China automotive industry risk study

Enhance auto dealership's capability to survive in L - shaped economy

Purpose and methodology

China Automotive Industry Risk Study: Enhance auto dealership's capability to survive in a L-shaped economy is designed to understand the current operation and development of auto dealerships in China through an analysis on dealers' financial and operational data, then further incorporating Deloitte's survey results on dealer's operational performance. Based on the financial data of China's listed dealers (group) and Deloitte China Dealership Excellence database, the study examines the risks from the industry, policy, operation and management perspectives and provides improvement recommendations for the OEMs, dealer groups and independent dealers.

Target audience and content

This study focuses on the listed auto dealers (group) in China. Through an in-depth analysis on auto dealers' public financial data, the Deloitte China Dealership Excellence Performance Benchmarks tool, and the feedbacks from an independent auto dealer survey conducted by Deloitte, it objectively demonstrates their development status and offers pointed professional recommendations. The study touches upon the key operation factors including the impacts of the policy, profitability, business models, cost management, financing, management efficiency and talent development.

Data processing

Building upon a highly specialized auto dealerships database and the aggregation and analysis of public information, along with the argumentations from OEMs, dealers groups and Deloitte automotive industry experts, Deloitte China Auto Dealership Team has formulated the insights on "performance analysis report" and "performance improvement" for China's auto dealers.

Viewpoints and findings

In the last two years, China automotive market has experienced a significant slowdown in the dealership sector. The automotive market bounced back in the second half of 2013, yet the trend failed to continue in the next two years. In 2015, the contradiction between the production and sales became increasingly prominent. The anti-monopoly investigations and constantly amended and released regulations on industry management as well as intensified competitions in the market singling a dimming future for auto dealers' operation in China.

Auto dealers are in need of industry consolidation and business model innovation. Since 2015, 4S shops in China have experienced deterioration in operations with a wide range of loss. "Continued loss" has even become a norm for some dealers. The unbalance between input and output will surely trigger reform in operation models. An increasing number of dealers choose to introduce new businesses or seek capital cooperation to adapt to the changes in the market.

Dealers are facing significant compliance risks. Since 2014, the government authority has initiated a large scale of anti-monopoly investigations in the automotive industry, and at the same time, has modified and released a series of rules and regulations specific to the automotive industry to facilitate fair competitions and regulate the industry players' operations. In June 2015, the Bureau of Price Supervision and Anti-Monopoly of NDRC initiated to draft anti-monopoly guidelines. As the first detailed rules guiding enforcement of Anti-Monopoly Law, these guidelines will define the abuse of intellectual properties, anti-monopoly regulations, leniency policy, exemption procedures, procedures of investigation suspension, and penalty calculation in automotive industry. It suggests that the full-scale deployment of Anti-Monopoly Law is on the agenda. The changes in the regulatory environment have forced the OEMs and the dealers to face the legal consequences for their long-standing business conducts which are against the newly released regulations. In the long run, the competitive landscape of the automotive industry will look rather different than what it is today.

The dealers′ profitability has dropped sharply. Ove the past year, the contradiction between OEMs' aggressive expansion on production capacity and the sluggish sales performance at the store front has become increasingly apparent. From January 2014 to December 2015, the cumulative undigested inventory of passenger vehicles in China reached 347,400, which was at high level and occupied a huge amount of working capital. In addition, since 2014, new vehicle sales has been depressing with the profit margin dropped constantly to 2.54 percent by the end of 2015. Meanwhile, confronted with increasingly fierce competition in the auto aftermarket, dealers' profit margin was 35.61 percent for 2015, lower than previous years. Although dealers have adjusted their business structures to some extent in response to market changes, the situation is still grim.

Capital demand and cost of capital remain high. Dealers' inventory coefficient has hit or even exceeded the warning line for several times. The distribution channels of several brand dealers are shaky. Dealers' withdrawal from dealership network and bankruptcy have become commonplaces. Bad sales and wide price gaps of new vehicles lead to slow circulation of capital. While, OEMs constantly force dealers to increase inventories, making dealers spend large amount of liquid funds on buying new vehicles, and many dealers are on the verge of capital chain break. The cost of capital for different financing channels varies, therefore, being able to obtain cheap but quality loans becomes the key for dealers to solve the liquidity risk.

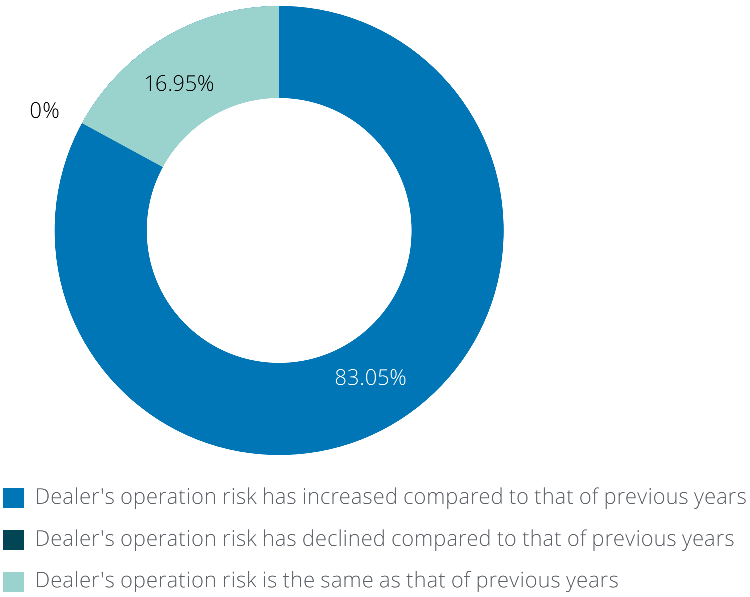
Lean management ability needs to be improved. In respect of expense management, as new vehicle market on the sell side is facing fiercer competition and the high inventory leads to a higher selling expense and interest, many dealers are struggling at the edge of break-even line. Then, in terms of operation management, dealers lack lean management on business units. Under the severe market environment, an increasing number of dealers are aware of crisis and the significance of performance management for improving dealers' management. However, currently dealers' understanding of performance management is limited to basic business data and financial statements, neither of them are adequate for the management decision making process. At the same time, the management usually only considers indicators directly related to the operating performance, rather than analyze them from the perspective of investors, not to mention to perform effective management.

Rapid expansion at the early stage leads to the absence of excellent management talents. The industry of auto dealers is adopting a model of merger and expansion under which the strong one will get even stronger. However, some dealer groups have neither fully considered whether existing resources can meet the needs of development when formulating the strategies, nor built an overall evaluation system. Meanwhile, as group brands diversify and cross-regional expansion develops, the scarcity of management talents at the group level as well as the single shop level becomes an issue.

Dealership performance analysis

Throughout the year of 2015, the impact of market downturn and policy control has emerged gradually. On the one hand, the growth rate of vehicle sales slowed down considerably. According to the data released by China Association of Automobile Manufacturers, the sales volume of passenger vehicles in 2015 reached 21,146,300 with a year-on-year increase of 7.30 percent, but 2.59 percent lower than that of last year. On the other hand, according to Deloitte's recent survey on auto dealers, 83 percent of respondents hold the view that under current gloomy market condition, the auto dealers' operation risk has increased significantly compared to previous years. In the in-depth interviews, the risk issues pointed out by dealers mainly focus on the increased regulation compliance risk, the difficulties in obtaining operation capital, the declining profitability and the rising operation cost, etc.

Figure 1: China auto dealers' overall operation risk



Source: Deloitte China Auto Dealership Survey 2016

1. Auto dealers face industrial consolidation and business model innovation

1.1 Dealers' consolidation becomes more prominent

In the case of severe unbalance between overall investment and return, fission and reform seem to be imperative for dealers. In May 2015, Greenland Holdings (Shanghai Stock Exchange: 600606) announced to acquire 30 percent share of Rundong Auto (Hong Kong Stock Exchange: 01365) by HK$1.55 billion, which enabled itself to be the primary shareholder of Rundong Auto. The cooperation between Greenland and Rundong is a typical example of the trapped dealers' seeking for transformation since 2014. For the listed dealers, making use of listed shell resources, actively integrating and combing more external advantages, understanding their strengths and weaknesses and enhancing enterprise competitiveness are effective ways to cope with downward pressure and challenges in the market. Also, dealers were devoted to optimal allocation of internal resources. In 2015, Pang Da Automobile Trade Co., Ltd., one of China's largest dealer groups released an asset deflation plan, which indicates that in the next three years, it will reduce its total fixed assets to half of the current amount by selling lands and adjusting non-performing businesses so as to provide sufficient cash flows for main business.

1.2"Internet+" model has been initiated quietly

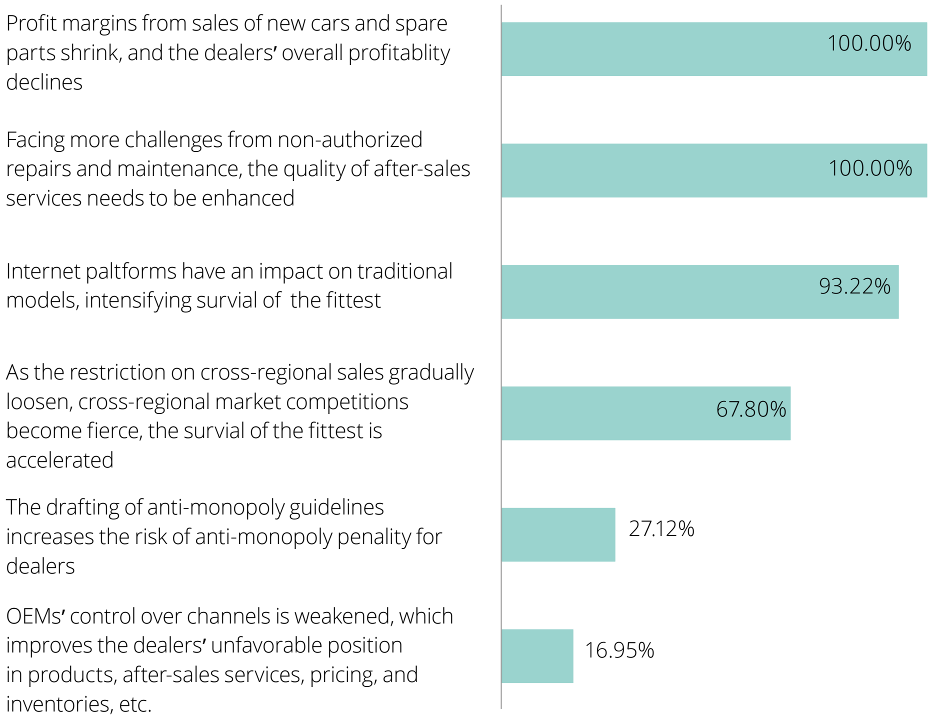
Proactively seeking for business model innovation and service products with high profit margin will be the key for the traditional industry to get out of the difficulty, with no exception for auto dealership. Currently, the emerging O2O platforms for auto maintenance, accessories and used vehicles trade attract a large amount of capital, during which, offline dealers acting as service provider also become one of the key factors to the success of O2O platforms. At the same time, "Internet+" model has been initiated quietly.

- In March 2015, Foxconn, Tencent and Harmony Auto jointly signed a strategic cooperation framework agreement on "Internet+ Smart Electric Vehicle" to develop innovative cooperation in related fields.
- In May 2015, China Grand Auto and Autohome jointly announced the completion of signing the comprehensive strategic cooperation agreements. According to the agreements, both parties will explore the integration and reform of auto dealership industry in the era of "Internet+" through complementary advantages and resources integration.
- In June 2015, Shanghai Dongzheng Automotive Finance Co., Ltd, a subsidiary finance company of Zheng Tong Auto Service, reached strategic partnership with Yiche.com, China's largest auto e-commence company. They will collaborate on the innovation in the fields like Internet marketing, product development and online & offline resources sharing to establish a new model focusing on online auto finance.
- In August 2015, main principals from about 40 key auto dealerships in China signed a strategic cooperation agreement on building an e-commerce platform for auto dealers on the "Autostreets" platform. Such cooperation was the first case in China's auto industry, which will cover thousands of automobile 4S stores and billions of auto users. Therefore, its development trend will directly define the layout of China's auto O2O in the age of Internet+.

1.3 Competitions in the dealership sector are intensified

Intensified competitions in future dealership sector will bring fierce competitions in both vehicle sales and aftermarket for dealers. The anti-monopoly regulations, the amending Measures for the Implementation of the Administration of Automobile Brand Sales and the drafting anti-monopoly enforcement rules are likely to weaken the OEM's control over the sales of new vehicles and spare parts. And the Guidance on the Promotion of Transformation and Upgrading of the Automotive Maintenance Sector for Improvement of Service Quality jointly promulgated by 10 administrative ministries and commissions in September 2014, aimed at the elimination of trade barriers in the auto aftermarket, such as OEM's technology protection in spare parts and accessories, aftersales repairs and maintenance, etc. and accelerated the competitions in the aftermarket. According to the Deloitte China 2016 Auto Dealership Survey, the impacts of policy change on the dealers' operations are listed as the followings:

Figure 2: The impact of policy changes on dealers′ operation



Source: Deloitte China Auto Dealership Survey 2016
Note: The percentage in the columns represents the proportion of samples choosing this option among the respondents.

2. Dealers are facing significant compliance risks

From 2014 till now, the State's policies on traffic control and vehicle purchase restriction have covered wider areas. Consumers' consumption on vehicles is restrained and auto dealers face a tougher market condition. At the same time, the State has speeded up its pace to regulate the automobile market. The anti-monopoly investigation and the revision of the regulations have brought unprecedented compliance risk to OEMs and dealers and exerted a long lasting impact on automobile industry's competitive landscape.

2.1 The anti-monopoly risk further exacerbates

Since 2014, the National Development and Reform Commission (NDRC) and other law enforcement agencies have strengthened investigation into monopolistic practices and imposed more than RMB2 billion fines to those who violated the anti-monopoly regulations. It appears that the anti-monopoly investigation in the auto industry will become a norm. For OEMs, price monopoly on vehicle spare parts, mandatory levels of inventories, tying with the non-best-selling models, and restriction on cross-regional sales that have been criticized for a long time are likely to face the anti-monopoly penalties. And the Measure for the Implementation of the Administration of Automobile Brand Sales implemented for a decade is going to be further amended, which may shake the foundation for the OEMs' long-term favorable position from the regulatory perspective.

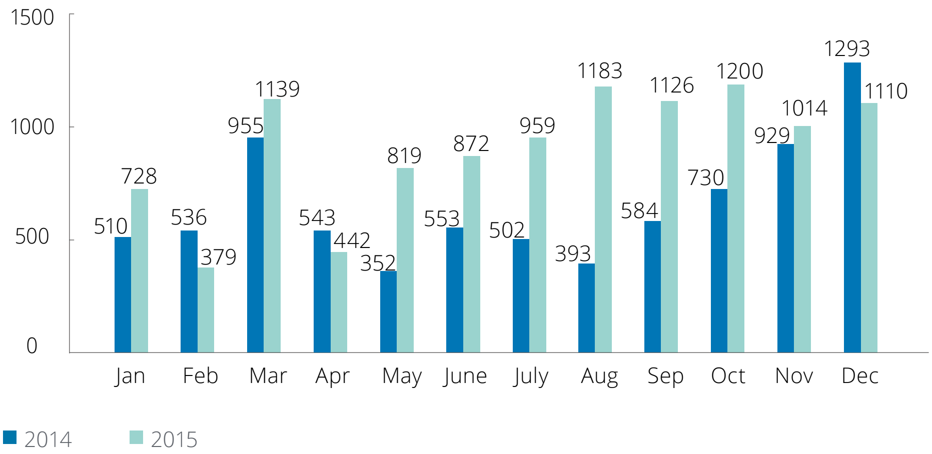
In June 2015, the Bureau of Price Supervision and Anti-Monopoly of NDRC formally announced that China has officially launched the research and draft of anti-monopoly guidelines for auto industry in its related preparatory meeting. The responsible officer of the Bureau said that the enactment of the guidelines will promote the anti-monopoly enforcement to be further normalized and institutionalized. NDRC continues with its anti-monopoly investigation into auto industry while drafting the guidelines. Media reported that after a series of anti-monopoly penalties, several spare parts enterprises and OEMs are caught in a new round of anti-monopoly investigation.

Auto dealers' retail business began to be brought into the anti-monopoly regulations. We have noticed that a series of investigations have been conducted on issues regarding joint definition of minimum prices for new car sales and aftermarket services among the dealers, and PDI service charges, etc., and punitive measures such as imposing of heavy fines and confiscation of proceeds have been undertaken. It is expected that the State will continue to strengthen its supervision and administration over China's automobile market through the enactment of laws and regulations in the future. Those auto dealers who overlook the interpretations of relevant policies will probably undertake higher compliance risks. In June 2015, the Price Control Administration of Jiangsu Province announced the Administrative Penalty by the Price Control Administration of Jiangsu Province on Mercedes Benz's Price Monopoly on its official website. The announcement showed, according to the NDRC, the Price Control Administration of Jiangsu Province fined Mercedes Benz RMB350 million and its dealers in Nanjing, Wuxi and Suzhou RMB7.869 million. In September 2015, Dongfeng Nissan was fined RMB123.3 million by Guangdong Province Development and Reform Commission and its 17 dealers in Guangzhou were fined RMB19.12 million due to their involvement in vertical and horizontal monopoly.

2.2 Infringement of consumer's rights has been repeatedly exposed

With the increase of car parc and intensified connections between auto consumption and daily life, infringement and rights protection issues concerning auto consumption have been exposed repeatedly by public media. Under such background, issues including unequal contract terms between dealers and consumers, illegal mortgage of vehicle certificates and turning minor repair into overhaul are likely to be defined as infringement and will be exposed by media. The sluggish auto market and frequent complaint or right protection from consumers bring nothing but harm to the brand image of OEMs and dealers. According to the complaint analysis report monthly released by www.315che.com, the annual cumulative complaints in 2015 increased by nearly 40 percent compared to 2014.

Figure 3: Complaint statistics from www.315che.com



Source: www.315che.com

3. The dealers' profitability is declining sharply

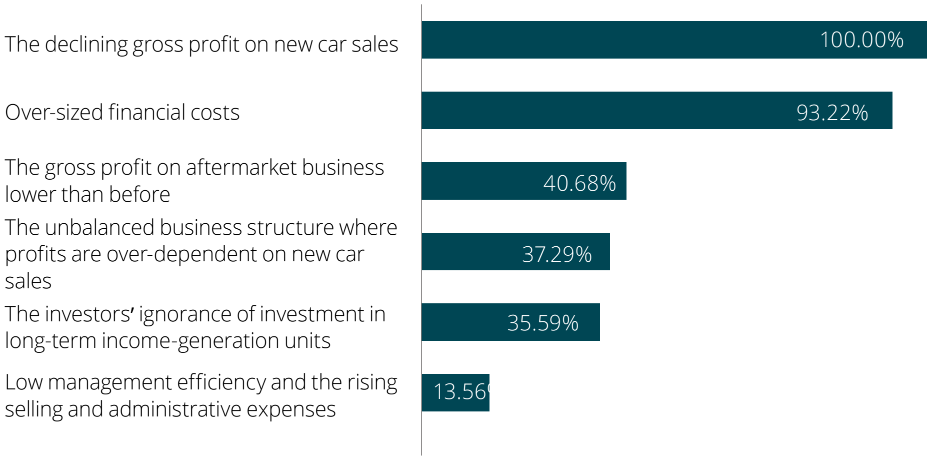
The results of Deloitte's survey in 2015 reveal the reasons contributed to the decline of auto dealers' profitability as the followings: the declining gross profit on the new car sales, over-sized financial costs, and lower gross profit on aftermarket business than before, etc.

3.1 Profits on new car sales and overall profitability are dwindling

At the beginning of 2014, China's auto market continued the upward trend in 2013, but with the impacts from the changes in industry policy, customer demand and other factors, the auto dealers' profitability gave little reason to be optimistic. In 2015, the average return on sales of major public listed dealer groups was only 1.33 percent, which is obviously declining compared to those of previous years.

The high inventory of new cars severely occupies the operational capital, which forces the dealers to take the action as lower the price to boost sales volume, thus reducing inventory and relieving liquidity pressure, and supplement cash flows with OEMs' commercial rebates. Looking at the average gross margin on new car sales of listed dealer groups, the profit on new car sales is being squeezed.

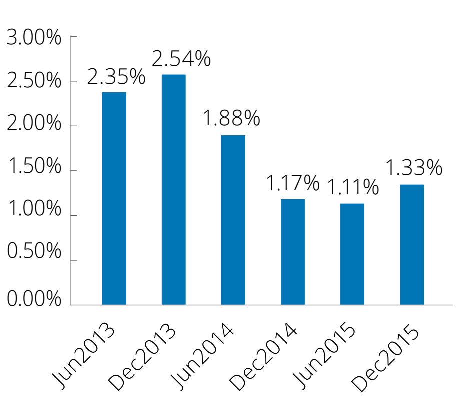
Figure 4: Reasons contributing to the decline in china auto dealers' Profitability



Source: Deloitte China Auto Dealership Survey 2016

Note: The percentage in the columns represents the proportion of samples choosing this option among the respondents.

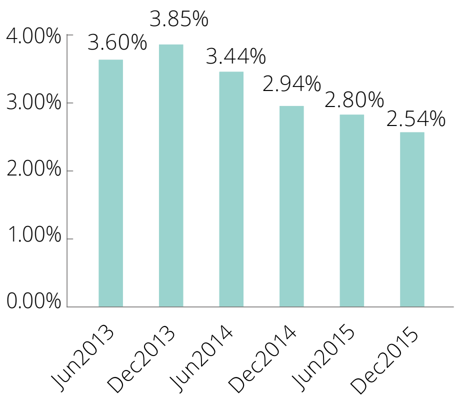
Figure 5: Return on sales*



Source: Financial reports of listed auto dealer groups

*Return on sales=net profit before tax/ sales revenue

Figure 6: Gross margin on new car sales*



Source: Financial reports of listed auto dealer groups

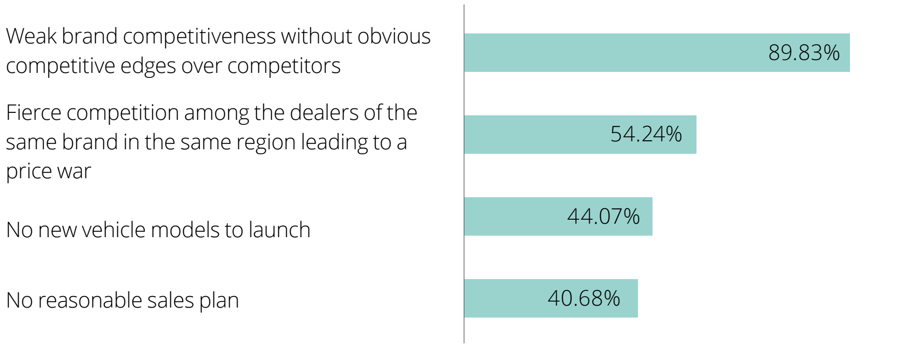
*Gross margin on new car sales= gross profit on new car sales/ revenue from new car sales

According to the results of Deloitte's survey in 2016, reasons contributing to the decline of gross margin on new car sales are as follows: (see Figure 7)

3.2 The aftermarket is squeezed and the structural transformation is facing challenges

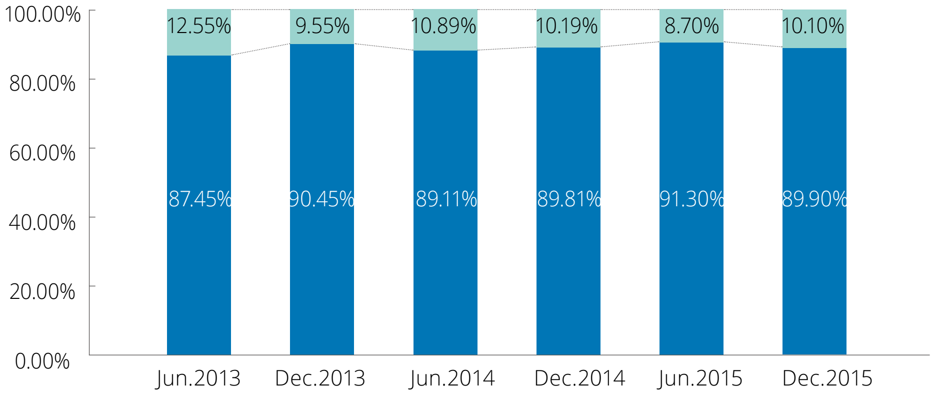
According to the financial reports of listed auto leader groups, though China's dealers are actively adjusting their business structures, the ratio of sales revenue to aftermarket revenue in 2015 remained 9:1, that is, aftermarket revenue only accounted for 10 percent in gross revenue. In an unfavorable market with a sharp margin decline on the new car sales, the small-scale aftermarket fails to effectively reduce the impact from changes in the external environment on the dealers' profitability. Compared with the 40% of aftermarket revenue ratio in mature markets like the United States, there is plenty of room for China's auto dealers to make further structural adjustments.

Figure 7: Reasons contributing to the decline of gross margin of new car sales



Source: Deloitte China Auto Dealership Survey 2016

Figure 8: Revenue contribution for new car sales and aftermarket

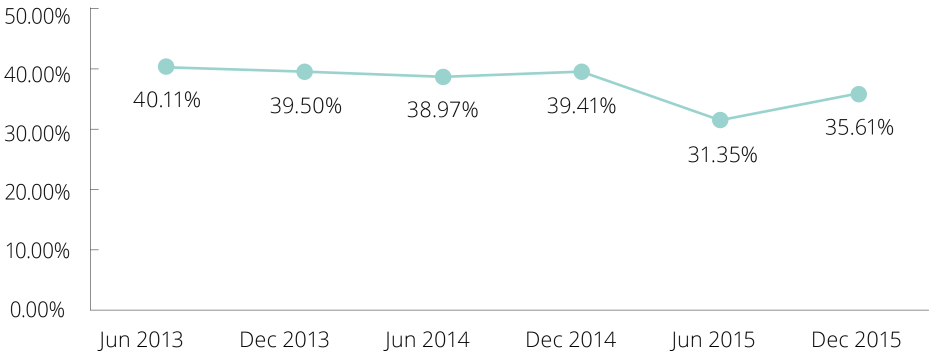


Aftermarket business accounts for about 10 percent.

New car sales revenue   Aftermarket revenue

Source: Financial reports of listed auto dealer groups

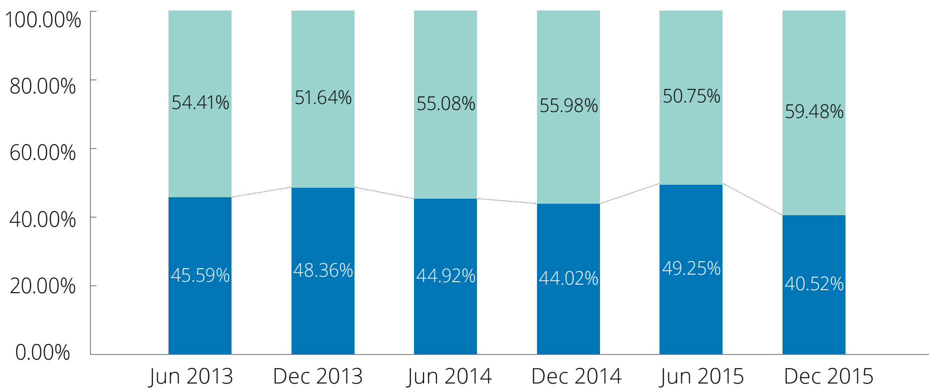
Figure 9: Gross margin of aftermarket business*



Source: Financial reports of listed auto dealer groups
*Gross margin of aftermarket business=gross profit of aftermarket business/ revenue of aftermarket business

As a segment which is less impacted by macro-economic environment, the aftermarket business is of vital significance to dealers' overall profitability. The gross margin of aftermarket business has reduced to 35.61 percent in 2015, a further decline over those of previous years.

Figure 10: The ratio of aftermarket business profits on the rise



Meanwhile, the ratio of aftermarket business profits has increased to 59.48 percent compared to that of previous years.

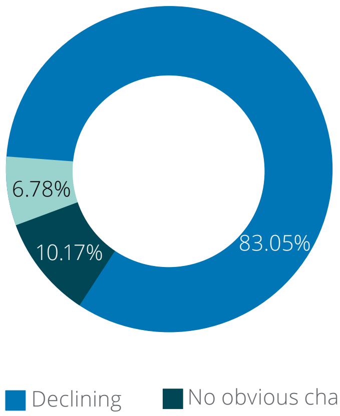
New car sales profit ratio | Aftermarket profit ratio

Source: Financial reports of listed auto dealer groups

A comprehensive analysis on revenue structure of new car sales and aftermarket business as well as the structure of gross margin and gross profit leads to a conclusion that the aftermarket business has become the main profit source for dealers at present. It owes to the elastic effect brought by the improvement of the scale of aftermarket business instead of the increase of profit margin of aftermarket business. Additionally, when predicting the aftermarket profits in the next 1 to 3 years, 80 percent of respondents believe that the gross margin of the aftermarket sales will fall down.

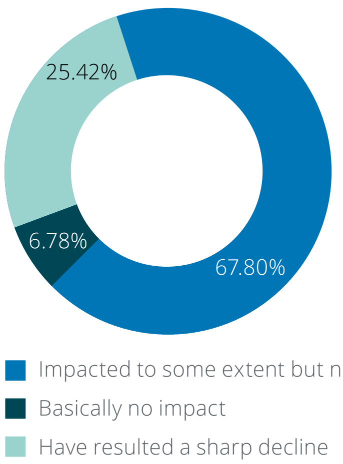
The primary reason contributed to the pessimistic view among the dealers on the aftermarket profit is that their existing aftermarket services are lack of competitive edges when competing with the independent and fast repair chain stores. According to the Deloitte China Auto Dealership Survey 2016, 25.42 percent of the dealers believe that the emergence of independent and fast repair has resulted a sharp decline in the dealers' outputs and profits. And 67.80 percent of the dealers hold that, though the current impact of independent and fast repair chain stores to dealers' aftermarket business is not yet obvious, with the continuous anti-monopoly investigations and the release of relevant regulations, the monopoly of auto parts and after-sales repair techniques will be broken, independent and fast repair chain stores and other non-authorized repair shops will embrace more opportunities. As a result, the dealers' aftermarket business will be affected. However, the dealers with strong service awareness and high service quality will be more confident when facing the challenges ahead, and will have more competitive advantages.

Figure 11: China auto dealers' prediction on aftermarket profit changes in the next 1 to 3 years



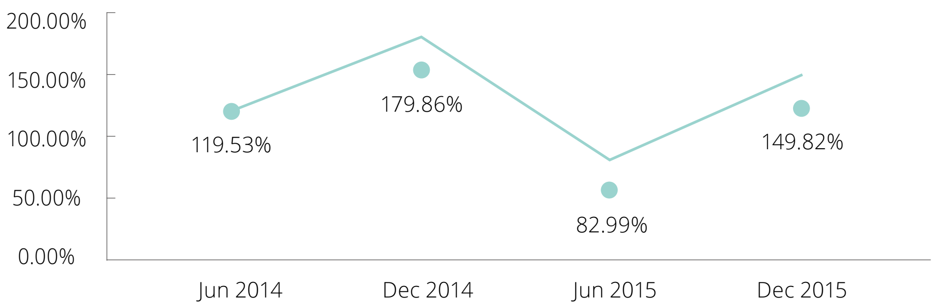
Source: Deloitte China Auto Dealership Survey 2016

Figure 12: Impacts of independent or fast repair chain stores on dealers' aftermarket sales outputs & profits



Source: Deloitte China Auto Dealership Survey 2016

Figure 13: Asset turnover*



Source: Financial Reports of Listed Auto Dealer Groups
*Asset turnover=sales revenue/average asset balance

3.3 Low asset turnover and separation between inventory management and sales strategies

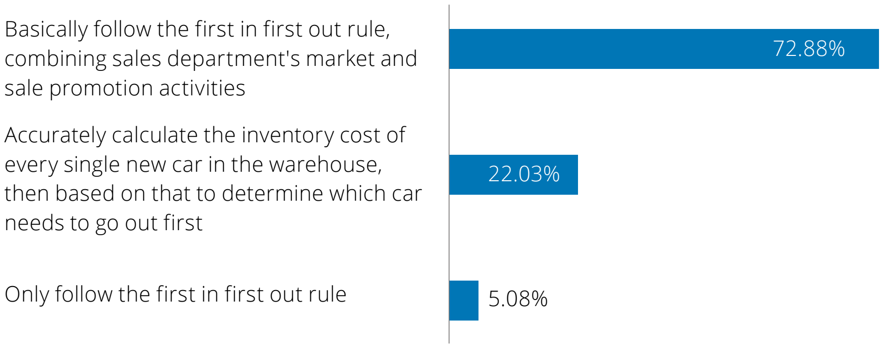
Throughout the year of 2015, the dealers' asset turnover has declined considerably year-on-year, so the assets utilization and liquidity need to be improved.

Meanwhile, according to the Dealership Survey, we have found that only 22 percent of the dealers take full consideration of the financing costs of vehicles during new car sales, in order to arrange the best order for vehicle sales and delivery out of warehouse.

4. Fund demand and fund cost remain high

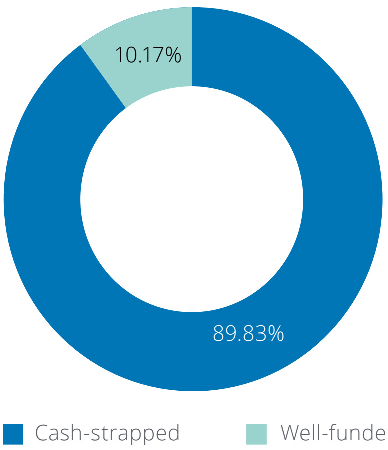
Since 2014, the overall environment of China's automotive industry hasn't been looking pretty. One of the major indicators reflecting the increased pressure on dealers' operation is the shortage of capital becoming more severe and the risk of breaking the capital chains has been intensified. According to the Deloitte's survey, nearly 90 percent of the dealers believe that they will encounter capital shortage in the coming year, among which the rising inventory level is the main trigger of the capital shortage.

Figure 14: Current situation of inventory management strategy



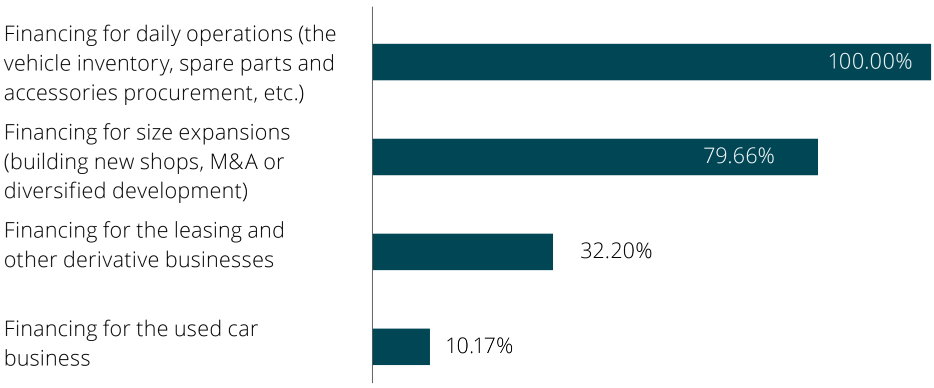
Source: Deloitte China Dealership Survey 2016
Note: The percentage in the columns represents the proportion of the sample choosing this option among the respondents.

Figure 15: Forecast of dealers' financial status in the coming year



Source: Deloitte China Dealership Survey 2016

Figure 16: Financing needs



The survey results reveal that the dealers' financing needs stem mainly from new cars for wholesale, spare parts and accessories procurement, business expansion, etc.

Source: Deloitte China Dealership Survey 2016
Note: The percentage in the columns represents the proportion of the sample choosing this option among the respondents.

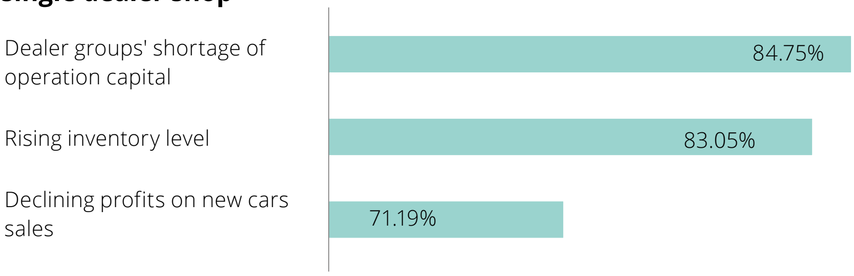
Meanwhile, dealer groups' shortage of operation capital , rising inventory level and declining profits on new cars sales have become primary factors contributing to the capital shortage of the single dealer shop.

4.1 Demands for funds are increasing greatly

Throughout the year of 2015, the dealers' average inventory coefficient was 1.53, slightly lower than that of 2014, but it still exceeded the early-warning threshold by 1.5. Inventory backlogs have occupied the dealers' operation capital.

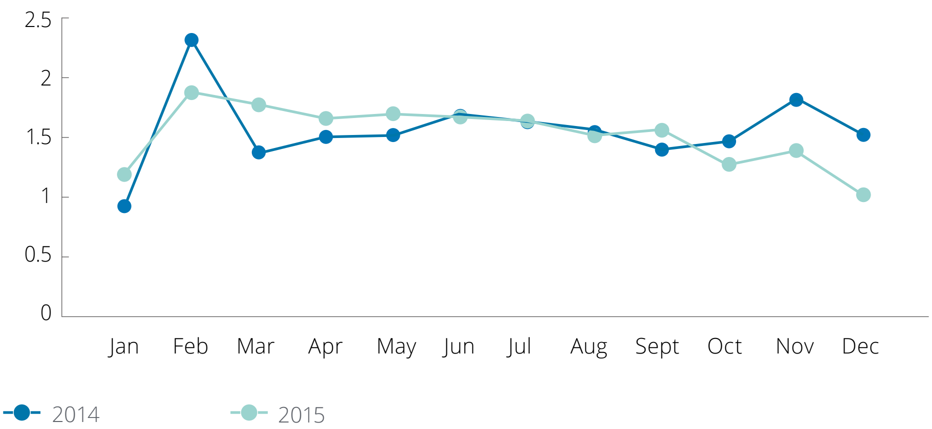
As new car inventory turnover rate slows down and the liquidity is weakened, it is likely that the dealers are unable to obtain sufficient cash flows to pay the debts. According to the data analysis in the financial reports of major listed dealer groups, the dealers' current ratio throughout the year of 2015 is under 100 percent, indicating that the dealers are facing certain liquidity risks.

Figure 17: Major factors contributing to the capital shortage of the single dealer shop



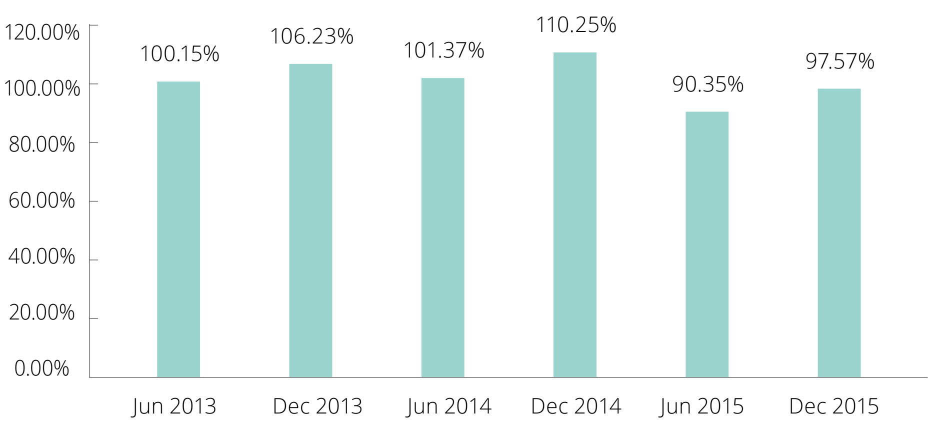
Source: Deloitte China Dealership Survey 2016
Note: The percentage in the columns represents the proportion of the samples choosing this option among the respondents.

Figure 18: Inventory coefficient



Source: China Automobile Dealers Association

Figure 19: Current ratio*

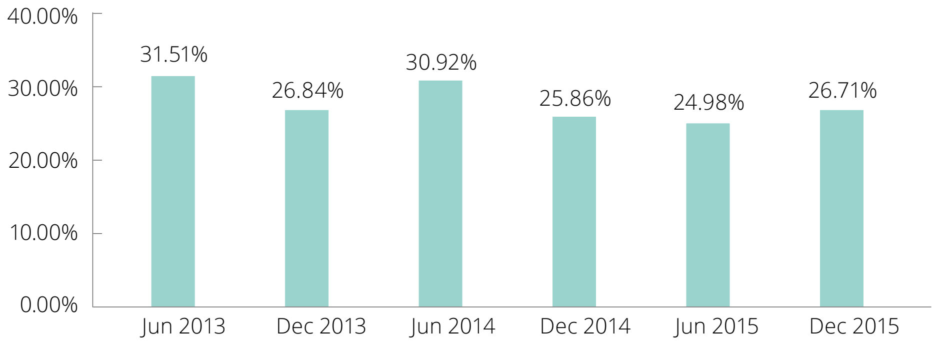


Source: Financial reports of listed auto dealers groups
*Current Ratio = current assets/ current liabilities

For the group dealers, the capital status of a single shop relies largely on the financial support provided by the dealer's group. In recent years, due to the declining return on investment in 4S shops, the dealer groups have begun to seek diversified developments with the intention to reduce the investment risks. It has resulted in large amounts of funds flowing out of the auto industry. In addition, as OEMs continue to elevate the standards of the hard wares of newly built shops, the dealer groups' capital investments are growing as they expand their footprints, but the time of getting the return on investment is becoming increasingly longer. For the above reasons, it is difficult for the groups to provide sufficient funding to support the single-shop dealers for their daily operations, and therefore intensifying the fund pressures on the single-shop dealers.

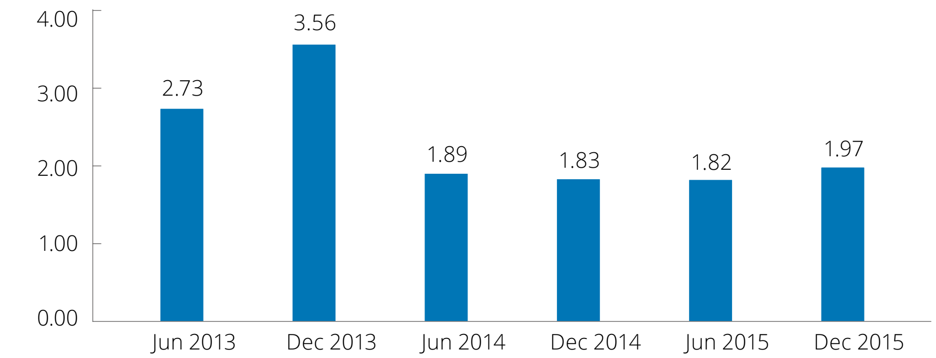
Due to the group's expansion and increased inventory financing needs, the dealers have obtained stable long-term borrowings and short-term working capital loans through various external channels, and gradually improved their capital structures. In 2015, the equity ratio of China's auto dealers was 26.71 percent and the interest coverage was only 1.97. Since early 2014, the dealers' solvency risk has been rather high and their operating profits have been severely eroded by financing costs.

Figure 20: Equity ratio*



Source: Financial reports of listed auto dealers groups
*Equity ratio = total assets/ owner's equity

Figure 21: Interest coverage*



Source: Financial reports of listed auto dealer groups
*Interest coverage = earnings before interest and tax/ interest expense

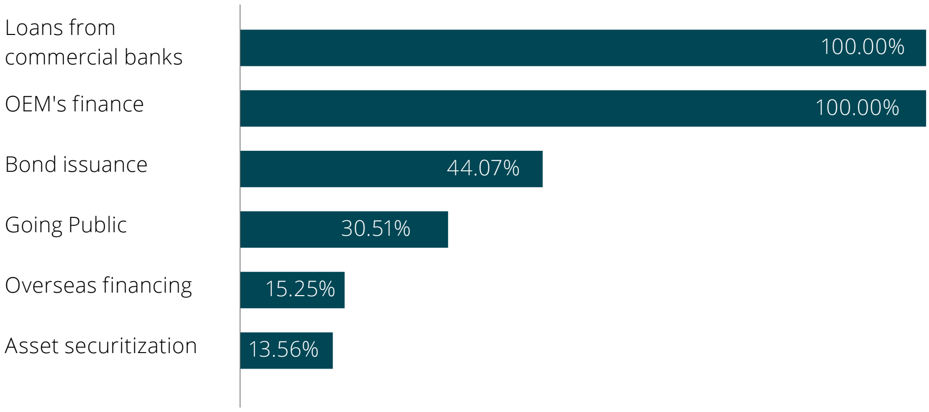
4.2 Capital management and control capability differ greatly

Deloitte's survey results show that only 37 percent of the dealer groups use the management model of capital pool for capital management and control. The dealer groups are still relatively extensive in capital management with limited capital usage efficiency.

4.3 Financing channels become dealers' operational bottleneck

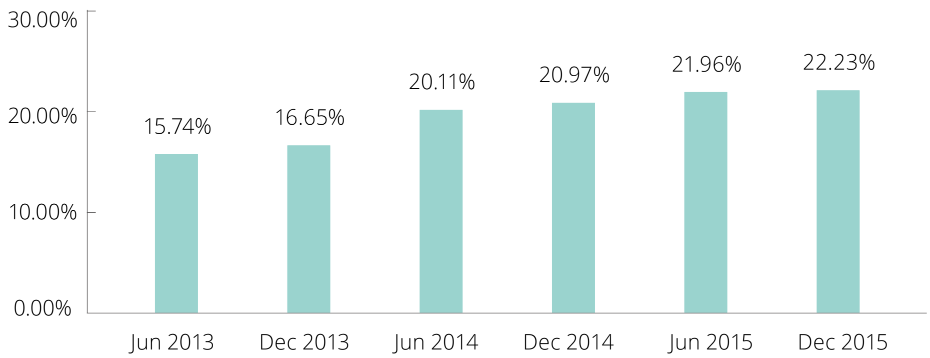
The Deloitte China Dealership Survey results show that, except a few dealers who can obtain low-cost and long-term financing support through their group's IPO. Commercial banks remain to be the most reliable financing channel for the auto dealers. The dealers' overall financing costs are largely determined by the borrowing costs from banks. Through in-depth interviews with the dealers from different backgrounds, we found that it is easier for a dealer group to obtain sufficient low-cost financing from banks dependent on the group's unified financing or guarantee, so as to effectively relieve its financial stress and lower the capital usage costs. However, for the independent dealers with relatively weak operation status, they usually face more strict approval processes and preconditions when working with the banks. Compared to the dealer group, their financing channels are also limited and the financing costs are relatively high.

Figure 22: Distribution of dealer's financing sources



Source: Deloitte China Auto Dealership Survey 2016
Note: The percentage in the columns represents the proportion of samples choosing this option among the respondents

Figure 23: Financial costs to gross margin ratio



According to the financial reports of listed dealer groups, the dealers' financial costs to gross margin ratio in 2015 has reached 22.23 percent.

Source: Financial reports of listed auto dealer groups

5. Lean management ability needs to be improved

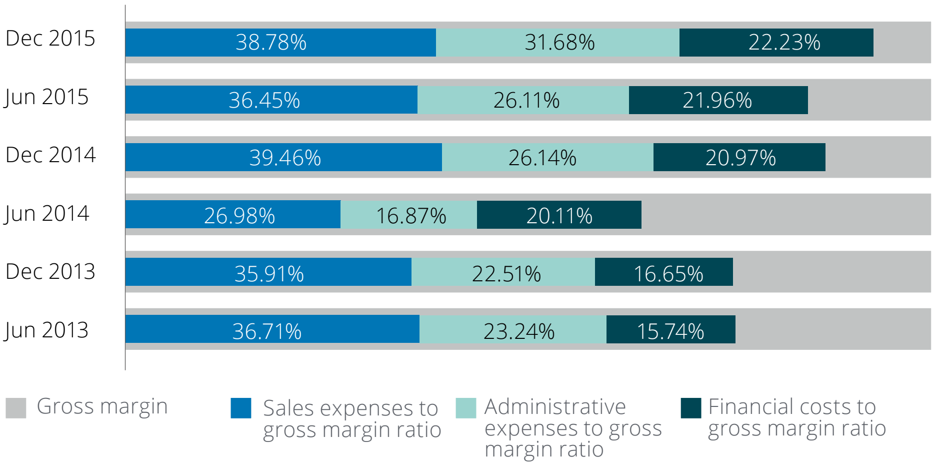
5.1 Operational costs continue to rise

According to the financial reports of listed dealer groups, the three period expenses to the dealers' overall gross margin ratio was 75 percent in 2013, but it rose to 93 percent in 2015. Under the slower growth of the auto market, the erosive effect from high operational cost on the dealer's profit becomes more apparent.

5.2 Dealers' insufficient knowledge and experience in lean management

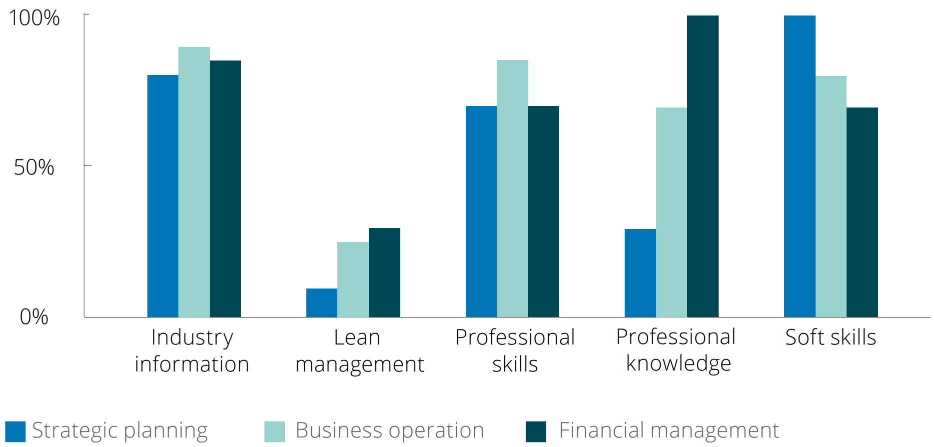
Through the survey on the dealers, we found that they have the following common problems about lean management: firstly, most general managers are short of understanding of a scientific and systematic business operation; secondly, the business management has insufficient cognition on lean management of business units; thirdly, the precision degree of financial management cannot support the financial analysis and business analysis. At present, more and more dealers have come to realize the significance of lean management for the dealers' survival and development. Through the survey on the dealers' training needs, we found that trainings related to lean management have become one of the Top Five training types that the dealers urgently need. For example, among most dealers, the internal maintenance business provided by aftersales departments for new cars sales and the dealers is excluded from the performance assessment for aftersales departments, which results in a lower output value than its total actual contributions.

Figure 24: Dealer group's major operating expenses to gross margin Ratio



Source: Financial reports of listed auto dealer groups

Figure 25: Dealers' training satisfaction



Source: Deloitte China Auto Dealership Survey 2016

6. Early rapid expansion leads to excellent management talent shortage

With the dealer group's brands diversification and the cross-regional expansion, talent reserves fail to keep up with the pace of expansion, so the shortage of management talent at the group level as well as the single shop operational level has emerged. Mid-level management positions usually are filled up by excellent front-line employees from the old stores, which has led to some common issues including insufficient management experience and poor management benefits, together with rising expenses on management personnel cost, office and administration to gross margin ratio.

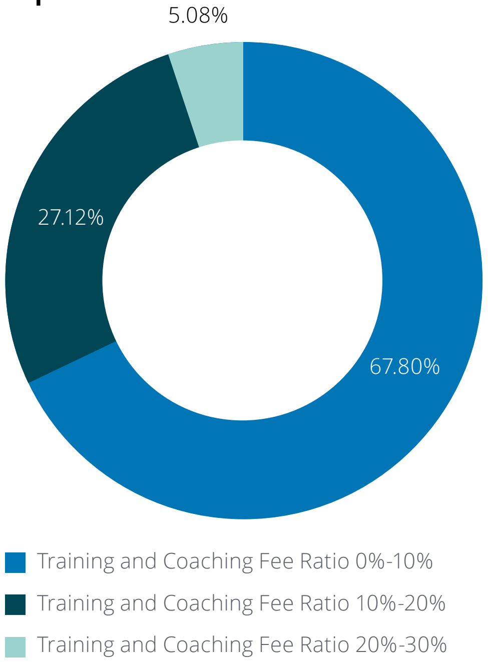
6.1 The dealers' great demand gap for coaching promotion

We found that among the auto dealer groups' consultation expenses, expenditure for training and coaching is still relatively low. However, more and more dealer groups have realized that it is extremely urgent to employ external professional organizations for their comprehensive coaching promotion. Allocation of high-quality resources, and employment of experienced professional organizations to provide strategy consulting, training for senior management and business coaching have become an important part of the dealer groups' work plans.

6.2 The dealers' management talents account for a relatively low proportion

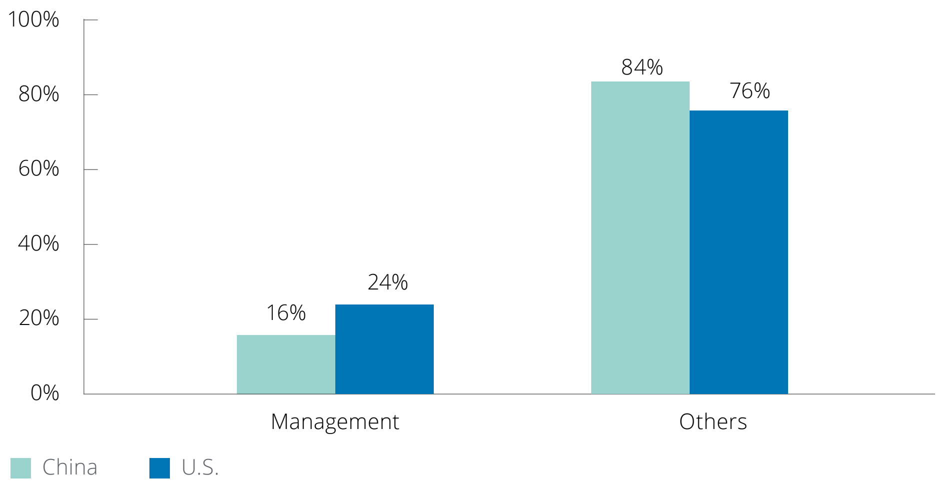
We found that in China's auto dealers, the management talents account for a significantly low proportion as compared to the staff composition of American mature dealers. Talent reserve and development are unable to keep up with the dealers' development pace. Meanwhile, insufficient management experience also exerts negative impacts on the dealers' operational efficiency.

Figure 26: Ratio of training and coaching fee to overall consultation Expenses



Source: Deloitte China Auto Dealership Survey 2016

Figure 27: Management talents ratio for dealers



Source: Deloitte China Auto Dealership Survey 2016, NADA

Analysis and summary

In general, the year of 2015 represents a continuous downturn in the market for China's auto dealers, a year of further squeeze in profit margins, with more fierce competition, and coexistence of opportunities and challenges. As rigid demands will be further released by China's positive policies along with the vigorous promotion of new energy vehicles, we still have confidence in China's automotive market. However, the dealers should strive to strengthen their capabilities and develop reasonable strategies and network layout as to be able to succeed in such a hostile environment.

Performance improvement

1. Recommendations on improving the dealer's performance

1.1 Optimize financing strategies and reduce the cost of capital

The constant rise in the cost of capital occupation due to high inventory has severely squeezed the dealers' slender profit margins. Therefore, it is critical for dealers to optimize their inventory financing channels, increase liquidity, and reduce inventory financing costs.

First of all, the dealers should actively expand the financing channels. The dealers need to understand local commercial banks' auto dealership financing packages and policies. Then, based on their own financing needs, the dealers should establish extensive and solid financing cooperation relationships with the financing channels.

Secondly, the dealers should fight for favorable loan terms and conditions. When it comes to the terms and conditions of the commercial banks' financing packages, such as the amount of deposit, repayment period, and loan interest rates, etc., the dealers should further negotiate with the banks to obtain more favorable term and conditions that are suitable for their circumstances.

Thirdly, the dealers need to select financing methods rationally. Based on the characteristics of inventory turnover for different vehicle models, the dealers should take advantage of the interest-free period or fixed-interest period in financing terms to choose the financing method matching the inventory turnover.

Last but not the least, the dealers should synchronize the financing strategy with the sales strategy. The new vehicle sales department should take full considerations of the financing cost when they formulate sales and pricing strategy for a car model or a single vehicle. If the cumulative cost of capital occupation exceeds the early-warning threshold, the dealers should consider targeted promotional activities to digest inventory in a timely manner.

1.2 Transform business models to improve profitability

Against the backdrop of gloomy economy and tightening macro policies, the dealers should take the initiative to explore suitable business development models and high value-added services in order to improve overall profitability and risk resistance capacity.

First of all, enhance customer stickiness. The dealers can improve customer service experience by providing differentiated quality services and three-dimensional customer relationship management so as to achieve the transformation from business orientation to customer orientation.

Secondly, strengthen cross-functional cooperation to obtain more cross-selling opportunities through cooperation across multiple business units.

1.3 Digital strategies to improve customer experiences and values

With the further innovation on sales models throughout the auto dealership, OEMs including the dealers are faced with the challenge about how to improve customer experience and their own value to the fullest possible extent. For example, a well-designed online mobile App may have a fundamental impact on the overall dealership (group) networks and the process of customer communication. It enables the dealers to carry out a more effective customer management by obtaining the first-hand customer experience and feedbacks in a timely manner. Accordingly, it is of great importance for a professional digital strategy team to customize digital products for the dealers (group) to adapt to the current market environment.

1.4 Support businesses by finance and understand performance from an investment perspective

Nowadays, more and more dealers have realized the significance of performance management and performance assessment under the current crisis. A comprehensive performance analysis system should include a performance analysis model, a series of business and financial analysis reports, as well as distribution simulation and business forecasting. In the dealers' transformation process, the financial department needs to deliver better reports to the management so that every number in the reports can play a more important role in the management's decision-making.

Meanwhile, while conducting performance management, the management needs to understand from the perspective of investors. For example, the management usually uses return on sales (ROS) to assess the performance of the dealers and every business unit. But for investors, what they are most concerned is how much returns each cent invested can yield, so return on equity (ROE) is also an important indicator for the management to take into account.

2. Recommendations on improving the dealer groups' performance

Adjust the expansion pace and improve the management

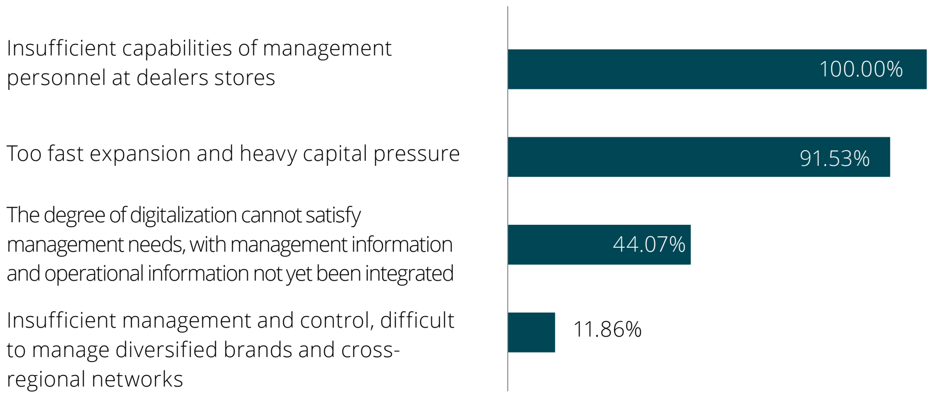
The conglomeration of dealer is an essential path for China's auto dealership industry evolving to a mature stage. However, with the emergence of many shortcomings in the expansion process, the dealer groups should also avoid blind expansions, make timely strategic adjustments, and aggressively eliminate unfavorable factors hindering groups' development.

First of all, adjust the expansion strategy in due time. When formulating the development strategy, the dealer groups should assess whether their existing resources can support the development, identify possible risks that may arise in the expansion process, and then come out with the response mechanism. While implementing a specific expansion project, the evaluation mechanism should be established to ensure that the increase of brands and networks can bring real benefits and avoid blind expansion.

Secondly, the dealer groups should enhance the effectiveness of the group's fund management. The dealer groups should improve rational predictions on the cash flows for the entire group and the each dealer store, enhance the planning and flexibility of fund management, and shorten the turnover time of funds within the group. Additionally, the dealer groups should leverage the groups' resources to assist their dealers in obtaining quality financing channels.

Thirdly, the dealer groups should speed up the formation of the group's management teams at all levels. At the group level, the talent recruiting and management should be part of the group's development strategy. Establishing stable talent recruitment channels and designing the talent incubation plan should be planned in advance to accelerate the formation of the group's management teams at all levels. At the dealer store level, the group should integrate dealers' resources, improve the deployment of incentive mechanisms, and assist the single stores in talent recruiting and appointment, and improving the talent management system. When designing compensation system, the dealer groups should consider the reality in different regions, and

Figure 28: Key factors hindering the development of the dealer groups



Source: Deloitte China Auto Dealership survey 2016
Note: The percentage in column represents the proportion of samples choosing this option among the respondents.

provide the single shop managers adequate flexibility to adjust the salaries at the local level to ensure the competitiveness and prevent the further brain drain.

Fourthly, the dealer groups could strengthen resource allocation and support to the dealers. For the dealer groups, they should fully tap the advantage of resources and size effect to assist training, coaching and improving the dealers not only in business, but also in management concepts, development strategies and management efficiency. For instance, the groups may consider helping single dealer stores carry out consistent CRM at the group level, therefore, more diversified data and more centralized resources would bring the dealers practical and positive effects in terms of customer attraction, new vehicles, aftermarket etc.

Lastly, apply overall performance management to subordinate dealers. Except building a complete set of performance management system, the dealer groups should also consider how to balance the performance of different brands and regions, ensuring the results of performance management fairly reflect the dealers' current situations as much as possible. Only in this way can the groups provide more targeted assistance and support including resource allocation for the dealers.

Strengthen the value management of assets

Based on field researches of numerous dealers, we found that the dealers often ignore the significance of their financial departments to the dealers' development. It can be seen frequently that the management doesn't pay enough attention to the financial department, and most of the financial staff of the dealers are not competent enough. Therefore, the dealers should use professional financial analysis systems and tools to sort out and analyze their financial data, find out weak and irrational links (such as inappropriate capital structure, excessive proportion of costs, and bad liquidity etc.) and integrate the dealers' finance with business management, so as to maximize the shareholders' benefits.

3. Recommendations on improving OEMs' performance

Focus on network risks and adjust control and management ideas

The contradiction between OEMs and dealers has become increasingly prominent. Under the pressure of price decline and inventory backlog, a number of branded dealers initiated a series of defense campaigns, such as stop taking cars from OEMs, collectively withdrawing from dealership networks, and requesting sales rebates from OEMs, etc. These campaigns have caused unmeasurable negative impacts on the stability of OEMs' sales channels as well as their brand images. Meanwhile, with the release of several auto industry policies, the market positions between OEMs and dealerships in China's auto industry will experience subtle changes. Therefore, OEMs should also adjust their management ideas and pay more attention to the soundness and stability of brand network to adapt to the changes in new situation.

First of all, OEMs should strengthen their financial management over the dealership network to get a timely and precise control on the network's overall profitability and profit distribution, and the dealers' liquidity level, set an early-warning mechanism, in order to identify the dealers with upcoming financial crisis and take effective measures in a timely manner.

Secondly, OEMs should develop flexible business policies aiming at long term mutual benefits, such as adjusting wholesales pace, market strategy and sales incentives, to support the dealers' sound operations.

Thirdly, OEMs should provide targeted technical and channel support based on the characteristics of the dealers' business development and resource bottlenecks to enhance the dealers' operation and management expertise and business decision-making ability, so as to improve the dealers' profitability.

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