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The Hidden Gem for Private Equity Investors

The Chinese word for “crisis” consists of two ideograms meaning “danger” and “opportunity.” Faced with slowing auto sales, lowering dealer margins, and more than a few bankruptcies, potential investors such as private equity funds can be forgiven for concluding that China’s auto dealerships are in crisis. However, there is increasing evidence to suggest that the dangers facing the dealership sector could help to revamp the sector and thus be turned into an opportunity to create value for intelligent investors.

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On the surface, it is difficult to develop an investment case for the auto dealership industry. Though the market is quite concentrated at the front end, with top ten players taking 44 percent of market share, the rest of the market is shared by tens of thousands of small dealers across the country, with no dealer having yet developed anything remotely resembling nationwide coverage. Furthermore, dealer margins have little variability, and customer prices are essentially fixed – the average dealer operating margin is just under two percent. The vast majority of dealers are unsophisticated in their management and operations know-how.

The reason for this low degree of sophistication across the industry is essentially a lack of incentive to improve. With low car penetration and a rapidly growing market, most dealers have not had to work hard to achieve substantial profits. Besides, with sky rocketing property prices, dealers often see the dealership as a side business as they watch the land on which the dealership sits double and triple in value.

Of late, however, the situation has changed. The combination of growing competition, slowing car sales, declining dealer margins, and a cooling property market will force

dealers to return to their core. By implementing a few key initiatives, auto dealerships can become a highly lucrative sector for direct investors:

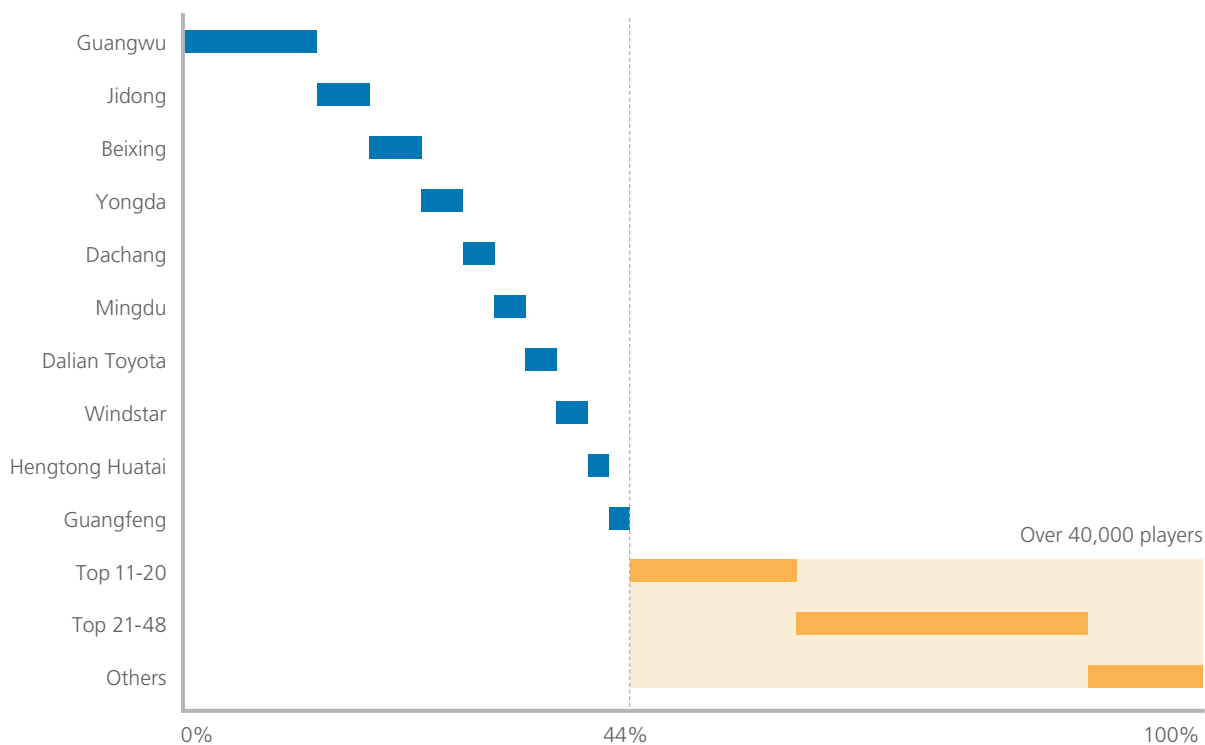
Scale up. Investors need to help dealers to scale up on operations and network through consolidation. Increasingly stringent dealer policies will require large investments in know-how and human capital, which will be offset by greater economies of scale. Those players that can quickly realize network effects through quick consolidation will be able to differentiate themselves.

Focus on downstream profits. As the installed base of vehicles continues to grow, the ability to maximize profit capture from downstream offerings will become critical. By 2015, downstream businesses are expected to account for 65 to 75 percent of the industry's profits. Dealers must adopt measures to enhance dealer loyalty and focus on building a broader after-sales network.

Develop strong OEM relationships. Successful OEM relationships require a combination of cordiality and bargaining savvy to obtain favorable policies and support from OEMs. Scale is certainly one important factor, but, for instance, Shanghai's Yongda has also created a powerhouse of multi-brand dealerships in Eastern China, allowing it to obtain significant concessions from OEM partners.

Adopt best practice HR operations. More so than in other markets, China's dealership market is very much a people business. At the same time, a lack of qualified talent and intense competition has caused turnover in this sector to run as high as 40 percent in some cities. Dealerships that develop HR policies that allow them to hire, train, develop, reward and retain the best and the brightest will create significant strategic control.

Top ten players have a market share of 44 percent



Source: China Commerce Statistic Year Book 2007, CATARC Statistics, Private Company Database, Oliver Wyman analysis