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Foreword

The Russian automotive industry is going through challenging times. The current macroeconomic situation has changed the auto market landscape and is holding back the recovery in auto sales. At the same time, the Russian market has high growth potential and in the next few years is expected to show signs of improvement, driven by stronger macroeconomic performance.

This report presents an analysis of the current state and future development of the Russian and CIS automotive industry. We believe it will successfully move away from stagnation to sustainable growth driven both by the commitment of most international players to develop business in Russia and by government support for the industry.

We would be glad to share with you our market expertise and assist you in meeting your business needs and identifying investment opportunities, and provide risk, operational and cost management advisory services.

Alexei Ivanov
Partner,
CIS Transaction Advisory
Services Leader

Andrey Tomyshev
Senior Manager,
Head of the CIS
Automotive Group
Executive summary and key findings

After a sharp rebound in 2010–11, the Russian automotive market slowed down in 2012 and has been facing a decline in sales since 2013 in the face of a weaker macroeconomic environment.

In 2016, sales of passenger cars and light commercial vehicles (LCVs) totaled 1.4 million units.

The forecasts suggest that the market may begin to recover in 2017, with passenger car sales growing to reach 2 million vehicles by 2020, and further growth to follow.

Key findings:

- Despite a significant drop in car sales during the crisis, we remain positive about the long-term prospects for the Russian auto market due to the population’s low level of vehicle ownership, the aging car fleet and major international players’ dedication to business development in Russia.
- In 2016, sales continued to decline along with real GDP, finally hitting the bottom. The share of domestic car brands continued to grow, with a decreasing share of imports.
- The market recovery may start in 2017, with passenger car sales growing to reach 2 million vehicles by 2020, and further growth to follow.
- The main drivers of growth will be the ruble exchange rate, oil prices, auto loans interest rates, the effectiveness of government support measures and the potential to reduce vehicle ownership costs.
- Russia still has a lower auto loan penetration rate than the western countries. However, a gradual decrease in the CBR’s key interest rate, the growing role of automakers’ captive banks and the overall recovery of consumer lending will ramp up the share of credit in car sales and boost growth in the automotive market.
- The crisis has forced some dealers to exit the market or close dealership centers. This trend is largely explained by lowering margins due to weak business diversification and high levels of debt. It is also accompanied by industry consolidation and an increase in the market share of major players. To maintain their business for the long term, dealers need to transform the business model and better diversify their products and services, as well as invest in areas of the business such as the sale of used vehicles and financial products.
- The commercial vehicle market has been largely captured by Russian players, who increased their share during the crisis. The truck market is more sensitive to economic downturns than the passenger car fleet, although it can recover more quickly in the future.
- Our positive outlook for the Russian bus market is based on the considerable age of vehicles used for passenger transportation, as well as government support.
- International OEMs continue to localize their production, although the process is being largely hindered by the lack of a high-quality pool of second-tier (and lower) suppliers. This can be addressed by targeted government support for Russian companies, consolidation of their production facilities, and cooperation with foreign players to gain access to advanced technologies.
- The secondary market for automotive components and spare parts has declined more slowly than the automotive market, backed by the growth of the vehicle fleet even during the crisis.
- The other CIS markets have declined due to a weaker macroeconomic environment and devaluation of the national currencies. Ukraine saw the highest volume of cars sold in 2016, while Uzbekistan remained the largest automotive producer.
## Key considerations

<table>
<thead>
<tr>
<th><strong>Key issues</strong></th>
<th><strong>Manufacturers</strong></th>
<th><strong>Suppliers</strong></th>
<th><strong>Retail and distribution</strong></th>
</tr>
</thead>
</table>
| **How will demand for vehicles and mobility evolve?** | - Focus on vehicle ownership costs  
- Take advantage of modern information technology and telematics | - Cooperate with market entrants and expand geographically  
- Help build capabilities in the auto component industry  
- Satisfy the demand for basic goods that meet automotive standards  
- Take advantage of opportunities in the after-sales segment | - Align the car brand portfolio with the current macroeconomic environment and the trend toward localized production  
- Be flexible with manufacturers and be capable of quickly switching from one car brand to another  
- Encourage manufacturers to develop more offerings using modern information technology and telematics |
| **How will products need to adapt?** | - Implement changes to meet the needs of end consumers and the conditions in which the vehicles are to be used  
- Focus on the subcompact, premium and SUV segments | - Analyze factors that have the most potential, such as efficiency, emission reduction, fuel efficiency or safety technologies  
- Develop low-cost products with consumer qualities required in a certain region | - Maintain a balance between selling vehicles and related service packages  
- Develop and maintain communication mechanisms to retain customers’ loyalty |
| **How will business models need to adapt?** | - Enhance marketing activities to promote brand recognition  
- Cooperate with new players in order to leverage their technology and experience  
- Optimize the portfolio, expand into the CIS and non-CIS markets | - Incorporate sustainability into the core business strategy for long-term revenue growth | - Develop sales techniques and marketing strategy using social media and the Internet  
- Diversify business to reduce the risk of a decline in consumer demand (trade in used cars, sale of used cars on a commission basis, sale of insurance policies, loans and other products)  
- Analyze the cumulative profit margin over the vehicle’s life-cycle as a tool for managing the business  
- Expand through M&A |
| **What are the new market dynamics?** | - Strengthen positioning of the manufacturers’ captive banks  
- Actively develop and implement telematics solutions | - Form strategic alliances with car manufacturers to enhance cooperation at the advanced phase of the R&D process | - Consider a multi-brand retail and distribution strategy  
- Develop new areas of business and new ways of winning customers, such as taxi services, automotive logistics and operating leases |
| **What are the value chain issues and implications?** | - Monitor compliance with localization programs and requirements  
- Monitor changes in tax and customs legislation | - Use enterprise management systems that enable transparency of cooperation across the supply chain  
- Leverage special economic zones (SEZs) for new production facilities  
- Develop the second-tier (and lower) supplier segment to ensure proper localization and establish a complete value chain | - Evaluate the distribution footprint and opportunities to expand into regions with high growth potential |
In 2015, Russia’s real GDP fell by 3.7% under the pressure of economic restrictions and plunging oil prices. All sectors of the Russian economy were largely affected by external factors, as a result of which the industrial production index declined by 4.5% and purchasing power dropped on the back of lower real disposable income.

The decline in Russian GDP slowed to 0.6% in 2016 and an economic recovery is expected in 2017.

Russian economic indicators were largely affected by the restrictions, coupled with the sudden drop in oil prices. This severely weakened the Russian ruble and increased the cost of borrowing. On the positive side, the new economic reality made Russian assets more attractive to potential investors. In the coming years, foreign direct investment is expected to surge. Russia’s long-term investment attractiveness depends heavily on developing the legislative framework and reducing government involvement in the economy, as well as introducing new technologies in production and management.

Consensus forecasts of nominal and real GDP growth in Russia

Sources: MED, EIU, Oxford Economics, World Bank, CEEMEA, IMF, EY analysis, the Development Center of the Higher School of Economics

*F – Forecast
### Projected key macroeconomic indicators

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, million</td>
<td>143.2</td>
<td>143.3</td>
<td>143.4</td>
<td>146.3</td>
<td>146.4</td>
<td>146.7</td>
<td>147.0</td>
<td>147.2</td>
</tr>
<tr>
<td>Real GDP growth, %</td>
<td>4.3%</td>
<td>3.4%</td>
<td>1.3%</td>
<td>0.5%</td>
<td>-3.7%</td>
<td>-0.6%</td>
<td>1.0</td>
<td>1.5%</td>
</tr>
<tr>
<td>GDP per capita, US$</td>
<td>14,177</td>
<td>15,016</td>
<td>15,537</td>
<td>14,276</td>
<td>9,279</td>
<td>8,853</td>
<td>10,294</td>
<td>11,140</td>
</tr>
<tr>
<td>Inflation, %</td>
<td>8.4%</td>
<td>5.1%</td>
<td>6.8%</td>
<td>7.8%</td>
<td>15.5%</td>
<td>7.1%</td>
<td>5.1%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Industrial Production Index, %</td>
<td>5.0%</td>
<td>3.4%</td>
<td>0.4%</td>
<td>1.7%</td>
<td>-4.5%</td>
<td>0.4%</td>
<td>1.1%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Brent crude oil price, US$ per barrel</td>
<td>110.9</td>
<td>112.0</td>
<td>108.9</td>
<td>98.9</td>
<td>52.7</td>
<td>44.1</td>
<td>52.9</td>
<td>56.6</td>
</tr>
<tr>
<td>Unemployment rate among economically active population (annual average), %</td>
<td>6.5%</td>
<td>5.5%</td>
<td>5.5%</td>
<td>5.2%</td>
<td>5.6%</td>
<td>5.9%</td>
<td>5.9%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Exchange rate RUB/US$ (annual average)</td>
<td>29.4</td>
<td>30.8</td>
<td>31.8</td>
<td>38.4</td>
<td>60.9</td>
<td>66.8</td>
<td>62.5</td>
<td>63.1</td>
</tr>
<tr>
<td>Exchange rate RUB/€ (annual average)</td>
<td>40.9</td>
<td>39.6</td>
<td>42.3</td>
<td>51.0</td>
<td>67.5</td>
<td>74.1</td>
<td>66.1</td>
<td>66.9</td>
</tr>
</tbody>
</table>

Sources: BMI, MED, EIU, Oxford Economics EIA, Bloomberg, EY analysis, CEEMEA, the Development Center of the Higher School of Economics

\*F - Forecast
Current state of the global automotive market

Over the past decade, sales of passenger cars and light commercial vehicles (LCVs) have grown by approximately 30%. In 2008 through 2013, this growth was largely driven by emerging markets, whereas today it is accelerated by Western Europe, China and India.

In 2015, the global passenger car and LCV market grew by 2%, followed by a further increase in 2016 of 4% to reach 92.8 million units, primarily due to increased sales in China (10.8%), India (7.3%), and Western Europe (6.3%). This growth was sparked by the drop in oil and fuel prices, economic revival in the West European markets after the Eurozone debt crisis, the continued urbanization and rising vehicle ownership rate in China (especially in small towns), and accelerated economic growth.

In 2016, sales in the US remained flat, whereas in Eastern Europe and Latin America they dropped by 1.8% and 11.5%, respectively. This trend is attributed to a lingering economic slowdown or downturn in the major economies of Latin America (Brazil and Argentina), as well as the recession and depreciation of local currencies in Russia and other countries under the pressure of low world oil prices and economic restrictions.
Industry growth prospects

World car sales are set to rise in the near future, largely as a result of the rebounding markets in Eastern Europe and Latin America and significantly stronger demand in India. In 2017, worldwide sales of passenger cars and LCVs are forecast to rise to 94 million units, up 1.33% from 2016. The weaker growth is attributed to a temporary slowdown of demand in China.

The surge in global demand for vehicles will be fueled by low oil prices, resulting in an estimated sales rise of another 5–7 million units in the years between 2017 and 2022.

The Eurozone economy has largely become accustomed to the UK’s determination to exit the EU, although there is still no agreement on the terms of the exit. The uncertainty will continue to affect business decisions in the coming years, giving rise to a potential risk of stagnation in the automotive market in both the UK and the Eurozone in the event of a ‘hard’ Brexit.

In the short and medium term, the currently underpenetrated Indian auto market will become a major contributor to global demand growth, driven by an improving national economy and increased consumer spending.

The automotive industry in highly developed countries, such as Japan, South Korea and Australia, has no significant growth potential. Moreover, with Japan’s population shrinking and aging, automobile demand may be in a downtrend.

Growth in the Russian automotive market will be underpinned by economic recovery and higher purchasing power.

Building infrastructure for the growing vehicle fleet is becoming a key challenge for developing countries. China is still facing the risks of economic slowdown and tighter limits on car ownership in big cities. The developed markets are primarily trying to renew the car fleet and are more dependent on consumer preferences.

Apart from stimulating demand, the drop in oil prices may lead to some changes in the market structure. Lower vehicle ownership costs will encourage consumers to switch to larger cars. At the same time, the sales growth in electric vehicles and lightweight materials is expected to slow.
Russia in the context of the global automotive industry

After breaking the 2008 record in 2012, passenger car and LCV sales in Russia have been sliding since 2013 as a result of the deteriorating macroeconomic situation.

In 2015, car sales were down 36% according to AEB statistics, due to the economic decline, sharp devaluation of the Russian ruble, growing loan rates, falling real household disposable income and depressed consumer sentiment. The decline slowed in 2016, to 11% year-on-year. Car prices grew 40% on average between 2014 and 2016, while sales of passenger cars and LCVs almost reached their 10-year low (1.4 million units) in 2016.

Russia’s auto market ranked fifth in Europe in 2016 after Germany, the UK, France and Italy. In the long term, however, Russia will remain one of the most attractive markets.

Its growth will be largely driven by the population’s low level of vehicle ownership and the aging car fleet. In 2016 passenger car density in Russia was 358 units per 1,000 adults, which is 42% lower than in Western Europe (615 units) and 55% lower than in North America (776 units).

The average age of a passenger car in Russia is 12 years (there have been no significant changes in this since 2012), with foreign vehicles being on average much younger than local ones (10 years versus 16 years). The car fleet’s age structure reveals the need to replace obsolete and worn out vehicles.

The market potential is also underpinned by the fact that foreign companies are carrying on with their plans to expand local production capacity, including the development of new plants and production of auto components. Though plunging sales suspended the output of certain brands and models, as well as triggering lower capacity utilization rates, companies that have localized their production do not intend to abandon their business development plans. The major exception is General Motors, which has stopped assembling Chevrolet and Opel and mothballed its St. Petersburg plant indefinitely. A number of new market players, including those from China, are working on their plans to enter the Russian market.

The following facts show that the market has strong potential:

- Almost 20 major local and international manufacturers operating in Russia
- Annual capacity of over 3 million cars, with prospects to increase by 2020
- Nearly 100 localized global suppliers, many of which have several production sites
- About 600 local suppliers servicing Russian assembly lines
- Passenger cars sold through some 4,000 dealers.
Russian automotive manufacturers are looking to substantially increase their exports, partially as an alternative to the shrinking domestic market.

Growth in the domestic automotive industry is supported by government policies aimed at creating new, and expanding existing, production facilities, as well as attracting additional investment to the industry.

The government significantly increased its support to the industry in 2015-16. The 2013 program for subsidizing car loan interest rates and the 2014 vehicle scrappage program were both resumed in 2015-16, and supplemented by car leasing subsidies as well as direct subsidies for vehicle procurement by public sector entities.

The government has voiced its willingness to maintain its substantial support for the industry in the future. It has announced that the program for subsidizing car loan interest rates and leasing will continue in 2017, and there is a plan to complement these with new programs aiming to subsidize demand among certain groups of consumers, such as first-time car buyers, buyers of family cars, and others. Export support measures will be enhanced.
Passenger car and light commercial vehicle (LCV) market

Sales of new passenger cars and LCVs decreased by 35.7% and 11.0% in 2015 and 2016, respectively, according to AEB statistics.

The slump in sales was primarily caused by the devaluation of the Russian ruble, more expensive car loans, lower business activity and purchasing power, as well as the turbulent geopolitical situation. Ruble devaluation has reduced car prices denominated in foreign currency and encouraged exports of cars by cross-border consumers (mostly from CIS countries) who purchased them from Russian dealerships. As a result, the number of cars registered in Russia in 2015-16 was lower than the number of cars sold to dealerships. The difference amounted to 0.2 million cars in 2015, narrowing to 0.1 million in 2016 as prices adjusted to the ruble devaluation. Once prices fully adjust to the devaluation over time, sales to dealerships should almost match the number of registered cars.

Sales of new passenger cars and LCVs in Russia, 2012-16

<table>
<thead>
<tr>
<th>Year</th>
<th>LCVs (Thousand units)</th>
<th>Passenger cars (Thousand units)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>2,734</td>
<td>205</td>
</tr>
<tr>
<td>2013</td>
<td>2,584</td>
<td>193</td>
</tr>
<tr>
<td>2014</td>
<td>2,316</td>
<td>175</td>
</tr>
<tr>
<td>2015</td>
<td>1,482</td>
<td>119</td>
</tr>
<tr>
<td>2016</td>
<td>1,308</td>
<td>118</td>
</tr>
</tbody>
</table>

Sources: AEB, LMC Automotive
Analysis of passenger cars and LCVs by brand indicates that Russian and localized foreign brands dominate the market, with their share increasing 5 percentage points in 2015-16. This was achieved due to the price advantage of automakers with production facilities in Russia, able to adopt a more flexible pricing policy in response to ruble devaluation.

At the same time, sales of Russian brands as a share of the total fleet are declining, since obsolete LADA, Izh and Moskvich models are no longer in production and are being replaced by lower-priced foreign brand vehicles. This trend is building up as more foreign companies develop localized production and new lower-priced foreign subcompact and compact SUVs come on the market.

The share of premium brands is set to grow. This shift in demand is due to the smaller share of cars in the aggregate spend of people who buy premium cars. Against a backdrop of declining purchasing power, premium car owners can maintain absolute levels of car running costs similar to their pre-crisis level for longer than other car owners. Those sales were further fueled by the conversion of ruble savings into foreign currency assets, including into luxury vehicles, and more brands from premium manufacturers coming on to the market. However, the share of premium brands in the structure of total vehicle sales in Russia remains modest, accounting for only 10% of the market, which is far behind the comparable figures for developed countries. For example, in Europe the premium segment captured 19% of the market in 2016. Given the above, the share of premium brands is likely to keep growing in the long term.
Production and market balance

According to LMC, Russia produced 1,125,000 passenger cars and 106,000 LCVs in 2016. Capacity utilization decreased along with demand and exports, according to customs statistics, forcing companies to focus on cutting costs and enhancing business processes. According to official statistics from the Federal Customs Service (FCS), exports of passenger cars amounted to 133,000 units in 2014, dropping to 100,000 units in 2015. The estimate of exports for 2016 is 66,400 units. Key reasons that caused auto manufacturers to reduce their exports include dwindling purchasing power in CIS countries and the introduction of a recycling levy in Kazakhstan in 2016.

Share of premium brands in total sales

Despite the downturn, foreign automotive companies are not leaving the Russian market and some auto manufacturers are planning to build new auto plants:

- Haval is building a plant with an annual capacity of 150,000 vehicles in the Tula region, which is scheduled for commissioning in 2018.
- Lifan is planning to launch the construction of a plant with an annual capacity of 60,000 vehicles in the Lipetsk region in 2017.
- Mercedes-Benz is planning to build a new plant with an annual capacity of 25,000 vehicles in the Moscow region by 2019.

Car manufacturers are building their supply chains on a global level by setting up production facilities in different countries, taking into account proximity both to the outlet market and to raw materials. Russia’s geographical position offers both of these advantages, making it possible to manufacture for the local market and increase exports by leveraging local resources and ruble devaluation.

Russian manufacturers are looking to boost their exports too by increasing their assembly capacity and partnering with foreign distributors. The initiative has strong government support, including subsidized product transportation, adaptation and certification for export markets. There is also a plan to provide government support for setting up warehouse and service facilities abroad.

Government agencies estimate that Russia’s car export potential may grow to 200,000-300,000 units per year by 2020.

Automotive market development prospects

When it comes to market development prospects, the year 2017 may see an upturn in market activity if the base case scenario holds up owing to an overall economic recovery. Our forecast is that Russian brands and localized foreign brands will capture the largest market share.

Future sales of vehicles will depend on the following factors:

- Movements in the exchange rate of the Russian ruble, oil prices and real household disposable income
- Access to auto loans, and interest rates
- The volume and effectiveness of government support measures
- The expansion of transport infrastructure and potential savings on vehicle ownership costs
- The localization rate of the auto companies, which impacts the cost and prices.

The market recovery will be driven by significant deferred demand that has accumulated since the beginning of the market decline in 2013.

Sources: LMC Automotive, EY analysis

1 The annualized amount, derived by multiplying the actual amount of export sales for January–November 2016 by 12/11

Actual and projected sales volumes of passenger cars and LCVs in Russia

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Registrations</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>2.8</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>1.6</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>2017F*</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>2018F*</td>
<td>1.5</td>
<td></td>
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<td>2019F*</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>2020F*</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>2021F*</td>
<td>2.2</td>
<td></td>
</tr>
</tbody>
</table>

Sources: AEB, AUTOSTAT analytic agency, LMC Automotive, EY analysis

* F – Forecast

Fleet of passenger cars and LCVs in Russia

<table>
<thead>
<tr>
<th>Year</th>
<th>Million units</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>40.6</td>
</tr>
<tr>
<td>2013</td>
<td>43.1</td>
</tr>
<tr>
<td>2014</td>
<td>44.8</td>
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<tr>
<td>2015</td>
<td>45.5</td>
</tr>
<tr>
<td>2016</td>
<td>46.0</td>
</tr>
<tr>
<td>2017F*</td>
<td>46.6</td>
</tr>
<tr>
<td>2018F*</td>
<td>47.3</td>
</tr>
<tr>
<td>2019F*</td>
<td>48.3</td>
</tr>
<tr>
<td>2020F*</td>
<td>49.5</td>
</tr>
</tbody>
</table>

Sources: AEB, AUTOSTAT analytic agency, LMC Automotive, EY analysis

* F – Forecast

The used car segment appears to be one of the most promising, since its decline has been slower than that of the new car market. This segment shrank from 6.9 million units in 2014 to 5.7 million units in 2015 and, further, to 5.3 million units (6.2%) in 2016. The coming years will see the segment grow due to the average length of car ownership decreasing following the recovery from the crisis, meaning that there will be a higher supply of used cars, including, in particular, a higher proportion of cars under five years old.

Government support

The government is planning to maintain substantial spending on subsidizing car demand in 2017 by extending the programs for subsidizing both car loan interest rates and leasing, as well as by launching new programs that target certain groups of consumers: “My First Car”, “Family Car”, etc. The total spending approved by the government to support the automotive industry in 2017 is RUB 60 billion.

However, direct subsidizing of demand does not address the fundamental drawbacks in the industry that arise from excessive capacity, low localization, and a persistent quality gap between domestic and foreign products, including automotive components. The industry support program is therefore being designed to include extra measures to build up exports, develop the supplier base, promote R&D, and secure technological independence.

The development of the automotive industry will also stand to gain from reducing the tax burden on motorists, enhancing transport infrastructure, and taking other measures to reduce ownership costs. At the same time, it is crucial to develop capacity for collection and scrappage of old fleet in order to trigger its renewal.

Approved measures to support the automotive market in 2017

<table>
<thead>
<tr>
<th>Description</th>
<th>Maximum amount of financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidies for organizations to partially reimburse costs related to the production of wheeled vehicles</td>
<td>RUB 17.5 billion</td>
</tr>
<tr>
<td>Subsidies for organizations that operate in the auto manufacturing industry to partially reimburse interest costs</td>
<td>RUB 7.4 billion</td>
</tr>
<tr>
<td>Programs “My First Car”, “Family Car”, “Russian Truck”, “Russian Farmer”, “My Own Business”; programs to support sales of natural gas-powered vehicles and electric vehicles for urban public transport, and purchases of school buses and ambulances</td>
<td>RUB 17.4 billion</td>
</tr>
<tr>
<td>Subsidizing interest rates on car loans</td>
<td>RUB 10.0 billion*</td>
</tr>
<tr>
<td>Subsidizing the lease of wheeled vehicles</td>
<td>RUB 10.0 billion</td>
</tr>
<tr>
<td>Total</td>
<td>RUB 62.3 billion</td>
</tr>
</tbody>
</table>

Source: Government of the Russian Federation

* Including RUB 7.0 billion for loans issued in previous years

It should be noted that if the conservative scenario holds true and stagnation of the economy continues, sales may decline in 2017, causing a slower market recovery.
Truck market

Truck sales depend on the number of current investment projects in the oil & gas and other major buying industries, commercial freight volumes, as well as wholesale and retail turnover.

The medium- and heavy-duty truck market is far more exposed to the negative economic trends than the passenger car and LCV market, due to the susceptibility of the end-buyer companies’ investment programs to the crisis, significantly reduced freight traffic and limited access to debt financing for new investment and infrastructure projects.

In 2012-15, truck sales fell by 53% versus a 46% drop in sales of passenger cars and LCVs. 2016 marked the beginning of a recovery in the truck market, despite the shrinking passenger car and LCV market.

The downturn is pushing demand towards Russian truck brands due to their price advantage, extensively localized production and a higher

New medium- and heavy-duty truck sales in Russia by brand, %

Sources: LMC Automotive, EY analysis

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1 Medium- and heavy-duty trucks are vehicles with gross vehicle weight rating (GVWR) of over 6 tons
resilience of their costs and prices to ruble devaluation. The Russian companies’ price advantage is further enhanced by the fact that they receive the majority of the government support. In addition, long-term relationships with Russian metals companies and significant purchase volumes give domestic manufacturers the benefit of better prices for raw materials. In the short term, the truck market will feel the pressure of uncertainty over oil’s upward trajectory and the freezing of investment projects in the oil & gas and related sectors. The market recovery may gain momentum from the need to replace obsolete vehicles and purchase new ones in order to satisfy pent-up demand and re-launch investment projects that were shelved.

Along with the rebound in the freight sector and investment inflows, long-term market growth will be driven by the following factors:

- The insufficient fleet of reliable trucks for long-haul freight transportation
- The development of fleet management and operating lease services, especially in the foreign brand segment (this process will accompany the improvement in road quality, as well as the enhancement of transport and telecommunications infrastructure)
- The gradual development of a dealership and service network in the foreign brand segment, which will stimulate growth in both sales and the number of serviced vehicles.

Medium- and heavy-duty truck sales in Russia by origin, %

<table>
<thead>
<tr>
<th>Year</th>
<th>Russian brands</th>
<th>Foreign brands</th>
<th>Localized foreign brands</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>130</td>
<td>92</td>
<td>88</td>
</tr>
<tr>
<td>2013</td>
<td>109</td>
<td>80</td>
<td>69</td>
</tr>
<tr>
<td>2014</td>
<td>88</td>
<td>61</td>
<td>57</td>
</tr>
<tr>
<td>2015</td>
<td>80</td>
<td>71</td>
<td>64</td>
</tr>
<tr>
<td>2016</td>
<td>76</td>
<td>70</td>
<td>77</td>
</tr>
<tr>
<td>2017F</td>
<td>86</td>
<td>99</td>
<td>88</td>
</tr>
<tr>
<td>2018F</td>
<td>88</td>
<td>111</td>
<td>98</td>
</tr>
<tr>
<td>2019F</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2020F</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: LMC Automotive, EY analysis

Historical and projected sales of trucks in Russia

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales (1000 units)</th>
<th>Production (1000 units)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>130</td>
<td>92</td>
</tr>
<tr>
<td>2013</td>
<td>109</td>
<td>80</td>
</tr>
<tr>
<td>2014</td>
<td>88</td>
<td>61</td>
</tr>
<tr>
<td>2015</td>
<td>80</td>
<td>71</td>
</tr>
<tr>
<td>2016</td>
<td>76</td>
<td>70</td>
</tr>
<tr>
<td>2017F</td>
<td>86</td>
<td>99</td>
</tr>
<tr>
<td>2018F</td>
<td>88</td>
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</tr>
<tr>
<td>2019F</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2020F</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: LMC Automotive, EY analysis

* F – Forecast
In Russia, most buses are purchased by municipal bus fleets. The economic crisis forced municipalities to significantly revise their budgets, which depressed the demand for buses and their production volume.

Similar to the light vehicle and truck markets, Russian bus brands increased their share of the market in 2015. In the long term, apart from general economic factors, the recovery in bus sales will be driven by the need to replace obsolete fleet. The average age of buses in Russia is over 15 years. Furthermore, the majority of older buses in the fleet are Russian brands.
Localization and production of automotive components

Localization is required in order to minimize currency risks and to cut down logistics costs at different supply chain levels.

Localization processes are regulated by the industrial assembly regime and are stimulated by the import benefits granted when localization increases. The number of M&A deals and joint ventures on the automotive component market has been on the rise since 2013 due to new contract commitments.

At the same time, the actual localization rate has come short of expectations, mainly due to the lack of local suppliers complying with international requirements for costs, quality and technology. The current situation suggests that 90% of the 600 Russian suppliers will have to terminate their business in the foreseeable future unless they obtain immediate government support or assistance from foreign partners. The most underperforming segments include the production of complex components, i.e. transmissions, engines and electronics, which realistically can only be developed in cooperation with foreign manufacturers.

Only a few Russian suppliers are able to compete as they are. Others need foreign partners to survive (through mergers, license agreements or joint ventures), in which case they would provide tangible assets (land, buildings, communications) and access to their customer base in Russia, while their foreign partners would provide technology. For most suppliers, the only opportunity lies in descending to the second or lower tier and consolidating their facilities to generate economies of scale.

Turning to operating efficiency, the greatest effect may be achieved by upgrading the basic production types (casting, stamping, mechanical processing), and using numeric control machines and high performance machinery. They also need to introduce state-of-the-art management disciplines, improve supply chain and working capital management (the “Just-in-Time” system) and consolidate the production facilities of medium-size suppliers to generate economies of scale.
Secondary market for automotive components and spare parts

The downward trend on the secondary market for spare parts is less apparent compared with both car sales and the primary market for automotive components, largely due to the rising number of motor vehicles. The decline is being driven by the diminished purchasing power and increased mileage, as well as by savings through extending the service life of spare parts.

The share of Russian brand spare parts has decreased to one-third of the total market, mirroring the changes in the car fleet structure.

Tires, suspensions, brakes and steering components dominate the Russian market due to the poor road surface and aging car fleet, which is not the case for Europe where tires and oils are predominantly in demand. In Russia, nearly half of the expenses incurred during the first three years of using a car are on oils, liquids, filters and other consumables.

Original spare parts comprise only 20%-30% of the total sales due to the availability of cheaper non-original parts and counterfeit products, notably in the fast wearing parts segment.

More than 70%-80% of the components are sold in Russia through retail stores and spare parts markets, which stands in stark contrast to Europe where this figure barely reaches 20%. The rest is sold through authorized dealerships and independent service centers.

Practically all secondary market segments are dominated by imports, except for tires, since tire manufacturers are actively localizing production and developing exports on the back of the ruble devaluation. It seems likely that this trend will persist in the foreseeable future since there is no information on whether foreign players have any significant construction plans, while the quality of local products remains low.

The position of Russian automotive component suppliers

- Around only 10 suppliers are able to compete as they are.
- 35-60 suppliers need partners, joint ventures, license agreements or to sale their business.
- Consolidation is possible within limited product groups.
- More than 500 suppliers should descend to another tier or leave the market.
- This segment has the highest potential for business consolidation.

Source: EY analysis
Overview of the Russian and CIS automotive industry

Structure of the Russian secondary market broken down by spare parts origin

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original parts</td>
<td>20–30%</td>
</tr>
<tr>
<td>Non-original parts (replica)</td>
<td>40–60%</td>
</tr>
<tr>
<td>Counterfeit products</td>
<td>20–30%</td>
</tr>
</tbody>
</table>

Source: EY analysis

Russian secondary market for automotive components

<table>
<thead>
<tr>
<th>Year</th>
<th>Other components</th>
<th>Suspension components</th>
<th>Brake components</th>
<th>Oil and lubricants</th>
<th>Tires</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>368</td>
<td>104</td>
<td>57</td>
<td>9</td>
<td>65</td>
</tr>
<tr>
<td>2011</td>
<td>511</td>
<td>116</td>
<td>57</td>
<td>9</td>
<td>65</td>
</tr>
<tr>
<td>2012</td>
<td>1,011</td>
<td>123</td>
<td>60</td>
<td>9</td>
<td>72</td>
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<tr>
<td>2013</td>
<td>1,091</td>
<td>123</td>
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<td>9</td>
<td>127</td>
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<td>107</td>
<td>54</td>
<td>9</td>
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<tr>
<td>2015</td>
<td>1,056</td>
<td>105</td>
<td>52</td>
<td>9</td>
<td>74</td>
</tr>
<tr>
<td>2016E*</td>
<td>1,110</td>
<td>116</td>
<td>57</td>
<td>9</td>
<td>76</td>
</tr>
</tbody>
</table>

Sources: AUTOSTAT analytic agency, EY estimates

* E – Estimate
Dealership networks

Currently the number of dealership centers is on a downward slope, falling from 4,500 to 4,000 in 2016. This is largely explained by lower margins owing to weak business diversification, high levels of debt and increased bankruptcy risks.

For many years, sales of new cars have been the key source of dealers’ income, whereas in the western market revenue is generated mainly from the sales of used vehicles, maintenance and after-sales services. Putting this into perspective, the share of used cars sold through dealership networks in Russia is roughly 10%, while in the UK this figure stands at around 40% and in some West European countries it is nearly 50%. In Russia, authorized dealerships mostly service new vehicles under three years of age and still under warranty, whereas in Germany almost 50% of vehicles under the age of eight are serviced by authorized dealers.

Comparison of the number of dealers and passenger cars and LCVs sold in Russia

Sources: AutoBusinessReview, AEB, EY analysis
During the downturn, some companies were unable to find funds to service loans that they raised in order to expand their business before the ruble devaluation, hence their new facilities have actually become an additional burden. According to the survey of auto dealers performed by EY in cooperation with the Association of Russian Automotive Dealers (ROAD), 57% of respondents in 2015 faced a debt/EBITDA ratio between 3 and 5x, while for 22% of respondents this ratio exceeded 5x. More than half of dealers were in negotiations over their debt servicing terms with creditors.

At the same time, some large companies are opening new centers and increasing their market share by purchasing vacated ones, which is driving industry consolidation.

A comparison of Russia and western countries shows a relatively low penetration rate of dealership centers: there are only 34 dealers per 1 million adults against 80-120 dealers in Western Europe. This means that the market has growth potential that will be stimulated by the rebound of the economy and the automotive market, an increase in the size of the fleet and the higher vehicle-to-population ratio.

In the long term, an increase in GDP per capita and number of vehicles in the fleet will not be sufficient to achieve the level of western countries. That would also require a transformation of the business model. It will be necessary to diversify products and services, invest in sales of used vehicles, and promote the sale of car loans, various insurance policies (in addition to auto insurance), extended warranties and other services. Effective management of profit growth requires the use of the cumulative profit margin over the car's life cycle.
Car loan market

In 2014, the share of credit sales in total sales dropped substantially as a result of the deteriorating availability of car loans, with higher interest rates and lower real household disposable income, and on the back of Russian ruble devaluation. In 2015–16, a positive trend in the share of credit sales resumed in response to the government program for subsidizing car loan interest rates.

As a result of the 2014 ruble devaluation, the Russian car loan market has demonstrated stricter borrowing conditions and a growing share of credit sales in the used-car segment, in addition to higher interest rates, growing overdue balances and larger loans. The potential of the used-car loan market rests on the following factors:

- Low sales of used cars in Russia
- The loan penetration rate in the used-car segment, which is only a third of the level of the new-car segment
- The steady growth of used car sales via dealers.

Commercial banks maintain by far the largest share among credit institutions on the Russian car loan market, while the West is dominated by the automakers’ captive banks. In the West, 75% of credit sales are financed by captive lenders, while in Russia the figure is about 20%. This indicates that there are vast growth prospects for captive lending, which is more beneficial to consumers in terms of costs and other factors. In Russia, seven captive banks have emerged over the past decade, increasing their share in total credit sales, except in 2015.
Overview of the Russian and CIS automotive industry

Loans issued by captive banks and their share in aggregate car loans in Russia, year-end

- **Sources:** CBR, Banki.ru, Frank Research Group

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**Top banks in automotive lending, Q1 2016**

- **Sources:** CBR, EY analysis

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**Share of credit sales by region in 2016, %**

- **Sources:** National Bureau of Credit Histories, EY analysis

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**New car credit sales, %**

- **Sources:** National Bureau of Credit Histories, EY analysis
CIS automotive markets

Car sales in Ukraine, Kazakhstan, Belarus and Uzbekistan plunged from 476,000 in 2013 to 203,000 in 2016, based on vehicle registration data. Production fell dramatically as well – from 333,000 in 2013 to 117,000 in 2016. The main reasons were the depreciation of the national currencies, deterioration in the macroeconomic environment, and declining purchasing power. Higher imports of cars purchased from Russian dealerships partially offset the drop in sales over this period, because currency devaluation in some CIS countries against the Russian ruble occurred later, together with car prices denominated in foreign currency becoming lower in Russia.

Kazakhstan

The years 2015–16 saw a substantial decrease in car sales in the wake of the autumn devaluation of the tenge, from 163,000 units in 2014 to 42,000 units in 2016. The decline in 2016 was also partially due to the introduction of the recycling levy, followed by the drop in imports that it drove.

The most popular brands are LADA, Toyota, Hyundai and KIA (20%, 17%, 9% and 8%, respectively, in 2016), which shows that buyers tend to choose low-end models.

Movements in CIS currency exchange rates to US dollar

Sources: Bloomberg, EY analysis
Asia Auto (which mainly assembles Chevrolet, Kia, Lada, and Skoda) and AgromashHolding (Hyundai, Geely, Peugeot, SsangYong, Toyota and other brands) remain the largest car makers and are planning to build up their assembly capacity and add new brands to the manufactured product range in order to replace imports.

In 2016, SemAZ and GAZ Group signed a memorandum on the industrial assembly of GAZ vehicles of the NEXT family, including light commercial vehicles and heavy duty trucks, starting in 2017.

Demand for vehicles is expected to resume in 2017.

Belarus

Passenger car sales in Belarus grew substantially in 2014 to reach 50,000 vehicles, from 29,000 vehicles in 2013. The main reason for that was the sharp increase in imports from Russia of cars purchased from Russian dealerships. In 2015 sales remained flat for the same reason but then plunged in 2016.

The historically insignificant automotive production in Belarus increased more than 3.5 times in 2014 (up to 9,000 vehicles) due to the increasing output of the Chinese Geely, assembled by CJSC Belgee. Its production facilities, with capacity to assemble 10,000 semi-knocked down vehicles a year, are located at the premises of the Avtogydrousilitel Borisov plant that was rebuilt in 2012. The assembled vehicles are sold in Belarus, Russia and Kazakhstan.

In 2015, CJSC Belgee’s output declined, whereas total output in the country grew due to the launch of Peugeot and General Motors assemblies at CJSC Unison. In 2016, the company signed a Memorandum of Understanding for vehicle assembly with Iran Khodro Company.

Ukraine

Up until 2014, Ukraine had been the largest vehicle market in the CIS outside Russia, but the continuing economic recession caused an almost four-fifths decline in passenger car and LCV sales in comparison with 2013, and by 2015 they amounted to 50,000 units.

The market started to recover in 2016, with sales growing 38%. Sales may continue to grow, yet their amount and structure (by brand) will depend on customs and tax regulation. In early 2016, additional duties were imposed on Russian and Uzbek imports, and, later in 2016, excise duty was cut on imported vehicles other than those produced in Russia. Discussions are being held to eliminate duties on vehicles imported from other countries. If the elimination is approved, the sales of used foreign brands may rise, arresting the growth in the new car market and the renewal of the heavily aged car fleet (18 years on average).

Historically, the bulk of Ukrainian demand for low-end brands was met by domestic production. Brands in the middle and high price segments were imported primarily from Europe and Russia. During the recession, production in Ukraine declined more significantly than sales.

Several manufacturers went bankrupt (e.g. Kremenchuk Automobile Plant in 2014 assembling SsangYong and Great Wall), while others significantly decreased output.

For the automotive market to recover automotive lending needs to be restored together with a rebound in purchasing power and intensive government support for local manufacturers.

Uzbekistan

In 2015-16 the passenger car and LCV market in Uzbekistan remained essentially unchanged, with 58,000 units sold in 2016. The national currency in Uzbekistan did not depreciate as dramatically as in other CIS countries, and in 2015-16 real GDP was on an upward trend, growing 6% in 2016.

On the other hand, automotive production was down substantially — to 94,000 vehicles in 2016, versus 249,000 vehicles in 2014 — as a result of lower exports to Russia. General Motors Uzbekistan, which produces Chevrolet and Ravon (the former Daewoo) is the main car manufacturer, with annual output capacity of 250,000 vehicles. The output of Chevrolet fell as a result of this brand exiting the Russian market.

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Sales of passenger cars and LCVs in selected CIS countries, units

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016 (estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>28,810</td>
<td>50,000</td>
<td>50,000</td>
<td>33,200</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>163,911</td>
<td>162,542</td>
<td>145,915</td>
<td>42,092</td>
</tr>
<tr>
<td>Ukraine</td>
<td>225,861</td>
<td>102,772</td>
<td>50,322</td>
<td>69,462</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>57,500</td>
<td>58,100</td>
<td>58,773</td>
<td>57,782</td>
</tr>
<tr>
<td>Total</td>
<td>476,082</td>
<td>373,414</td>
<td>305,010</td>
<td>202,536</td>
</tr>
</tbody>
</table>

Sources: LMC Automotive, BMI, AUTOSTAT analytic agency

Production of passenger cars and LCVs in selected CIS countries, units

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016 (estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>2,476</td>
<td>9,126</td>
<td>10,255</td>
<td>7,900</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>37,469</td>
<td>37,782</td>
<td>12,453</td>
<td>10,427</td>
</tr>
<tr>
<td>Ukraine</td>
<td>46,619</td>
<td>26,262</td>
<td>5,921</td>
<td>4,418</td>
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<tr>
<td>Uzbekistan</td>
<td>246,691</td>
<td>248,828</td>
<td>185,400</td>
<td>94,473</td>
</tr>
<tr>
<td>Total</td>
<td>333,255</td>
<td>321,998</td>
<td>214,029</td>
<td>117,218</td>
</tr>
</tbody>
</table>

Sources: LMC Automotive, BMI

market in 2015. Ravon replaced Daewoo as of mid-2016, yet it is still lagging in popularity among Russian consumers. In 2H 2016, sales of Ravon in Russia amounted to 1,800 vehicles, versus 8,600 Daewoo vehicles sold in 1H 2016. Putting this into perspective, sales of Daewoo in Russia amounted to 20,500 vehicles in 2015.

Traditionally, domestically-produced brands dominate passenger car sales, largely due to high import duties and excise taxes.
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* Auditor data as of October 2016
** Auditor data as of September 2016
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