Qualification Programme (QP) Case Analysis Competition 2011

The case

Kunming Excellence Cars Co Limited

Kunming Excellence Cars Co Limited (KEC) is a medium-sized Chinese automobile manufacturer. It is a public company which has been listed on the Hong Kong Stock Exchange (HKEx) since 2001. Its head office is in Hong Kong and its manufacturing base is Kunming, capital of Yunnan Province, south-western China. Kunming is an emerging auto manufacturing centre, second only to Shanghai.

KEC produced 109,860 units of passenger vehicles in 2010, representing an increase of 26.9% as compared to 86,567 sold in 2009. The large increase in volume of sales is consistent with the performance of the booming Chinese automobile industry throughout 2009 and 2010.

KEC is a mini-van and sedan manufacturer. It is also engaged in the production and sale of automotive components and rechargeable battery in automotive and handset market.

Company structure and history

KEC is a relatively new entrant to the Chinese automobile industry and was established in 1995 by the Chai brothers and a consortium of private investors. The Chai brothers are Hong-Kong based entrepreneurs who oversaw the listing of the company on the HKEx in 2001.

Board of Directors, senior management and key employees are outlined in **Appendix A**.

In 2004, KEC acquired a smaller Kunming-based private automobile manufacturer with a specialisation in mini-van business. While company management and financials have been integrated into the KEC structure, the Kunming manufacturing plant operations have remained separate. This is the only acquisition to date.

In 2009, KEC entered into a collaborative agreement with Fast Trans SRL in Romania regarding the construction of an assembly plant. The plant became fully operational in February 2011.

Company mission and values

KEC's mission statement is as follows:

KEC places the 21st century global consumer first. A safe, affordable and reliable vehicle meeting customer's driving needs – and the needs of future generations.

Company values are as follows:

- ***Integrity*** – product safety, ethical working conditions, no wasted raw production materials, environmental practices, compliance with international law requirements, industry development support, ethical leadership
- ***Innovation*** – new product development, innovative service and extras, new market exploration, environmentally aware development, acquisitive, opportunistic
- ***Reliability*** – product operates as promised, brand delivers on promises, leading after-sale service
- ***Efficiency*** – right price, keeping costs down, staff development, product runs efficiently

Products and market share

KEC has three product areas – mini-van, sedan and the components used in the production of mini-van and sedan. KEC produced 109,860 units of automobiles in 2010, representing an increase of 26.9% as compared to 86,567 sold in 2009.

	For the year ended 31 December 2010			For the year ended 31 December 2009		
	Sales volume (units)	**Revenue (RMB mil)**	**As a % of revenue (%)**	**Sales volume (units)**	**Revenue (RMB mil)**	**As a % of revenue (%)**
Mini-van	65,797	3,393	46.5	53,543	2,919	49.7
Sedan	40,517	3,110	42.6	30,423	2,508	42.8
Other vehicles	3,546	280	3.8	2,601	195	3.3
Automotive parts and components		518	7.1		245	4.2
Total	109,860	7,301	100.0	86,567	5,867	100.0

Mini-van

According to the China Association of Automobile Manufacturers (CAAM), KEC's mini-van rank second in the PRC market in terms of sales volume. KEC has 20% of the PRC market and the leading manufacturer holds 30%. KEC has solidly held this percentage of the market for eight consecutive years, always staying approximately 10 - 12% behind the competition. Part of the reason for its second place in the market is its size compared to the competition (which is roughly twice as large based on annual revenues), sales network coverage and the competition's extensive investment in research and development (R&D). KEC has been unable to dedicate the same amount of funds to R&D in this area, meaning that the competition was first to market with a break-through diesel engine in the early 2000s.

Mini-van sales increased 16% from 2009 to 2010, but dropped to 46.5% of overall revenue in 2010.

Sedan

KEC is one of the dominant producers in the sedan market and holds about 15% of the market. KEC released a new model of its premier brand during the year, the '**Honey Bee**', and this was well received by the PRC market.

Sedan sales increased 24% from 2009 to 2010, but were at a lower overall revenue compared to previous year.

Other vehicles

KEC also has a small market in producing other vehicles, such as electric vehicles. Following on from other product trends, sales rose from 2009 to 2010 and accounted for 3.8% of overall revenue.

Automobile parts and components

Revenues from 2009 to 2010 increased from 4.2% to 7.1% of the overall revenue respectively. The rechargeable battery market in handset industry accounted for the leap in revenue growth. KEC continues its enhancement of production capacity to meet market growing demands.

Operating environment

The PRC still managed to post overall GDP growth of 8.7% and 8.9% in 2009 and 2010 respectively despite the global recession after the financial tsunami in 2008. This growth was driven by large-scale government stimulus measures and rising affluence that helped the continued boom of the domestic market. Overall growth is likely to be around 9.6% in 2011 amid in a period of high domestic inflation.

The global automobile market was in recession throughout 2009 and 2010 due to the uncertain international economy. Despite the gloomy outlook for the rest of world (ROW) automobile manufacturers, the Chinese industry continued to thrive. The China Association of Automobile Manufacturers (CAAM) reports that the production volume of automobiles increased by 30% in 2010 (18 million units) compared to the previous year (13.8 million units). This annual production of over 13 million vehicles in 2009 and 2010 resulted in China overtaking the United States to become the world's largest car manufacturer for the second consecutive year.

Most of the vehicles manufactured in China are sold within China, with only 369,600 vehicles being exported in 2010. The market for private vehicles within China is growing at an exponential rate due to the following factors:

- Overall economic growth and development leading to a rise in living standards.
- The resulting rapid increase of personal wealth of many Chinese (the rise of the 'middle class') leading to increased levels of car ownership.
- Government investment in transport infrastructure to facilitate more vehicles.
- An increase in the availability of raw production materials.
- Specific government policies designed to foster market growth (discussed in further detail below).

China purchased a record 266 million metric tons of crude oil in 2010 as 49,000 new vehicles took to the roads every 24 hours. The consultancy McKinsey estimates that China's domestic car market will grow ten-fold between 2005 and 2030. This estimation means that demand for diesel and petrol in China will rise from 100 million tonnes to 500 million tonnes – a large rise in emissions from a country that is now the world's biggest source of greenhouse gases.

Of the automobiles produced, 44.3% are local brands and the rest of the vehicles are being produced through joint ventures with foreign car makers, including Volkswagen, BMW, General Motors, Hyundai, Nissan, Honda, and Toyota.

PRC government policies and impact on KEC performance

The PRC government introduced policies designed to boost the domestic automobile market and the international export market. Chief policies are highlighted below:

- The purchase tax on passenger vehicles with a displacement engine of 1.6 litres (1.6L) or less was reduced by 50% in January 2009. As anticipated, this subsidy significantly boosted the sale of small displacement passenger vehicles with engines of 1.6L across China. It has also been instrumental in the 46% and 56% surge in domestic sales encountered in 2009 and 2010 respectively. Looking into 2011, the growth of production and sales of passenger vehicles would grow at a moderate pace after the government raising purchase taxes on small cars.
  - ➢ KEC was unable to garner this advantage as all its vehicles are over the 1.6L engine capacity and therefore other car manufacturers were able to significantly increase profits in this area.
- The PRC government increased general purchase tax from 5% to 7.5% on automobiles in December 2009. However the 50% discount still applies to vehicles with less then 1.6L capacity.
- Government subsidies for automobiles in rural China came into effect in March 2009.
  - ➢ This raised the purchasing power of farmers and resulted in a direct increase in sales for KEC's sedan after that date.
- The government implemented a policy of replacing old vehicles and electrical home appliances with new products to spearhead a general boost in the industry, as well as to encourage the use of more environmentally friendly cars and appliances.
  - ➢ KEC has benefitted from the general surge in the domestic market.
- The government has committed to the development, sale, and use of electric and hybrid cars, referred to as “alternative powered cars”, in order to strengthen the deployment of energy conservation and emission reduction. It was scheduled to announce subsidies, perhaps in the forms of rebates, for alternative powered cars in January 2012. This has been delayed.

  Most of China's largest automobile manufacturers have plans to mass-market hybrid and electric cars but many are now holding off due to the delay in government subsidies. R&D is expensive and many manufacturers have entered into joint ventures with foreign manufacturers to develop this market, in addition to expanding overseas markets.

  There are over 100 electric models approved by the government for production.
  - ➢ KEC's internal R&D division is developing an electric car prototype. There are no joint-ventures with foreign manufacturers.

Domestic market

As discussed above, the domestic market is very strong and this is forecast to continue into 2012. It is expected that overall sales for KEC in the domestic market will continue to grow, and there will be an increase in mini-van sales due to the continuous improvement on economic climate.

However, the impact of the 50% government rebate on purchase tax on passenger vehicles with a displacement engine of 1.6L had tempered the growth of KEC's sales compared to other Chinese manufacturers as consumers turn to smaller, environmentally-friendly, and cheaper vehicles. If the government re-introduces its subsidies on alternative powered cars in the latter half of 2011 then sales growth may be further impacted.

International market

KEC's major export markets include Asia Pacific, Eastern Europe, South America, Africa and the Middle East and there is an established international sales network. In 2010, KEC exported its products to 42 countries and regions.

KEC has not entered into any joint ventures with foreign car makers but would like to explore this possibility. It finds that its current size limits these opportunities.

Due to the aftermath of the global financial crisis, sales in the existing overseas markets decreased throughout 2009 and stayed level throughout 2010. There was a slight recovery seen in the fourth quarter of 2011 as the global economy started to show signs of recovery. The Board considers this is the opportune time to expand overseas.

	For the year ended 31 December	
	2010	**2009**
International Markets Analysis	**RMB '000**	**RMB '000**
China (incl. Hong Kong)	6,102,021	4,537,070
Iraq	246,864	280,845
South Africa	195,431	330,968
Libya	145,111	146,990
Australia	137,367	140,735
Russia	76,545	52,333
Italy	58,836	59,975
Ukraine	32,987	0
Other countries	305,789	318,154
	7,300,951	5,867,070

As at December 2010, the export volume of automobiles of KEC reached 1,198,930 (RMB ‘000), representing 16.4% of total product revenues. In 2009 export volume of KEC was 1,330,000 (RMB ‘000) representing 22.7% of total product revenues.

The company expects its export volume to rebound in 2011 in its existing markets and to increase in developing markets, such as Eastern Europe. The collaborative agreement, the first of its kind in Chinese automobiles going abroad, to operate a complete knock-down (KD) assembly plant in Romania means it can better meet European and Eastern European demand. The European market for the '**Honey Bee'** is expected to increase due to certification, with a flow-on effect to other models.

The international market is, generally, weaker than the domestic market. PRC vehicles are perceived as being of poor quality in the developed (for example, European and US) markets and are often viewed suspiciously by consumers. However, this reputation is slowly changing as PRC maintains its status as number 1 world producer.

In addition, these markets (particularly Europe) are showing a trend towards smaller, more environmentally-friendly vehicles; or even towards substitutes such as public transport and bicycles. Lastly, while electric-powered cars have been released worldwide, consumer take-up has been extremely disappointing in all instances to the point of causing serious investment loss.

A wide survey of the Chinese auto industry in 2010 shows that manufacturers do not expect major export growth in 2010-15, rather a slow recovery (Source: Alix Partners 2010 Auto Survey)

Operations

The operational structure of KEC is as follows:

- Two manufacturing plants in separate locations of Kunming. The largest site produces all mini-van, 70% of sedan (four of six models) and the associated accessories. The second site is significantly smaller and produces two of the six current models of sedan and associated accessories. This site belonged to the 2004 company acquisition. Most of the key components are sourced overseas.
- Both manufacturing plants are operating with out of date and ageing production equipment.
- Both manufacturing plants are adopting traditional costing instead of activity-based costing when costing and pricing products.
- One R&D plant located on the same site as the main Kunming manufacturing plant.
- One manufacturing head office located on the main Kunming manufacturing plant.
- One corporate head office located in Hong Kong.
- One collaborative venture site with Fast Trans SRL in Romania, which became fully operational in February 2011 (see below).
- The industry standard for receivable settlement days was 65 days and 60 days for 2009 and 2010 respectively
- The industry standard for inventory holding days was 70 days and 60 days for 2009 and 2010 respectively.

Romanian Production Plant Joint Venture

In 2009, KEC entered into a collaborative agreement with Fast Trans SRL in Romania regarding the construction of an assembly and distribution plant. The plant became fully operational in February 2011.

The plant uses the **knock-down** (KD) approach to assemble the '**Honey Bee**' for the European market. The KD approach is where the vehicle manufacturer (KEC) sells their foreign affiliate (Fast Trans) the kit needed to assemble the motor vehicle. The affiliate then assembles the vehicle from the kit, adds some local components, and then distributes to the European market.

Knock down production is common in the automobile, bus and rail industries. KEC has entered into its venture to Romania to avoid import taxes and to receive tax credits for creating local Romanian jobs. To receive tax credits, Fast Trans has to add local parts to the KD kit, one of which is the full range of safety features.

Research and development (R&D)

KEC has one R&D plant based at its main manufacturing facility in Kunming. It has been in operation since company formation in 2001 but has not been successful in being first to market on any new product. It is poorly funded and inadequately staffed.

Summarised financial accounts for 2010 and 2009

Kunming Excellence Cars Co Limited

Consolidated Income Statements – Years to 31 December

	2010	2009
Revenues	**RMB mil**	**RMB mil**
Mini-van	3,393	2,919
Sedan	3,110	2,508
Other vehicles	280	195
Automotive parts and components	518	245
Total automobile revenues	**7,301**	**5,867**
Other revenue and gains	71	57
Total revenues	**7,372**	**5,924**
Operating Costs and Expenses (Excluding Depreciation)		
Manufacturing costs - Mini-van	2,980	2,532
Manufacturing costs - Sedan	2,641	2,111
Manufacturing costs - Other vehicles	127	80
Manufacturing costs - Automotive parts and components	310	135
Sub Total - Manufacturing Costs	**6,058**	**4,858**
Selling and distribution costs	339	278
Administrative costs	192	136
Other costs	199	172
Total operating expenses	**6,788**	**5,444**
Total operating profits	**584**	**480**
Less: corporate expenses	147	133
EBITDA	**437**	**347**
Depreciation, amortisation and impairment	236	243
Net operating profits (EBIT)	**201**	**104**
Less: Interest expense, net	92	51
Add: Other non-operating income	125	107
Net profit/(loss) before tax	**234**	**160**
Taxation (2009 - 25%, 2010 - 25%)	58	40
Net profit /(loss) after tax	**176**	**120**
Dividends	43	35
Increase in retained profits for year (rounded up)	**133**	**85**

Consolidated statements of financial position as at 31 December

	2010 RMB mil	2009 RMB mil
Assets		
Current assets		
Cash and cash equivalents	1,308	1,056
Pledged bank balances and time deposits	178	173
Trade receivables	720	235
Bills receivable	682	637
Prepayments, deposits and other receivables	363	341
Inventories	1,300	994
Total current assets	**4,551**	**3,436**
Non-current assets		
Property, plant and equipment	1,917	1,676
Lease prepayments	68	67
Intangible assets	172	162
Goodwill	49	50
Other long term assets	117	117
Deferred tax assets	85	77
Total non-current assets	**2,408**	**2,149**
Total assets	**6,959**	**5,585**
Liabilities and equity		
Current liabilities		
Trade payables	1,000	918
Bills payable	700	514
Other payables and accruals	872	670
Interest-bearing borrowings	760	681
Income tax payable	80	84
Provisions	56	56
Total current liabilities	**3,468**	**2,923**
Non-current liabilities		
Interest-bearing borrowings	1,210	508
Provisions	12	17
Deferred tax liabilities	7	8
Total non-current liabilities	**1,229**	**533**
Total liabilities	**4,697**	**3,456**
Equity		
Issued capital (RMB 10 par value)	903	903
Reserves	725	733
Retained profits	591	458
Proposed final dividend	43	35
Total equity	**2,262**	**2,129**
Total liabilities and equity	**6,959**	**5,585**

Appendix A – Directors, senior management and key employees

Board of Directors

James Chai, 42 – Chairman and executive director

James Chai is the middle son in the prosperous Hong Kong Chai business dynasty, started by his grandfather in the 1920s. He has an economics degree from Oxford and a Master of Business Administration (MBA) from London Business School.

Timothy Chai, 32 – Managing Director

Timothy Chai is the youngest son in the Chai business dynasty and has been working in the business in a full-time capacity since completing his MBA at Harvard Business School in 2005. He is a CPA and a member of the Audit Committee.

David Chai, 46 – Non-executive director

David Chai is currently chairman of Chai Family Holdings. He has been a non-executive director of KEC since listing in 2001. He has no formal qualifications and entered the family business at age 19. He has no responsibility for daily management of KEC.

Michael Yip, 68 – Non-executive director

Appointed to the Board in 2001, Michael Yip has no formal qualifications but was managing director of a large Kunming-based government car manufacturer for 20 years.

Katie Soon, 48 – Independent director

Appointed to the Board in 2005, Katie Soon is a CPA with approximately 25 years experience. She is a member of the Taxation Committee on the Hong Kong Institute of CPAs. She is chair of the Audit Committee.

Kevin Wong, *52* – Independent director

Kevin Wong is a Barrister and solicitor with over 25 years experience and is originally from Yunnan province. He worked in Hong Kong for over 15 years for a leading Hong Kong law firm. Kevin Wong is a member of the Audit Committee.

Senior management

In addition to James and Timothy Chai, the Senior Management Team includes:

David Chan, 44 – CPA and Chief Financial Officer

David Chan is responsible for all accounting, IT, finance and administration.

Steven Lee, 37 – Operations Manager – Kunming Production Plant A

He is responsible for the overall operations of the largest Kunming production plan which includes the R&D facility.

Jenny Wang, 48 – Sales and Marketing Manager

She is responsible for the marketing and promotion of all vehicles.

Kenneth Luo, 58 – Operations Manager – Kunming Production Plant B

He is responsible for the overall operations of the secondary Kunming production plant. Kenneth was Operations Manager of KEC's 2004 acquisition and was with that company since its inception in 1993.

***Daniel Macek**, 32* – Operations Manager – Romanian Production Plant

He is responsible for the overall operations of the Romanian complete knock-down facility.

***Alison Wang**, 31* – Operations Manager – Head Offices

She is responsible for the overall operations of the Hong Kong and Kunming head offices.

Romanian production facility

Razvan Lazar, 52 – Owner of Fast Trans SRL

Razvan Lazar is the director and majority owner of Fast Trans SRL who operates several factories throughout Romania. The agreement with KEC is Fast Trans's first joint venture.

***Mr Stefan Popescu**,* 32 – Supervisor, Fast Tran SRL

Stefan Popescu is a product supervisor and comes with excellent references from other Romanian production facilities. He is responsible for the implementation and testing of airbags in the *Beep Beep Coyote 5* SUV.

***Ms Ana Dimitru**, 36* – Factory worker, Fast Tran SRL

Ana Dimitru is a single mother of two. Her job is to install locally produced airbags.

The Summary

Kunming Excellence Cars Co Limited (KEC) is a medium-sized Chinese automobile manufacturer, producing mini-van and sedan vehicles. It is also engaged in the production and sale of automotive components and rechargeable battery in the automotive and handset markets.

KEC is a public company which has been listed on the Hong Kong Stock Exchange (HKEx) since 2001. Its head office is in Hong Kong and its manufacturing base is Kunming, capital of Yunnan Province, south-western China. Kunming is an emerging auto manufacturing centre, second only to Shanghai.

The global automobile market was in recession throughout 2009 and 2010 due to the uncertain international economy. The Board considers it is the opportune time to expand overseas through joint venture with foreign partners. Despite the gloomy outlook for the rest of world (ROW) automobile manufacturers, the Chinese industry continued to thrive.

KEC needs to decide on a cohesive and unified corporate strategy for the medium-term. David Chan, the CFO, has asked your team to attend a KEC Board meeting. Your team is required to do a thorough market analysis to identify which of the following four strategies is the best strategy to grow the business in the next five years.

1. Cost control
2. Growth in existing markets and/or existing products
3. Expansion into new markets
4. Development of new products

Requirements:

a. Carry out a comprehensive SWOT analysis of KEC and list them in order of priority to the organisation.

b. Complete an Ansoff product-market matrix of KEC using the SWOT analysis.

c. Recommend the best strategy for the company.