



Gaining momentum:
Recent trends in China's
automobile parts market

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Executive summary

2011 is the first year of China's "12th Five-Year Plan", which will witness economic transition from policy-stimulated rapid growth to stable growth amid structural adjustment, during which, the development of the auto industry in China is shifting from scale expansion to strength growth. "Proprietary brand", "M&A and restructuring" and "new-energy auto" are three key words in the draft of the "12th Five-Year Plan" for the auto industry. During April to May 2011, National Development and Reform Commission (NDRC) and Ministry of Commerce jointly amended *Catalogue for the Guidance of Foreign Investment Industries*, specifying for the first time that the percentage of foreign equity shall not exceed 50 percent in enterprises of key new-energy auto parts. This provision may have far-reaching impact on the overall layout of multinational companies in the parts industry in China.

As a key link in the global production and supply system of autos and parts, China now houses almost all the world-leading auto parts manufacturers and is itself a huge exporter of home-made auto tires, glasses and audio products. The scale of China's auto parts and accessories industry approached RMB1.5 trillion in 2010, with the CAGR of 30 percent in the past five years. Percentage of the total output of the parts sector in the total output of the auto industry has increased steadily to above 40 percent. Despite the large number, average small size and overall technological backwardness of local auto parts manufacturers, some listed Chinese manufacturers posted better net profit margin than international tycoons in the recent years, which is mainly attributed to their investment in advanced technology in certain market segments, products cheaper than but almost as good as those of world-leading suppliers', and higher production efficiency.

Major competitors in China's auto parts market post the following development momentum respectively:

- Multinational auto parts enterprises: Monopolistic core technologies, intensifying localisation and active M&As
- Local parts manufactures: Development polarisation, accelerating industry integration and leading companies' speeding up internationalisation
- Local OEM In-house: Transition from providing support to the group to seeking independent development

Going forward, we believe the auto parts market segments will demonstrate the following development tendencies:

1. Domestically, despite slowed-down growth of new auto sales, some auto parts market segments like auto electronics and interior & exterior decorations will markedly surpass that of the entire auto market thanks to the rising decoration rate.
2. Overseas, recovery of auto sales and supply decrease caused by Japan's earthquake will push up demand for China-produced parts, which will most benefit China's exports of arresters, tires and auto body parts in the short term.
3. China's after market (including spare parts and service) promises huge potentials, and will become a new growth engine of demand for parts.
4. From the perspective of supply, as regular auto and new-energy auto markets both face overcapacity risks, the parts industry will also enter an accelerating integration stage.

Exploration of rapidly developing China's auto parts after market will bring an opportunity to the industry. Combining in-depth understanding of China's market with project practice of world-leading enterprises, Deloitte may help customers establish successful operation mode of after-sale service and spare parts supply chain to achieve sustained growth.

In the accelerating integration stage over the next few years, China's auto parts industry may build up scale through horizontal and vertical integration of domestic enterprises; and through multinational M&A optimise allocation of production and market resources worldwide; as well as obtain advanced technologies and management experience. Deloitte has set up ad hoc cross-functional and cross-regional M&A service teams to offer one-stop service over the whole M&A life cycle with various experts participating in corresponding steps of M&A process.

Overview of regulatory environment

1. Macro economic environment

2011 is the first year of "12th Five-Year Plan", which will witness economic transition from policy-stimulated rapid growth to stable growth amid structural adjustment. Domestically, it is planned to divert the focus of accelerating economic growth mode from speed to quality, increase income of residents and equality of income distribution to enlarge domestic demand, especially consumption, and speed up industrial structural adjustment and foster seven emerging strategic industries including new-energy auto industry. International trade will shift from stubborn pursuit of exports and trade surplus to a focus on increasing demand and balancing imports and exports.

2. Policies relating to auto and parts industry

As the long and broad-based auto and parts industry chain is one of pillars for the national economy, China has also rolled out a string of related policies to guarantee the healthy and sustainable development of auto and parts industry. In 2011, most auto consumption incentive policies in the *Plan on Adjusting and Revitalizing the Auto Industry* issued in 2009 are withdrawn. Industry regulators refocus their attention on energy conservation and new-energy autos. In this context, auto output and sales, have terminated rapid growth in the past years and retreated considerably in 2011.

2.1 Draft of "12th Five-Year Plan" for auto industry

The draft of "12th Five-Year Plan" for auto industry aims to redirect China's auto industry from scale expansion to strength growth. Unlike the *Plan on Adjusting and Revitalising the Auto Industry*, which specifies "striving to produce and sell 10 million autos in 2009 with the average growth rate of 10 percent in the three years", the existing draft merely "projects China to produce and sell 25 million autos in 2015" and places emphasis on "proprietary brand", "M&A and restructuring" and "new-energy autos".

First, efforts should be made to increase domestic shares of proprietary brands. The plan is aimed to further expand domestic market shares of proprietary brand autos in 2015, with the market share of proprietary brand passenger vehicles over 50 percent, of which, proprietary brand cars will take up more than 40 percent. In addition, exports of proprietary brand autos will account for more than 10 percent of the output and sales volume in 2015. However, in fact, China saw sales of 6.27 million proprietary brand passenger vehicles in

2010, representing a growth of 37 percent year on year and accounting for 46 percent of total passenger vehicles sales. On the one hand, the super-high growth rate has overdrafted part of the auto demand in the next few years. On the other hand, the market share of proprietary brands who focus more on small-displacement low/medium-end vehicles, declined in the first half of 2011, affected by the withdrawal of consumption incentive policy of under-1.6-liter autos, the chain reaction triggered by Beijing's limits on auto purchase and persistent high inflation. On the contrary, sales of foreign and joint-venture brands increased consistently. Volkswagen Group including two joint ventures (i.e. Shanghai-Volkswagen and Faw-Volkswagen) recorded sales growth of 16.4 percent year on year in January-June 2011 with the market share of about 19 percent, according to statistics from China Association of Automobile Manufactures. General Motor's statistics indicate that in the first half of 2011, GM and affiliated joint ventures in China have sold 1,273,500 autos, including 193,900 autos sold in June 2011 alone, both scaling a new historic high. Proprietary brands, which secured market shares thanks to the special incentive policies rolled out in 2009-2010, have to overcome great difficulties in the coming years, in how to sustain and expand market share and achieve the planned target amid a slowed-down total market growth after withdrawal of policies.

Second, efforts should be made to encourage M&A between the auto OEMs and parts manufacturers to address structural overcapacity through elimination of obsolete capacity. Draft of "12th Five-Year Plan" continues to encourage cross-regional M&A of auto groups in China with resources centralised towards leading enterprises. The future will see two to three large auto enterprise groups with annual production and sales of more than 3 million autos and four to five auto enterprise groups with annual production and sales of more than 1.5 million autos.

Third, efforts should be made to encourage development of energy-saving autos including new-energy autos. According to the Plan, small and electric autos will lead China's auto development in the future. By 2015, the total number of electric autos will reach 1 million, with the capacity of power cells of about 10 billion watt-hours. To this end, China plans to promote the development of electric auto industry chain centring on power cells, motors and electronic controls.

2.2 Interim Regulations of Beijing on Adjusting and Controlling the Quantity of Cars

To alleviate the traffic jams, Beijing municipal government released *Interim Regulations of Beijing on Adjusting and Controlling the Quantity of Cars* in late December 2010, restricting car purchase by limiting car license plate issuances in 2011 to a total of 240,000, including private cars: 88 percent; operating cars: 2 percent and cars bought by other units: 10 percent. Consequently, auto sales of Beijing accounted for 1.65 percent of the national total in the first half of 2011, down from 4.65 percent during the same period in 2010.

At present, other cities are following Beijing's suit, which will exert further impact on auto market in 2011. This shows that in tier-1 cities of China, what restrains the development of the auto is not purchasing power but the extent to which the cities can tolerate air pollution and the replicable resources (incl. roads and energies) can support autos.

2.3 Guiding Catalogue of Industrial Structural Adjustment (2011)

On 27 March 2011, NDRC issued *Guiding Catalogue of Industrial Structural Adjustment (2011) (Catalogue)*, effective as from 1 June 2011. For domestic investment projects encouraged by Catalogue, except non-tax-free commodities specified in relevant provisions, the imported self-use equipment within the total investment quota will be exempted from customs duty but be subject to value added tax on imports. Encouraged domestic auto investment projects mainly include:

- 1) Key auto parts: gasoline engine turbo-charger, electric eddy current retarder, tire pressure monitor system (TPMS), adaptive front-lighting system, LED front-lighting and digital meter;
- 2) Efficient diesel and gasoline engines;
- 3) Key new-energy auto parts: power cells, anode materials of cells, cell diaphragm, cell management system, motor management system, electronic-controlled integration of electric autos and driving motor of electric autos.
- 4) Auto electronic-controlled system: engine control unit (ECU), transmission control unit (TCU), antilock brake system (ABS), acceleration slip regulation (ASR), electronic stability program (ESP), network bus control and on-board diagnostics (OBD).

2.4 Catalogue for the Guidance of Foreign Investment Industries (Amended)

During April to May 2011, NDRC and Ministry of Commerce jointly amended the *Catalogue for the*

Guidance of Foreign Investment Industries. The draft for comment adds many projects relating to emerging strategic industries to the encouraged category and encourages establishment of new-energy auto joint ventures in China. However, the percentage of foreign equity should not exceed 50 percent in enterprises of key new-energy auto parts. It is the first time that China has specified the percentage of joint equity in key new-energy auto parts, which may have far-reaching impact on the overall layout of multinational companies in the parts industry in China. It is worth noting that in the transportation equipment manufacturing, "projects of auto manufacturing (with percentage of foreign equity not higher than 50 percent) and auto R&D centres" included in the encouraged category in Catalogue 2007 are not set out in the encouraged category in the draft for comment.

The foreign shareholding percentage limit in key new-energy auto parts will lead to adjustment of percentage of equity of a large number of foreign enterprises in China, for many key parts producers are not established as per the percentage of equity "not higher than 50 percent". Such restriction reflects China's strategic endeavour to prevent Chinese enterprises from lagging further behind their overseas counterparts in key technologies relating to new-energy autos.

Some hold that new-energy autos provide an opportunity for China to catch up with the world in auto technology. In fact, there is still a wide gap between China and the world in new-energy auto technology. On technological build-up over decades or in some cases nearly a hundred years, multinational auto companies are now able to provide technologically mature new energy products, quickly followed by multinational auto parts manufacturers who have started to explore markets in China. If China adopts a laissez-faire policy, China's auto parts manufacturers may once again lag far behind others. Although the shareholding percentage limit cannot directly help Chinese enterprises obtain and improve key technologies, they can at least share the market benefits. Experience from OEM joint venture shows that how much China's auto parts manufacturers can benefit from the new "shareholding percentage limit" in the future is largely dependent upon whether these enterprises can learn advanced technology and management skills in the joint venture. If they are simply satisfied with the profit share brought by their equity in joint ventures, they will never grow no matter what policy the government will implement.

Market size and key players' trends' analysis

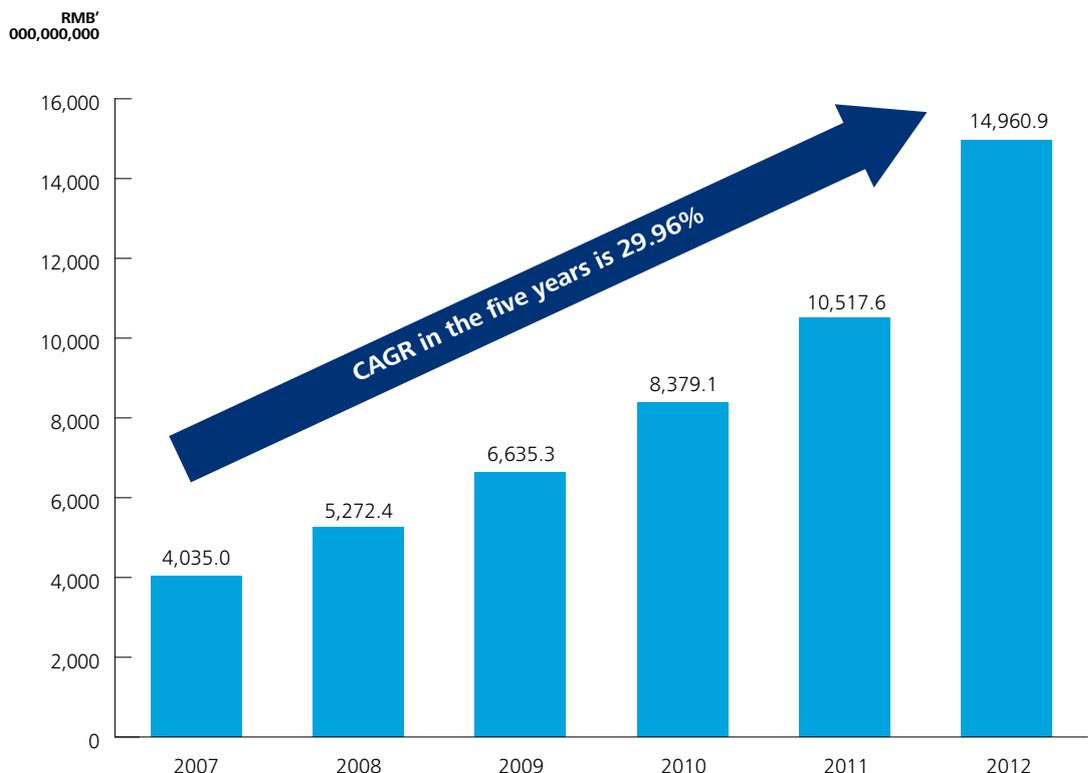
1. Market size

Since the 1990s, the auto parts industry has formed a system of global production and global purchase. Auto OEMs purchase auto parts in the world as per QCDS or QCDD (i.e. Quality, Cost, Delivery, Service or Design), making auto parts typical international products.

Owing to the complexity and professional production of auto parts, auto OEMs have dramatically reduced the self-producing parts' rate and formed a pyramid multi-tier supplier system with independent auto parts suppliers, i.e. suppliers are divided into tier-1 suppliers, tier-2 suppliers, tier-3 suppliers, etc. according to their relations with auto OEMs. In the auto parts industry, tier-1 suppliers directly provide products for auto OEMs and even participate in the primary research & development, thus forming a long-term stable cooperation relationship with auto OEMs. Tier-2 suppliers provide products for auto OEMs through tier-1 suppliers, and so on.

China has already become a key link in the global production and supply system of autos and auto parts. On the one hand, currently almost all world-leading auto parts manufacturers have entered China and are constantly expanding their businesses. On the other hand, large quantities of auto parts like auto tires, auto glasses, audio products, etc. produced by Chinese enterprises are exported. China's auto parts industry has been developing rapidly during 2005-2010, reaching a sales revenue of RMB1.5 trillion in 2010, with the CAGR of 30 percent in the past five years. Percentage of the total output of the parts sector in the total output of the auto industry has increased steadily to above 40 percent.

Exhibit 1: Sales income from China's auto parts and accessory markets (2005-2010)



Source: CAAM

2. Scale and profit margin of various enterprises

Owing to China's fast growing economy and relevant favourable policies, the number of scale domestic and foreign-invested auto parts and accessory enterprises in China surged to 11,610 in 2010 from 6,142 in 2006. However, domestic and foreign-invested enterprises vary widely in scale, income and profit. From the perspective of sales income, foreign-invested enterprises and enterprises invested by Hong Kong, Macau and Taiwan seized the largest market share, reaching 45 percent. Private enterprises stand out in number (6,403), accounting for more than a half of all enterprises. However, their market share of sales income is only 28 percent and the average annual income of each enterprise is less than RMB70 million, presenting a "scattered, small and weak" pattern. According to 2007-2010 *AutomotiveNews*, the rankings of global top 100 auto parts suppliers have been changing over the four years, but no Chinese auto parts supplier has entered the top 100 so far.

Exhibit 2: Number and market share of sales income of auto parts enterprises by ownership type in 2010

	Number of enterprises	Income (RMB' 000,000,000)	Sales income market share	Profit (RMB' 000,000,000)	Assets (RMB' 000,000,000)
Foreign-invested enterprises	2,471	6,743	45%	706	5,482
Private enterprises	6,403	4,259	28%	253	2,911
Other domestic enterprises	2,736	3,959	27%	234	3,387
Total	11,610	14,961	100%	1,193	11,780

Note: Other domestic enterprises include state-owned enterprises, collectively-owned enterprises, joint-stock cooperative enterprises, joint-stock enterprises and others.

Source: NBS

Nevertheless, a few leading Chinese auto parts enterprises have recorded higher profit margins than their overseas counterparts in recent years. According to a market survey on 50 major domestic auto parts enterprises, the average profit margin of these enterprises was estimated to reach 9 percent in 2009 (which is about two percentage points higher than that of auto OEMs) and around 10 percent in 2010 and 2011. In 2010, the net profit margins of some listed Chinese auto parts enterprises are shown in the following Exhibit. In 2010, global top ranking auto parts supplier by net profit margin were Hyundai Mobis (17.7 percent), Visteon (13.7 percent), Bosch (5 percent) and Denso (4.6 percent). We hold that the relatively high profit margin of a few Chinese auto parts enterprises is mainly attributed to their investment in advanced technology in certain market segments, products cheaper than but almost as good as those of world-leading suppliers', and higher production efficiency.

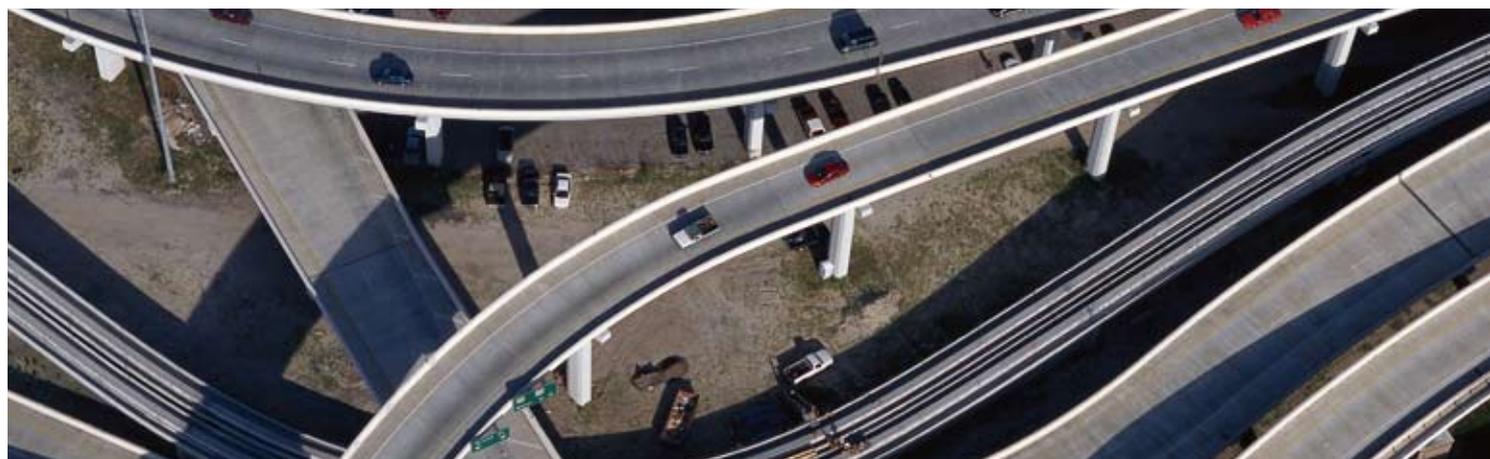


Exhibit 3: Top 20 listed Chinese auto parts enterprises by net profit margin in 2010

Ranking	Listed companies	Net profit margin	Operating income (RMB)	Principal businesses
1	Weifu High Technology	24.95%	5,371,213,196	Diesel fuel injection system
2	Fuyao Glass Industry Group	21.01%	8,508,037,837	Auto safety glasses and industrial glasses
3	Guangdong Julun Mould Co., Ltd.	18.62%	569,412,999	Equipment for producing auto radial tires
4	Far East Drive Shaft Co., Ltd.	18.25%	1,014,814,964	Drive shafts
5	Zhejiang Wanliyang Transmission Co., Ltd.	18.17%	827,139,657	Transmissions
6	Songzhi Automobile Air Condition	17.58%	1,301,437,474	Automobile air conditioners and their accessories
7	Tianrun Crankshaft Co., Ltd.	15.91%	1,393,393,876	Engine crankshafts
8	Shenzhen Terca Technology Co., Ltd.	15.70%	257,136,347	Automobile auxiliary braking products
9	Xingyu Automotive Lighting	15.66%	870,769,514	Automotive lights
10	Kuangda Group	14.55%	781,881,702	Fabrics for internal decoration of vehicles
11	Ningbo Shuanglin Auto Parts Co., Ltd.	13.42%	775,887,892	Auto parts like plastic parts, metal sheets, machining parts, etc. and moulds
12	Ningbo Huaxiang	12.61%	3,333,110,387	Internal & external
13	Anhui Zhongding Sealing Parts Co., Ltd.	12.32%	2,522,429,744	Sealing parts and auto non-tire rubber products
14	Weichai Power	10.72%	63,279,564,390	Power assembly and commercial vehicle and auto parts
15	Jiangxi Huawu Brake Co., Ltd.	10.67%	314,519,038	Industrial brakes
16	Asia-Pacific Technology Group Co. Ltd.	10.66%	1,136,349,044	Precision aluminum tubes and special materials for automobiles
17	AVIC Aero-Engine Controls Co., Ltd	10.57%	1,514,358,573	Dynamic control system
18	Hongda High-Tech Holding Co., Ltd.	9.79%	409,467,457	Fabrics for internal decoration of automobiles
19	Guangdong Hongtu Technology (Holdings) Co., Ltd.	9.54%	894,076,956	Precision aluminum and magnesium alloy castings
20	Faw Fuwei	9.23%	6,182,502,373	Auto parts like tires

Source: Gasgoo.com, statements of respective listed companies

3. Development trends of various enterprises

3.1 Multinational auto parts enterprises: monopolistic core technologies, intensive and active M&As

Although now most high-tech auto parts products are made in China, key technologies are still in the hands of global giants. In China, less than 43 percent of auto parts suppliers have patents and suppliers with invention patents are less than 20 percent. About 80 percent of applications for auto technology patents in China are on utility models rather than on invention. According to a recent report by Gasgoo.com based on large-scale research and evaluation on China's auto parts industry, as of June 2010, wholly foreign-invested enterprises and joint ventures basically hold over 70 percent of market share in EMS (Engine Management System), airbags, ABS system, three-way catalytic converter, automatic skylights, air-conditioning system, automotive seating assembly, motor glass elevator, lighting system, automatic transmissions, high pressure fuel pumps, etc. and some products are almost monopolised by foreign-invested enterprises. Multinational companies are still taking the lead in R&D and industrialisation of new key technologies like hybrid power, key electric car parts and electronic control.

With strong synchronous development ability, data and experience accumulation, and massive investment in the research & development of core parts, multinational auto parts enterprises not only supplies to foreign brands and joint venture brands in China but also provide auto parts to many local auto OEMs as well. Multinational auto parts companies' entry to Chinese markets has driven the development of China's auto industry, meanwhile China auto market's outstanding performance enabled multinational companies to earn big money. In 2010, Bosch's sales revenue in the Chinese market reached RMB23.3 billion, up by 38 percent compared with 2009. China has become its third largest market after Germany and the United States. ZF Friedrichshafen AG's sales amount in China reached Euro1.324 billion in 2010, up by 44 percent compared with 2009 and accounting for over 10 percent of its global sales. China has become ZF Friedrichshafen AG's second largest market next only to Germany. In 2005-2010, Valeo's average growth rate of sales amount in China is 30 percent.

As China mounted the throne as the largest auto production and sales country in the world, multinational auto parts enterprises are stepping up localising their operations in China.

- French auto parts manufacturer Valeo expressed that Valeo's investment in China is expected to reach Euro400-500 million by 2015 and it plans to increase its sales amount in China from Euro460 million in 2009 to Euro920 million in 2013.
- In 2010, Delphi increased the capacity of its auto air conditioner production base located in Shenyang, and its connection system production base located in Jiading, Shanghai has become Delphi's largest connection production base in the world. Furthermore, Delphi formally launched China-based production of Delphi diesel electric control system by transferring technological licences to local auto parts manufacturers.
- In June 2010, ZF Friedrichshafen AG officially opened its new Asian headquarters and Shanghai research centre (which is one of the eight global engineering research centres). In September 2010, ZF Friedrichshafen AG respectively renewed strategic cooperation agreements with Dongfeng Commercial Vehicle Company and Beiqi Foton Motor Co., Ltd., and reached an intent of joint venture with Baotou Bei Ben Heavy-Duty Truck Co., Ltd.

Besides increasing investment, building or expanding production bases, setting up research centres and strengthening cooperation with local auto OEMs, multinational companies are also aggressive in their M&A activities in China. Data from Mergermarket showed that there were a total of 21 domestic M&A transactions on auto parts from 2010 to June 2011, with the disclosed transaction amount topping US\$977 million.

3.2 Local parts manufactures: development polarisation, industry integration and leading companies' speeding up globalisation

Generally speaking, local parts enterprises are weak in independent research & development, especially in core technologies of entire autos assembly and key parts. Some auto parts enterprises are able to research and develop single parts but lack total parts solutions, making it hard for them to become tier-1 suppliers for auto OEMs. Currently Chinese auto parts enterprises' average investment in research & development only accounts for 1.4 percent of their sales income, far below international average (6.6 percent). If such a situation continues, the overall technology and research & development ability of local parts enterprises can hardly make significant headway in the short term.

Development of 8,000 scale domestic auto parts enterprises varies, presenting a trend of pyramid polarisation. A few enterprises excelling in comprehensive design and technology like Weichai Power (engine system), Wanxiang Qianchao Co., Ltd. (transmission system), Ningbo Huaxiang (internal decoration system), etc. can provide modularised components and system assembly. There are also a few Chinese enterprises which have made outstanding achievements in market segments and can directly compete with global giants and whose products and technologies are recognised in both domestic and international markets. Examples are Fuyao Glass focusing on automobile glasses and Tianrun Crankshaft engaging in casting and processing engine crankshafts and connecting rods. However, a majority of Chinese enterprises are small in size and deficient in profitability, manufacturing similar products with low technological level. With potential excess capacity in certain sub-sectors, industry integration is just on the way, and enterprises lagging in product and technology will have to get out of the way in the competition.

Competition in auto and auto parts industries has become global. Global giants and Chinese enterprises compete in the Chinese market, meanwhile many Chinese enterprises also venture out to overseas markets. However, currently Chinese enterprises mainly export material-intensive and labour-intensive products with low added value like glasses, tires, wire harnesses, sound equipment, etc. The relatively low added value is largely determined by fluctuations of material and labour cost. Under the background of global inflation, price hike of raw materials and shrinking demographic dividend in China, Chinese enterprises are losing their cost advantage and auto parts exports are calling for structural upgrading.

Apart from exporting products, some leading Chinese enterprises are also speeding up globalisation by establishing overseas factories and joint ventures, and implementing cross-border M&As. In July 2011, Wanxiang Qianchao Co., Ltd. contributed RMB50 million to establish a joint venture with Magneti Marelli (an auto parts company under Fabbrica Italiana Automobili Torino), with 50 percent of shares held by each party. Businesses of the joint venture include researching, developing, producing and selling shock absorbers and related products, and providing relevant technology consultation, assistance and other after-sales services. Joint venture cooperation with foreign counterparts not only helps to improve Chinese enterprises' technological development abilities but also enables domestic auto parts enterprises to enter the supplier list of foreign auto OEMs, thus reaching out further to domestic and overseas markets.

On 8 April 2011, Aviation Industry Corporation of China (holding 51 percent shares) and Beijing E-Town International (holding 49 percent shares) held a signing ceremony in Beijing for joint purchase of Nexteer Automotive. This purchase was worth US\$420 million, the largest overseas M&A ever by a Chinese auto parts enterprise and the largest M&A of auto parts between China and the United States up to now. By way of the high-end auto steering and transmission technologies acquired through M&A of Nexteer, the existing auto parts sector under China National Aviation Corporation may both achieve product upgrading and enter the mainstream auto markets of the world as tier-1 supplier of core parts through Nexteer's channels. Before M&A, Nexteer took about 10 percent market shares worldwide in the sectors of traditional auto transmission system and hydraulic power steering system, and has world leading core technology in emerging electric power steering system, becoming the fourth largest global supplier of electric power steering system and occupying 9 percent market shares worldwide. It is estimated that in 2020, half of the world's autos will use electric power steering system, and China National Aviation Corporation will become a world leading parts supplier by virtue of the advanced technology of Nexteer.

Xinhuanet: This purchase indicates that Chinese auto parts enterprises now have world leading core technologies, products, quality customers, mature talents and management teams in key parts and systems, and have secured global leadership in both industrial scale and technological level. This purchase helps Chinese enterprises to rapidly enter the mainstream of international auto parts industries and participate in global competition as multinational players.

General manager Lin Zuoming of Aviation Industry Corporation of China (AVIC) said, as China's backbone aviation industrial enterprise and a global-500 enterprise, AVIC has been devoted to developing aviation manufacturing and transport industries and auto-related industries. At present, AVIC auto parts and relevant industries have laid a certain foundation and is now at a stage of accelerated development. Based on the status quo of domestic auto parts industry, AVIC promotes the development of Chinese auto parts industries by purchasing powerful overseas high-end parts enterprises. He said, as a controlling shareholder, AVIC will fully support the development of Nexteer, developing it into a leading supplier of auto steering system in China.

Remenar (CEO and President of Nexteer Automotive) said, Nexteer is a multinational corporation with a history of more than 100 years, and was a wholly owned subsidiary of General Motors Corporation before the purchase. Headquartered in Michigan, the United States, the corporation has 20 factories, three R&D Centres, two skid pads and 11 technical and customer service centres in seven countries. More than 70 high-end customers worldwide of the company include General Motors, Ford, Chrysler, Volkswagen, Peugeot Citroen, Fiat and BMW. After this purchase, Nexteer Automotive becomes a supplier completely independent of auto OEM, ensuring its preeminence on its original markets and developing new market space and customer groups. Capitalising on the background and power of AVIC, policy and capital support of Beijing, and a growing auto market in China, Nexteer Automotive will also develop rapidly.

3.3 Local OEM in-house: transition from providing support for the group to seeking independent development

Representative enterprises are Huayu Automotive Systems Company, Parts & Components Business Unit of Dongfeng Motor Co., Ltd and Fawer Automotive Parts Limited Company, providing auto parts to SAIC Group, Dongfeng Group and FAW Group respectively. At present, they mainly provide various parts and supporting systems to local OEMs and joint ventures of the group, with their performance highly linked to the group. For example, about 67 percent operation revenue of Huayu Automotive in 2009 came from auto OEMs under SAIC Group including Shanghai Volkswagen and Shanghai General Motors. Due to the rapid development of SAIC Group's joint venture, the proportion of the connected business with SAIC Group in 2010 rose to 84 percent.

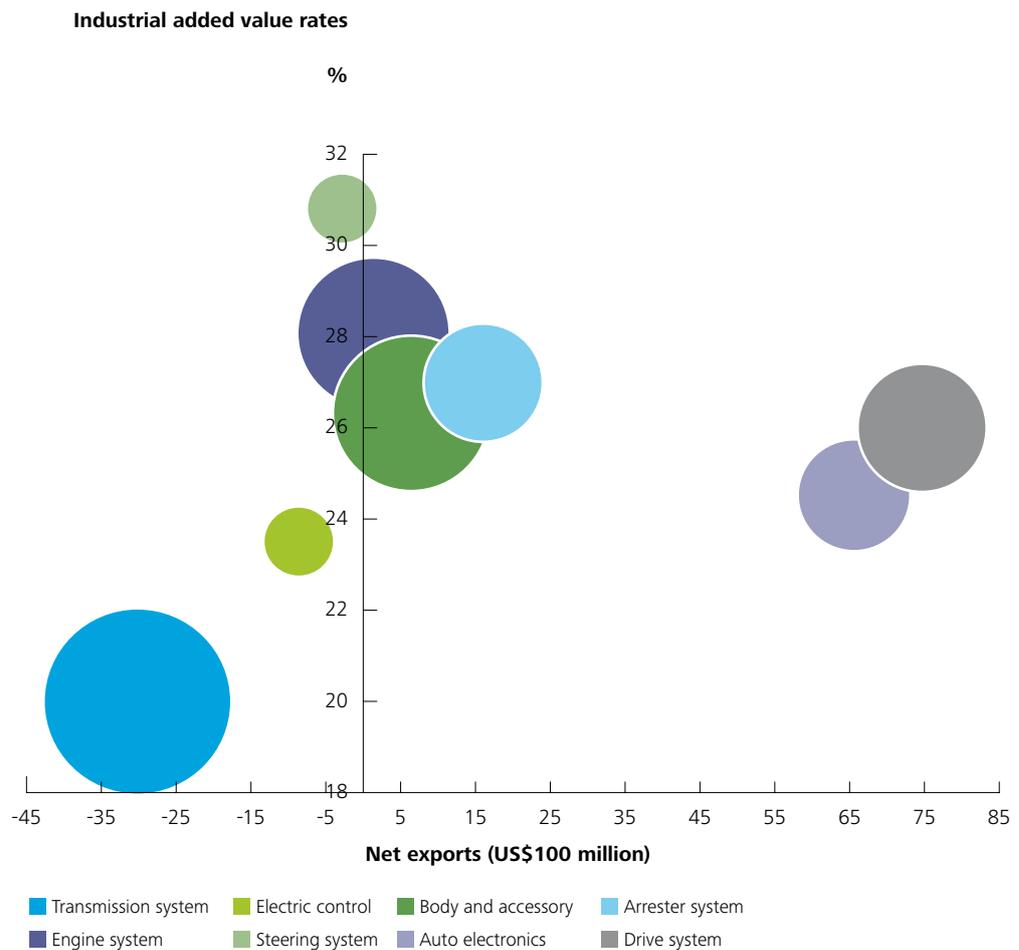
However, these in-house parts enterprises of local auto groups are also seeking independent development. Huayu Automotive clearly put forward the strategic objective of "tier zero, neutralisation and internationalisation" to develop highly integrated and neutralised parts supply chain system and positively develop customers besides SAIC Group. In March 2010, Huayu Automotive signed a strategic cooperation framework agreement with Jianghuai Automotive. In internalisation, products of Huayu Automotive including interior decorations, lamps, auto electric and oil tank systems have entered markets in Europe, America, South Korea, Australia and Southeast Asia, and Huayu is preparing to build overseas customer centres to further develop global markets. At present, Fawer Automotive Parts Limited Company provides support for FAW Group with about 70 percent of its products, but also for more than 40 auto OEMs and main engine manufacturers including Volkswagen, Shanghai General Motors, Dongfeng Peugeot Citroen Automobile, Huachen Auto Group, Guangzhou Fengshen Motor, Chery Auto, China National Heavy Duty Truck Group, Northern Benz, Anhui Hualing and Dandong Huanghai Automotive.

Recently, SAIC Group transferred its shares of Huayu Automotive (600741, SH) to Shanghai Motor (600104, SH) for an overall listing. However, in the long run, it is a trend that local OEMs' in-house auto parts business will develop independently, to explore OEM markets outside the group and profitable after market.

Market segments' outlook

An auto is composed of tens of thousands of parts which are divided into four systems including engines, chassis, bodies and accessories and electrical equipment; chassis includes arrester system, drive system, steering system and transmission system, and electrical equipment is divided into electronic control and auto electronics. Industrial output values of parts systems reflect the sizes of relevant market segments, industrial added value rates indicate gross margins of relevant market segments, and imports/exports reflect their development in China, as shown in the following Exhibit.

Exhibit 4: Development of auto parts systems in China (2008)



Note: Sizes of circles indicate business sizes

Source: State Information Centre, GAC statistics and Deloitte Analysis

Due to the high cost proportion of raw material (steel) of transmission shafts, transmission system posts the highest industrial output value but limited industrial added value; and it is also the subsystem with the highest net import value due to large proportion of imports of transmissions. Electronic control is also a parts subsystem depending heavily on imports. It is a high-tech and asset-light sector which should have high gross margin. However, lack of domestic core technologies leads to distorted gross profits in China, but the sector promises the highest growth potential. Engine system and body and accessory system log large output value, high technical barrier and gross margin, and along with production transfer of international tycoons and technological progress of Chinese enterprises, export value will increase year by year. Subsystems including arrester system, drive system and auto electronics with moderate output value and gross margin log the largest parts export value in China due to massive exports of arresters, wheels and tyres.

Looking to the future, we believe:

1. Growth of market segments including auto electronics and interior & exterior decorations will be far higher than that of entire auto markets due to rising decoration rate

Due to the super high growth in automobile sales in the past two years, overdrawing part of auto demand and the withdrawal of auto consumption incentive policy in 2011, we think that the growth of auto sales from 2011 to 2013 will greatly slow down. In April and May 2011, auto output and sales of China posted the first continuous year-on-year negative growth after the global financial crisis. In June, auto output and sales increased slightly on both month-on-month and year-on-year grounds. Total sales in the first half of 2011 was 9.3252 million autos, increasing by only 3.35 percent year on year. CAAM has drastically lowered the year-on-year growth target from annual 10-15 percent to about 5 percent.

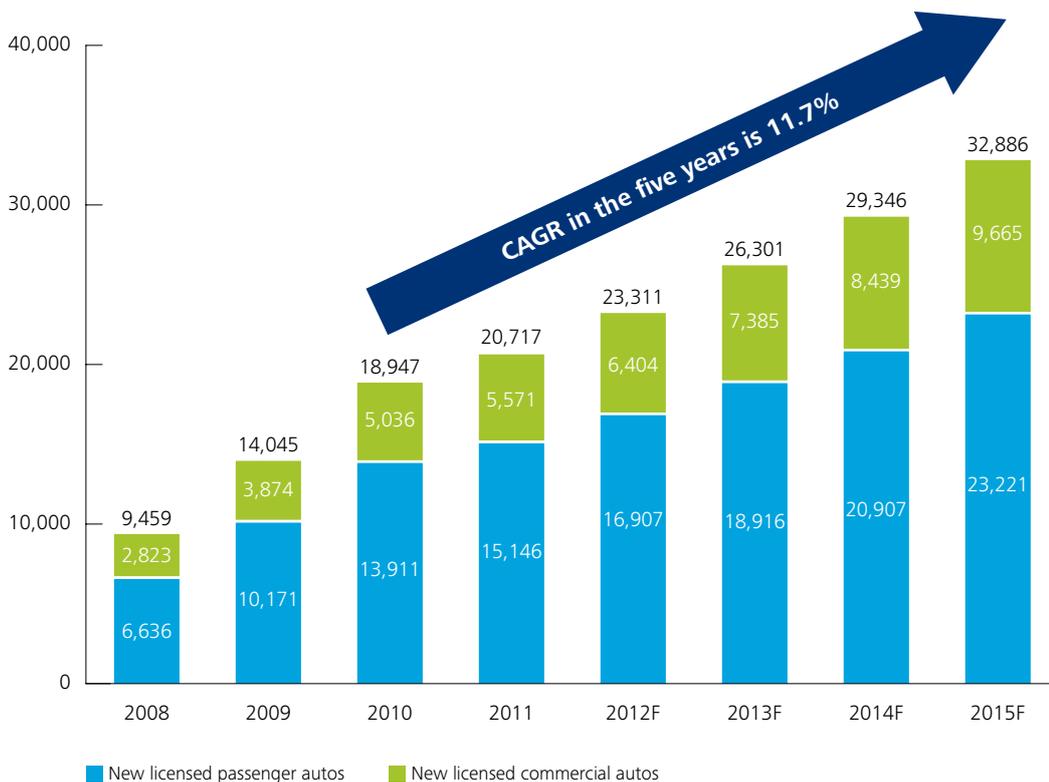
However, we think that China’s auto ownership still has large growth potentials in the long run, owing to such major driving forces as:

- Low auto ownership leads to huge growth potentials. NBS data show that every thousand Chinese people own 52 autos, far less than 833 of the United States, 583 of Japan, 355 of South Korea, and the world’s average of 141, promising huge growth potentials.
- Increasing urbanisation drives auto consumption demand in central and western China and tier 3/tier 4 cities.

Economist Intelligence Unit forecasts that in 2015, annual sales volume in Chinese markets will record 23.221 million passenger autos and 9.665 million commercial autos, and CAGR from 2010 to 2015 will reach 11.7 percent.

Exhibit 5: Forecasts on 2010-2015 auto sales in Chinese markets

1k autos



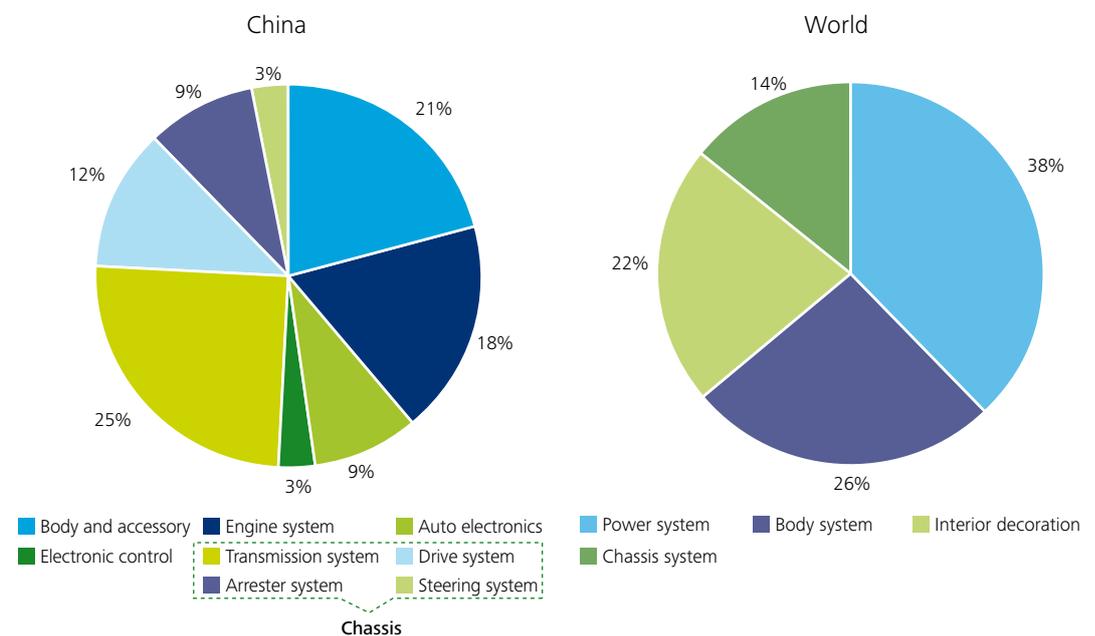
Source: Economist Intelligence Unit

Although growth forecasts from different parties slightly differ, it is commonly acknowledged that the growth of market segments including auto electronics and interior & exterior decorations will be far higher than that of entire auto market owing to increased decoration rate. Main factors are:

First, intelligence, electronisation and comfort are general development tendency of the auto industry. Modern autos are developing from simple means of transport to meeting human needs and the requirements of safety, comfort, convenience and cleanness. In Chinese markets in recent years, GPS, in-vehicle infotainment and anti-lock braking system (ABS) developed rapidly, and electronic stability programme (EPS), omnibearing-distance system (OBD) have gradually become standard configurations of medium/high-grade autos. In the future, new applications and solutions of auto electronics will emerge in endless succession, and reach from medium/high-grade to economic autos.

Second, the decoration rates of electronic control, auto electronics and interior decorations of Chinese autos are low therefore have huge room to grow. Electronic expense of each new auto in China accounts for only about 7 percent of the value of the entire auto, far lower than the global average of 26 percent. The following Exhibit also shows that the proportions of interior decorations (including auto electronics) and power systems (including electronic control) in China's output value is far lower than the world's average. Along with the upgrade of consumption structure, Chinese consumers' requirements for comfort, technology and safety become higher, and the decoration rates of interior decorations, electric equipment and electronic controls will also rise gradually.

Exhibit 6: Comparisons of output value proportions of various parts systems of China and the world (2008)



Source: State Information Centre, CIC Securities Research Institute

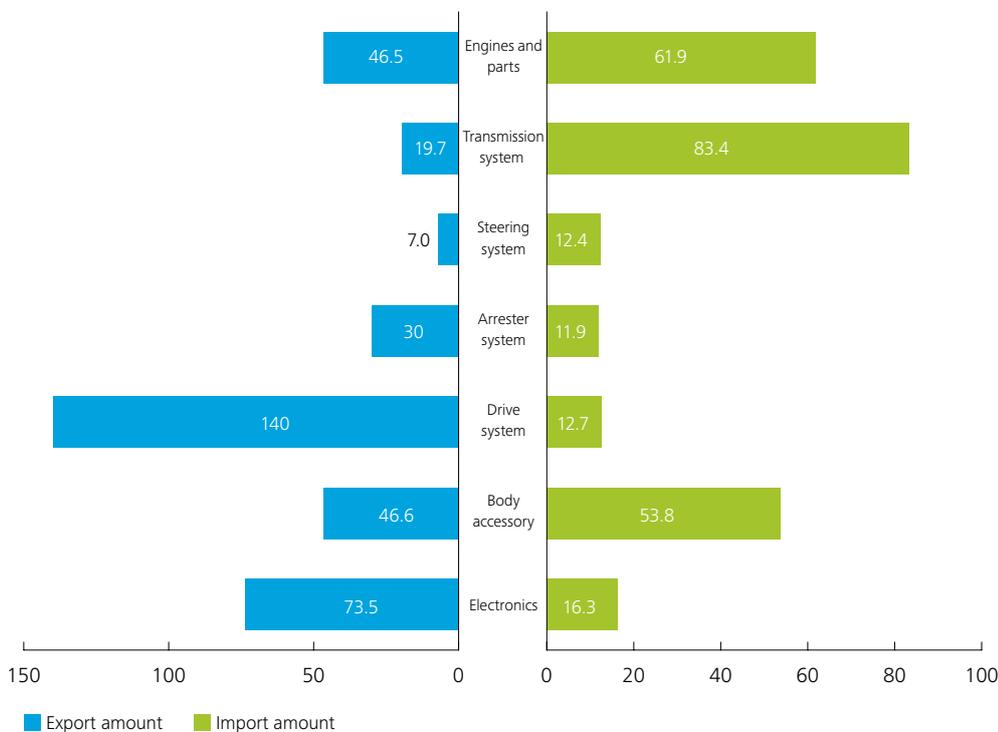
Third, mode and structure of entire autos to be sold will change. Owing to consumption upgrade, inflation's little impact on purchases of medium/high-end earners, the growth of sales volume of medium/high-end autos will be faster than the overall market, especially in recent three years. Sales data of the first half of 2011 has proved that high-end, imported and luxury autos grew fast, and low-end, domestic and common autos grew slowly. Driven by rising market shares of higher electronization and more comfortable medium/high-end autos, such market segments as auto electronic control, auto electronics and interior & exterior decorations will maintain higher growth.

2. Recovery of sales in overseas auto markets and supply decrease caused by Japan's earthquake will push up demand for China-produced parts, exports of arresters, wheels and body parts of China will benefit most in the short term

China is vital for global production and purchase of auto parts. Auto parts exports in 2010 reached US\$40.6 billion, accounting for 78 percent of total exports of auto commodities and posting a year-on-year growth of 42 percent, contributing most to exports.

Seen from the imports & exports structure in 2010, drive system parts including wheel hubs and tyres, arresters and other arrester system parts, body and accessory system parts including glasses and lamps registered robust exports.

Exhibit 7: Imports and exports of China's auto parts by system in 2010 (US\$100 million)



Source: GAC, CAAM

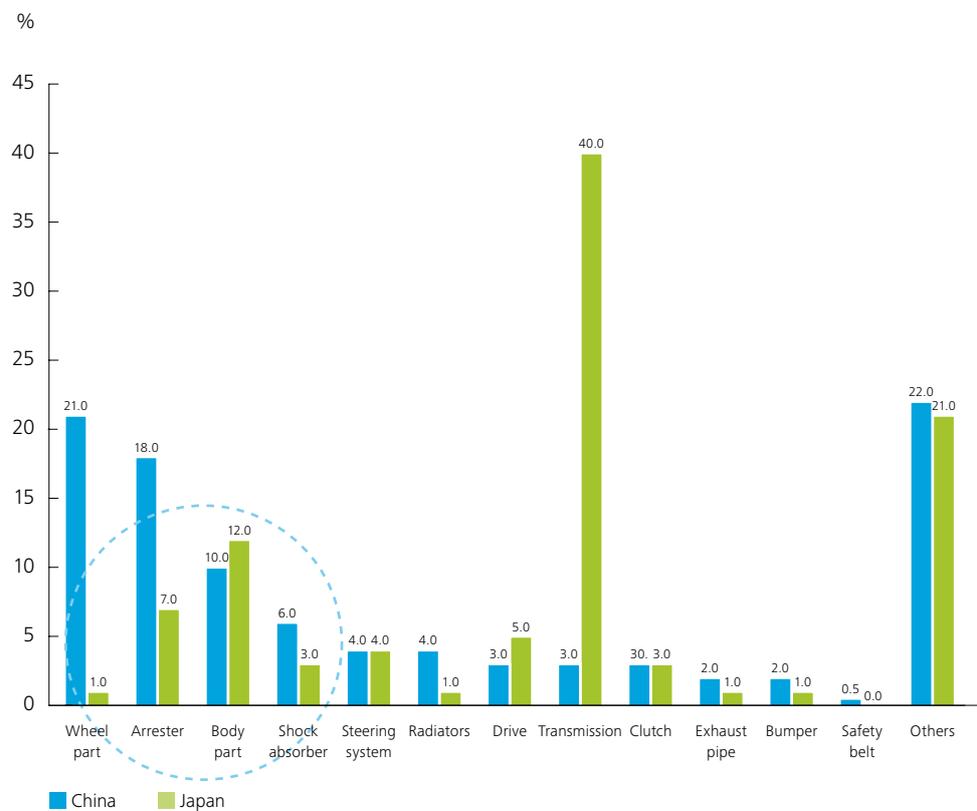
After the financial crisis, auto sales in mature markets led by the United States and emerging markets led by Russia have been gradually recovering. On the other hand, the requirement for further cost control in the post-crisis period also forced General Motors, Volkswagen and other European and US auto OEMs to increase parts purchase from emerging markets. These two factors drive up demands on auto parts exports of China. Although China entire auto market only increased by 3.35 percent year-on-year from January to June this year, according to CAAM statistics, China's auto parts export value in the same period grew rapidly, specifically, year-on-year growths hit 37.9 percent of steering parts, 25.7 percent of transmission parts, 25.1 percent of arrester parts, 17.9 percent of electronics, and 17.3 percent of body and accessories.

Japan earthquake in March 2011 harmed its auto industrial capability and will bring about two long-term impacts: On the one hand, Japanese enterprises may slow down its overseas expansion to recover its local capacity; on the other, auto supply system is expected to be more decentralised throughout the world, both bringing opportunities for a transferred demand to Chinese auto parts.

Take the United States (China's largest parts exporter) as an example, Canada, Mexico, China, Japan and South Korea take up approximately 80 percent of the United States imports. As the second largest source country of auto parts imports of the United States, China takes 11 percent shares, only next to Japan (18 percent). Japan earthquake this year influenced its entire autos and parts supply capability and may force orders to be transferred to other suppliers of the same products worldwide.

However, the parts export structure of Chinese autos is different from that of Japan. China is the biggest source country of arrester imports of the United States. Auto parts exports of Japan are mainly transmissions which account for about 40 percent of Japan's parts exports, and China was not capable of supplementing enough of this product in the short term. Body parts, arresters and wheel parts accounting for 12 percent, 7 percent and 1 percent of Japan's export amounts are key auto parts that China supplies to the United States, and the demand shortage caused by Japan earthquake is expected to be supplemented by these parts from China. Therefore, China's exports of arresters, wheels and body parts will benefit most in the short term.

Exhibit 8: Comparison between composition of auto parts exports of China and Japan (2009)



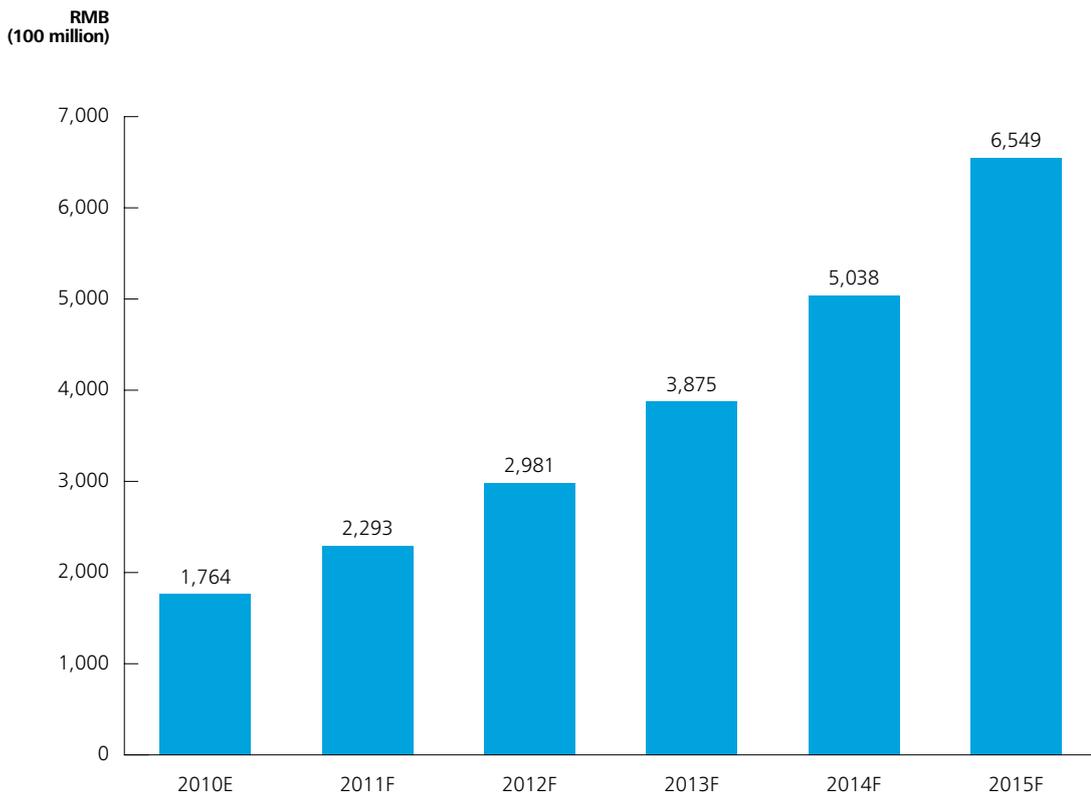
Source: The United Nations (U.N.)

3. China's after market (including spare parts and service) promises huge potentials, and will become a new growth engine of demand for parts.

Auto parts industry is closely related to but different from entire auto market. Auto parts have demand in both auto OEM market and after market. According to global experience, aging and increasing ownership of autos push up parts demand from after market. At present, auto manufacturers usually provide a warranty period of two to three years for new autos, and the maintenance fees after the period will be borne by auto owners. Judged from the frequency of auto parts update, after a period of two to three years or a mileage of about 40,000 km, many important parts have increasing need for maintenance and replacement. According to the data announced by the Ministry of Public Security Traffic Management Bureau of the People's Republic of China, after the rapid development in recent years, as in June 2011, China owned 98.46 million autos, which means expanding derivative demand for after-sale services including check, maintenance, repair, accessory, auto decoration and refitting.

Compared with mature auto markets, the percentage of revenue and profit contribution rate of Chinese auto parts and service business in the industry chain still have large room to increase. Along with the maturity of auto markets, after market (including spare parts and service) will become a new growth engine of demand for parts. Gasgoo.com estimates that in 2010, demands from domestic after market accounted for 14 percent of all revenue from China’s parts sales, and the proportion will increase. In the five years from now to 2015, the CAGR of China’s auto after market will exceed 30 percent.

Exhibit 9: Forecasts of sales volume of parts in Chinese after-sale markets (2010-2015)



Source: Gasgoo.com

In China, auto OEMs, no matter from consideration of profit increase or competition advantage, will attach increasing importance to the after market, which benefits auto parts suppliers. In the first half of 2011, due to sluggish sales of entire autos, inventories increased and prices underwent downward pressure. In the second half of 2011, auto manufacturers are expected to further lower prices to complete the annual sales plan. With auto prices decline, profits of auto OEMs also decrease. After market with higher profit margin than entire auto market will become another large undeveloped goldmine auto OEMs scramble for. Due to intensifying competition in China’s auto market, the after market (including spare parts and service) becomes the second battlefield of auto sales and is vital to auto OEM's differentiation during the competition.

In addition, auto parts multinational companies have begun actions in China’s auto after market. Recently, the 1,000th Bosch Car Service Station was opened in Changzhou, Jiangsu. Based on global after-sale strategic concept of “accessories + diagnosis + services”, Bosch Car Service Stations provide customers with one-stop auto services integrating hardware (Bosch accessories and measuring equipment) and software (technical information, training and management ideas), covering the main cities in China and will expand to tier-2 and tier-3 cities. By 2015, there will be a total of 2,000 Bosch Car Service Stations in China.

4. From the perspective of supply, as regular auto and new-energy auto markets both face overcapacity risks, the parts industry will also enter an accelerating integration stage.

The draft “12th Five-Year Plan” expects the total auto sale at 25 million in 2015. However, according to information disclosed so far, the top 12 mainstream auto enterprises set their capacity at 35 million in 2015. China has over 120 auto OEMs (the figure will be nearly 700 if refitting factories are counted), while in developed countries there are generally fewer than five main auto manufacturers.

Such overcapacity is generally recognised as structural overcapacity. Most joint-ventures are under capacity, while some companies owning proprietary brands blindly “outpace” the forecast of sales and capacity expansion. The surge of auto sales in 2009 and 2010 and blind launch of auto projects of local governments together lead to the structural overcapacity in the auto industry. Since the auto industry has a long industrial chain and provides strong driving force for other industries, there are a total of 27 provinces, regions and cities in China producing autos and taking autos as their pillar industry.

Upstream parts industries are also faced with structural oversupply. Core parts with hi-tech content are in short supply and rely on imports; and some low-end products are faced with serious oversupply. In the last two years when auto sales was upbeat, a total of 2,234 enterprises entered into the auto parts industry in 2009 and another 1,073 enterprises followed in 2010. In 2011 when there is a structural adjustment in the auto market, the state rolled out clear-cut policies to encourage M&A and restructuring of auto enterprises and solution of structural overcapacity through eliminating obsolete capacity. In the following five years when the upstream parts industry will usher in the peak of integration, enterprises with advanced technologies and high-quality products will have more opportunities on the accessories and after-sale markets, while those with backward technologies will be merged or knocked out.

It is also true with the new-energy auto market. As new-energy auto and parts enterprises nationwide swarm to request state subsidies, there exists the risk of serious overcapacity. The state sets the total sale of only 1 million autos in 2015 in the draft of the “12th Five-Year Plan”. According to the incomplete statistics collected from different areas or auto enterprises, over 5.5 million new-energy autos are planned for 2015. Obviously, the state target capacity of new-energy autos is by far lower than the total planned capacity of all provinces. Likewise, the planned capacity of provinces is also generally lower than that of cities under their jurisdiction. For instance, the *Zhejiang Development Plan of New Energy Automotive Industry* plans a capacity of only 60,000 autos in 2015 (as compared with 450,000 for Shaoxing and 105,000 for Jinhua). The *Guangdong Development Action Plan for Electric Automobile* plans a capacity of only 200,000 electric autos for Guangdong, but Zhuhai Yintong Energy Co., Ltd alone will complete a project with annual output of 500,000 new-energy autos. Besides Shaoxing and Zhuhai, other cities with large planned capacity include Beijing (0.75 million), Tangshan and Hefei (0.5 million respectively), Changsha (0.3 million), Changchun, Wuhan and Xiangyang (0.2 million respectively).

In fact, there still exist some uncertainties in the policy of new-energy autos. On 16 July, 2011, *Seeking Truth* excerpted the report of Premier Wen Jiabao at the Eighth National Congress of China Association for Science and Technology (CAST), indicating a series of problems such as the unclear development direction of new-energy autos in China, “What are the direction and ultimate goal? It is not clear whether hybrid power and electric autos will be the final products.” The *Energy Saving and New Energy Automotive Industry Development Plan (2011-2020)*, which should have been issued in the first half of 2011, hasn’t yet come out. Recently, sources with Ministry of Industry and Information Technology denied that “RMB100bn government subsidy programme” is included in the *Energy Saving and New Energy Automotive Industry Development Plan*. Uncertainties of policy and absence of technical standards are other nuisances besides overcapacity. Moreover, new-energy auto enterprises and their parts enterprises may see their investment go up in smoke in the coming integration.

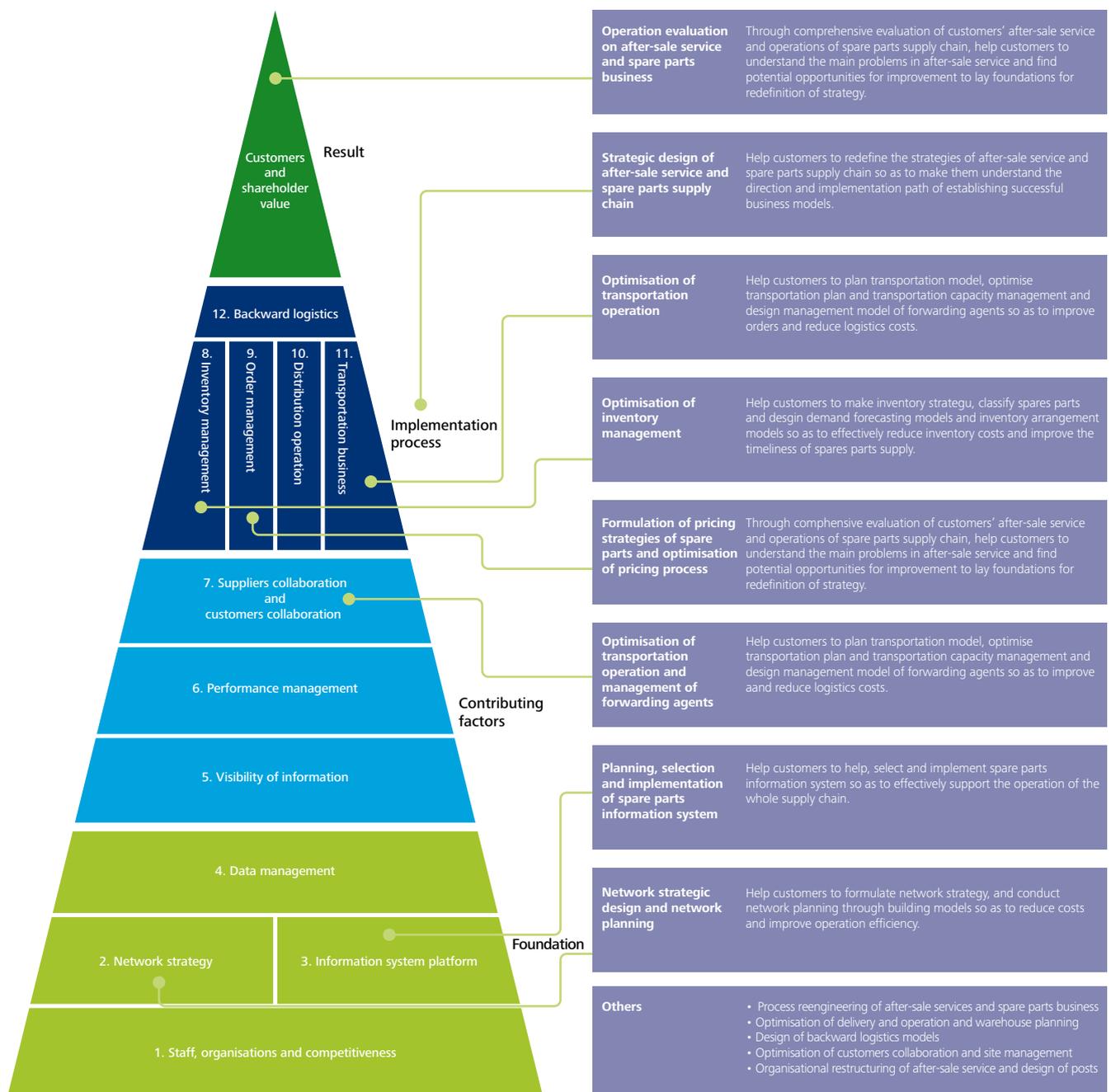
Market opportunities and the suggestions from Deloitte

1. Develop parts aftermarket

As mentioned above, the huge demands from China's auto after market for autos parts will be released in the coming few years. Compared with the entire auto market, after market can bring more profits and is less affected by seasonal fluctuations.

After-sale service and spare parts business have significant influence on financial performance and customer satisfaction. As the service market (incl. after-sale service) will be the main competition battlefield of the auto industry, it is necessary to provide high-level services at reasonable costs. Besides, improving the operating results of after-sale accessories supply chain can significantly increase revenue, raise profits, improve cash flow, timely provide customers with accessories needed and enhance their loyalty toward core business and brands.

Exhibit 10: Deloitte's supply chain model of after-sale accessories



It is an industry consensus that it is not easy to manage after-sale accessories well. Based on key factors, Deloitte has developed a model of after-sale accessories supply chain and may help customers establish successful operation mode of after-sale service and spare parts supply chain and achieve sustained growth by combining in-depth understanding of China's market with practice of projects of world-leading enterprises

2. Opportunities of industry M&A and integration

The auto parts sector saw very active M&A transactions in the past few years. From 2006 to the first half of 2011, the outbound, inbound and domestic M&A transactions of five auto parts enterprises are shown in the following Exhibit. M&A and integration among domestic auto parts enterprises is an inevitable trend of industrial development and under the support and encouragement of state policies. Overseas M&A of Chinese enterprises (i.e. the aforesaid joint purchase of Nexteer Auto by China Aviation Industrial Auto and Beijing e-Town International), contributes to rapid acquisition of international leading core technologies, products, high-quality customers, mature talent and management teams as well as opportunities to enter into mainstream markets of international auto industry, and is a shortcut for China's parts enterprises to overtake world advanced levels.

Exhibit 11: Top five Outbound, Inbound and domestic M&A transactions (2006-1H2011, by value)

Types of M&A	Date of announcement	The merging & acquiring party	The merged or acquired party	Transaction value (US\$1m)
Outbound M&A	In December 2010	China Aviation Industrial Auto (holding 51% shares) and Beijing e-Town International (holding 49% shares)	Nexteer Auto (a worldwide leading supplier of transmission systems and power steering systems)	420
	In April 2011	Beijing Hainachuan Automotive Parts Co., Ltd.	Inalfa Group (an auto roof system supplier with its headquarters located in Netherland)	373
	In March 2009	BWI Group	Delphi Corporation (suspension systems and brake businesses worldwide)	100
	In November 2010	Beijing Automotive Industry Holding Co., Ltd.	WEIGL Transmission Plant AB	41
	In March 2009	DSI Holdings Limited (acquired by Geely)	Drivetrain Systems International Pty Ltd. (businesses in Victoria and New South Wales)	33
Inbound M&A	In July 2010	Bain Capital	ASIMCO Technologies Ltd.	150
	In July 2008	Affinia Group Inc.	HBM Investment Co., Ltd. (holding 85% shares and indirectly controlling Longkou Haimeng Machinery Co., Ltd.)	49
	In October 2007	Hong Kong Xin Yi (International) Investment Limited (Xin Yi Glass)	Shenzhen CSG Automotive Glass Co., Ltd.	31
	In February 2010	Michelin Tires	Shanghai Michelin Warrior Tire Co., Ltd. (holding 30% shares)	25
	In April 2011	Toyo Tire & Rubber Co., Ltd.	Shandong Silverstone Lu River Rubber Tire Co., Ltd. (holding 75% shares)	22
Domestic M&A	In June 2008	Shanghai Bashi Industrial (Group) Co., Ltd.	Shanghai Automotive Industry Group Corporation (owning 23 auto parts enterprises and other relevant parts assets)	1,101
	In March 2008	Zhejiang Zhongda Group Co., Ltd.	Zhejiang Yuantong Mechanical & Electrical Products (Group) Co., Ltd.	560
	In June 2008	Sichuan Jinyu Automobile City (Group) Co., Ltd.	Western Auto City Co., Ltd. (holding 64.53% shares)	82
	In April 2006	China National Heavy Duty Truck Group Jinan Truck Co., Ltd.	China National Heavy Duty Truck Group Jinan Caxle Co., Ltd. (holding 51% shares)	68
	In September 2009	Gold Stone Investment Co., Ltd., Jilin Yadong Investment Management Co., Ltd., Jilin Tianyi Investment Co., Ltd.	Fawer Automotive Parts Co., Ltd. (holding 29% shares)	49

Source: Mergermarket

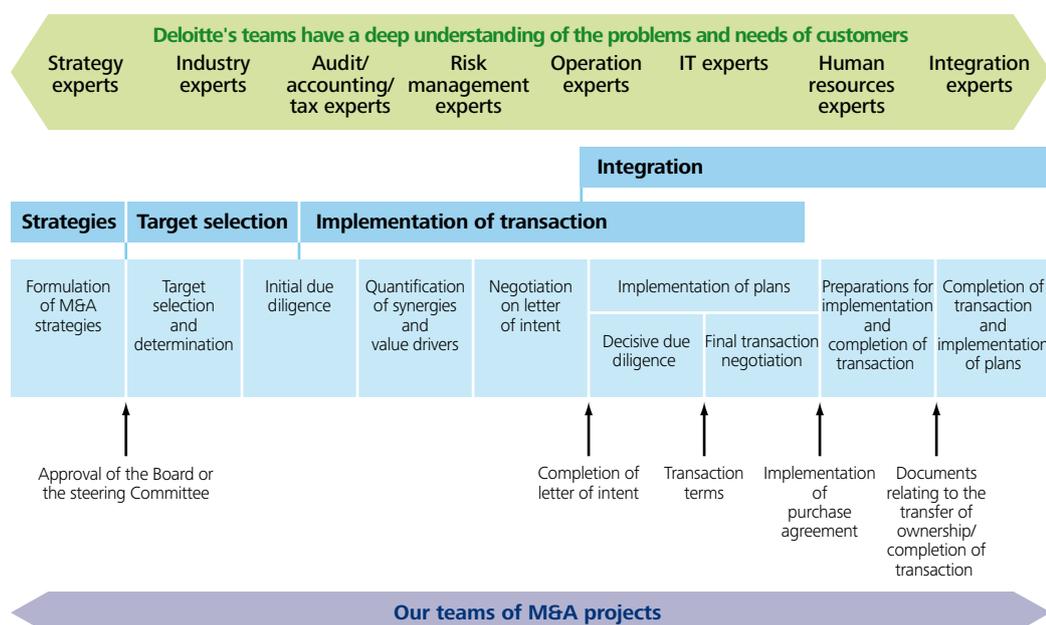
In the next few years, China's auto parts industry will enter into an stage of accelerating integration, which includes horizontal and longitudinal integration aiming at achieving scale effect, as well as multinational M&A aiming at optimal allocation of resources including production and market resources worldwide. The effects of various M&A models and available corresponding services of Deloitte are as follows:

Exhibit 12: M&A modes of China's auto parts industry and corresponding services of Deloitte

The merging or acquiring party	The merged or acquired party	Goal of M&A	Examples of service of Deloitte
Domestic enterprises	Domestic enterprises	<ul style="list-style-type: none"> Increase products line Expand market coverage Enhance the effect of W-mode 	<ul style="list-style-type: none"> Consulting of M&A and integration Growth and customer strategy Improvement of performance management
Domestic enterprises	Domestic enterprises	<ul style="list-style-type: none"> Enter into overseas market Obtain advanced technologies and management experience Obtain brands 	<ul style="list-style-type: none"> Consulting of overseas M&A and integration Growth and customer strategy Improvement of performance management Supply chain management
Domestic enterprises	Domestic enterprises	<ul style="list-style-type: none"> Enter into China's market Transfer production facilities to reduce costs 	<ul style="list-style-type: none"> Consulting of inbound M&A and integration Growth and customer strategy Improvement of performance management. Supply chain management
Outside enterprises/ investment organisations	Domestic/ overseas enterprises	<ul style="list-style-type: none"> Enter into the auto parts industry Diversified operation Obtain revenue from capital operation 	<ul style="list-style-type: none"> Consulting of M&A and integration Entry strategy of new markets

Deloitte has set up ad hoc cross-functional and cross-regional M&A service teams, which will serve in corresponding links and help customers during M&A from formulating M&A strategies, selecting and setting M&A target, initial financial and commercial due diligence to implementation of M&A during the implementation period of transaction, final due diligence, negotiation and file preparation, and to risk management during the integration period, management and integration of IT, human resource and others.

Exhibit 13: Deloitte's M&A-specialised service



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