OLIVER WYMAN

This piece was published before the May 2007 rebranding of Mercer Management Consulting, Mercer Oliver Wyman, and Mercer Delta Consulting as Oliver Wyman.

Oliver Wyman

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

www.oliverwyman.com

BEAR STEARNS

Research Analyst(s):

Gerwin Ho

Vickie Lo

Equity Research
China Autos / Rated: Market Underweight
September 23, 2005

China Auto Conference Call - "Value Migration in China's Car Sector: Winning in the After-market"

Key Points

*** Bear Stearns and Mercer Management Consulting (Mercer) hosted a conference call on China's car market on Sept. 22. The call centered on two key themes: 1) value migration in the auto sector from new cars to downstream, and 2) the development of spare parts, services, and other downstream opportunities. Replays of the call are available through Sept. 29 (see details below).

*** In this call, we explored after-market opportunities in China in light of declining profitability in the OEM segment. Despite unit sales growth, car manufacturers' profits have declined due to price cuts, slower growth in unit sales, and a product mix shift toward smaller-engine-size cars. In particular, China's 1H05 auto industry profit declined 48% YoY to RMB23bn (US$2.8bn).

*** Mercer believes China's auto market is progressing to stage two of its value migration framework whereby downstream profits (service and spare parts, used cars, and financing businesses) start to exceed new car profitability. Mercer also expects tier one and tier two cities in China to reach the level of maturity exhibited by European markets in less than ten years.

*** Mercer believes the after-market space is important for OEMs because it can: 1) improve customer loyalty and retention, and 2) realize untapped revenue and profit opportunities. Mercer shared its views on the development of the after-market space, including spare parts, after sales services, used car sales, and auto financing businesses in China.

*** To summarize, Mercer believes change in China's car market will accelerate. It also believes spare parts and after sales services will provide immediate opportunities. Used car sales and auto financing have significant potential but should take longer to develop. Mercer believes early recognition of value migration trends and repositioning are key to succeeding in the after-market.

U.S. INVESTORS CONTACT YOUR BEAR, STEARNS & CO. INC. REGISTERED REPRESENTATIVE AT 1-800-999-2000

Replays are available through September 29, 2005

Bear Stearns and Mercer Management Consulting (Mercer) hosted a conference call on China's car market on September 22. Mercer was represented by Mr. Raymond Tsang, Director and Shanghai office Head, and Mr. Frank Leung, Principal and one of the leading partners of Mercer's China auto practice. The call centered on two key themes: 1) value migration in the auto sector from new cars to downstream, and 2) the development of spare parts, services, and other downstream opportunities. Replays of the call are available through September 29 at 1-877-519-4471 (U.S.); 973-341-3080 (International); pin#: 6490120.

China's car market posting unit sales growth but profit decline

China was the world's fourth-largest auto producer in 2004, behind the U.S., Japan, and Germany, producing 5.1mn units. China was the world's seventh-largest car producer in 2004, producing 2.3mn units. At the end of 2004 there were an estimated 26mn vehicles in China. In the first eight months of 2005, China's car sales grew 14% YoY to 1.7mn units. China's top-three foreign brands by unit sales are VW, GM, and Hyundai, with 15%, 10%, and 9% market share, respectively.

PLEASE SEE PAGE 5 OF THIS NOTE FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION.

Despite unit sales growth, car manufacturers' profits have declined due to price cuts (estimated at 8%), slower growth in unit sales, and a product mix shift toward smaller-engine-size cars (unit sales of 1.6L and below cars +40% YoY vs. -17% YoY for 1.6L and above cars). In particular, China's 1H05 auto industry profit declined 48% YoY to RMB23bn (US$2.8bn). Key Shanghai 'A'-share listed auto manufacturers posted a 1H05 profit decline averaging 63% YoY. In this conference call, we explored after-market opportunities in China in light of declining profitability in the OEM segment.

<u>Theme 1: Value migration in the car sector: From new cars to downstream</u>

Q1. China's car market has undergone tremendous change over the past 12 to 18 months. Can you comment on the market's development?

Mercer defines automotive markets' evolution in three stages:

1. In stage one, the majority of profits come from new car sales with some service and spare parts profits. Examples include India and Russia.
2. In stage two, downstream profits (service and spare parts, used cars, and financing businesses) start to exceed new car profitability. Examples include Eastern European countries such as Poland.
3. In stage three, more than 70% of profits come from downstream activities. Examples include Germany and the U.S.

Mercer believes that China's auto market is progressing from stage one to stage two. Signs of this transition include:

1. Profitability of new car sales for OEMs has declined over the past 12 months.
2. OEMs show increased interest in expanding their service networks.
3. Used car sales have grown rapidly over the past 12 to 18 months.
4. OEMs are cautiously moving into auto financing.

Mercer believes we should expect value migration from new car sales to after-market services over the next 18 months. OEMs that can best adapt to the changing playing field will succeed.

Q2. How quickly will China reach the level of maturity of markets such as the U.S., Japan, and Europe? Will it progress faster or slower than other developed markets?

While it took the U.S., France, and Germany 15 to 20 years to evolve from stage two to stage three, Mercer expects China's auto market to evolve much faster, because:

1. China's auto market has experienced very fast growth, which Mercer expects to continue. Mercer expects China to become the second-largest car market in the world after the U.S. by 2010.
2. Most of the large global OEMs have invested heavily in China and brought with them experience and best practices.
3. Intense competition for new car sales forces OEMs to turn to the after-market as a way to differentiate offerings.
4. The government has the power and the will to bring transparency and healthy competition to the after-market.

As a result, Mercer believes that in less than ten years, tier one and tier two cities in China will reach the maturity exhibited by European markets. Another implication is that profits and losses will be magnified as a result of this rapid evolution.

Q3. The outlook for new car sales seems to be quite muted, both in terms of margin and growth. What should OEMs do to protect their share of the market and improve profitability?

Mercer believes it is still possible to make money from new car sales. For example, BMW and Toyota are still managing to achieve 5%-plus operating margins through high-quality products, superior brand and loyalty management. In China, the car market has endured significant price cuts over the past two years. However, Honda has been able to cut prices by only 7% to 8% compared with more than 15% by its competitors. Honda has done so through a strong product portfolio and brand management across the entire life of the vehicle, particularly in the after-market. Mercer found in their Chinese auto consumer price elasticity study that brand equity accounted for 40% of a premium vehicle's value. This illustrates that strong brand management is a much better lever than price cuts for profitability. Mercer concludes that OEMs that suceed in differentiating their brands across the customer lifecycle are able to generate profit from new car sales.

Q4. You spoke of value migrating to the after-market space. Can you elaborate on the potential of the after-market for OEMs and other operators?

Mercer believes the after-market spaces are critical for OEMs in two ways:

1. Improving customer loyalty and retention:
    - Mercer found that more than 55% of brand-switching was due to dissatisfaction with exiting OEMs' after-market services.
    - Tailored after-market service packages that target different customer segments are proven to be effective in improving customer retention in mature markets.
    - Customers' experiences in the after-market will influence the market price of a car.
2. Realizing untapped revenue and profit opportunities:
    - Revenue: In mature markets new car sales make up just 25% of revenue throughout a vehicle's lifetime. The remaining revenue comes from: 1) after sales and financial services (50%), and 2) used car sales (25%). In China, the after-market currently accounts for just 35% of revenue.

- Profit: After-market services in mature markets account for about 80% of all profits across the value chain. In China the after-market currently accounts for just 40% of profit.

Mercer believes that OEMs should redefine their after-market strategies to capture more profit from downstream opportunities. OEMs also need to differentiate their offerings to enhance customer experience.

Theme 2: Development of the spare parts and services markets, and other downstream opportunities

Q5. Given the proliferation of "gray" (or counterfeit) parts in China, is there money to be made for OEMs in this sector? To whom will the profits go?

Despite Chinese car owners' tendency to use "gray" (or counterfeit) parts, Mercer believes it is still possible to make money from spare parts because:

1. OEMs are increasing their control over service centers. Three years ago, 70% of Shanghai VW's service centers were non-exclusive. By way of a comparison, currently only 25% of Hyundai's service centers are non-exclusive.
2. The sector will become easier to regulate as consolidation occurs, with large-scale fast-fit chains driving out "mom-and-pop" shops.
3. Beijing is focusing on restricting gray part sales. The Ministry of Communications released a new policy that prohibits the use of gray parts and encourages the development of large-scale service centers.

Mercer believes OEMs will capture most of the profit for safety-critical parts and suppliers will capture most of the rest of the parts market.

1. Mercer finds that Chinese consumers are much more willing to buy an OEM-branded safety-critical part because the perceived quality is better, even though it may cost more.
2. For non-safety-critical parts, however, 60% of consumers are willing to buy from a fast-fit chain or parts dealer.

Mercer believes excellent supply-chain and distribution controls are key to winning in the spare parts market.

Q6. How about after sales services? How does the emergence of 3S/4S shops impact the service sector?

Increasing convergence of sales and after sales stores over the past two years has increased the number of 3S (sales, service and spare parts) and 4S (sales, service, spare parts, and customer service) stores. In China 3S store penetration has increased to over 70% for some OEMs today from 15% of all service centers in 2003. Despite the large upfront investments, Mercer finds that customers overwhelmingly prefer to bring their cars for servicing to the same people who sold them their cars. From the OEM's perspective, 3S/4S stores are also easier to manage and ensure consistent brand experience.

Mercer believes three trends will influence service formats in China:

1. 4S shops are expected to account for more than half of the market in five years, and several mega-dealer groups with multiple dealerships and service centers will likely emerge. Many of these will be global dealers of a given OEM in other geographies such as Taiwan or Hong Kong.
2. Fast-fit chains are also expected to grow to 30% of the market over the next five years. They will expand their portfolio to higher value-added services with the theme of "convenience" from a focus on vehicle safety and performance services. Examples include Japanese fast-fit chains like YellowHat and Autobacs.
3. Independent service centers' market share is expected to contract to less than 20% within the next five years from more than 50% today. They lack economies of scale and specialized knowledge and are likely to be impacted by future regulations.

Q7. Based on your description of market evolution stages, the next big opportunity in the after sales market would be used car sales. How do you see development in that sector over the short to medium term? How critical is it for OEMs to participate in this sector?

Mercer estimates average vehicle age in China to be about three years versus six to seven years in mature markets. As a result, China's used car market is under-penetrated, accounting for only 30% of total vehicle sales versus 70% in mature markets. However, over the past year used car sales increased more than 30% and accounted for half of all vehicle sales in some cities such as Guangzhou and Shanghai.

Currently, most used car transactions in China are consumer to consumer without any intermediary. As a result, the system is opaque making it difficult to assess vehicle quality, service history, and pricing. Several developments could help overcome these obstacles:

1. Beijing is putting together a used car policy that should help clean up and professionalize the used car market.
2. Global information providers are looking to provide standardized pricing information in the near future.

With OEM involvement, Mercer expects the used car market to experience rapid growth over the next five years. OEMs such as VW and GM have begun to offer basic trade-ins to achieve repeat purchases and manage residual vehicle values. In addition, operators such as Japan's Qinland have entered the market by forming a joint venture with Shanghai Xietong. Large U.S. used car dealers are planning to enter the Chinese market.

Mercer believes a strong accreditation system, distribution network, and understanding of price elasticity across different regions are key ingredients to succeeding in China's used car market.

Q8. The auto financing market has received a lot of hype, but so far has not lived up to its potential. Will this market take off? Why or why not?
Mercer believes that China's auto financing market has not taken off because of:
1. The lack of a central credit system, which has led to 30%-50% non-performing auto loans in Chinese banks.
2. The lack of risk management experience in Chinese banks.
3. The lack of a legal framework and difficulties in vehicle repossession.
4. The difficulty facing foreign auto financing companies to secure long-term cost-effective funding and hedge interest rate exposure.

Mercer believes there are substantial opportunities in auto financing, however:
1. China is far behind international standards in terms of market penetration. Auto financing penetration for U.S., Germany, India, and Taiwan is 80%, 70%, 60%, and 50%, respectively, versus about 5% in China at the end of 2004. China's peak was in 2003 when penetration reached 25%.
2. Financing can be highly profitable.
3. U.S. and European credit rating agencies are looking to enter the China market, which will help establish higher standards and best practices.

VW, GM, Toyota, Ford PSA, and DaimlerChrysler have all received Chinese auto financing licenses. Hyundai is applying. Mercer believes local financial institutions are unlikely to be able to win in this market due to auto companies' overseas experience and dealer relationship advantages. Mercer also believes auto financing is likely to take a further three to five years to develop versus other downstream markets.

Q9. To wrap things up, any additional comments on the development of China's car market over the next 18 months? How should the OEMs prepare?
Mercer believes change in China's car market will accelerate. Second-stage development signals should soon be clear. They include:
1. Further decline in new car sales profitability.
2. Massive investment in sales and distribution networks and other downstream business infrastructure.
3. Emergence of a large number of non-OEM operators competing in the after-market.

Mercer believes spare parts and after sales services will provide the most immediate opportunities among downstream businesses. The used car market could provide an even larger opportunity for profit, but not until further down the road. While Mercer is bullish on the auto financing market, it is probably five years away because of all the structural barriers that need to be overcome. Mercer believes the after-market winners will be the ones who recognize the value migration trends before their competitors and reposition their business models accordingly.

Questions from the audience

Q10. In terms of the used car market, and probably relating to auto financing, is there any emerging standard in China for accreditation in terms of used cars?
Mercer indicates the lack of an accreditation system is affecting the emergence of a used car market, and also auto financing. There is currently no standard for accreditation similar to the blue book or black book in the U.S. Mercer believes the eventual standard bearer will need to have good access to information and a neutral position in the market. Mercer believes potential candidates could be banks or specialized publishing houses, but are unlikely to be OEMs. It is likely to take several years for the standard to emerge.

Q11. Which categories are dominating in the used car market?
Mercer categorizes China's car market into three groups:
1. Low cost (i.e. local operators).
2. Mainstream (i.e. most of the Chinese OEMs, like Shanghai VW and Shanghai GM).
3. Premium (i.e. Mercedes and BMW).

Mercer indicates that the majority of used cars belong to the mainstream segment because:
1. Low-cost cars are perceived to be of low quality and hence there is limited demand in the second-hand market.
2. Premium cars are mostly imported with no rigorous pricing standard. Their stock is also limited; therefore, there are few second-hand transactions.

Q12. Where do car exports fit into Mercer's three-stage automotive evolution framework?
Mercer indicates that there is no direct relationship between exports and the three stages of the framework. Mercer believes the key factors for exports include:

1. The ability to produce high-quality cars at a competitive cost, and the availability of excess capacity for exports.
2. Policy and regulatory frameworks that promote exports (e.g. tax and financing).

Mercer believes China currently lacks these factors but is likely to develop them over time. China's exports to developed markets are currently insignificant. Mercer believes the more mature a market is, the more likely it is to have economies of scale and product quality to achieve exports.

IMPORTANT DISCLOSURES

ANALYST CERTIFICATION

The Research Analyst(s) who prepared the research report hereby certify that the views expressed in this research report accurately reflect the analyst(s) personal views about the subject companies and their securities. The Research Analyst(s) also certify that the Analyst(s) have not been, are not, and will not be receiving direct or indirect compensation for expressing the specific recommendation(s) or view(s) in this report.
Gerwin Ho

For important disclosure information regarding the companies in this report, please contact your registered representative at 1-888-473-3819, or write to Sandra Pallante, Equity Research Compliance, Bear, Stearns & Co. Inc., 383 Madison Avenue, New York, NY 10179.

The costs and expenses of Equity Research, including the compensation of the analyst(s) that prepared this report, are paid out of the Firm's total revenues, a portion of which is generated through investment banking activities.

This report has been prepared in accordance with the Firm's conflict management policies. Bear Stearns is unconditionally committed to the integrity, objectivity, and independence of its research. Bear Stearns research analysts and personnel report to the Director of Research and are not subject to the direct or indirect supervision or control of any other Firm department (or members of such department).

This publication and any recommendation contained herein speak only as of the date hereof and are subject to change without notice. Bear Stearns and its affiliated companies and employees shall have no obligation to update or amend any information or opinion contained herein, and the frequency of subsequent publications, if any, remain in the discretion of the author and the Firm.

Bear, Stearns & Co. Inc. Equity Research Rating System:
<u>Ratings for Stocks (vs. analyst coverage universe):</u>
Outperform (O) - Stock is projected to outperform analyst's industry coverage universe over the next 12 months.
Peer Perform (P) - Stock is projected to perform approximately in line with analyst's industry coverage universe over the next 12 months.
Underperform (U) - Stock is projected to underperform analyst's industry coverage universe over the next 12 months.

<u>Ratings for Sectors (vs. regional broader market index):</u>
Market Overweight (MO) - Expect the industry to perform better than the primary market index for the region (S&P 500 in the US) over the next 12 months.
Market Weight (MW) - Expect the industry to perform approximately in line with the primary market index for the region (S&P 500 in the US) over the next 12 months.
Market Underweight (MU) - Expect the industry to underperform the primary market index for the region (S&P 500 in the US) over the next 12 months.

Bear, Stearns & Co. Inc. Ratings Distribution as of June 30, 2005:
Percentage of BSC universe with this rating / Percentage of these companies which were BSC investment banking clients in the last 12 months.
Outperform (Buy): 38.5 / 19.5
Peer Perform (Neutral): 50.4 / 12.4
Underperform (Sell): 11.1 / 6.0

Securities covered by the author(s) of this report include:

Gerwin Ho (Asian Autos): BRILLIANCE CHINA AUTOMOTIVE LTD. (ADR), Brilliance China Automotive Holdings Ltd., DENWAY MOTORS LTD., GEELY AUTOMOBILE HOLDINGS LTD.

OTHER DISCLAIMERS

This report has been prepared by Bear, Stearns & Co. Inc., Bear, Stearns International Limited or Bear Stearns Asia Limited (together with their affiliates, "Bear Stearns"), as indicated on the cover page hereof. This report has been adopted and approved for distribution in the United States by Bear, Stearns & Co. Inc. for its and its affiliates' customers. If you are a recipient of this publication in the United States, orders in any securities referred to herein should be placed with Bear, Stearns & Co. Inc. This report has been approved for publication in the United Kingdom by Bear, Stearns International Limited, which is authorized and regulated by the United Kingdom Financial Services Authority. Private Customers in the U.K. should contact their Bear, Stearns International Limited representatives about the investments concerned. This report is distributed in Hong Kong by Bear Stearns Asia Limited, which is regulated by the Securities and Futures Commission of Hong Kong. Additional information is available upon request.

Bear Stearns and its employees, officers, and directors deal as principal in transactions involving the securities referred to herein (or options or other instruments related thereto), including in transactions which may be contrary to any recommendations contained herein. Bear Stearns and its employees may also have engaged in transactions with issuers identified herein. Bear Stearns is affiliated with a specialist that may make a market in the securities of the issuers referred to in this document, and such specialist may have a position (long or short) and may be on the opposite side of public orders in such securities.

This publication does not constitute an offer or solicitation of any transaction in any securities referred to herein. Any recommendation contained herein may not be suitable for all investors. Although the information contained in the subject report (not including disclosures contained herein) has been obtained from sources we believe to be reliable, the accuracy and completeness of such information and the opinions expressed herein cannot be guaranteed. This publication and any recommendation contained herein speak only as of the date hereof and are subject to change without notice. Bear Stearns and its affiliated companies and employees shall have no obligation to update or amend any information or opinion contained herein.

This publication is being furnished to you for informational purposes only and on the condition that it will not form the sole basis for any investment decision. Each investor must make their own determination of the appropriateness of an investment in any securities referred to herein based on the tax, or other considerations applicable to such investor and its own investment strategy. By virtue of this publication, neither Bear Stearns nor any of its employees, nor any data provider or any of its employees shall be responsible for any investment decision. This report may not be reproduced, distributed, or published without the prior consent of Bear Stearns.

This report may discuss numerous securities, some of which may not be qualified for sale in certain states and may therefore not be offered to investors in such states. This document should not be construed as providing investment services. Investing in non-U.S. securities including ADRs involves significant risks such as fluctuation of exchange rates that may have adverse effects on the value or price of income derived from the security. Securities of some foreign companies may be less liquid and prices more volatile than securities of U.S. companies. Securities of non-U.S. issuers may not be registered with or subject to Securities and Exchange Commission reporting requirements; therefore, information regarding such issuers may be limited.

NOTE TO ACCOUNT EXECUTIVES: For securities that are not listed on the NYSE, AMEX, or Nasdaq National Market System, check the Compliance page of the Bear Stearns Intranet site for State Blue Sky data prior to soliciting or accepting orders from clients.