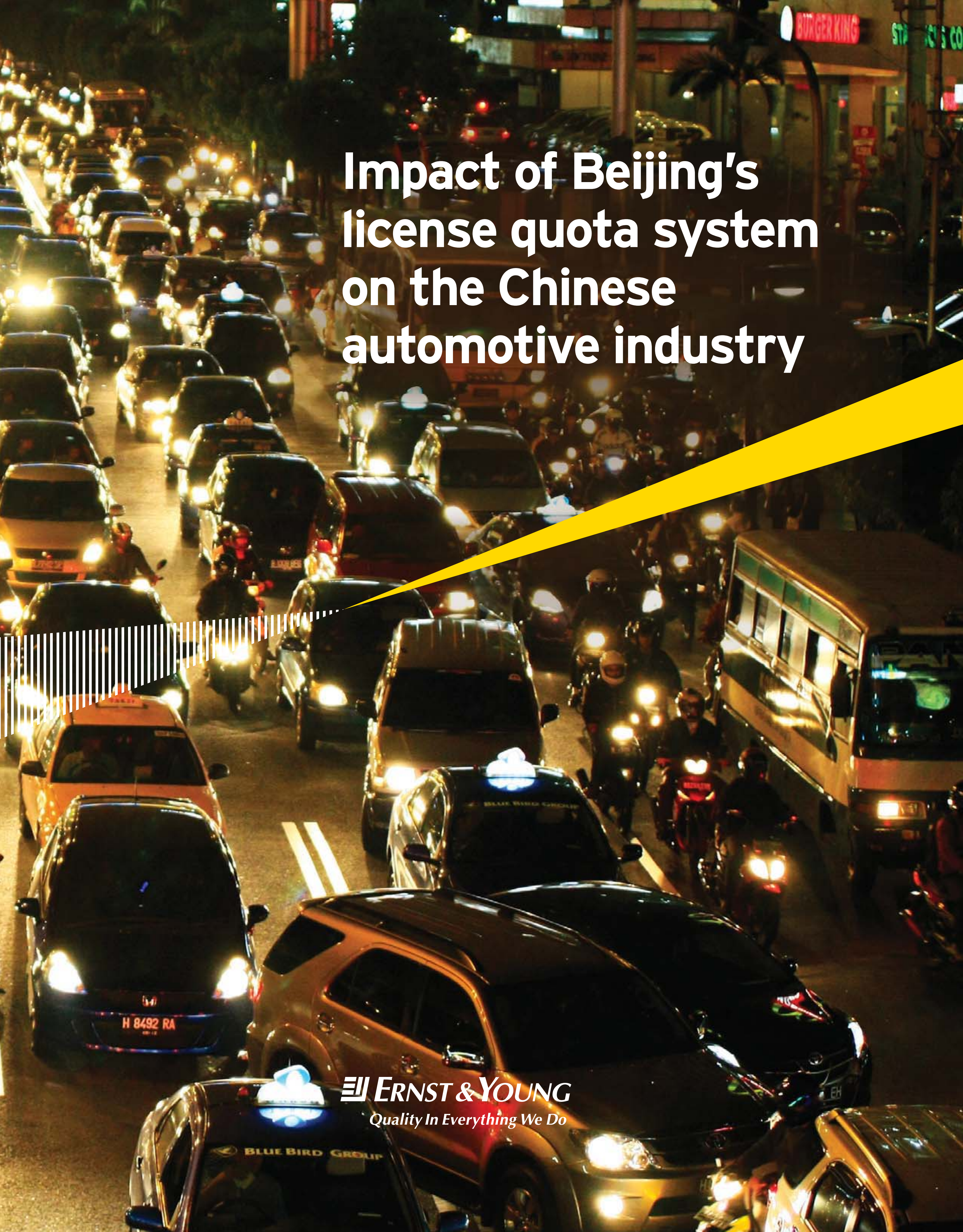
Impact of Beijing's license quota system on the Chinese automotive industry



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Background

Trigger event	**On 23 December 2010, Beijing's municipal government announced a package of new rules aimed at easing traffic gridlock and pollution:** ▸ Only 20,000 new license plates to be issued each month (240,000 in 2011) ▸ Ban vehicles registered outside Beijing from entering the city during rush hour ▸ Curbs on Government vehicle purchase programs ▸ Increases in parking fees, and limiting time in Beijing
Immediate implications	**While there is an agreement that the regulation will immediately impact new vehicle sales in Beijing, there is significant uncertainty regarding the wider implications of the restrictions on demand and also the wider auto industry in China.**
Critical issues	**This document aims to present facts and concisely analyze the following areas of uncertainty:** ▸ How will demand for vehicles evolve in Beijing? ▸ What are the implications for competition among OEMs – international and domestic – in Beijing as well as other parts of China? ▸ How do these restrictions fit in the broader automotive industry vision of the Chinese Government? ▸ What are the wider implications on the industry – manufacturing capacities, future of dealerships, used vehicles market?

Executive summary

Background	▸ Automotive market in China has effectively doubled in size over 2008 - 2010 – increasing challenges of excessive energy consumption, air pollution and traffic congestion ▸ Severe overcrowding and limited geographic coverage of the public transport system in Beijing gives commuters little option but to use personal vehicles to meet their mobility needs ▸ Beijing Government announced a new package of rules on 23 December 2010, aimed at easing traffic gridlock and congestion
Short-term impact	▸ Ernst & Young estimates license quota restriction likely to reduce 2011 car sales in Beijing by 43% to around 500,000 vehicles – first-time and additional car buyers significantly affected ▸ Local OEMs may risk being squeezed out of the Beijing car market as consumers choose global brands, and also weakening their brand image in lower-tier cities ▸ Global OEMs could well win market share in a smaller Beijing car market overall, however, significant pressure to compete with local OEMs in Tier 2 and Tier 3 Chinese cities ▸ Impact on dealerships – China Automobile Dealers Association estimates almost 50% of dealerships to leave Beijing, in particular, those recently established or focused on the low end of market or just single-brand dealers ▸ Used vehicle market in Beijing is expected to shrink significantly in 2011, with most cars being sold in neighboring regions ▸ Alternative mobility services in Beijing have an opportunity to innovate
Long-term impact	▸ China will continue to remain largest automotive market with growth rate cooling down to 10%-15% over the next decade according to Ernst & Young estimate ▸ While market holds organic growth potential to reach over 30 million vehicles by 2015 according to Ernst & Young observation, Chinese government envisions 25 million vehicles and will be driving consolidation in sector in the draft of 12th five-year plan ▸ Global OEMs will need to increase focus and competition with local OEMs in-lower tier cities

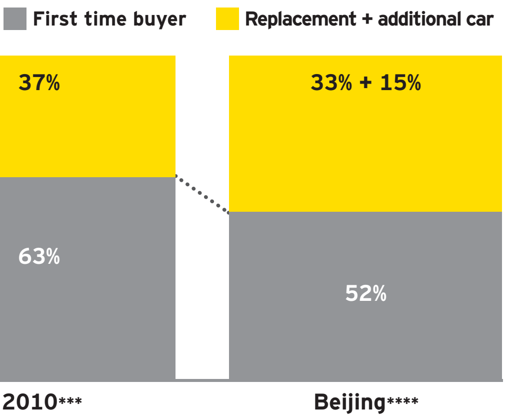
Beijing's licensing restrictions are likely to create significant challenges and opportunities for stakeholders across the automotive industry value chain.

Overall automotive industry	▸ Anticipated annual growth rate in vehicle sales to decline to 10% ▸ Without an export strategy, expected overcapacity may pose significant risk to industry ▸ Slowdown in growth likely to increase competitive pressures ▸ Consolidation across the sector likely to accelerate
Local Chinese OEMs	▸ Significant risk of losing share over the coming 1-2 years in Beijing and consequently negatively impacting brand image in other cities ▸ Pressing need to improve brand image in terms of quality and safety ▸ Opportunity to add export strategy, technical competence, scale, brand image and ensure capacity management
Global OEMs in China	▸ Increase presence in lower-tier cities in China that will drive most of future vehicle demand ▸ Need to further localize their R&D, product development for local consumers' needs and therefore compete with local OEMs in terms of price ▸ Need to cope with the consolidation trend and leverage local counterparties' cost structure to be competitive with the local OEMs
Dealerships	▸ Need to transform from a car seller to a service provider ▸ Need to form a dealer group or be bought out ▸ Implement more robust sales, incentives and management processes to ensure profitability
Suppliers	▸ Need to cope with their customers capacity reassessment and M&A activities ▸ Local suppliers must develop export strategies and diversify customer base to outside China

The automotive market in China has effectively doubled in size over 2008-2010, increasing challenges of excessive energy consumption, air pollution and traffic congestion.

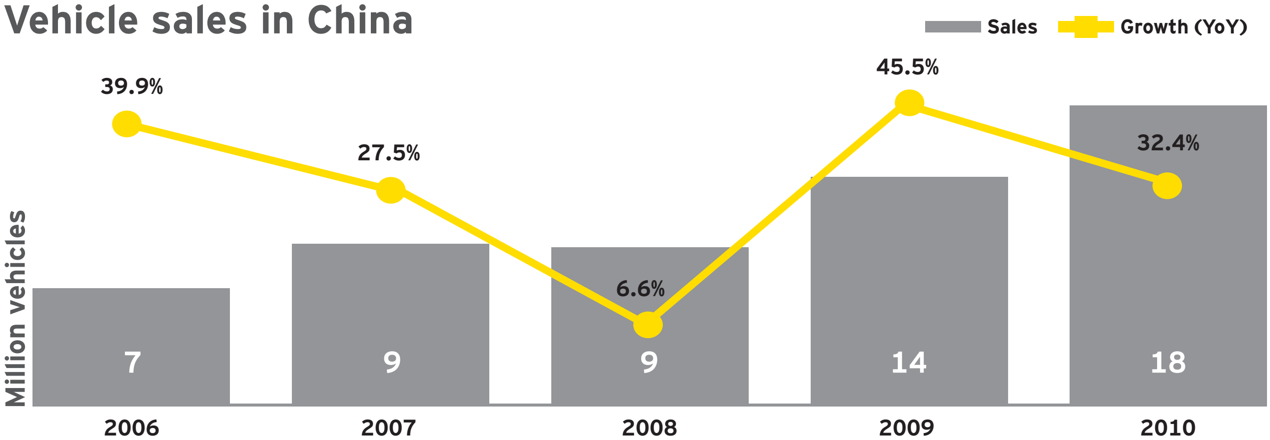
- Largest automotive market in the world for 2nd year according to China Association Of Automobile Manufacturers (CAAM)
- Only 52 cars per 1,000 people in China compared to 228 in Beijing and world average of 128
- China remains a first-time buyer market, however, replacement/additional car buyers growing – significant in Beijing
- Existing license plate number restriction in Beijing not considered effective owing to the growing number of new and additional car buyers

Mix of car buyers in China vs. Beijing



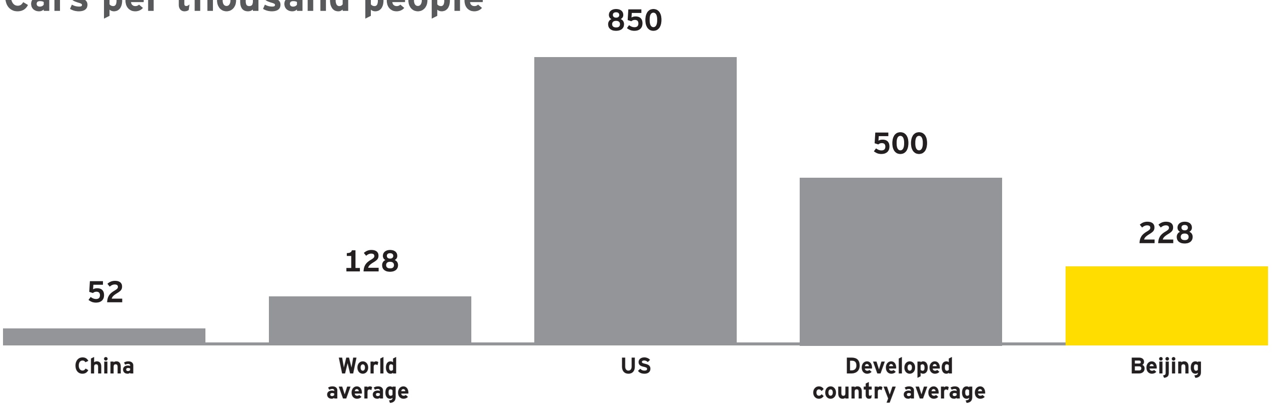
Source: *J.D. Power and Associates, **3.15 Car Annual Report in March 2009, ***ePanel, for top 11 cities in China, in January 2010, ****Beiya Auto Market, 1 of 4 largest used car markets in Beijing, in July 2009

Vehicle sales in China



Source: China Association of Automobile Manufacturers (CAAM)

Cars per thousand people



Source: the Ministry of Public Security (MPS), Ernst & Young calculation

Beijing Government announced new package of rules on 23 December 2010, aimed at easing traffic gridlock and congestion

- Number of new license plates issued to be limited to 20,000 a month (240,000 units in 2011) to ease gridlock
    - Plates will be randomly assigned to applicants via lottery, which will be held on the 26th day of each month
    - Individual car users will account for 88% of the 2011 license plate quota.
    - The new measures stipulate a driver may only register one car.
    - The license is attached to a name and ID card, and remains with the person, not the car. The used car buyer will also have to participate in the lottery system for a license plate.
    - Eligible individuals include local residency permit (hukou) holders and foreigners who have lived in the city for at least a year.
    - Residents without Beijing hukou must provide proof they have paid social security fees and income taxes for five consecutive years.
    - Anyone who provides false information will be banned from applying for three years and must assume legal responsibility.
- Vehicles registered outside Beijing banned from entering the city (within "5th Ring Road") during rush hour – aimed at stopping Beijing residents from purchasing cars in other regions to avoid the restrictions.
- Curbs on Government programs so that purchases will be flat for 5 years
- Increase in parking rates in Beijing and cap on parking time

Possible scenarios for extending scheme to other major cities: Annual sales growth rate over 2015-2020 in China could be reduced by 6%-14%, depending on the number of cities that follow Beijing's example according to Ernst & Young calculation

The Chinese government will aim to strike a balance between sustainable vehicle sales, congestion and pollution, but will not let the growth rate slip below 5%.

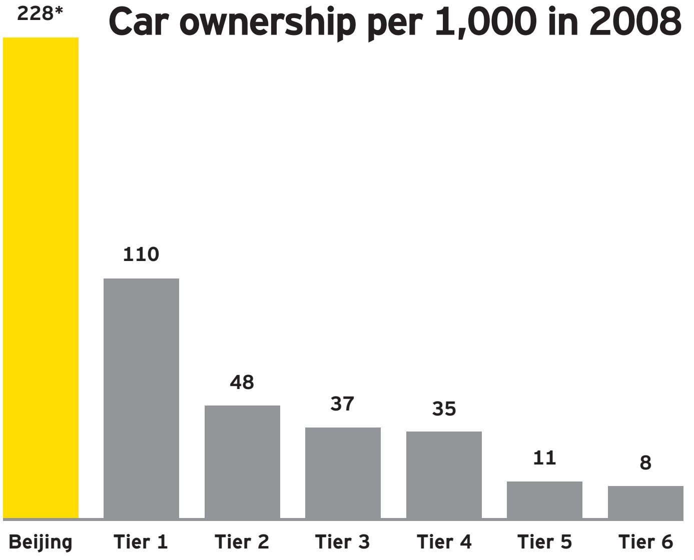
Optimistic scenario

- Unlikely for other major cites in China to follow Beijing quota system:
  - Vehicle density in other major cities is still low compared to Beijing: The average cars per 1,000 people for Tier 1 cities is only 110, comparing to 228 in Beijing.
  - Other cities will likely to implement a weekly one day usage restriction rule and restrict official car purchase and usage.
  - Guangdong recently confirmed they would not implement the quota system to avoid weakening buyer sentiments. Instead, they will restrict the use of official cars as reported by China Daily.

Balanced scenario

- Number of cities implement system within 3-5 years:
  - China's urbanization rate will reach above 50% in 2015: This implies 10 million people migrating to cities each year.
  - Improving public transportation, especially subway construction, and city re-planning take time and cannot keep pace with the increasing traffic flow.
  - Curbing ownership of vehicles will become the only option to ease congestion.

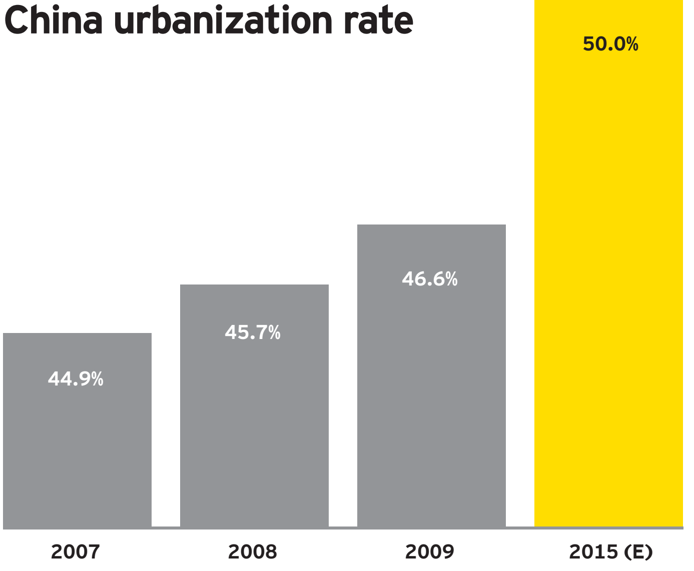
Car ownership per 1,000 in 2008



Note: *Beijing data is 2010

Source: State Information Centre (SIC) , 2008. Refer to Appendix 2 for cities classification in China

China urbanization rate



Source: National Bureau of Statistics (NBS)

Challenges and opportunities for stakeholders

Stakeholders	Challenges and opportunities
Overall automotive industry	▶ Anticipated annual growth rate in vehicle sales growth rate to decline to 10% ▶ Expected overcapacity without an export strategy may pose significant risk to industry ▶ Consolidation across the sector likely to accelerate ▶ Slowdown in growth likely to increase competitive pressures
Local OEMs in China	▶ Significant risk of losing share over the coming 1-2 years in Beijing and consequently negatively impacting brand image in other cities ▶ Need to move up the value chain with respect to quality and safety improvement ▶ Need to manage the M&A opportunity to add technical competence, scale, brand image and ensure capacity management ▶ Development of export markets and strategy
Global OEMs in China	▶ Increase presence in smaller cities and therefore compete with local OEMs ▶ Need to further localize their R&D, product development for local consumers' needs ▶ Need to cope with the consolidation trend and leverage on local counterparties' cost structure
Dealerships	▶ Need to transform from a car seller to a service provider ▶ Need to form a dealer group to be bought out ▶ Implement more robust sales, incentives and management processes to ensure profitability
Suppliers	▶ Need to cope with their customer's capacity reassessment and M&A activities ▶ Chinese suppliers must establish export strategies and diversify customer base to outside China
Mobility services	▶ Need to educate consumers on benefits of alternative mobility services ▶ Capitalize on demand for alternative mobility services such as car sharing

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