



INDUSTRIAL & AUTOMOTIVE PRODUCTS

China's automotive and components market 2004

ADVISORY

Preface



Interest in the Chinese automotive and component parts market shows no sign of abating. The market grew strongly in 2003 and there have been significant changes in the regulatory and competitive environment. The continued pace of change within this dynamic sector has made updating our 2003 sector report imperative.

2003 was a watershed year for China's automotive industry. Sales of new vehicles exploded in such a manner that the Chinese government has undertaken measures in order to cool the industry down. Recently announced price cuts for the majority of passenger cars have increased pressure on market participants and forced them to find a suitable strategy which will allow them to remain in the market during these momentous times.

The picture that emerges this year is one of increasing pressure on margins for all market participants as market consolidation moves forward and general vehicle prices continue to decline.

The purpose of this report is again to provide an independent analysis of the automotive and component parts market in China and to provide commentary on key issues facing the sector in the future. In producing this report, KPMG in Hong Kong has drawn on a number of public sources of information and spoken to a wide number of industry figures across China.

Please contact us if you wish to discuss the report or obtain additional copies; contact information can be found at the end of the report.

Paul Brough

Head of Financial Advisory Services, China and Hong Kong
KPMG in Hong Kong

September 2004

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- KPMG in Hong Kong does not accept responsibility to any party that relies on information or views expressed in this report; companies should seek professional advice and conduct a thorough assessment of the particular situation prior to making any business decision.
- Our report is based on information available to us at the end of July, 2004. Our information and analysis is based on research and interviews conducted in June and July, 2004.

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Executive summary

<p>Growth in demand remains high in 2004 despite being lower than the previous year</p>	<ul style="list-style-type: none"> • Sedan^(a) sales grew by around 30 percent in first half (1H) 2004 year on year (YoY); although high, it did not match 2003's sizeable growth of 70 percent • Demand fell in recent months as new automotive loan rules came into effect, and despite falling prices, consumers appear to be waiting for the next round of price cuts before purchasing a car
<p>Prices continued to fall in 1H 2004</p>	<ul style="list-style-type: none"> • Sedan prices fell by around 11 percent in 2003; this trend continued in 1H 2004 as manufacturers looked to increase market share and respond to decreased demand from consumers as banks tightened automotive loan approvals • Prices are expected to stabilize over the next six months although with large inventories reported, further cuts are possible
<p>Automotive manufacturers continue to increase production capacity</p>	<ul style="list-style-type: none"> • Fears of over investment in the automotive sector continue as manufacturers continue to plan increasing production capacity over the next five years; the total planned capacity additions of the major manufacturers exceeds total 2003 sedan sales • However, it remains uncertain if all expansion plans are going to be realized or whether they will be adjusted to suit changing market conditions

Note: (a) The term 'sedan' includes both small and medium sized passenger cars

<p>China is still largely a domestic market; imports and exports of vehicles are low</p>	<ul style="list-style-type: none"> • Both imports and exports of vehicles experienced double-digit growth in the first months of 2004, however, they still represent an insignificant amount of domestic sales and production • Imported component parts have grown steadily but still account for a small portion of sales; the continued decrease in tariffs will likely increase demand but it is not likely to challenge domestic production • Exports of component parts, on the other hand, accounted for almost half of production, and are expected to continue increasing as China becomes a key exporter of parts
<p>China's new automotive policy was released in mid 2004</p>	<ul style="list-style-type: none"> • Foreign investment is still capped at 50 percent and the number of joint ventures a foreign manufacturer is allowed to establish in China remains at two per vehicle segment • New restrictions on investments in China have been introduced to increase market entry barriers • The new policy encourages domestic sourcing and production as well as local R&D activities
<p>Foreign companies enter the automotive financing market as local banks face new curbs</p>	<ul style="list-style-type: none"> • More automotive manufacturers are looking to offer their own automotive financing services in order to boost their vehicle sales as three foreign companies look to be operational next year • In April 2004, the banks' automotive loan rules were tightened as a result of the increasing number of automotive loan defaults in China resulting in a downturn in sedan sales in the second quarter

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Automotive market overview



China's automotive market continues to grow at a rapid pace despite a slowdown from last year's record growth

The Chinese automotive industry is still enjoying double-digit growth rates

- China's automotive sector^(a) is a largely domestic industry: imported and exported vehicles represent only about four percent of 1H 2004 vehicle sales in China
- The industry is highly fragmented both in terms of geographical spread and numbers of participants in the bus, truck and sedan market
- Domestically made sedan sale growth continued strong at around 32 percent in 1H 2004, compared to China's growth in gross domestic product of 9.7 percent over the same period. However, this half-year growth hasn't matched 2003's sizeable growth of around 70 percent
- Despite recent market growth, car ownership in China is not yet widespread at only 0.5 cars per 100 people, compared to Germany (55 cars per 100 people) and the US (80 cars per 100 people), indicating continued long term growth potential⁽¹⁾
- The steady increase of import quotas and a reduction in import tariffs at the beginning of 2005 to 30 percent from the current level of 34.3 - 37.6 percent is expected to increase demand for imported cars; though, this is not expected to seriously erode demand for domestically produced sedans
- The Chinese automotive industry made a profit of USD 5.36 billion in 1H 2004⁽²⁾, an increase of around 14 percent over the same period last year; this growth was significantly lower than in 2003 as manufacturers' margins shrank significantly due to increasing competition and an increase in automotive parts prices
- In the course of increasing competition and several rounds of price wars among Original Equipment Manufacturers (OEM), prices for sedans continued to decrease significantly during 1H of 2004

Note: (a) The automotive sector for the purpose of this report includes buses, trucks and sedans, and excludes other vehicles, such as motorcycles
Sources: (1) China Daily, "Auto-parts quadruple China sales", 27 July 2004
(2) China Machinery Industry Federation Statistics, June 2004

New rules governing auto financing have been put in place recently

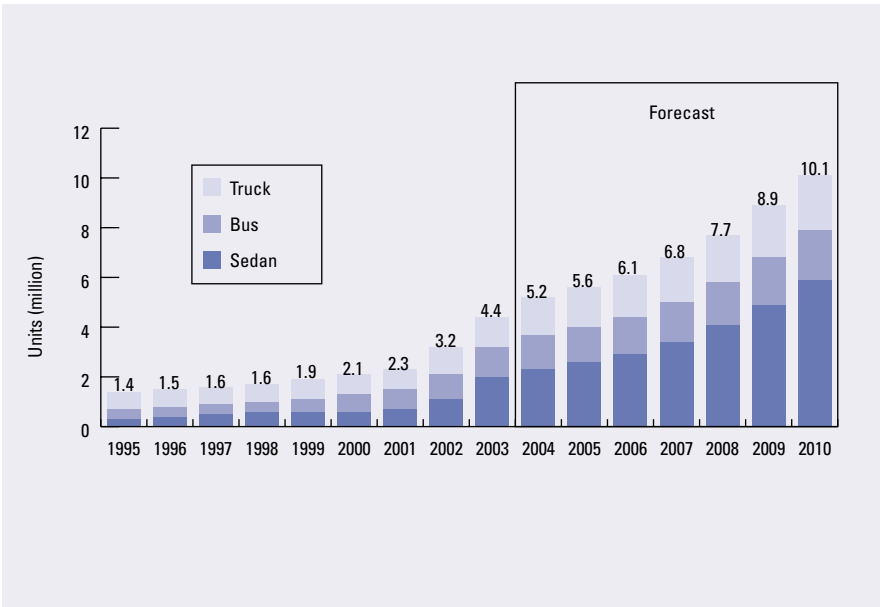
- The People's Bank of China issued draft rules on allocating automotive loans in April 2004; these have had a significant negative impact on overall automotive sales
- At present only domestic banks are permitted to provide car loans, however, foreign manufacturers have been granted licenses since October 2003; Volkswagen Financial Services AG, General Motors Acceptance Corporation and Toyota are expected to begin financing operations this year while Ford Credit is expected to begin by mid-2005⁽¹⁾
- A key aspect of the rules is the loan period has been restricted to five years with a maximum outlay of 80 percent of the vehicle price; additional guidance is provided on second-hand automotive financing
- The aim of these rules is to reduce loan defaults in the automotive sector, which had reached a high level in the past
- This increase in loan defaults had resulted from the lack of consistent data on individual credit worthiness compared to international standards and improvement in this area is expected
- Recent restrictions on loans have had a significant impact; less than 10 percent of total car purchases in 1H 2004 were purchased using bank loans, compared to more than 30 percent in 2003⁽²⁾

China is largely on track in implementing its World Trade Organization (WTO) obligations		
	Pre-WTO	Post-WTO
Import tariffs on vehicles	70-80 percent	25 percent by 2006
Import tariffs on vehicle components	15-50 percent	10 percent by 2006
Import quotas	Annual quota	Quota increased 15 percent per year, phased out by 2006
Local content	40 percent in first year of production; 60 percent and 80 percent in 2nd and 3rd years	No local-content requirement
Auto financing	Foreign non-bank financial institutions prohibited from providing financing	Foreign non-bank financial institutions permitted in selected cities prior to gradual national rollout

Sources: (1) China Economic Net "Ford offshoot approved for auto loan services" August 2004
(2) South China Morning Post, "Car sales growth slips to two-year low", 9 July 2004

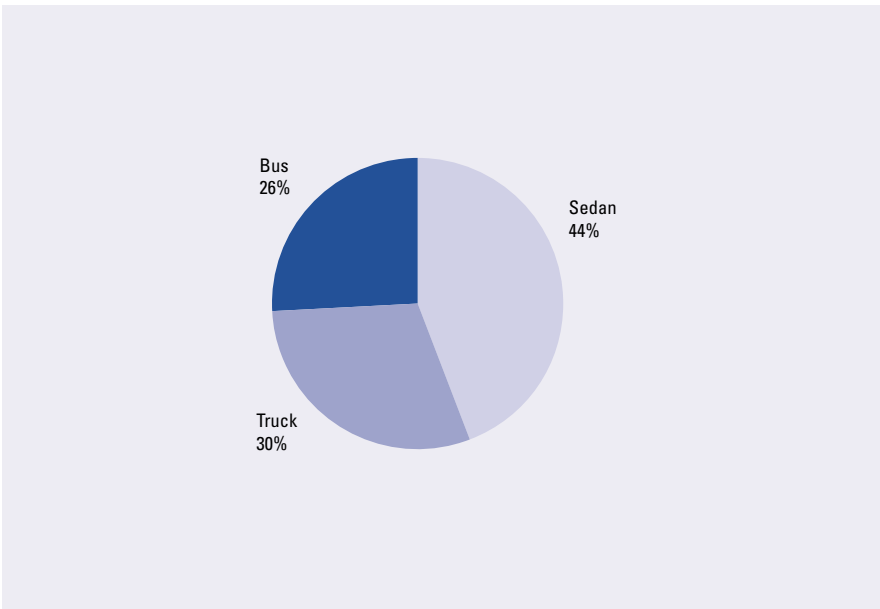
Vehicle sales in 2004 are expected to continue to grow, but more slowly than 2003's pace

Annual sales of vehicles by type (1995-2010)



Sources: Access Asia "Automobile parts and aftermarket in China" 2003; China Auto monthly - July 2004; KPMG in Hong Kong estimates

Vehicle sales by type in 1H 2004



Source: China Auto Monthly - July 2004

"Chinese people tend to be very brand conscious these days"

- Regional Executive of a European sedan manufacturer

Although growing fast, the market still remains relatively small

- Rising consumer spending and increasing individual incomes both had significant impact on sedan sales in 2003, the major growth driver in China's automotive industry
- Although this development continued the 1Q 2004, there has been a significant decrease in sedan sales from the beginning of April 2004, mainly due to government intervention to cool the sector and a change in consumer purchasing patterns in reaction to manufacturers' recent price-cut strategies
- Over 2.5 million vehicles (sedan: 1.13m, truck: 0.76m, bus: 0.66m) were sold in 1H 2004, compared to 4.4 million vehicles for the whole of 2003; sedan sales in 2004 are expected to exceed 2003 levels
- China's sedan sales in 2003 (roughly two million sedans) were around the same level as Italy's, twice those of South Korea and around one and a half times the level of Spain⁽¹⁾

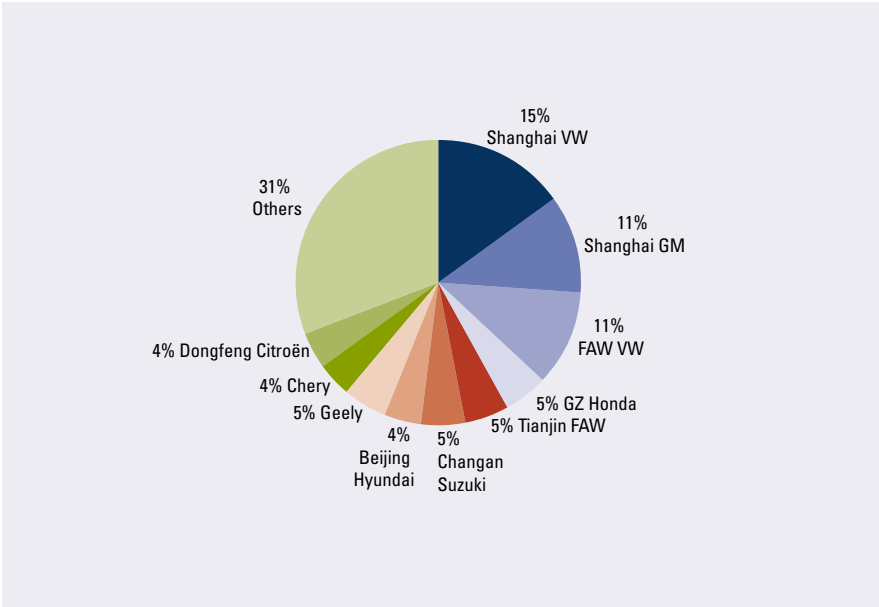
Market growth has been strongest in the sedan segment

- All three vehicle segments have been growing steadily over the past few years with the sedan segment being the strongest growth area
- The compounded annual growth rate (CAGR) between 1995 and 1H 2004 was 25 percent, 15 percent and nine percent for the sedan, bus and truck segments, respectively

Source: (1) Economist Intelligence Unit "Coming of age: Multinationals in China" June 2004

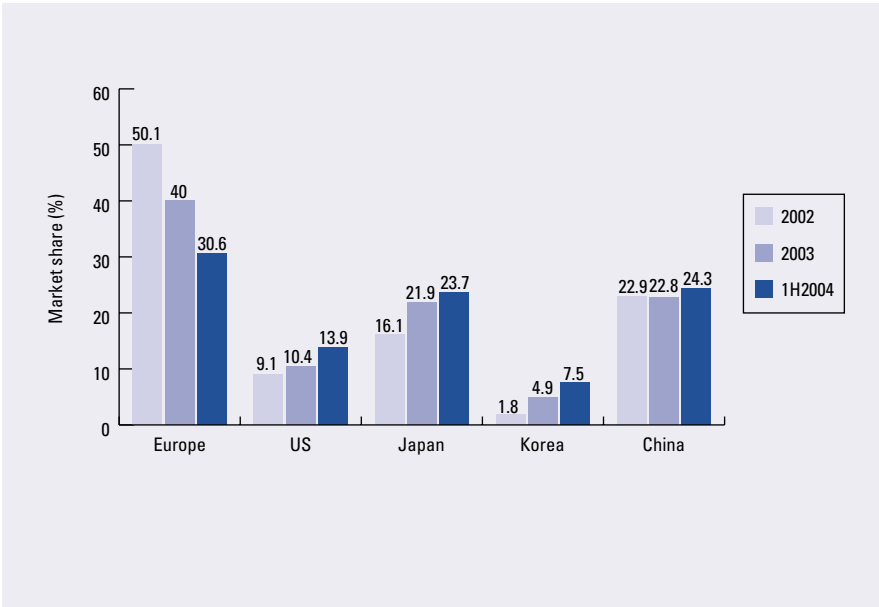
The competitive situation is fluid with major OEM's scrambling for market share

Share of sedan market by automotive manufacturer June 2004



Source: China Auto Monthly - July 2004

Share of sedan market by country of manufacturers' origin



Source: China Auto Monthly - July 2004

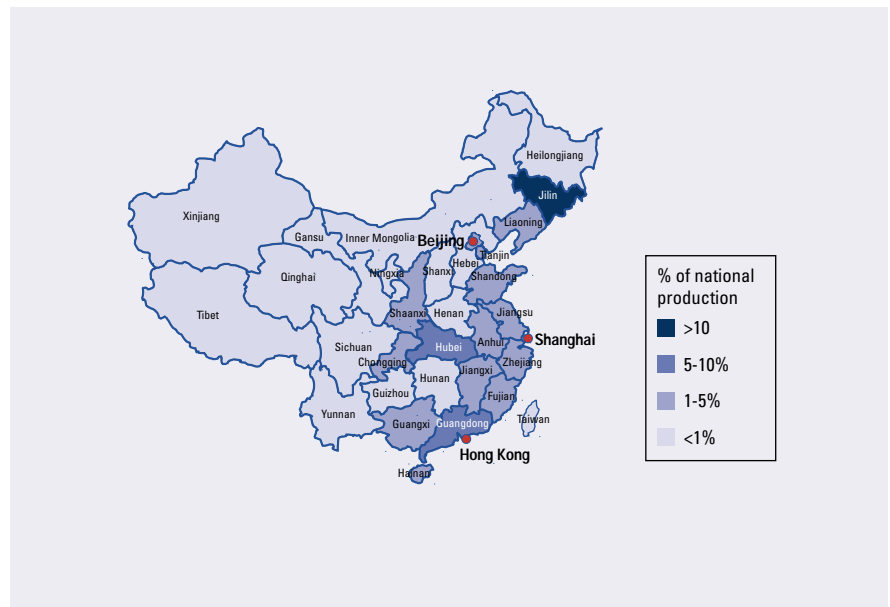
The market is still "up for grabs" as it remains highly fragmented

- The number of automotive manufacturers continued to reduce over the past two years as the market continues to consolidate; in 2002 there were 215 automotive manufactures with revenues above RMB 600,000 per year (sedan: 45, truck: 89, bus: 81)⁽¹⁾
- Volkswagen (VW) had originally dominated the sedan market with 36 percent share in 2003, however, General Motors (GM) has steadily increased its market share and in June 2004 sold more sedans than VW for the first time; combined, their joint ventures accounted for around 40 percent of the total sedan market in May 2004, a decrease from around 46 percent in 2003⁽²⁾
- Only two companies have double-digit market share and European joint ventures have continued to lose market share over the last year to US, Japanese and Korean competitors, whereas local manufacturers have managed to maintain their share at around 24 percent⁽³⁾
- The "big three" Japanese automotive manufacturers - Toyota, Honda and Nissan - account for an estimated 11.5 percent of the total sedan market⁽³⁾
- Among domestic brands, Geely Auto has emerged as the second largest company, replacing Chery; FAW Tianjin remains the domestic leader with around five percent of market share⁽³⁾

Sources: (1) China Markets Yearbook 2004
 (2) China Auto Sector, Feb 2004
 (3) China Auto Monthly, July 2004

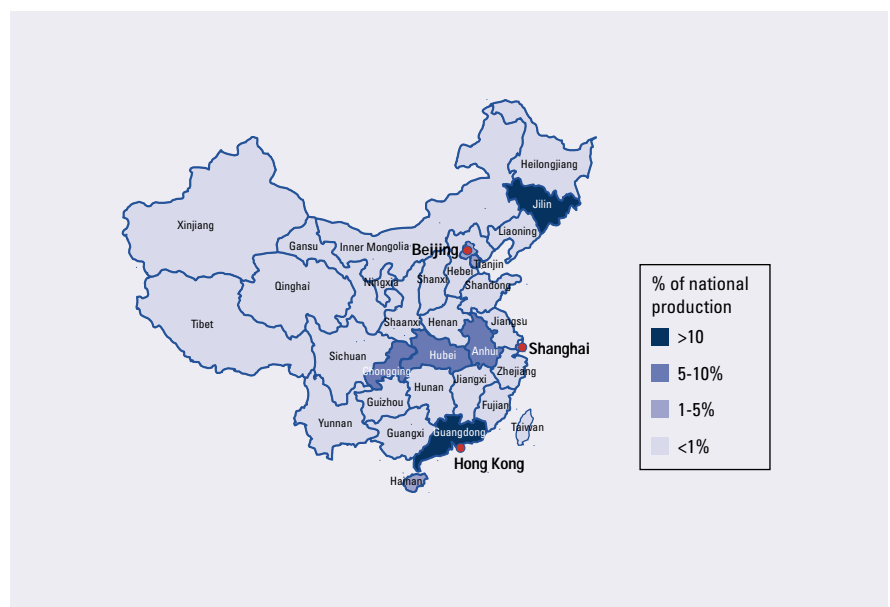
Like many industries in China, the automotive sector is still geographically dispersed

Vehicle production by province (2002)



Source: China Markets Yearbook 2004

Sedan production by province (2002)



Source: China Markets Yearbook 2004

"More than one city like "Detroit" is expected to develop in China"

- Regional Executive of a European
automotive parts manufacturer

- The cities of Changan, Tianjin, Beijing, Wuhan, Chongqing, Guangzhou and Shanghai are all major manufacturing bases
- Jilin overtook Shanghai as the top location for sedan manufacturing by revenue in China, accounting for 35 percent and 31 percent of total production by revenue in 2002, respectively, compared to Shanghai's market share of 40 percent in 2001
- Combined, Shanghai, Jilin and Guangdong represented around 78 percent of total sedan production in 2002
- The top province for bus manufacturing is Fujian, accounting for 24 percent of total production by revenue in 2002, followed by Liaoning and Anhui with 12.4 and 12.3 percent, respectively
- For the truck segment, Jilin is the largest province producing trucks and accounted for 28 percent of total production by revenue in 2002
- The market is expected to consolidate in three to four geographic areas, however, this may take some time

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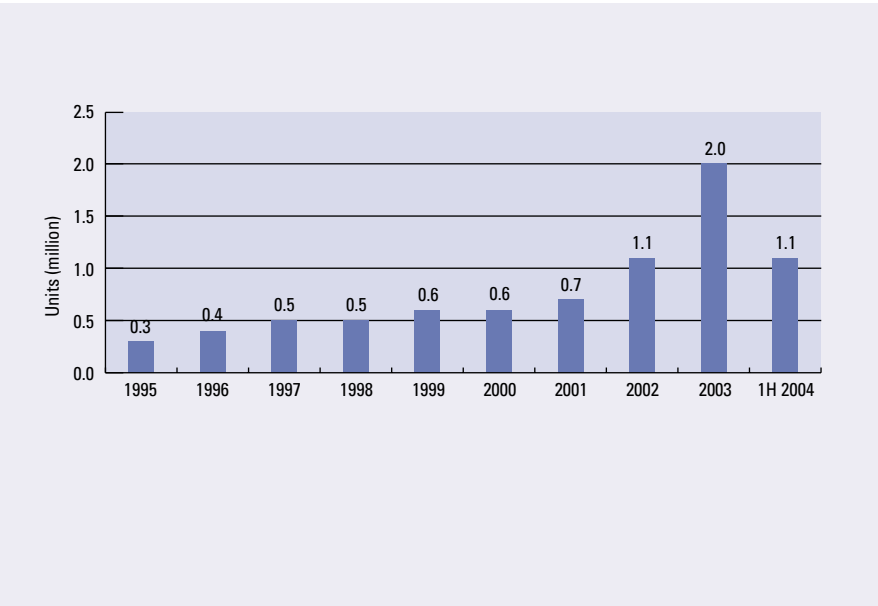
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Passenger car market



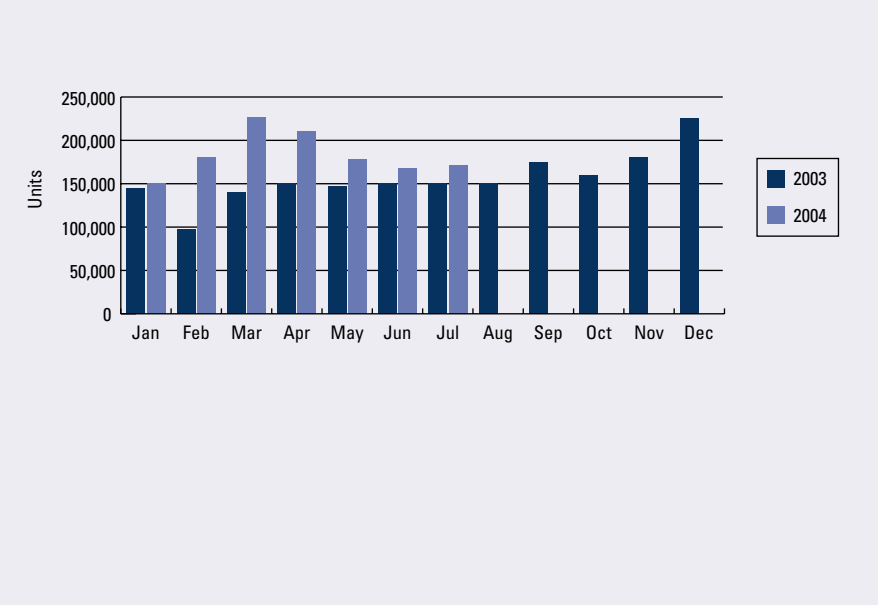
2003 was an exceptional year for sedan sales; while growth remains strong in 2004, it is unlikely to match the previous year

Annual sedan sales (1995 - 1 H 2004)



Sources: China contact "Automobile parts and aftermarket in China" 2000; Credit Suisse First Boston "China Auto Sector" Jan 2003; China's 10th 5 Year Plan; KPMG in Hong Kong estimates

China monthly sedan sales (2003 - July 2004)

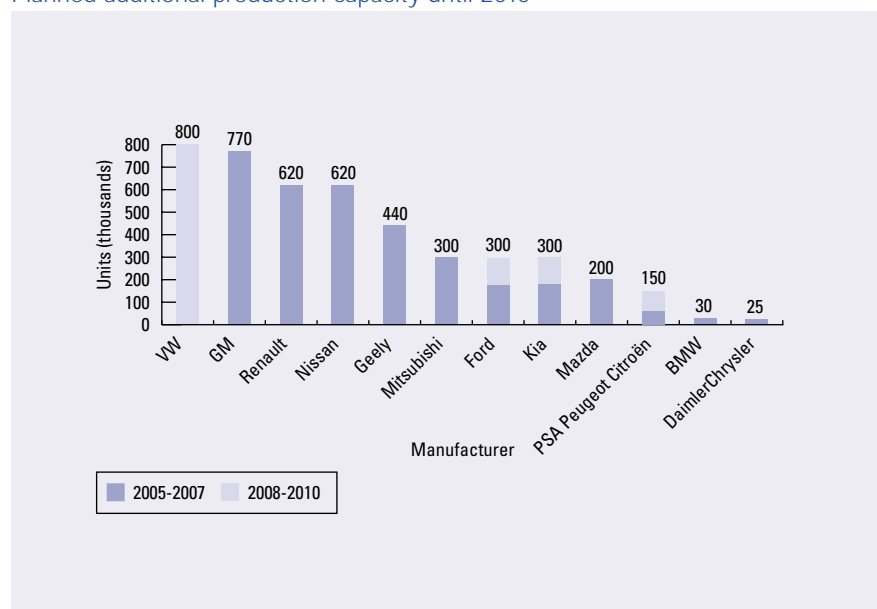


Source: China Auto Monthly; several press articles

- Total vehicle sales are expected to reach around 5.3 million units in 2004, compared to 4.43 million last year
- Sedan sales in 1H 2004 accounted for 1.1 million units and are expected to increase to 2.3 million by year-end, compared to 2003 sales of 1.97 million units
- Total vehicle sales increased by 24 percent YoY to 2.55 million units in 1H 2004. However, this growth rate was down from last year's 34 percent, mainly due to sluggish sedan sales in 2Q 2004
- The recent slowdown in sedan sales was primarily due to banks decision to restrict automotive loans, following an increasing number of loan defaults in the market, as well as the government desire to cool down the overall economy
- With falling prices in the market, sales are expected to pick up in 2H 2004

Sedan manufacturers are scrambling to expand production capacity

Planned additional production capacity until 2010 (a)



Source: Company announcements^(b)

Notes: (a) Selected automotive manufacturers

(b) Data were collected through companies press releases (2003-2004)

"Having a strong presence in this dynamic and growing market is not an option anymore, it's a necessity"⁽⁷⁾

- Chief Executive Officer of a US sedan manufacturer

Many industry commentators have been worried about over-investment in the sedan sector

- Despite declining sales and increasing warehouse inventories, many major manufacturers have announced plans to increase production capacity over the next few years
 - VW Group is planning on doubling its existing capacity of 800,000 vehicles per year to 1.6 million by 2008⁽¹⁾
 - General Motors announced a capacity increase to 1.3 million vehicles per year by 2007 from its existing capacity of 530,000 units⁽²⁾
 - Ford plans to increase production capacity from 20,000 to 300,000 units by 2010 at its joint venture with Changan Ford in Chongqing⁽³⁾
 - Daimler Chrysler's initial capacity of 25,000 units at its new plant in Beijing will be able to produce C- and E-class sedans⁽⁴⁾; no specific year has been announced
 - In May 2004, BMW inaugurated its new plant in Shenyang, Liaoning province; in the medium term, BMW expect an annual production of around 30,000 units per year for their 3 and 5 series⁽⁵⁾
 - Local manufacturer, Geely is planning on increasing capacity from 210,000 to 650,000 by 2007⁽⁶⁾
- The total planned increase in capacity to 2010 of the selected manufacturers in the left hand graph is equivalent to total vehicle sales in 2003
- Manufacturers may scale back plans, but potential for over-investment and 'white elephant' facilities cannot be easily dismissed; with so many participants not all manufacturers can be winners in China

Sources: (1-5) Companies' official press release,
 (6) China Daily, "Geely to acquire listed chemical firm", 15 June 2004,
 (7) azcentral.com, "General Motors accelerating in China", 11 July 2004

The Chinese government released a new automotive policy in mid 2004 in order to bring the existing policy in line with China's WTO membership obligations

Policy	Policy Regulation
Foreign ownership	<ul style="list-style-type: none"> Foreign ownership will remain limited to 50 percent
Number of Joint ventures	<ul style="list-style-type: none"> The number of joint ventures a foreign manufacturer is allowed to establish remains at two per vehicle segment (sedan, bus and truck)
Minimum investment size	<ul style="list-style-type: none"> A minimum investment of RMB 2 billion (USD 241 million) is required
Manufacturing License Transfer	<ul style="list-style-type: none"> License transfer from existing vehicle production companies to non-automotive enterprises is not permitted
Domestic sourcing and production	<ul style="list-style-type: none"> From 2005 (no specific date mentioned), imported vehicles can no longer be stored in bonded warehouses in China Certain imported parts will be subject to the same level of import tariffs as complete vehicles (currently, tariffs on imported cars are 30-38 percent, while tariffs on parts range from 10-23 percent)⁽¹⁾ Cars with major subassemblies (e.g., chassis, engine) that are imported may be taxed as imported vehicles
Research and development (R&D)	<ul style="list-style-type: none"> R&D expenses will be tax deductible in the future

Source: (1) WTO accession tariff schedule, People's Republic of China, July 2004

	Impact
	<ul style="list-style-type: none"> Although China obtained an exemption from the WTO on rules that ban limits placed on foreign investment, many auto manufacturers were hoping China would eventually relent: this does not appear to be the case
	<ul style="list-style-type: none"> This regulation gives domestic manufacturers more opportunity to develop its own technology and production bases by increasing the barrier for foreign manufacturers
	<ul style="list-style-type: none"> The restriction on investments increases the market entry barrier in China
	<ul style="list-style-type: none"> The policy makes it more difficult for non-automotive companies to diversify its business into the fast growing automotive market in China
	<ul style="list-style-type: none"> Import duty on vehicles will be payable upon entry to China An increase in local manufacturing and sourcing is expected; foreign automotive manufacturers are likely to continue to step up efforts to identify local sources of parts in order to have price competitive products This is already forcing some automakers to further localize their vehicles
	<ul style="list-style-type: none"> This policy is expected to continue to encourage foreign companies to establish domestic R&D centers as well as encourage local R&D activities and the development of local intellectual property, for example <ul style="list-style-type: none"> GM has already established its own R&D center in Shanghai At present, Nissan and Dongfeng Motors are building a new R&D center in Guangzhou, which will be ready at the end of 2005

Interviewees did not appear too concerned with the impacts from the new policy regulations

"The more often carmakers cut prices, the longer consumers will wait"

- General Manager of Sino-foreign automotive manufacturer

Recent price cuts taking place throughout the industry have not yet provided the desired boost in overall sales

Models	Spec.	Manufacturer	Feb 2004 Price ('000 USD)	July 2004 Price ('000 USD)	% of Feb. ('000 USD)
1 Lobo	1.1L	AviChina	7.5	5.7	-24.3
2 Sail	1.6L	Shanghai GM	9.5	7.8	-17.7
3 Fiesta	1.6L	Changan Ford	11.8	9.8	-17.0
4 Siena Ex	1.5L	Nanjing Fiat	11.6	9.7	-16.4
5 Golf	1.6L	FAW VW	18.2	15.5	-15.2
6 Outlander	2.4L	Beijing Jeep	26.2	22.3	-14.6
7 QianLiMa	1.3L	Yueda Kia	10.7	9.2	-14.2
8 Palio HL	1.5L	Nanjing Fiat	12.1	10.4	-14.1
9 Bluebird (04 ver)	2.0L	Dongfeng Motors	27.0	23.2	-14.1
10 A6	2.4L	FAW Audi	55.5	47.7	-14.1

Note: These models have had the most aggressive price cuts from February to July 2004
Source: China Auto Monthly - Feb - July 2004

Car purchase - Cost break-down:

	USD
• Vehicle price VW Bora, 1.6l	17,620
• Registration fee (Shanghai), July 2004	2,840
• Stamp duty	1,500
Subtotal car purchase	21,960
• One Year car insurance	240
• Yearly fuel expenses (est. 20,000 km / USD 0.418 per liter)	1,250
• Parking costs per year (est. USD 120 / month)	1,450
• Service/maintenance costs per year (est. USD 80 / month)	300
Subtotal yearly costs	3,240
Total costs first year of ownership	25,200

Source: China Auto Monthly - July 2004; KPMG in Hong Kong research

Manufacturers have continued to decrease prices

- Sedan prices fell by approximately 11 percent in 2003⁽¹⁾; this trend continued in 1H of 2004 as many manufacturers reduced prices hoping to gain market share and build critical mass
- Even Mazda, previously stating it would not cut its sedan prices for at least three years, at the end of July 2004 announced it would discount its Mazda 6 2.3 liter model by around RMB 12,000 (USD 1,450)⁽²⁾
- However, these frequent price changes seem to have had a negative effect on consumers' buying behavior; automotive executives interviewed shared the opinion that consumers appear to no longer trust the manufacturers and may "hold off" on making their purchase until the next round of price cuts

Price cuts are reducing margins for automotive manufacturers and suppliers

- Margins for automotive manufacturers have been relatively healthy with average margins in the sector of 30 percent and margins for sedan manufacturers staying between 10 and 20 percent, compared with average global levels of around five percent⁽³⁾
- These margins have been under threat as a result of recent price cuts and increasing input costs; material prices, especially steel, have increased by 11 percent in the first few months of 2004 along with labor costs, which has placed additional pressure on manufacturers

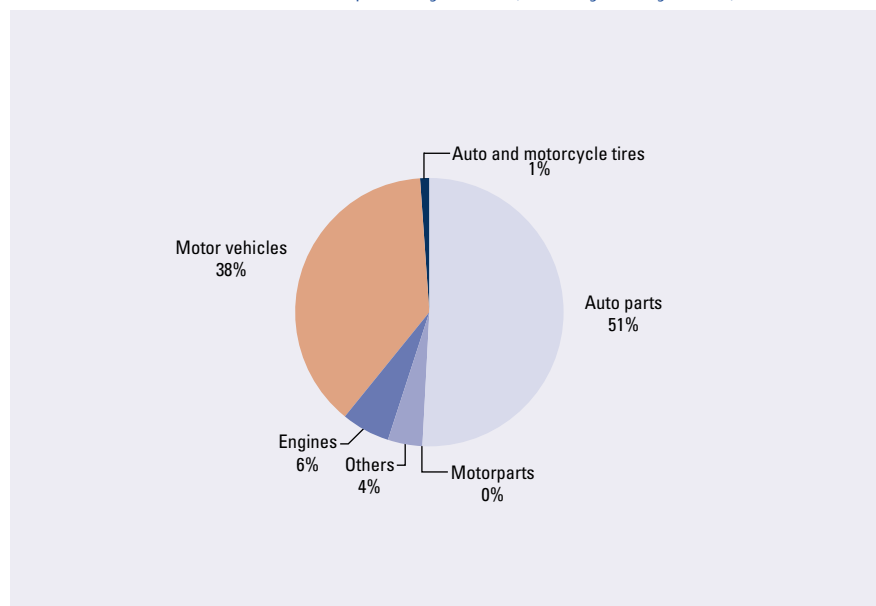
Sources: (1) China Business Update, "Automotive", 15 Jan 2004.

(2) China Daily, "Mazda hits reverse on price-cut pledge", 26 July 2004.

(3) Economist Intelligence Client, "Coming of age: multinational companies in China" June 2003

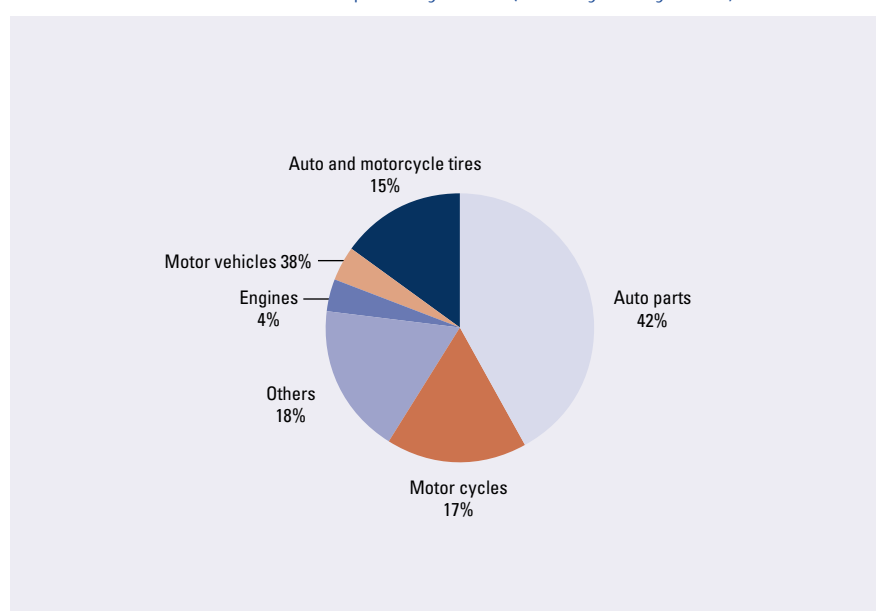
Although imports and exports experienced double-digit growth in the first months of 2004, they still represent a small portion of the total automotive market

Share of Chinese automotive imports by value (January - May 2004)



Source: China Auto Monthly - July 2004

Share of Chinese automotive exports by value (January - May 2004)



Source: China Auto Monthly - July 2004

"Domestic vehicles still suffer from the "Made in China" image"

- Regional Executive of a European automotive parts manufacturer

Most of the value of automotive imports comes from automotive components

- China's automotive imports for the first five months of 2004 were USD 6.49 billion, a YoY increase of nearly 30 percent⁽¹⁾; this increase was mainly due to continued cuts in tariffs
- Over 96,000 vehicles were imported from January to June 2004⁽²⁾ (four percent of vehicle sales in 1H 2004), up 6.7 percent over the previous year; in total, around 170,000 vehicles (mainly sedans) were imported in 2003 (four percent of total vehicle sales in 2003)⁽³⁾
- Japan, Germany and the Republic of Korea represented the major car exporters to China in 1H 2004, accounting for 88 percent of China's vehicle imports⁽⁴⁾
- Given the tariff of 30 percent on imports and the increasing range of domestically produced vehicles, it is not likely that imports will command a major share of the market overall

Components are still seen as the major driver for automotive exports

- Total automotive exports for the first five months of 2004 increased to approximately USD 4.5 billion, a 56 percent YoY increase⁽⁵⁾
- Vehicle exports are negligible at under 10,000 units per year (mainly buses and trucks); automotive parts still represent the bulk of automotive exports
- It will take some time for China to become a major vehicle exporter as several factors need to be overcome for manufacturers to export a larger volume of vehicles
 - Chinese automotive manufacturers still do not have well developed distribution, sales and maintenance networks overseas, making it more difficult to reach foreign markets
 - Local automotive production standards are still lower than the quality standards of other international manufacturers
 - China does not yet have a significant cost advantage for producing vehicles
 - Foreign vehicle manufacturers in China may not wish to cannibalize their international markets with Chinese-made vehicles

Sources: (1) China Auto Monthly - July 2004

(2) China Daily, "Japan Germany, ROK top 3 car exporters", 27 July 2004

(3) KPMG in Hong Kong analysis based China Daily, "Japan Germany, ROK top 3 car exporters", 27 July 2004

(4) Statistics from China's Ministry of Commerce

(5) China Auto Monthly July 2004

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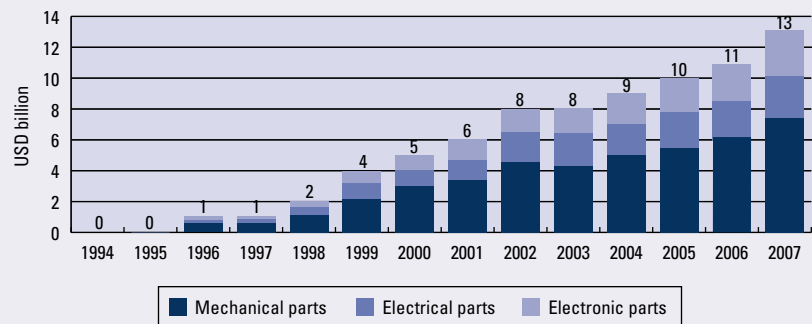
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Automotive components market



China's automotive component industry^(a) is growing, but facing intense pressure from their OEM customers to reduce prices

Automotive parts and aftermarket value (1994 - 2007)



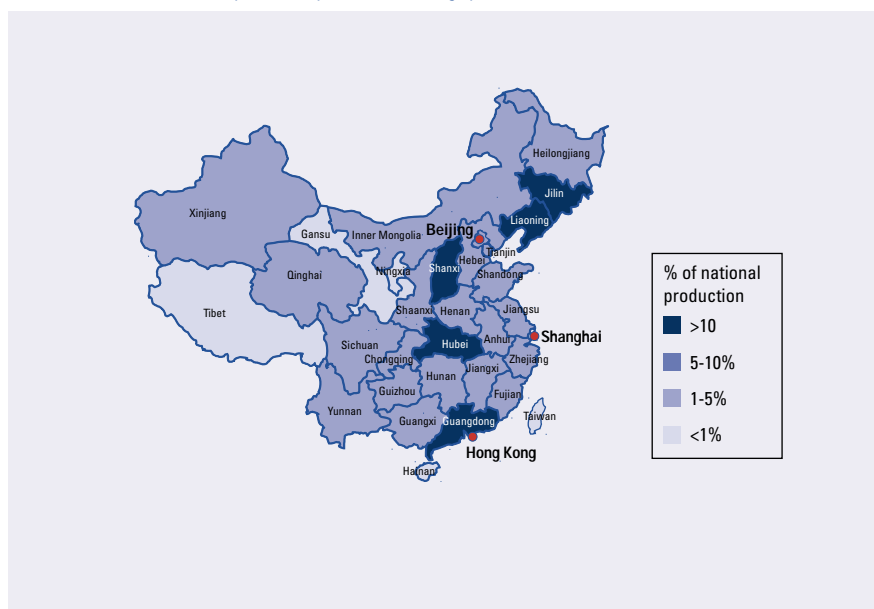
Source: Access Asia, "Autoparts and aftermarket in China", August 2004

Note: (a) The auto components market for the purposes of this report includes mechanical, electronic parts, and excludes other items such as body, chassis, tyres and maintenance products

- Total component production reached around USD 8 billion in 2003, a CAGR of 38 percent from 1994; production is expected to continue growing by around 50 percent to around USD 12 billion in 2007
- Mechanical parts make up the majority of production, accounting for around 56 percent, with electrical and electronic parts accounting for the remainder
- As with automotive manufacturers, local component manufacturers rely largely on imported technology, making it difficult for them to meet international quality standards and making foreign manufacturers with advanced technology attractive partners
- In line with changing regulations and the need to reduce costs, OEMs are increasingly sourcing parts locally; this is placing pressure on international parts suppliers to relocate and produce parts in China to remain competitive
- Component companies cannot easily service all customers in China from one location; the decision on where to locate plants becomes very crucial

Automotive component manufacturing is expected to remain close to automotive manufacturing locations

Share of vehicle component production by province (2002)



Source: China Markets Yearbook, 2004

"OEMs always want component suppliers located close to their premises"

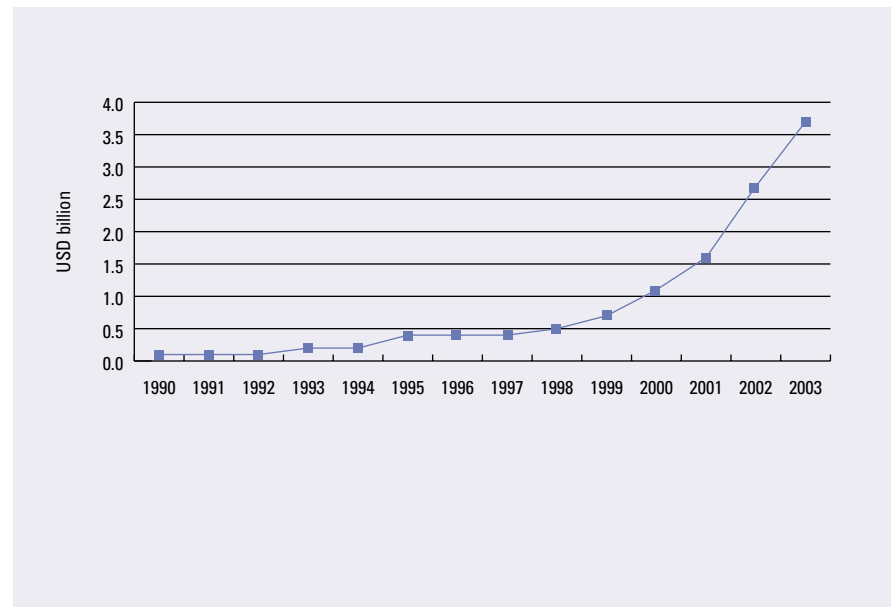
- Managing Director of a local automotive component manufacturer

Component production is fragmented, much as the OEM sector is

- Provinces and municipalities around the Yangtze River Delta accounted for around 17 percent of total component production by revenue in 2002, a decrease from over 40 percent in 2001
- Shanghai remains the largest component manufacturing center with around 10 percent of total production in 2002; Zhejiang and Jiangsu, provinces south and north of Shanghai, together account for around eight percent of total production
- Other key areas of production include Guangdong, Liaoning, Shanxi, Jilin and Hubei, with a combined market share of 32 percent
- The remaining 51 percent of production is divided between China's 23 other provinces and municipalities

Exports of automotive components are growing rapidly and accounted for nearly half of overall component production in 2003

Exports of automotive components (1990 - 2003)



Sources: Access Asia, Automotive parts & aftermarket in China, Aug. 2003; China Markets Yearbook 2004; KPMG in Hong Kong analysis

"China will be a strong contender for exports within the next five years"

- General Manager of a Sino-foreign joint venture

- Exports of automotive components accounted for 42 percent of automotive exports with a total value of USD 1.89 billion in the first five months of 2004⁽¹⁾
- By the end of 2004 automotive component exports are expected to reach around USD 4.5 billion, an increase of over 20 percent compared to USD 3.68 billion in 2003⁽²⁾
- However, China remains significantly behind the global leader for automotive exports, Mexico, which has exports of around USD 11 billion⁽³⁾
- Major overseas markets for exports are the US, Western Europe and South-east Asia; Japan and South Korea are also becoming large export markets as sedan manufacturers such as Isuzu, Honda, Daewoo and Hyundai are increasingly exporting from their China plants to assembly lines overseas⁽³⁾
- Automotive component exports have increased as a portion of total component production from around 26 percent in 2001 to 46 percent in 2003 suggesting an increased focus by component manufacturers on the export market

Sources: (1) China Auto Monthly - July 2004

(2) Qian Long, "The total figure of the PRC automobile product import & export has a nearly 10 billion USD difference", 23 Jan 2004

(3) Access Asia, Automotive parts & aftermarket in China, Aug. 2003

The component manufacturer market is still very fragmented

Summary of selected foreign component manufacturers' China activities

Name	Country of Headquarters	Summary of China activities
Calsonic Kansei	Japan	<ul style="list-style-type: none"> Established a USD 8.6 million wholly owned company in Shanghai in August 2003 Calsonic plan to establish a production base in Xiangfan (Hubei) and Huadu (Guangdong)
Cummins Corp	USA	<ul style="list-style-type: none"> Established 15 wholly owned and JV companies in China Has developed a network of 8 regional service centers and over 70 authorized dealers
Delphi Automotive Systems	USA	<ul style="list-style-type: none"> Invested more than USD 500 million in 12 businesses, 10 of them are manufacturing JVs Established 3 customer service centers, 1 technical service center and 1 training center Plan to invest USD 12 million in a new engine management system component - Multec 3 gasoline fuel injectors
Denso Corp	Japan	<ul style="list-style-type: none"> Established 6 manufacturing joint ventures throughout China Plan to continue developing partnerships with foreign carmakers in China and expanding retail sales
GM Daewoo Auto & Tech. Group	USA	<ul style="list-style-type: none"> Inherited 2 JVs after GM acquired Daewoo Corp in 1999: FirstAuto/Daewoo Auto Engines Co Ltd and Shandong-Daewoo Auto Parts & Components Co Ltd
Hyundai Mobis	Korea	<ul style="list-style-type: none"> Established 3 manufacturing and distribution centers in Jiangsu, Beijing and Shanghai Plan to double production of module parts to 1 million units by 2008
ITT Industries	USA	<ul style="list-style-type: none"> ITT's Connectors & Switches division established 2 JVs in China, one of which has 4 manufacturing locations
Koito Manufacturing Co.	Japan	<ul style="list-style-type: none"> Established a Shanghai JV in producing over 100 automotive related products Commenced construction of a technical center in June 2000, due for completion in 2001
Robert Bosch		<ul style="list-style-type: none"> Established 10 representative offices, 4 trade firms, 7 wholly-owned subsidiaries and 10 JVs, with a total investment of USD 600 million Plans to develop a technical center in 2004 and establish 1,000 after sales centers by 2010
SKF	Sweden	<ul style="list-style-type: none"> Established 2 JVs: Anhui Zhongding CR Seals Ltd, with ASIMCO, manufacturing oil seals, the other is the Beijing Nankou SKF Railway Bearings Company Ltd
Tong Yang	Taiwan	<ul style="list-style-type: none"> Established 6 automotive parts and accessories plants including 3 JVs in Changchun, Chongqing, Fuzhou, Guangzhou, Jiangsu and Tianjin
TYC Brother Industrial Co. Ltd.	Taiwan	<ul style="list-style-type: none"> Established 8 automotive headlight plants Continue to expand production at Changzhou Tamao Lighting Co., its mainland affiliate, in a bid to become the largest auto headlight maker within 5 years.
Zahnradfabrik Friedrichshafen	Germany	<ul style="list-style-type: none"> Established 6 wholly owned subsidiaries specializing in driveline, steering systems and chassis technology

Source: Access Asia, "Automotive parts and aftermarket in China", August 2003

- Approximately 1,700 automotive components manufacturers have registered with the government, of which around 450 are foreign invested companies; there are around 3,000 additional smaller component parts manufacturers in the industry, most of which manufacture products for the aftermarket⁽¹⁾
- The market remains highly fragmented with the top 10 component manufacturers contributing only around 20 percent of total revenue⁽²⁾
- Many of the major global automotive component manufacturers have already established manufacturing operations in China through a combination of wholly owned enterprises and financial or strategic joint ventures, and in many cases, these operations have followed the automotive manufacturers that have established in China
- Over the past year, an increasing number of new, more specialized automotive component manufacturers have been establishing operations in China which has helped increase the availability of higher quality locally produced component parts; examples of investments from Japanese manufacturers include⁽³⁾
 - Sumitomo Metal Industries established a USD 14 million manufacturing operation in Guangdong to produce cranks and crankshafts for both the China and South-east Asian markets
 - Yorozu Corp and Unipres Corp separately invested around USD 27 million and USD 13 million, respectively, in manufacturing plants in Guangzhou to supply component parts used in Nissan vehicles; Ichikoh Industries Ltd is also planning on establishing manufacturing operations by 2006 to supply Nissan vehicles
 - Mitsubishi established Shenyang Aerospace Mitsubishi Motors Engine Manufacturing Co Ltd, a USD 250 million joint venture in Shenyang (Liaoning province) producing engines and other components for around 10 automotive manufacturers

Sources: (1) Access Asia, "Automotive parts & aftermarket in China", Aug. 2003
 (2) China Markets Yearbook 2004
 (3) Access Asia, "Automotive parts & aftermarket in China", Aug. 2003

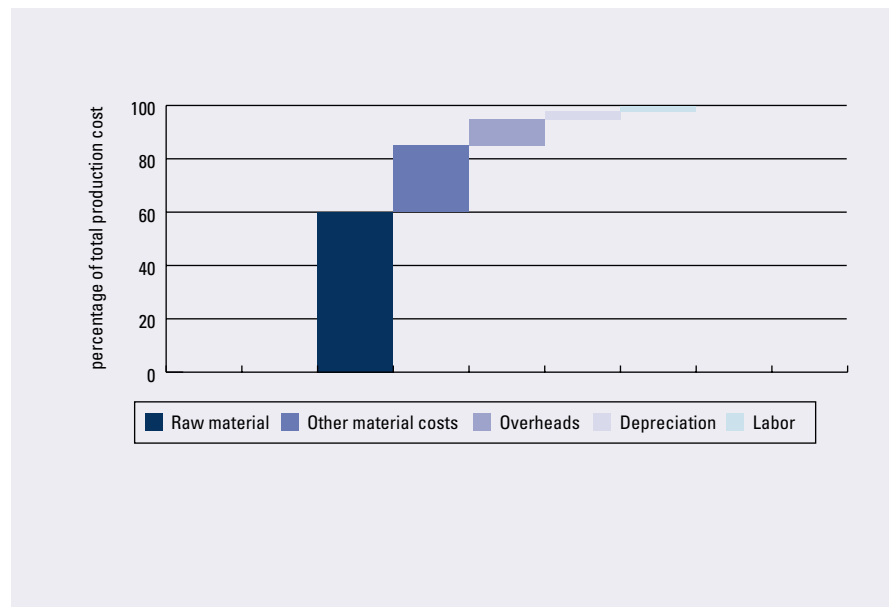
Lack of access to qualified staff, pressure on prices and local sourcing issues are seen as major headaches in the component sector

- A survey of automotive component manufacturers conducted by the Economist Corporate Network⁽¹⁾ identified the main areas of business concern of respondents as finding experienced and qualified employees and having access to quality product and process technology; other concerns identified during interviews with component manufacturers are
 - Increasing price pressure
 - Rising inventories
 - Quality of local electrical parts
- Increasing price pressure on suppliers from automotive manufacturers continues to be a challenging issue to manage; one interviewee commented that in the worst case component manufacturers have gone bankrupt
- As automotive sales decreased recently, increasing inventories have been a major concern for both automotive and component manufacturers; however, component manufacturers have at times resolved some of this problem by stopping production activities for a period of time to reduce the build up of inventories
- Although the quality of mechanical automotive parts are of a reasonably high standard, there is still a concern among industry participants interviewed with the quality of electrical parts made in China; several interviewees commented that the general quality levels set by some international OEMs will remain beyond the reach of Chinese suppliers for some time

Source: (1) Economist Corporate Network, "China auto suppliers survey", 2004

There is little opportunity for automotive component manufacturers to adjust their product cost structure in response to recent market developments

Product cost structure of a selected automotive components manufacturer (2004)



Source: KPMG in Hong Kong estimates based on personal interviews with Industry Executives

- Industry participants interviewed reported an increase in labor costs of up to 20 percent compared to last year, however, total labor costs remain relatively low compared to total production costs
- The major cost component for many suppliers is raw material. Since many components suppliers still use a high proportion of imported materials, they often have little space for price negotiation
- When considering the cost breakdown illustrated above, for example, the majority of the producer's costs can be regarded as fixed costs, which provides them with little opportunity to adjust their cost structure to changing market conditions
- Under a new policy, which is set to become effective in 2005, domestically assembled sedans made with imported key assemblies (e.g., chassis, gear box, engine) may be treated as 'imported' vehicles. This is expected to spur localization of these assemblies by OEMs to help ensure their products remain price competitive

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