an increase of 34 percent compared to 2005.² Passenger car sales reached 1.2 million in the first quarter of 2007, rising 20 percent from the same period last year.³ Similarly, according to the National Bureau of Statistics of China, the number of privately-owned motor vehicles rose 18.8 percent year-on-year to 22 million in China in 2006. In terms of new passenger cars, individual buyers contributed 80 percent to the 4.4 million units sold. As a general trend, the number of privately-owned vehicles has been soaring since China's accession to the World Trade Organization (WTO) in 2001. This is illustrated by the fact that private ownership of civilian vehicles has grown from just 43 percent in 2001, to more than 60 percent by the end of 2006.⁴

Today, China has approximately 50 car manufacturers (OEMs) and the automotive industry is relatively fragmented: the country's top two manufacturers account for around 20 percent of passenger car market share. Also, foreign brands currently dominate the market, accounting for almost 75 percent of China's car sales. However, domestic manufacturers are increasing their activities rapidly, as they expand their product lines in the medium and lower-end segments. An example of this kind of development includes Shanghai Automotive Industry Corporation's (SAIC's) recent independent launch of the "Roewe," a mid-size passenger car based on the Rover 75 technology it acquired from BMW in 2005. Together, Chery (7 percent) and Geely (5 percent) now have a combined 12 percent share of the domestic car market (see Figure 1).

Figure 1: China's car market share by manufacturer (2006)



Source: CAAM

¹ China Association of Automobile Manufacturers (CAAM)

² Deutsche Bank

³ China's Passenger Car Sales Reach 1.2mn in Q1, *SinoCast China Business Daily News*, 9 April 2007

⁴ Number of private motor vehicles in China hits 22m, *China Daily*, 26 February 2007

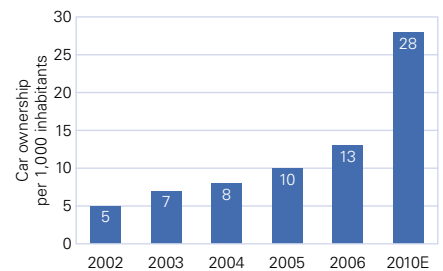
China is currently one of the most profitable markets in the world for OEMs. This is partly explained by relatively high prices in comparison to international levels, especially for high-end models. However, increased competition for market share has driven car prices down in the last two years. China's auto sector reported an increase in profits in 2006, with combined profits from the industry rising 46 percent to USD 10 billion, the first increase in three years. Industry profits on items including vehicles, engines, spare parts, and motorcycles fell by 24.3 percent in 2005 and 5.2 percent in 2004. The 2006 rise was driven by stronger-than-expected car sales and the launch of a record number of new car models.⁵

Future growth

Passenger car sales are expected to reach 6.7 million by 2010, representing an average annual growth rate of approximately 14 percent,⁶ mainly driven by:

- **Gross domestic product (GDP) growth:** China's real GDP grew by 10.7 percent from 2005 to 2006. This growth is forecasted to continue at an annual average rate of 8.4 percent until 2010.⁷
- **Increasing car ownership rates:** In comparison to more developed markets, relatively few Chinese citizens own cars. Vehicle ownership currently stands at around 13 vehicles per 1,000 residents, compared to 950 in the United States and 546 in Germany (see Figure 2).
- **Growing middle class and rises in disposable income:** China's disposable income per capita is expected to grow at an annual average rate of 14 percent, rising from USD 872 per capita in 2006 to USD 1,474 by 2010. With this rise in disposable income, China's middle class — defined as individuals earning more than RMB 50,000 or USD 6,220 annually — is expected to double by 2010. In 2006, China's middle class was estimated at approximately 12 percent of the country's total population.⁸ Additionally, Chinese consumers that earn more than RMB 100,000 per year (about USD 12,500) currently only represent 1 percent of China's total population. However, this segment is expected to reach 520 million people by 2025, or more than half of China's urban population.⁹ China's emerging middle class is likely to play a significant role in driving automotive retail sales (see Figure 3).

Figure 2: China's ratio of car ownership per 1,000 people



Source: Autoinfo.gov.cn, Haitong Securities

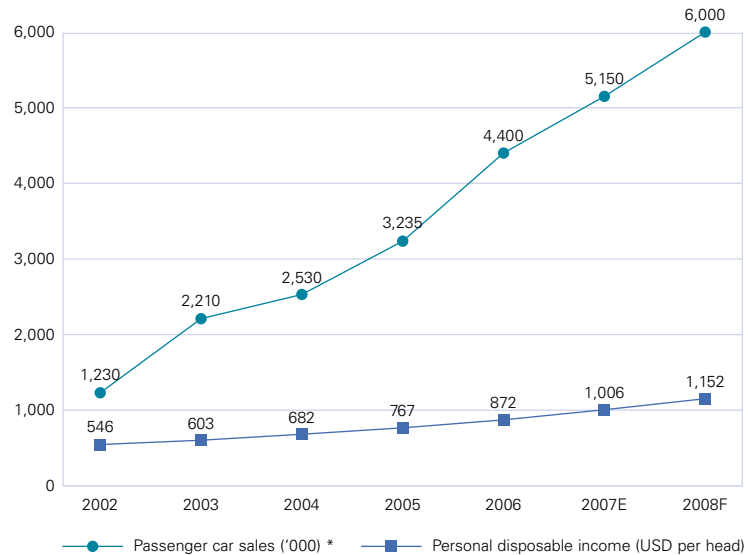
⁵ Auto industry profits rise 46%, *China Daily*, 14 March 2007

⁶ CAAM

⁷ Economist Intelligence Unit (EIU)

⁸ Middle class will double by 2010, *Shanghai Daily*, 4 April 2006

⁹ The value of China's emerging middle class, *McKinsey Quarterly*

Figure 3: Annual disposable income and passenger car sales

Cars, SUVs and MPVs only
Source: EIU, Deutsche Bank, CAAM

- China's continuing development of road networks:** China has been investing heavily in improving its highway network. For example, the government has invested USD 123 billion in the country's national expressway system over the last five years and is planning further expansion of its road network. The Government's objective is to double the length of its motorways by 2020.¹⁰
- Growing demand in Tier 2 and Tier 3 cities and changes in living patterns:** Today, Tier 2 cities in China represent both major production locations and retail markets.¹¹ Third-tier cities are also growing significantly. On average, Tier 2 cities are growing at a rate 2 percent faster than the whole economy. In 2005, these second-tier cities accounted for 12 percent of China's population, but generated 21 percent of GDP and consumed around 45 percent of foreign direct investment.¹² It is estimated that new car sales in Tier 2 cities will grow at an annual average rate of 16 percent until 2010; in Tier 3 cities, this rate is expected to be 26 percent until 2010. In contrast, it is estimated that new car sales in Tier 1 cities will grow at average rate of 12 percent over the same period. These diverging growth rates are predicated on changing living patterns in China, increasing urbanisation and the impact that this is likely to have on transport needs and the cost of land. In 2006, China's urban residents accounted for 43.9 percent or 577 million of the national population, approximately 1 percent higher than the previous year. The Chinese government is anticipating an urbanisation rate of 47 percent by 2010.¹³

¹⁰ Expansion plans for expressways mean higher costs for transporters, *Shanghai Daily*, 28 February 2007

¹¹ Tier 1: Beijing, Shanghai & Guangzhou

Tier 2: Provincial capital

Tier 3: Major cities in province (City level)

Tier 4: County capital

¹² China Briefing

¹³ www.gov.cn

- **Increasing competition driving down prices:** China's automotive market is highly competitive and OEMs are flooding the market with new models to gain market share and drive sales. In 2006, approximately 75 new car models were launched.¹⁴ It is expected that car prices will continue to decline as competition increases.

The role of the OEM and the automotive dealer

China's steady economic growth in recent years has nourished a developing market for cars. Since 2001, the average incomes of urban households have risen by more than 70 percent, raising the aspirations of the new urban working and middle classes. The purchase of a car has proved to be one of the priorities for the most affluent households, as it increases their mobility and allows them to display their newfound prosperity.

The majority of new cars, approximately 7-8 vehicles out of 10, are bought by 'first-time buyers'. This continuous addition of new car owners has led to impressive market growth and, taking this into account, the car-buying environment has quickly transformed from being a 'seller's market' into a 'buyer's market'.

Today, virtually all major car manufacturers are operating in China, and the variety of models produced and offered has expanded considerably. By the end of 2006, 116 locally-manufactured models of cars were marketed under 48 different brands, giving consumers a wide range of products to choose from.¹⁵

Despite this growth, however, the industry is facing serious challenges. These include intense competition, new product proliferation, pricing pressures, declining profitability, and changing consumers needs and behaviours. For the OEMs, the strategic issue is no longer whether to enter the market, but rather securing or consolidating profitable market share and achieving differentiation. One of the keys to the future success of OEMs will be their ability to retain customers and manage effectively their distribution networks. Dealers will play a critical role, as they manage the greater part of the interaction with the customer and, to some extent, are the 'custodians' of the OEMs' brand promises and how they are delivered.



¹⁴ KPMG analysis
¹⁵ TNS analysis

In China, OEMs have the opportunity to create, almost 'from scratch', distribution networks customised to their strategic direction and consumer preferences. At the same time, both the OEMs and auto dealers need to understand rapidly changing consumer needs and behaviors and act accordingly, with such actions encompassing how they:

- Define and execute their development and network strategies
- Design and implement systems for understanding business dynamics in the dealership environment
- Manage performance at the dealership
- Improve day-to-day operations
- Build customer loyalty and retention
- Seize the available opportunities to enhance revenues through the sale of 'value-added' products and services
- Ensure that relationships between the OEM and dealer remain productive and mutually beneficial.

The basis for this report

Set against this background, this joint KPMG and TNS report is built upon two main pillars of research and analysis.

The first pillar comprises a TNS research study, undertaken in early 2007, with more than 1,000 car-buyers across China (the methodology employed for this study is described further below). The purpose of this research was firstly, to identify and comment upon consumer perceptions of various car brands, as well as their shopping experiences at automotive dealerships. Secondly, the study looked at consumer behaviour, in terms of how first-time and subsequent purchasing decisions are made, and what factors are likely to influence purchases in the future. TNS' research covered 12 brands — both foreign and domestic — and was conducted in Tier 1, Tier 2, and Tier 3 cities across China.

The second pillar of our research was aimed mainly at blending the findings of TNS' work together with:

- KPMG's knowledge and understanding of the automotive dealership environment, gained through the work we have done for automotive companies globally and based on the issues and challenges we see
- Interview-based research on the views of analysts and senior executives working for OEMs and automotive dealerships in both China and Hong Kong SAR
- Desktop research covering various industry and analyst reports, as well as government publications and other statistical and financial information.

Bringing these pillars together, this report is structured to provide commentary on:

- The main findings of TNS' consumer research and the key messages for OEMs and automotive dealers to consider
- The current state of the automotive dealership environment and the key issues and challenges likely to be faced, both now and in the future
- Comparisons between China and the more mature automotive markets to identify likely future developments and any lessons that can be learnt
- The leading practices followed by some OEMs and automotive dealers, and how these fit within a proposed model for the Chinese 'dealer of the future'.

TNS' consumer research methodology

TNS' research was conducted between February and March 2007, with a total of 1,041 respondents interviewed face-to-face by means of a structured questionnaire. All of the respondents interviewed were recent new-car owners, having owned their vehicle for less than 12 months. Ownership was equally distributed between the compact/small, mid-size/mid-upper, and luxury car segments. This distinction between segments is defined on the basis of purchase price, as follows:

- Compact/small cars: Purchase price less than RMB 130,000
- Mid-size/mid-upper cars: Purchase price from RMB 130,000 to RMB 250,000
- Luxury cars: Purchase price more than RMB 250,000.

The survey's sampling was equally distributed across the 12 best-selling car brands in China and covered all car segments, as long as the brand had a presence in the market being surveyed. Coverage included joint venture brands from the US, Japan, Korea and Europe, as well as local Chinese brands. Respondents were also distributed between first-time car owners and experienced owners.

The study covered a total of eight Tier 1, Tier 2 and Tier 3 cities:

- Tier 1 cities: Beijing, Shanghai and Guangzhou
- Tier 2 cities: Xian, Changsha and Xiamen
- Tier 3 cities: Harbin and Qingdao.

Consumers and the automotive dealership in China

There are significant regional differences in car pricing across China. If you ask me what the price of a particular car is in China today, I often say 'it depends' — Auto analyst interviewee

Introduction

Until recently, the Chinese car market was a seller's market. Today, it is a buyer's market, in which consumers have been empowered by an ever-widening range of choices.

To be successful over the long-term, automotive dealers must understand what consumers are looking for when purchasing a car, and what triggers them to choose a brand and a specific car dealership.

It is easy to be distracted by the dynamics of new car sales growth in China. In the longer term, dealerships will succeed not only by selling cars to new customers, but also by maintaining contact with their customers through after-sales service and repeat purchases. Clearly, much depends on car brand appeal, and car manufacturers must support their distribution networks through attractive product offerings and competitive prices. Car dealers, on the other hand, will have to leverage the OEM's marketing activities through optimised customer service at the point of sale.

Car distribution in China faces several challenges. Overall sales volumes are rising dramatically, but the supporting market structures are not yet as developed. The enormous scale of the country means that service offerings and pricing often differ from region to region, and consumers' experiences as well as those of dealers may also vary. Car dealerships have an important role to play in identifying new customer trends and formulating their needs into new product and service offerings. The distribution networks that are earliest to market with these solutions have an opportunity to achieve considerable competitive advantage.

More than three-quarters of cars produced and sold in China carry the label of an international car brand, be it American, German, French, Italian, Japanese, or Korean. Despite the mandatory cooperation with Chinese vehicle manufacturers and the creation of joint venture brands, most models are developed primarily by the foreign manufacturer, and their image perception is strongly influenced by the international brand. In recent years, some independent Chinese passenger car manufacturers such as Chery and Geely have emerged, and have established successful operations by offering cheap entry-level vehicles to the lower end of the market. To remain competitive, these Chinese brands will have to upgrade their range of products and services in order to meet the rising demands of Chinese consumers.

TNS' consumer survey examines the decision making triggers for Chinese car buyers from different angles:

- How do Chinese consumers make their decisions to purchase?
- To what degree do consumers behave differently across China's regions?
- Are Chinese brands competitive with foreign brands?
- How satisfied are consumers with, and how loyal are they to, their dealerships?

Purchasing behaviour: A function of market immaturity

Across many industries, the behaviour of the Chinese consumer is often a function of the emerging state of the market in which he or she is buying goods or services. In the automotive sector, the TNS research findings reflect a general lack of experience with cars. A majority of the consumers were first-time car owners.

This relatively low level of knowledge about cars has consequences for the purchasing decision process, which can take 12 to 15 months.¹⁶ During this period Chinese consumers try to gather the maximum possible information to select a brand. They behave differently from their peers in mature markets, in several key respects:

Chinese car buyers 'shop around' before closing the deal

Chinese car buyers will, on average, consider three brands and visit each dealership before making a purchasing decision. This compares to an average of less than two brands in mature markets, where brand profiles are better known and brand loyalty is stronger. The number of brands taken into account appears to decrease as the value of the purchase increases. In other words, the more premium the car, the more the car buyer tends to target a reduced set of brands (see Table 1). This is probably because more first-time buyers are found in the lower-end car segments, while luxury cars are more likely to be purchased by repeat buyers with some automobile ownership experience. It may also reflect the fact that in the Chinese car market, the luxury brands have already acquired a clear brand profile, while mainstream manufacturers have not yet successfully positioned their products. Functional product features still play a much more important role in the choice of a car than in mature markets.

¹⁶ Based on insights from various TNS China surveys

Table 1: Number of brands considered before purchase

	Chinese car buyer (n=1041)	Compact/small car (n=420)	Mid-size/mid- upper car (n=422)	Luxury car (n=199)
Number of brands considered	2.8	2.8	2.9	2.4
Number of dealership visited	2.5	2.5	2.7	2.3

Chinese car buyers rely on personal recommendations

Advice and recommendations contribute greatly to decision making for Chinese car buyers. For half of car owners, advice from family or acquaintances figures among the two most influential purchase factors. One out of four motorists stated that a recommendation from a friend or family was the main reason for choosing the dealership where the car was finally bought (see Table 2). Consequently, each individual dealership experience becomes critical, since positive word-of-mouth will help to bring new customers into the showroom. Results show that the point-of-sale experience is important for car buyers, yet levels of satisfaction with sales performance at the dealership show some room for improvement (see Table 3). This implies that many opportunities are being missed.

Table 2: Main reasons for car purchase at this dealership (%)

Attributes	Most influential factor	2nd most influential factor
Recommendation from friends/acquaintances	25.6	11.4
Availability of the preferred brands	18.0	14.2
Good service quality	16.8	21.1
Convenient location	14.6	8.6
Low prices	11.7	11.3
Good advice	5.9	5.2
Wide range	3.6	4.9
Close customer relations	2.7	6.0

NB: Low figures for service quality, good advice, and close customer relations do not actually mean that these aspects are unimportant for consumers. Rather, results indicate that these services are not well-delivered by car dealers, and therefore, do not considerably influence consumer purchase decisions.

Table 3: Level of importance vs. satisfaction with dealer salesperson performance

	Score (1-5 scale)
Level of importance of dealers' salesperson	4.3
Level of satisfaction with dealers' salesperson performance	3.7

Chinese consumers value the Internet

In addition to the traditional methods of looking for advice and recommendation, Chinese consumers use the Internet extensively to obtain pre-purchase information. In this respect, Chinese consumers have already caught up with their peers in mature markets. Four out of 10 car owners acknowledge that the Internet is “extremely important” or “very important” during the purchasing process (see Table 4), during which they can easily gather relevant data by browsing car-dedicated websites, reading news, comparing prices or participating in web discussions. The Internet as a source of information is valued as “highly informative” by almost a third of car owners, in particular first-time buyers. Almost 25 percent of respondents judge information from the Internet as being “very credible” (see Figure 4).

The growth of the Internet has several implications. It has made the marketplace more transparent and offers the opportunity to gather relevant data quickly from car-dedicated websites, reading news, comparing prices or participating in web discussions. Only by providing comprehensive, reliable information about products and services can car manufacturers, as well as dealers, benefit fully from the already advanced online behaviour of consumers.

The Internet also makes the dealership experience itself more transparent, and affords car buyers the opportunity to connect with unknown persons through web chats and blogs. With that, the notion of advice and recommendations enters another dimension, as individual experiences can easily be multiplied beyond the scope of personal friends or acquaintances. Negative comments posted on the web can have a particularly strong influence on purchasing decisions.

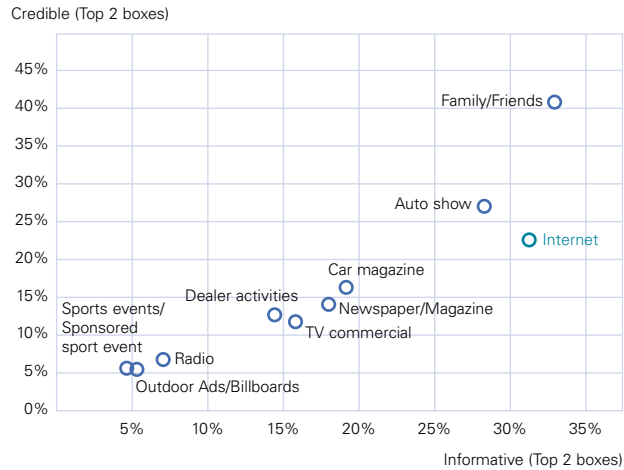
The importance of the Internet, compared with the relatively moderate impact of conventional ‘above-the-line advertising’ (see Figure 4) also raises the question of advertising budget allocations. In fact, the findings suggest that it may be worthwhile to divert a greater portion of advertising spending to Internet activities.

Often, there is too much information available. It is difficult to trust everything you hear and read and dealer approaches to things like pricing and promotion can vary widely. This is possibly why people shop around — Auto analyst interviewee

Table 4: Reliance on Internet content as a source of car purchasing information (%)

	Extremely important	Very important
Internet	6.3	34.1

Figure 4: Quality and credibility of information sources for car purchases (%)



Less than one out of six car buyers judges the dealer as being highly informative and credible — TNS research

In line with their quest to broaden their knowledge of cars, many Chinese car buyers attend auto shows to obtain product information. This is recognised as one of the most credible and informative channels for consumers to learn about different models and brands. Car manufacturers have understood this trend, and have multiplied auto exhibitions across the mainland at both the regional and local level.

Figure 4 also reveals the apparent reservations of car buyers towards dealership activities, as less than one out of six car buyers judges them highly informative or credible. Car dealers should attempt to reverse this image and aim to play a more important role as a source of relevant information, or even better, to be accepted as providers of recommendations. The negative effects of dealer activities seem to translate into a need for better client service, in terms of accurate and comprehensive product information and advice.

Car financing has not yet taken off as a means of purchasing a vehicle

Findings show that 25 percent of car buyers had access to finance offers during the purchasing process. However, very few took this opportunity. A further investigation of purchasing motivations reveals that, in general, car financing is not yet perceived by customers to be important, and is not yet having any meaningful impact on customer retention. Nevertheless, although low in absolute terms, offers of financing are taken up more frequently in Tier 1 cities as well as in the premium segments. These cities can be considered the most mature markets, and luxury car owners can be seen as more experienced than

mainstream car buyers. Therefore, it can be inferred that car financing has the potential to penetrate the market. Refined marketing efforts and improved market structures (for example, through the development of reliable credit checking systems) will contribute to the future development of these advanced service offerings (see Table 5). The question is, “how long will this take, and how/when should car financing providers invest in promoting their offerings?”

Table 5: Car purchase payment approaches and financing product available (%)

	Actual	Availability
Cash payment	96.1	N/A
Loan from banks	4.8	58.1
Loan from car financing company	0.4	25.3

China: Markets within a market

China’s geography, as well as its divergent market structures, generate variations in consumer behaviour across the mainland:

Variations between cities: Mainly a matter of availability

Despite the efforts of car manufacturers to increase the number of sales outlets in the lower tier cities, the distribution networks generally remain skewed towards the more economically mature Tier 1 cities, namely Beijing, Shanghai, and Guangzhou. This means that consumers in those cities have a greater selection of dealerships than in Tier 3 cities, and can match their final decision on a vehicle more precisely with their specific needs.

In the Tier 1 and Tier 2 cities, findings indicate that consumers choose a brand above all according to recommendations from friends and acquaintances, as they may be constrained by the proximity of a dealer of that brand. In addition, “good advice” and a “wide range” of product offerings appear more frequently as reasons for choice in Tier 1 cities, compared to the other population centres. In Tier 3 cities, the choice of a dealership is dominated by the availability of the preferred car brand. This suggests that dealerships there may be less exposed to competition, and benefit disproportionately from the brand appeal of car manufacturers (see Table 6).

In some respects, Tier 2 cities have matured to the level of Tier 1 (for example in terms of brand availability), while in other respects Tier 2 cities are similar to Tier 3 (for example in availability of low prices). The ‘maturing’ of Tier 2 cities potentially demonstrates, a development path that Tier 3 cities might follow.

Table 6: Main reason to purchase the car at this dealership (by class of city, %)

	Tier 1	Tier 2	Tier 3
Recommendation from friends/acquaintances	21.6	31.6	22.1
Availability of the preferred brands	15.0	12.4	30.9
Good service quality	16.3	17.2	16.9
Convenient location	17.5	14.8	9.8
Low prices	10.6	11.3	11.6
Good advice	8.9	4.5	3.1
Wide range	6.1	1.8	2.3
Close customer relations	2.5	2.9	2.5

In general, the quality of interaction with customers improves when dealers are exposed to more competition. A higher density of dealerships and increased competitive pressures in the Tier 1 cities has led to improved dealer performance and higher customer satisfaction. With an overall satisfaction score of 3.75 (out of 5), Tier 1 dealers scored significantly better than their peers in the lower tier cities (see Table 7).

Table 7: Overall satisfaction and importance of expectations met by the dealer

	Tier 1 city	Tier 2 city	Tier 3 city
Overall satisfaction with the dealer (1-5 scale)	3.8	3.6	3.5
Importance of expectations met (% of top 2 boxes — extremely and very important)	70.4	70.8	50.6

Customers in the Tier 1 cities appear more demanding than others. More than two-thirds of respondents underscore that it is “very important” or “extremely important” that dealers meet their expectations, while only half of Tier 3 car buyers agree (see Table 7). As the latter’s choice of dealerships is based primarily on brand availability, we may assume that customers in Tier 3 cities tend to be less sensitive to dealer performance compared to their counterparts in Tier 1 cities. In other words, customers in Tier 3 cities know that they have nowhere else to go. In these circumstances, dealerships may be tempted to compromise on client service. As with Tier 1 cities, findings show that car owners in Tier 2 cities expect much from their car dealerships, although lower overall customer satisfaction in those cities suggests that dealer performance is not yet at Tier 1 levels.

Our results strongly suggest the following improvements:

- Product ranges should be expanded and product information improved
- Salespersons' professional skills must be strengthened, particularly their capacity to explain product benefits and solve problems in the sales process
- According to respondents' explicit requests, enhanced after-sales offerings, such as emergency call centres and 24-hour customer service hotlines, should be considered across all tiers of cities.

Findings show that the strength of the customer/dealer relationship is the highest in Tier 1 and Tier 2 cities. Our Retention Index (see Figure 5),¹⁷ considers four essential conditions for retaining customers at the dealership. It enables us to understand that consumers in Tier 2 cities are as loyal as those in the most competitive top tier cities. In contrast, customers in Tier 3 cities are clearly the least loyal. This suggests that greater competition eventually benefits dealerships, under the condition that customer service is improved.

Chinese brands versus international brands: Mainly a matter of involvement

Owners of Chinese cars are less committed to their brands than owners of JV brand vehicles:

- Chinese cars owners are, in general, less satisfied with their vehicles
- Brand choice is less important to them
- They are torn between different car brands, and are ready to switch to another make for their next purchase (see Table 8).

Customers in Tier 3 cities appear to know that they have nowhere else to go. Dealerships may be tempted to compromise on client service — TNS research

Figure 5: Retention Index

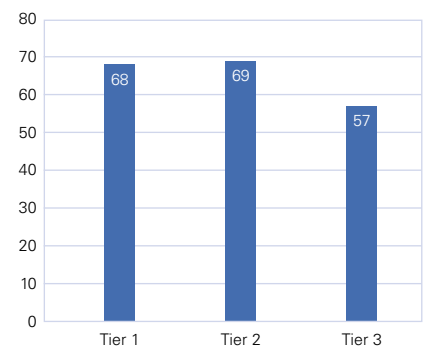


Table 8: Difference in consumer perception between Chinese brand owners and non-Chinese brand owners

	Chinese brand owners	Non-Chinese brand owners
Level of satisfaction with the dealer (%)	37.2	58.9
Importance of brand choice (1-5 scale)	2.6	2.2
Many good reasons to continue using the brand and no reason to change (%)	23.6	51.3
Committed to brand (%)	37.2	58.9

¹⁷ Retention Index include:
- satisfaction with dealer performance
- probable repurchase from the dealer
- recommendation of the dealer to others
- personal benefit by purchasing from the dealer

For Chinese brand owners, the choice of car is largely driven by price and affordability. The success of Chinese brands among consumers is not surprising, as price is often particularly important for first-time buyers in the lower vehicle segments.

As price has a major impact on the purchasing process, and focus criteria tend to be limited to basic product functionality, the importance of brand decreases. Some customers do not get involved in much more than price comparisons. This explains why the share of “uninvolved” Chinese brand customers — Chinese car owners who do not really care about brand choice — is 2.5 times higher than among owners of non-Chinese brands.

Figure 6: Chinese brand owner

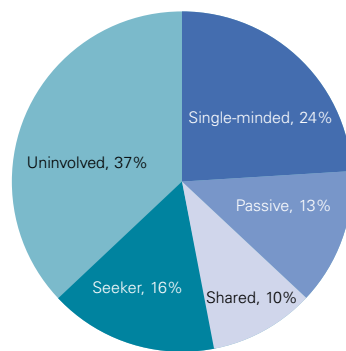
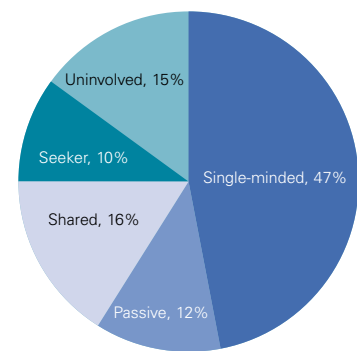


Figure 7: Non-Chinese brand owner



- Single-minded: Strong attachment to one brand. Committed to one, may be uncommitted to others.
- Passive: Committed, but less involved.
- Shared: Equally attracted to two or more brands.
- Seekers: Unhappy with current brand.
- Uninvolved: Don't care which brand they use.

	Single-minded	Shared	Uninvolved
US brand	50.5	7.2	11.6
Korean brand	42.7	6.5	22.1
Japanese brand	50.8	13.7	12.5
European brand	45.5	11.1	15.2

Interestingly, with regard to other countries’ brands, buyers of US and Japanese cars tend to be more “single-minded” and involved than the average car buyer. Conversely, buyers of Korean branded cars are less “single-minded” and involved, although not to the extent of the Chinese brand consumer.

The purchasing criteria of Chinese brand owners can weigh heavily on dealerships. When a car is principally chosen on the basis of price, dealer performance aspects play a lesser role. On the surface, the availability of low prices is therefore critical and service quality hardly features as a major reason for choice (see Table 9). However, our results clearly show that this does not mean that Chinese consumers do not want their expectations not to be met (see Table 10). Chinese consumers still have service expectations. Low levels of satisfaction with dealer performance leave no doubt that these expectations are currently not being met.

The car purchasing criteria of Chinese brand customers can weigh heavily on dealerships — TNS research

Table 9: Purchasing criteria for choosing one specific dealer (%)

	Chinese brand owner	Non-Chinese brand owner	First-time buyer	Repeat buyers	Compact /small owner	Mid-size/ mid-upper owner	Luxury owner
Recommendation from friends/ acquaintances	27.2	25.1	28.1	11.2	29.2	21.4	12.5
Availability of the preferred brands	9.1	20.2	18.4	16.1	12.8	23.4	37.5
Good service quality	9.1	18.7	11.1	24.7	14.9	19.5	20.3
Convenient location	13.6	14.8	14.2	16.4	14.9	14.4	13.1
Low prices	27.7	7.6	11.0	8.9	15.5	6.2	2.6
Good advice	5.5	5.9	7.6	11.1	5.9	6.3	3.1
Wide range	2.2	3.9	5.5	7.1	2.8	5.3	2.4
Close customer relations	3.0	2.6	1.9	3.5	2.2	2.9	5.2

Table 10: Gap between importance of expectation of dealer and actual experience

	Chinese brand owners	Non-Chinese brand owners
Importance for expectation to be met (1-5 scale)	3.32	3.69
Actual satisfaction (% of top 2 box — extremely and very satisfied)	43.3	65.0

For Chinese brands, the customer/dealer relationship remains very weak (see Figure 8). Factors important for customer retention, such as overall satisfaction, likelihood of recommendation to others, prospects for second purchases, as well as the level of perceived benefit are the lowest among all car owners. This means that Chinese brand dealers face the highest probability of losing their customers. In a market where consumer demands will rise as the market matures, an improvement in basic quality of service in Chinese brand dealerships appears to be indispensable to ensure sustainable success. This particularly pertains to:

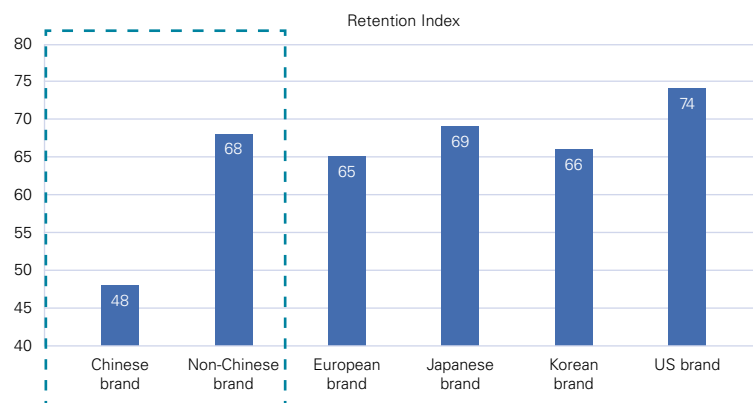
- Accuracy of sales and service information
- Better follow-up after the purchase
- An active service attitude.

Retention index

The categorisation of various types of consumers in this index is based on:

- The degree of customer satisfaction with dealer performance
- The probability of subsequent purchases from the dealer
- The likelihood of recommending the dealer to others
- The level of perception of the personal benefit of purchasing from the dealer

Figure 8: Retention Index – Chinese brands, non-Chinese brands and other origin of brands



Source: TNS research

Retention criteria can also be used to characterise customer loyalty. From the perspective of a car dealer, a satisfied and loyal customer is not only more likely to purchase more products and services, but will also act as an ‘ambassador’ spreading a positive message to other prospective customers. This is particularly important in China, as recommendations are essential to purchase decisions. Results indicate that only 20 percent of Chinese brand owners represent the ideal ‘satisfied customer’, while international brand dealers can count on 34 percent satisfied and loyal customers.

More critically, unsatisfied and disloyal customers are very unlikely to repurchase from the same dealership, and may have a negative impact on prospective new customers.

Results also indicate that the majority of foreign brand owners are somewhat disloyal to their dealerships. While most of them are not necessarily dissatisfied, a high proportion will not consider the current dealer for their future replacement of their vehicle, and may defect to another brand or dealership.

In summary

A look at the Chinese car market reveals structural disparities in mainland distribution networks, as well as considerable behavioural differences among customers. This is due to an extremely fast-growing car market where manufacturers and dealers are rapidly aligning their infrastructure to meet the requirements of a huge, diverse and increasingly complex environment. The behaviour of sellers as well as buyers is still heavily influenced by the emerging stage of the Chinese economy.

The findings of this research reveal a relatively low level of customer loyalty. Dealers who seek to strengthen customer relationships must improve customer service to meet demand. Significant opportunities appear to exist to succeed through enhanced product and service offerings.

Foreign brands should not be complacent. The majority of foreign brand car owners are also somewhat disloyal to their dealerships, just not to the same extent as Chinese brand owners — TNS research

Today's automotive dealership environment in China



Dealerships in China have traditionally been dominated by family-run businesses. Over the past decade these businesses expanded rapidly, while the regulatory environment struggled to keep pace. The result is an automotive retail market that is vigorous and competitive, but beset by a number of challenges.

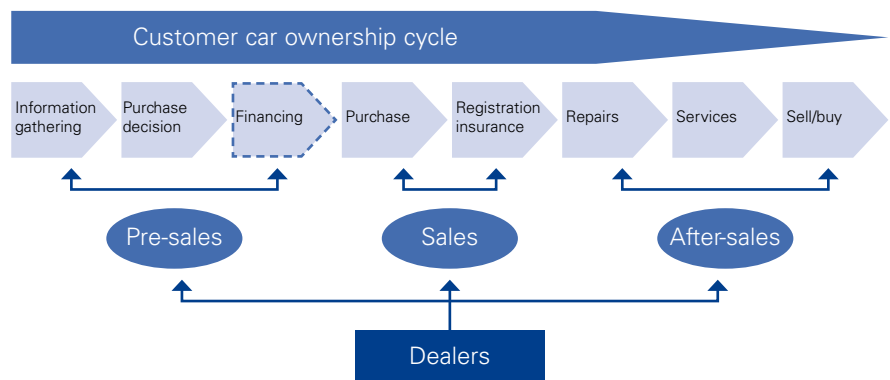
It was not until 2005 that the Chinese government implemented measures governing the sale of brand autos. Despite the introduction of this legislation, a legacy of inefficiency remains, particularly in areas such as:

- Dealer operations
- Profitability
- Disparities in terms of sales and service offerings
- The ability to meet consumer needs and expectations.

Given how far China has developed in recent years and how much potential there is for further growth, it would appear that a significant opportunity exists for China to 'leap frog' these inefficiencies and to reach, or even exceed, the performance levels of the more developed automotive retail markets.

Auto dealerships have always been the shop front and key link to the consumer. They serve as the face of the brand and are central to the relationship between the OEM and the consumer. They also manage customer interactions throughout the car ownership cycle (see Figure 9). As such, car dealerships are essential to the long-term growth of the automotive industry in China and more particularly OEMs. For instance, in 2006, 70 percent of Volkswagen's car sales in China were generated by the company's official dealer network.¹⁸

Figure 9: Dealers are the critical interaction points in the typical car ownership cycle



Source: KPMG

¹⁸ Volkswagen to expand car loans business, *China Daily*, 11 August 2006

The structure of China's automotive retail sector

China's demand for cars has led to a significant increase in the number of auto dealers. According to CAAM, China had over 30,000 dealers in 2005, with second level dealers — dealers that purchase cars from other dealers — accounting for more than 40 percent of the total.

At the same time, the automotive dealership sector is highly fragmented, comprising many small and independent players, which have been set up over time. This process has brought with it many issues. In an attempt to overcome these, in 2005, the Chinese government issued new rules aimed at better regulating the market and ultimately improving the services delivered by car dealerships to consumers. Under the new rules, car dealers must be granted an authorisation from car manufacturers, or general auto distributors, to sell cars and provide after-sales services (see Box: Professionalising dealerships in China). Since this regulation was introduced, many small and unqualified operators have been forced out of business.

Professionalising dealerships in China: Brand auto sales implementation measures

Recognising the pressing need to professionalise automotive dealerships amidst rapid growth in car sales, the government introduced "Implementation Measures Governing the Sales of Brand Autos" in 2005.

These measures called for sweeping changes. They required that all auto sellers — whether they be manufacturers themselves, or dealerships — develop consistent sales and after-sales networks. The rules apply to both domestic and foreign-invested dealerships.

Basic business requirements for companies to qualify as auto dealerships were laid out. For example, companies must comprise a full range of operational functions, including market research, strategic planning, marketing, parts supply chain and after-sales services. Dealerships must also obtain authorisation to use OEM brands, and display them consistently, as well as employ suitably-trained professional technical staff.

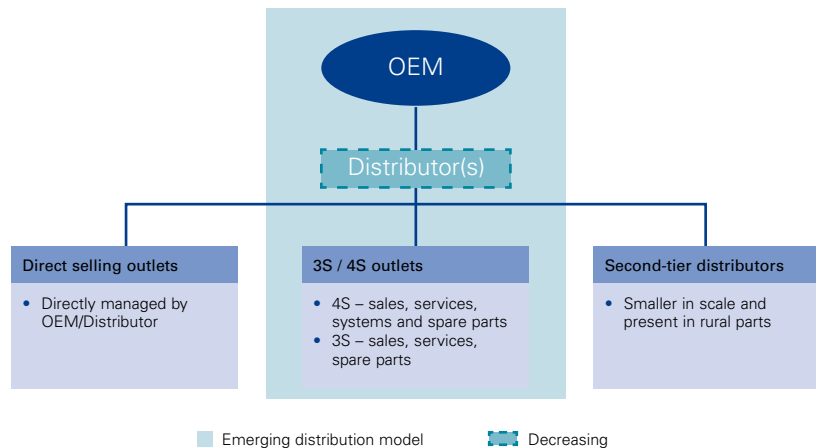
The implementation measures went even further, laying out two eight-point codes of conduct, one for auto suppliers and another for distributors. For manufacturers, the code of conduct includes standards for fairness and open co-operation with dealers, standardisation of after-sales services, a non-compete clause, and a requirement to provide technical training. Distributors must implement an accurate information management system, display warranty information, and — in what is still something of a novelty for many retail formats in China — standardise and clearly mark prices.

These implementation measures have effectively excluded the traditional existing dealership model — that of small, independent distributors — from the playing field, and have paved the way for larger, more professional, and ostensibly more accountable dealerships.

China’s retail distribution model

Historically, auto manufacturers and car distributors in China have had a multi-channel distribution strategy selling cars via direct outlets, 3S or 4S shops¹⁹ and second-tier distributors (see Figure 10). Dealerships are mainly local businesses, driven by geographic location and owned by local or foreign entrepreneurs. However, as the market consolidates, OEMs rely less on distributors. Direct-selling outlets as well as 3S/4S shops are emerging as the major channels for distribution. 4S stores are intended to be more responsive to consumers’ needs and expectations. They offer sales offices, showrooms, high standard service facilities, follow-up services, customer service, and spare parts areas in the same location. 4S stores drive consumer loyalty and sales, but traditional single brand dealers currently remain prevalent, both in terms of geographic reach and numbers.

Figure 10: Emerging car distribution model in China



Source: KPMG

OEMs have also realised that 4S type auto outlets provide them with more control over the aftermarket supply chain and increase their scope to capture more revenue (see Figure 11).

Figure 11: Distribution model of the auto aftermarket in China



Source: KPMG

¹⁹ 3S — sales, services, spare parts
 4S — sales, services, spare parts and customer service

Many dealers are choosing a multi-brand strategy to broaden their product offering to consumers in China. This is creating a tier of large dealerships that build their businesses by driving scale and achieving cost efficiencies due to their size, whilst offering more brands to the customer. Multi-brand dealerships present a significant risk to OEMs, as brand loyalties can shift more easily.

Auto manufacturers are expanding their retail networks in China

China is now a strategic market for most international OEMs. The country is now General Motors' second largest market behind the United States and was Volkswagen's fastest growing market in 2006, with annual sales rising 24.3 percent.²⁰ OEMs are dramatically expanding their distribution networks in China:

- Dongfeng Nissan plans to grow its distribution network of full-service dealers by 25 percent in 2007 from 250 dealers in 2006 to 310 dealers at the end of this year.²¹
- Mercedes Benz plans to establish 100 retail outlets by 2007 and 150 outlets by 2010.²² It now has 71 authorised dealers in China.²³
- In 2006, Dongfeng Honda Automobile had approximately 90 4S dealers and was planning to grow this number to 140 dealers by 2007.²⁴
- Skoda opened its first dealership in China's in March 2007. The Czech auto manufacturer is planning to open 140 dealers by the end of the year.²⁵
- In 2006, Audi had more than 120 dealers and BMW approximately 60 dealers across China.²³
- Volvo Cars China had 46 dealers in 45 Chinese cities in 2006.²⁶

Issues in the current environment

According to our research and the various market participants we have spoken to, the car dealership sector in China is currently facing some serious challenges.

Macro environment tightening — The industry is continually exposed to sudden or unexpected changes in industry regulations and fluctuations in fuel prices. Any further increase in oil prices will affect the costs of car usage, potentially slowing the demand for cars.

Rapid urbanisation — China's increasing urbanisation is having an impact on the availability and cost of land, especially in Tier 1 cities. Land costs as a proportion of total dealership set up costs are becoming more significant.

²⁰ Volkswagen sells record 202,600 vehicles in first quarter in China, *Xinhua News Agency*, 6 April 2007

²¹ Nissan aims to boost sales in China and Thailand this year, *AFX Asia*, 19 January 2007

²² Outlets of Mercedes Benz in China to Reach 60, *Xinhua News Agency*, 18 August 2005

²³ Mercedes to Beat BMW in Two Years, *China Daily*, 21 November 2006

²⁴ <http://world.honda.com/news/2006/060320dongfenghonda/>

²⁵ VW's Skoda opens first China dealership, *AFX Asia*, 28 March 2007

²⁶ Volvo Says China to Fuel Growth, *China Daily*, 18 November 2006



Profitability — China's auto industry made a profit of RMB 76.8 billion (approximately USD10 billion) in 2006, up 46 percent from the previous year, according to CAAM. However, dealers have generally experienced tough times in the last three years. In 2006, out of a reported 1,800 franchised auto dealers, about 700 were making losses, of which 300 have been forced to exit the market.²⁷

Pricing pressures — Product proliferation and increased competition are putting pressure on price levels. Car prices in China declined on average by 4.5 percent in 2006, although this was an improvement in comparison with trends in previous years. It is estimated that the average price decline across dealer companies for the period 2002-2005 was 31 percent over these three years.²⁸ Although, price levels are stabilising, pricing pressures are likely to persist at the dealer level as competition intensifies.

Management of operations — As the market grows and profitability declines, OEMs and their dealers face increasing operational challenges and cost pressures that affect their efficiency and performance. Any slowdown in car demand is likely to impact inventory levels and 'inventory push' to the dealers, which may have an impact on dealers' financial performance.

New competitors — New formats and players are emerging in China and represent a threat to OEMs' retail strategies. Large multi-brand dealership chains are being to compete with OEM single brand dealers (see Box: Mega-dealerships).

Auto aftermarket growth — The auto aftermarket in China is composed of thousands of small independent businesses. It is estimated that there are more than 345,000 aftermarket maintenance and repair facilities across mainland China.²⁹ The aftermarket sector faces major challenges such as fragmentation and intellectual property (IP) protection. However, consolidation has helped to drive improvements in service capabilities. For instance, brand-chain stores are expanding rapidly in China and are likely to be a significant indirect source of competition for car dealers and OEMs. For instance:

- Bosch entered China's automotive aftermarket in the 1980s. It now has more than 400 auto service centres throughout China and plans to have 1,500 service centres by 2013³⁰
- ACDelco currently has over 100 branded service centres in China and plans to expand rapidly

²⁷ China's auto makers earn \$10bn in 2006, *Asia Times*, 22 February 2007

²⁸ Goldman Sachs Global Investment Research

²⁹ China's Growing Aftermarket in Perspective, *Motor & Equipment Manufacturer Association (MEMA)*, 2007

³⁰ Auto-parts supplier to quadruple China sales, *People's Daily Online*, 11 June 2004

- Jiffy Lube, a U.S.-based chain of fast lube and oil change centres wholly-owned by Royal Dutch Shell, is expanding rapidly in China. In China, Shell joined forces with Shanghai Automotive Industry Sales Corporation (SAISC), a subsidiary of SAIC, to create Anji Jiffy Lube Automotive Service Co., Ltd. The company expects to have 500 to 600 outlets by 2015³¹
- Valvoline, a division of Ashland Inc, opened its first Valvoline Instant Oil Change (VIOC) store in China in June 2005³²
- Michelin opened its 300th TyrePlus outlet in mainland China in 2006.³³

The price sensitivity of Chinese consumers also presents a risk to OEMs and dealers in the aftermarket. Most consumers bring their vehicles to their appointed dealer during the warranty period, but after that, the Chinese consumer often tends to service their car or buy accessories at other independent service providers.

Mega-dealerships: A promising future in China?

Over the past two decades, the US has witnessed an ongoing trend in dealer consolidation. This has resulted in the emergence of mega-dealerships. These include AutoNation, which focuses on selling new cars through regional brand names, and CarMax, which operates over 75 used car superstores across the country.

There is no doubt that the mega-dealership model has been successful. AutoNation recently celebrated the sale of its six-millionth car, and sells more than any other auto retailer in the country. While CarMax, a spin-off from electronics giant Circuit City, trails AutoNation in terms of total auto sales, it has the largest used car operation in the US, with up to 1,000 used cars on offer at each store.

These giants have also embraced the Internet as a sales medium. AutoNation, for example, makes its entire inventory accessible and searchable online.

In the West, car dealerships have traditionally suffered from low consumer trust — the not-so-humble used car salesman is often referred to as a metaphor for untrustworthiness. One of the differentiating factors for the mega-dealerships has been their ability to improve the sector's credibility. CarMax, for example, refuses to negotiate on price — either on used car sales, or on trade-ins, removing a step in the sales process that is often stressful to buyers.

Will the trend towards consolidation into fewer and more powerful players spread to China? In some quarters, the trend is beginning to surface. Beiyacheshi (North Asia Car Market), is one such emerging player, which offers over 500 models of car through its superstores in China, and is responsible for one-fifth of the country's sales of imported cars. The company also has a major Internet presence, offering vehicle search capabilities, and, like its US counterparts, a wide range of financing and after-sales services/products. While the relative sales volume still remains comparatively low at 60,000 units per year, with China remaining a relatively immature market, plenty of room remains for expansion and consolidation. As the market evolves, with government regulations selecting for larger, more professional players, the future certainly appears to be promising for mega-dealerships in China.

³¹ Jiffy Lube Opens First Shanghai Store, *China Franchiser*, 9 March 2006

³² Ashland's Valvoline Instant Oil Change opens first store in Shanghai, available at www.valvoline.com

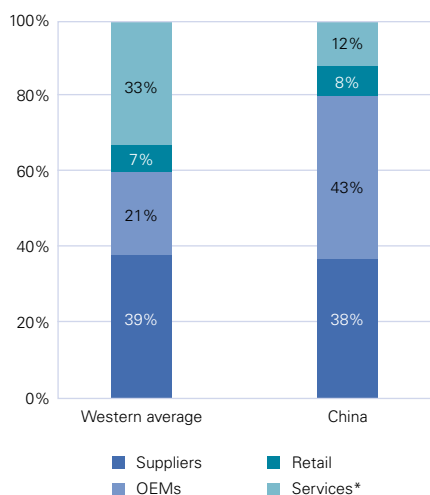
³³ China's Growing Aftermarket in Perspective, *Motor & Equipment Manufacturer Association (MEMA)*, 2007

Developments in mature markets and opportunities for China

The relationship between dealers and OEMs varies in mature markets. In the United States, car dealers are grouped under strong organised associations/ bodies and have a significant influence on auto manufacturers’ distribution and retail strategies, as well as industry regulators. In Western Europe, OEMs have traditionally exerted a high degree of influence on dealers. However, the automotive retail sector experienced a major change following the new Block Exemption Regulation (BER), which came into effect in 2002. This regulation gave more freedom to dealers and increased consolidation in the industry. In China, OEMs’ control over their distribution channels is increasing, although dealers still play a critical role, as most Chinese consumers are first time buyers and rely on car dealers to provide them with product and service information.

As previously discussed, in the world’s largest car market, the United States, a factor driving change has been the rise of high-volume car superstores. Their size gives them the ability to access capital and they are able to leverage the use of technologies in their operations and generate economies of scale. Such formats are starting to emerge in China.

Figure 12: 2005 Profits segmentation in the automotive industry



* Includes maintenance, financing, repairs etc

Source: CAAM

In mature markets, revenue streams for car dealers stem mainly from auto-related services. In China, car servicing and repair still remains dominated by small family-owned businesses. In 2005, only 12 percent of China’s auto industry profits were generated by services, in comparison to an average 33 percent in Western markets (see Figure 12). In fact, profits generated from spare parts, services or financing almost finance the sales of new cars in developed markets. In Germany, 82 percent of dealers’ sales are generated by selling car parts and accessories.³⁴ In the United States, the auto after-sales service industry is often referred to as the ‘golden industry’, with an annual production value amounting to USD 140 billion in 2005. The potential for China’s dealers is enormous, with the total market turnover of China’s automotive aftermarket being expected to reach RMB 300 billion by 2010.³⁵

Financing is a key marketing tool used by car dealers to drive sales and manage customer relationships, as it makes car purchasing more affordable. It also strengthens dealers’ sales capabilities and accelerates car turnover. In the US alone, auto financing is supporting roughly 80 percent of car sales.³⁶ In China, cars purchased on credit account for only 5-10 percent of total car purchases and auto loans account for just 1 percent in the total lending of Chinese banks.³⁷

³⁴ KPMG study, *Developments and success factors in automotive retail*, 2006
³⁵ Auto Aftermarket: Wealth Generated from Integration, *Foreign Economic Cooperation* (<http://fec.mofcom.gov.cn>), 11 August 2006
³⁶ China Merchants Chases Auto Finance, *SinoCast China Financial Watch*, 16 November 2006
³⁷ EIU

The proliferation of financing and leasing in the United States and Europe has reshaped the structure of the automotive retailing industry. In the case of leasing, for example, a new car is generally leased out for two or three years, after which it is returned to the dealer. This has created a large supply of used vehicles in the market. In the United States, the sale of used cars is two to three times that of new car sales. In China, by contrast, three out of four cars sold are new cars. Thus, China's used-car market is relatively immature at this stage, but is expected to grow significantly. According to CAAM, nearly 36 percent of current car owners are planning to purchase a new or used vehicle in 2007. Almost 2 million used cars were traded in China in 2006, representing an increase of 31.5 percent over 2005.

Financing is in its early stages in China and has been slow to develop for the following reasons:

- Concepts of credit and financing are generally new and unfamiliar to the Chinese consumer
- There is a general lack of reliable consumer credit information available, and very few integrated or shared databases for credit checking
- Car dealerships and their sales staff are still developing their approaches towards selling credit and financing products.

However, financing is likely to become an area of growth for dealers and OEMs. The market for auto finance services is expected to exceed RMB 500 billion in total value in the next decade.³⁹ China established its rules governing auto finance in December 2003 as part of the nation's WTO commitments. Some major international players have already established auto finance companies in China. For instance, GM's auto-financing joint venture with SAIC, the first foreign-funded auto-financing provider in China, had secured more than 22,000 retail contracts with local buyers by the end of June 2006. Volkswagen Finance China began operations in September 2004 and, over the following two years, established more than 3,000 contracts and expanded cooperation with 59 dealers.⁴⁰

The most pressing task is to equip dealers with financing know-how

Vice-President of Ford Motor Company (China), in press reports³⁸

³⁸ Wheeler dealers, *China Daily*, 12 December 2005

³⁹ China Merchants Chases Auto Finance, *SinoCast China Financial Watch*, 16 November 2006

⁴⁰ Volkswagen to expand car loans business, *China Daily*, 11 August 2006



In addition to retail financing, major auto financing players provide wholesale finance support for their dealers. For instance, by the end of 2006, Ford Automotive Finance (China) Co., Ltd. provided retail financing services to consumers in 26 major cities across China, as well as wholesale financing services to over 100 Ford brand-authorized dealers.⁴¹

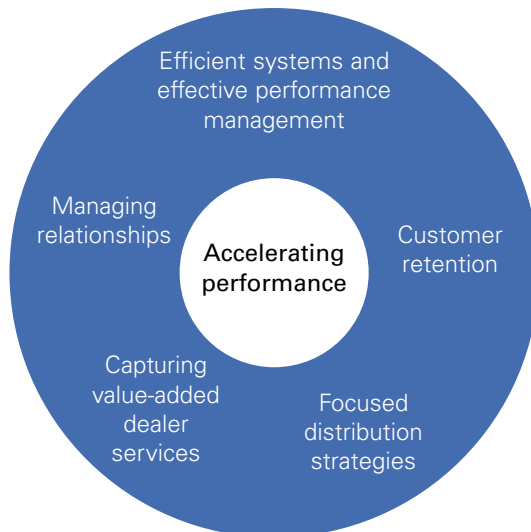
As mentioned previously, it is likely that China's domestic financial institutions will be looking to develop their automotive finance and credit offerings. These institutions may be in a position to provide stiff competition for the foreign players, given their extensive networks, client bases, liquidity and other resources.

⁴¹ Ford motor sales growth leads China auto industry increase exceeds 105% for first three quarters of 2006, available on www.ford.com, 10 October 2006

Accelerating performance

Based on our research with consumers, OEMs and dealers, we propose a model for Accelerating Performance, comprising the following five elements:

- Efficient systems and effective performance management
- Focused distribution strategies
- Customer retention
- Capturing value-added dealer services
- Managing relationships



Many car dealers are entrepreneurs who simply allow inefficient methods to disseminate into their operations — Senior executive, auto distributor interviewee

The following chapter examines these key success factors, describing where possible, some leading practices that might be applied in the Chinese market (derived from mature market examples, or based on some of the initiatives already underway in China's automotive dealership environment).

Efficient systems and effective performance management

OEMs and dealers must operate within a high-performance and integrated control system. As the automotive retail sector consolidates, effective dealer management systems (DMS') will be critical to managing dealerships across the country. OEMs must be able to look at their dealers across the key performance metrics that are important to their business, and dealers must be held accountable for their performance. We have identified three potentially high-impact areas of focus — front line sales and marketing, after-sales servicing and customer satisfaction.

Additionally, Chinese consumers conduct a significant amount of research prior to purchasing a vehicle. The Internet plays a key role in this process. Car dealers and OEMs must do more to incorporate the Internet into a unified sales and service system, as it is likely to remain and develop as a key innovation area for automotive sales.

In a recent initiative to understand better the financial systems and processes used by dealers, one OEM has recently undertaken a survey of its network aimed at:

- Identifying the nature and range of financial systems in place
- How they are used
- What improvements might be necessary to facilitate the effective gathering and communication of performance information
- Importantly, what the expectations are amongst dealers, in terms of the support required from OEMs and how communications should be managed.

The survey identified some significant challenges that will need to be addressed, in terms of creating an environment where reliable financial, management and operational information can be gathered on a timely basis and then subsequently used to identify and close performance gaps. These challenges included the following:

- The sheer number and disparity of financial systems in place amongst dealers, leading to issues in terms of compatibility, the creation and use of standard formats for reporting, and interfacing with other systems (for example DMS')
- The extent to which a relatively large number of dealers still rely on manual data entry
- The lack of systems in place for anything other than car and spare part sales, i.e. many dealers do not have systems in place covering used car sales, or added-value products and services

These challenges are unlikely to be restricted to this OEM and its particular group of dealers, and may well exist for most OEMs and dealer companies across China. Systems issues may be particularly prevalent in the multi-brand dealer environment.

Customer retention

Customer satisfaction drives loyalty, increases repeat sales and ultimately builds brand equity. Our study shows that dealers in China need to make improvements, as customers are increasingly looking for more services from car dealerships, convenience in making the purchase decision and greater after-sales support.

In order to achieve this, retail and back office staff must be trained and educated on customer requirements and how to provide service. Our study shows that there is room for improvement regarding sales representatives' skills. Expectations of customers regarding sales performance are below average. The rationale behind this is that Chinese car buyers are much less experienced than those in mature markets. Thus, more assistance is necessary through product information and advice, in order for them to make a purchase decision. It must be noted that experience levels are increasing and expectations are maturing extremely rapidly, prompting a need for almost immediate action.

Effective after-sales service and communication are essential to managing the customer relationship.

Focused distribution strategies

To win in China, OEMs must develop world-class, but locally relevant distribution networks that provide geographic coverage and adequate functionality, such as after-sales servicing (3S/4S models). OEMs must identify and discontinue relationships with under-performing dealers offering low market potential, whilst building stronger partnerships with their better-performing dealers.

OEMs have realised the importance of selecting dealers very carefully and have set very high financial and operational standards. For instance, 1,000 Chinese car dealers applied in 2005 for permission to sell Mercedes Benz cars, but fewer than 10 percent received an authorisation to operate.⁴²

OEMs are increasingly recognising the importance of establishing high performance dealer networks. Besides delivering the basics of product sales effectively, they also need to be capable of:

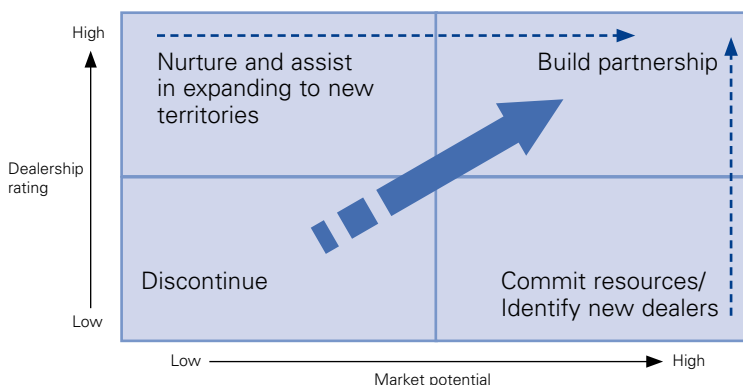
- Understanding broader concepts like 'customer lifetime value'
- Investing in expanding the scope and scale of their businesses, possibly into added-value product areas
- Managing their facilities, operations and people, such that performance gains work to the mutual benefits of the OEM and the dealer.

OEMs that entered China earlier may face challenges in 're-engineering' their dealer networks. Newer entrants can start more easily with a 'clean sheet of paper' — An auto analyst interviewee

⁴² Outlets of Mercedes Benz in China to Reach 60, *Xinhua News Agency*, 18 August 2005

Only the best managed car dealers will survive — OEM interviewee

Figure 13: KPMG’s automotive distribution evaluation framework



Source: KPMG

Increasingly, automotive dealers will be challenged to work with OEMs more effectively, to continuously improve performance. A model for how the OEMs are likely to evaluate dealers is defined by KPMG above (see Figure 13). Dealers that accept and respond to this challenge proactively will be the most likely to succeed.

Capturing value-added dealer services

Successful dealers are extending their relationships with customers through the entire ownership cycle. They drive customers back to dealerships for service work and manage the customer’s experience effectively. In China, repair and servicing continues to be the domain of aftermarket providers, and especially independent and small garages. Redesigning and expanding existing dealerships, establishing service satellites, training service technicians and intensifying parts wholesaling are among the strategic investments that dealers need to consider to capture new sources of revenue in the after-sales segment. This is one of the reasons why 4S dealers are emerging as a successful retail model in China.

After-sales service must be improved and offerings enhanced. After-sales activities begin with vehicle delivery, and may just be a simple follow up call to ensure the well-being of the client. They also include more advanced service propositions to current customers, such as extended-warranty periods and 24-hour customer hotlines or emergency call-centres.

As previously noted, financing and insurance are areas that can generate additional revenues. Dealers that offer auto financing from their OEMs are likely to take advantage and, for instance, Volkswagen Finance (China) Co. Ltd and GMAC are providing intensive financial services sales training to their partner dealers in order to push sales.

To capture the opportunities in auto-related financing and sales, Shanghai Volkswagen and China Construction Bank launched last year a co-branded credit card, the Shanghai VW Long Card. The card offers a range of discounts to Shanghai Volkswagen's customers on value-added auto services, such as test driving, auto financing or car servicing.⁴³

OEMs and their dealers must reinforce their position to capture after-sales services throughout the entire ownership cycle.

Service could prove to be a hard-to-copy advantage for the companies that get it right — OEM interviewee

Managing relationships

Collaboration between automotive manufacturers and dealers is key to driving customer satisfaction. Often OEMs see their dealers as one subdivision of their business, but in reality they are often separate business entities. Additionally, each dealer is unique in China, as they are mainly local businesses that cater to a localised market. This often creates conflicting objectives for manufacturers and dealers. Opportunities exist in the following areas to manage relationships more effectively:

- Integrating processes and leveraging the use of systems
- Aligning strategies and objectives
- Cooperating in developing joint marketing programs
- Achieving transparency through dealer benchmarking
- Improving communication with dealers to enhance visibility over dealer operations
- Rewarding successful dealers.

Together, both auto manufacturers and dealers need to be better positioned to respond quickly and effectively to consumers' needs and expectations.

⁴³ Co-branded card in auto industry, *Shanghai Daily*, 19 May 2006

The outlook for the automotive retail sector in China



As this report has described, China's automotive industry, and the environment in which it operates, are highly unique — in terms not only of the growth that has been achieved so far, but also the size and nature of the market opportunities that are still likely to present themselves.

In many ways, it is somewhat startling that China has now overtaken Japan to become the world's second largest automotive market after the United States. From a very low base just a few years ago, this position has been achieved in a remarkably short period of time, against a background of relative immaturity across virtually all elements of the automotive industry value chain. Even more noteworthy is the fact that:

- Levels of car penetration are still very low compared to mature markets, and
- Car buyers are still relatively inexperienced.

It is evident, of course, that market conditions are changing rapidly. Moreover, our research indicates that the pace of this change is increasing, which means that automotive industry participants will need to 'peddle even harder' just to stay still or make progress. One area where both the OEMs and dealers may not be able to keep up is profitability — hence why we argue that the future winners in China will be those companies that can both:

- Become much more effective and efficient, in terms of how their current business models operates relative to local market conditions, and
- Seize the emerging opportunities we have identified to create competitive advantage, diversify into and develop profitable revenue streams and, above all, satisfy and retain customers by providing products and services that address their needs and meet their expectations.

China's dealer environment is currently highly fragmented and we see many opportunities for *Accelerating Performance* at both the OEM and on a dealer levels. A consistent theme drawn from both TNS' consumer research and KPMG's strategic, management and operational analyses has been the need for OEMs and dealers to professionalise. We see this happening with:

- The establishment of new automotive retail formats
- Advances, for example, into markets such as automotive financing and insurance, and the used car segment
- OEMs being more selective about the dealers they work with
- Developing relationships and communications between OEMs and their dealers
- The introduction of better DMS' and financial management systems to increase transparency in relation to dealer performance and, importantly, to bridge the performance gaps that these often highlight
- Developing levels of customer service, particularly in China's Tier 1 and 2 cities.

An interesting question prompted by our research is whether or not Chinese brands have the capacity to catch up with their foreign counterparts in these areas. Current indications are that the Chinese players and their dealers have the will and capacity to do so. The follow-up question is: how long will it take them?

About KPMG



KPMG is a global network of professional firms providing Audit, Tax, and Advisory services. We operate in 148 countries and have more than 113,000 professionals working in member firms around the world.

KPMG in China and Hong Kong SAR

In 1992, KPMG was the first international accounting firm to be granted a joint venture licence in China, and our Hong Kong operations have been established for over 60 years. This early commitment to the China market, together with our unwavering focus on quality, has been the foundation for accumulated industry experience that is difficult to rival.

With our expanding number of offices and more than 5,200 professionals, our single management structure across China and Hong Kong SAR allows efficient and rapid allocation of resources wherever you are located.

Industrial Markets

KPMG is organised by industry lines of business across our offices to provide in-depth industry knowledge and professionals highly experienced in their sector. We are committed to providing quality services to our clients. Our Industrial Markets line of business has a global network comprising the major practices around the world. This network gives us the ability to provide consistent services to our clients, share best practice and provide thought leadership, while always maintaining a strong knowledge of local issues and markets.

KPMG's Automotive Team

KPMG's automotive team draws on a wealth of industry specific knowledge and experience gained from working with clients across the globe in all major markets. We are able to provide clients the convenience of a singular approach to performance assessment and evaluation that incorporates several discrete areas of knowledge and experience, matching clients' own internal structures. We understand the dynamics of the industry and who the key stakeholders are, including the implications of the challenging dealership to OEM relationship, what drives them and how their issues need to be addressed for effective performance evaluation. KPMG does not provide generic assistance, but rather provides specific, tailored support and guidance that reflects individual market realities, industry evolution and ever-changing customer preferences.

About TNS

TNS is a global market insight and information group.

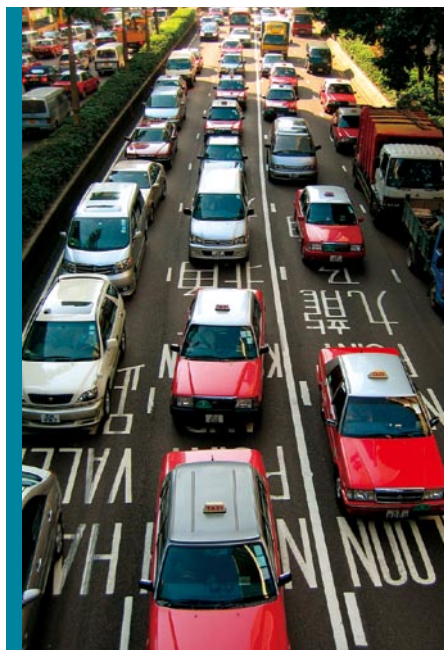
TNS' goal is to be recognised as the global leader in delivering value-added information and insights that help our clients to make more effective decisions.

As industry thought leaders, our people deliver innovative thinking and excellent service to global organisations and local clients worldwide. We work in partnership with our clients, meeting their needs for high-quality information, analysis and foresight across our network of over 70 countries.

We are the world's foremost provider of custom research and analysis, combining in-depth industry sector understanding with world-class expertise in the areas of new product development, segmentation and positioning research, brand and advertising research and stakeholder management. We are a major supplier of consumer panel, media intelligence and internet, TV and radio audience measurement services.

TNS is the sixth sense of business.

Contact us



Please contact a KPMG member firm for more information.

KPMG in China and KPMG in Hong Kong SAR

Nelson Fung

Partner in charge
Industrial Markets
China and Hong Kong SAR
Tel: +86 (21) 2212 2801
e-Mail: nelson.fung@kpmg.com.cn

Norbert Meyring

Partner, Industrial Markets, Shanghai
Tel: +86 (21) 2212 2707
e-Mail: norbert.meyring@kpmg.com.cn

Melvin Guen

Partner, Industrial Markets, Beijing
Tel: +86 (10) 8508 7019
e-Mail: melvin.guen@kpmg.com.cn

Ronald Sze

Partner, Industrial Markets, Guangzhou,
Shenzhen and Macau
Tel: +86 (755) 2547 1063
e-Mail: ronald.sze@kpmg.com.cn

Andrew Thomson

Director, Global Markets
KPMG in China and Hong Kong SAR
Member of KPMG's Global Automotive
Steering Group
Tel: +86 (21) 2212 2877
e-Mail: andrew.thomson@kpmg.com.cn

Paul Brough

Head of Financial Advisory Services
China and Hong Kong SAR
Tel: +852 3121 9800
e-Mail: paul.brough@kpmg.com.hk

Honson To

Head of Transaction Services, Shanghai
Tel: +86 (21) 2212 2708
e-Mail: honson.to@kpmg.com.cn

John Lee

Head of Tax, Shanghai
Tel: +86 (21) 2212 3402
e-Mail: john.lee@kpmg.com.cn

Thomas Stanley

Partner, Transaction Services
Commercial Due Diligence Unit
China and Hong Kong SAR
Tel: +86 (21) 2212 3884
e-Mail: thomas.stanley@kpmg.com.cn

Stephen Lee

Head of Risk Advisory Services
China and Hong Kong SAR
Tel: +852 2826 7267
e-Mail: stephen.lee@kpmg.com.hk

The information contained herein 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 upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2007 KPMG Huazhen, a Sino-foreign joint venture in the People's Republic of China and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative. All rights reserved. Printed in the People's Republic of China.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.

Publication date: April 2007

www.kpmg.com.cn

www.kpmg.com.hk

Northern China

Beijing

8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel : +86 (10) 8508 5000
Fax : +86 (10) 8518 5111

Qingdao

4th Floor, Inter Royal Building
15 Donghai West Road
Qingdao 266071, China
Tel : +86 (532) 8907 1688
Fax : +86 (532) 8907 1689

Eastern and Western China

Shanghai

50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel : +86 (21) 2212 2888
Fax : +86 (21) 6288 1889

Chengdu

18th Floor, Tower 1, Plaza Central
8 Shuncheng Avenue
Chengdu 610016, China
Tel : +86 (28) 8673 3888
Fax : +86 (28) 8673 3838

Hangzhou

8th Floor, West Tower, Julong Building
9 Hangda Road
Hangzhou 310007, China
Tel : +86 (571) 2803 8000
Fax : +86 (571) 2803 8111

Southern China

Guangzhou

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

Shenzhen

9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel : +86 (755) 2547 1000
Fax : +86 (755) 8266 8930

Special Administrative Regions

Hong Kong

8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel : +852 2522 6022
Fax : +852 2845 2588

Macau

23rd Floor, D, Bank of China Building
Avenida Doutor Mario Soares, Macau
Tel : +853 2878 1092
Fax : +853 2878 1096