Momentum:
Driving forces in China’s car market
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Introduction

China’s passenger car market continues to expand vigorously. Both sales and production rose by more than 20 percent in the first ten months of 2007, albeit not quite at the same rate as 2006, when both rose by more than 30 percent. The overall strong growth, however, masks much of what is going on in a highly dynamic market, the most significant development being the rise of domestic car making. Companies continue to compete fiercely on price, although this may change as the inflationary pressures currently impacting the economy become increasingly apparent.

With annual passenger car sales of just under 4 million last year, and above 5 million this year, the industry is still far from mature. Indeed, this makes its achievements all the more remarkable. In 1990, only 42,000 cars were made in China. And it was only in 1994 that the government designated the automotive industry a “pillar” industry of the national economy. Foreign investment, which had been present since the late 1980s, was further encouraged, particularly from Germany’s Volkswagen and then the US’s General Motors, which resulted by 2005 in output and sales being dominated by some dozen or so foreign-invested joint ventures.

For the government, the principal benefits of a strong car industry lie in its overall contribution to economic development, raising demand for everything from steel and tempered glass to tyres and petroleum products. The overall growth of the industry, however, has led in particular to the establishment of a major components production network. It has also enabled the development of a handful of independent domestic car makers, which have grown even faster than their international counterparts.

In March, Chery sold over 44,568 cars — more than any other company — marking the first time a domestic car maker has topped the monthly sales league table since China allowed foreign car makers into the industry in the mid-1980s. Overall, domestic companies have increased their share of the total passenger car market to more than 25 percent, up from just over 20 percent in 2004.

Chinese companies are also responding strongly to government proposals to develop their own car brands. All of the country’s leading car makers — Shanghai Automotive Industrial Corp, First Auto Works, Beijing Automotive Industry, Dongfeng Motor Group and Guangzhou Automotive — have already announced plans to follow the country’s leading independent car producers, Chery and Geely, and are creating their own brands. Despite the government’s wishes for the domestic industry to consolidate, new car makers continue to arrive in the market. It is estimated that the industry has more than 100 auto manufacturers competing with each other.

Germany’s Volkswagen is making a strong comeback, after seeing both its market share and profits decline for several successive years, while the US’s General Motors, the recent pacemaker among foreign companies, has found it tougher to sustain both sales and profits over the past twelve months. Japan’s Toyota, meanwhile, is making rapid strides towards its target of claiming 10 percent market share by 2010.

Exports are also growing rapidly, with overseas sales being driven by sales of domestic car makers, headed by Chery, to other emerging markets around the world. While total exports remain a small proportion of overall production, it is a significant share of output from domestic car makers. This suggests that Chinese branded cars have the potential to establish themselves on the roads of many countries in a way that few would have envisaged just half a decade ago.

We believe that this automotive industry update contains fresh and valuable insights. As always, we will be delighted to receive comments on this research.

Nelson Fung
Partner in Charge, Industrial Markets
KPMG in China and Hong Kong SAR

Andrew Thomson
Partner
Member of KPMG’s Global Automotive Steering Group
KPMG in China and Hong Kong SAR

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An expanding market

Demand for passenger cars shows no sign of decline. In the first 10 months of the year, the country’s auto makers produced 5.14 million cars and sold 5.08 million — up 21.7 percent and 23.6 percent respectively over the same period of 2006, according to industry observers Sinocast China Transportation Watch.²

China’s domestic car makers continue to grow in prominence, with their total share passing 30 percent in July 2007, up from 26 percent in 2006 and 22 percent in 2004, according to Automotive Resources Asia.³ Furthermore, in March 2007, Chery displaced Shanghai General Motors at the top of China’s car-sales league, selling 44,568 units, while Shanghai GM, China’s top car-seller in 2006, sold 40,750 units.⁴

China’s car production and sales show no sign of letting up over the medium term. The number of cars per 1,000 people looks set to more than double between the end of this year and 2011, which means it will be more than four times the number it was at the end of 2004. Although analysts see the overall vehicle market slowing, this will only happen after 2010, and even then it will still maintain a 15-20 percent growth rate.⁵

To feed this growth, foreign companies are continuing to invest in expanding capacity, particularly for an ever greater localisation of component-manufacturing. Most recently, in November 2007, GM formed another joint venture, Shanghai Onstar Telematics Co., with Shanghai Automotive Industry Corp (SAIC) to supply in-vehicle safety, security and communications services, such as global positioning systems and related technologies, to the two companies’ principal China joint venture, Shanghai GM. The venture will be 40 percent owned by GM through its wholly-owned subsidiary, Onstar, with 40 percent held by SAIC and 20 percent by Shanghai GM. Total initial investment will be USD 46 million.⁶

² “China automotive: China built over 7m vehicles in first 10 months”, Sinocast China Transportation Watch, 14 November 2007.
⁵ “China’s Auto Sales Growth to Slow Down By 2012”, theautochannel.com, 14 November 2007.
Market trends

Toyota performed particularly well in the first ten months of 2007, selling 380,000 units of its Camry, up 68 percent over the same period of 2006. This gave the company the confidence to raise its target for 2008 from 500,000 cars to 700,000. \(^8\) Competition at the high end of China’s car sales league now looks set to change from a rivalry between GM and Volkswagen to a four-way race between a German, US, Japanese and Chinese quartet.

Honda may also be part of that race. It currently has a market share of around 8 percent, and sales growth of some 32 percent in the first three quarters of 2007. GM’s growth rate slowed in 2007, recording just 17 percent in the first nine months of the year, \(^9\) compared with 32 percent for 2006 \(^0\) and 35 percent in 2005. \(^11\)

Sales growth is not being driven by demand alone. To claim market share, almost every company has cut prices, especially at the lower end of the market. GM has been among the most aggressive, slashing the price of its Chevrolet Sail by 27 percent and starting to offer interest-free financing for some of its models. Geely, with cuts of up to 16 percent, and South Korea’s Hyundai, with cuts of up to 13 percent, have also been very active in making price reductions. Volkswagen has reduced the price of its Passat by up to 7 percent. \(^12\)

Volkswagen is making a significant recovery. After seeing market share for its two joint ventures — one with Shanghai Automotive Industry Corp and the other with Changchun-based First Auto Works — drop from a high of around 50 percent to the low teens, its market share increased one percentage point to 18 percent on the back of a 25 percent increase in sales in the first half of 2007. \(^13\)

The company is aiming to respond to low-cost domestic competitors by marketing a range of cost attractive models through its Skoda subsidiary. Skoda went into production earlier this year at Shanghai Volkswagen. However, this remains a small part of VW’s China output, at just over 4,000 cars in October 2007. \(^14\)

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\(^{8}\) "Toyota revs up sales target 50pc," South China Morning Post, 20 November 2007.

\(^{9}\) "GM to open lab for green cars," China Daily, 30 October 2007.


\(^{11}\) "Record China sales cheer a limping GM," International Herald Tribune, 5 January 2006.


\(^{13}\) "Great leap forward for VW in China," Financial Times, 29 August 2007.

In the first half of the year, profits at China’s leading automotive companies rose 66 percent to RMB 109 billion despite price cuts, according to the China Association of Automobile Manufacturers. Chery led the way, with a rise of 211 percent, followed by Guangzhou Auto, which has joint ventures with Toyota and Honda, with a rise of 150 percent. Volkswagen’s China profits are reported to be recovering after the company embarked on a campaign aimed at reducing costs by 40 percent in four years.

One exception to the general trend was Geely, which reported that its first half net income was down 32 percent, a fall it attributed to increased competition. Another was Toyota, one of the few companies not to cut prices on its cars, which has seen its worldwide profits rise on the back of increased China sales. Honda is the one other major company that has avoided price cuts.

**China passenger car sales, January-April 2007, brand share, %**

- Volkswagen, 17%
- GM, 10%
- Chery, 8%
- Toyota, 8%
- Honda, 7%
- Hyundai, 5%
- Nissan, 5%
- Peugeot-Citroen, 4%
- FAW Xiali, 4%
- Kia, 2%
- Mazda, 2%
- Suzuki, 3%
- BYD Auto, 2%
- Geely, 4%
- Haima, 3%
- Ford, 3%
- Other, 11%

Source: Automotive Resources Asia

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Domestic strengthening

One trend which looks unlikely to reverse is the growing strength of domestic car manufacturers. With the Chinese government drawing up policies aimed at encouraging domestic companies to develop their own brands, either by themselves or as part of their joint ventures with foreign companies, almost all of China’s leading car makers announced ambitious schemes to follow this strategy.20

Guangzhou Automobile Industry Group, which operates joint ventures with both Honda and Toyota, announced in November 2007 that it planned to spend RMB 6 billion (about USD 905 million) on a research and development centre and production facility at Panyu, just south of Guangzhou, to start making its own cars.21 The company said its goal was to commence production by 2010. The plant will have a planned annual capacity of 200,000 cars. Guangzhou Auto and Honda had earlier in the year said they would invest JPY 30 billion (about USD 245 million) to build a research and development centre to jointly develop a new brand of cars for China.22

Shanghai Automotive Industry Corp (SAIC) had previously announced a bond issue to raise investment for a new factory with an annual capacity of 270,000 cars and 320,000 engines to be developed under its own brand separate from its joint ventures with GM and Volkswagen. In March, SAIC began selling its Roewe 750 series, a car based on designs bought from Britain’s MG Rover when the UK company went into liquidation. Nanjing MG Motor, part of the Nanjing Automobile Group, also began producing its first MG models after buying the brand from the UK’s bankrupt Rover in 2005. The company says production will be sold both overseas and on the domestic market.

A number of other domestic companies have ambitious growth plans. For example:

- FAW Group Corp, a China partner of Volkswagen AG and Toyota, announced plans to spend RMB 13 billion over eight years to develop cars under its own brand.
- Dongfeng Motor, which has car-making joint ventures with Nissan Motor, Honda and Peugeot Citroen, is reported to have plans to invest RMB 7.6 billion in a range of self-branded cars.
- Great Wall Motor, China’s largest maker of sports utility vehicles, is investing RMB 2.9 billion to develop its first self-branded passenger car. The company aims to be in production this year, and has already announced a target of 200,000 car sales by 2009.23

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23 “Great Wall gears up for own-brand car,” South China Morning Post, 22 August 2007.
Consolidation of the domestic industry, long forecast, is happening to a limited extent. For example, SAIC and Nanjing Automobile Corp are in discussions about merging their assets. However, new small companies are also being set up by businesses eager to claim a stake in China’s fast-growing car market. Typical of the newcomers is BYD Automobile, a subsidiary of a Shenzhen-based battery maker, which moved into the automotive industry after buying a small state-owned car maker in northern China. It now produces a small four-door passenger car, which it sells for just under USD 8,000. Despite selling fewer than 60,000 cars in the first seven months of 2007, it has announced its ambition to produce 13 million vehicles by 2025 — more than GM, the world’s biggest car maker, sells currently.  

24 “China’s auto startups target Toyota,” Asia Times, 6 November 2007.
The automotive components sector

China’s automotive components industry is also growing strongly, and even outpacing the output of vehicles. Between 2001 and 2005, its 6,300 or so companies had a compound average growth rate of just over 30 percent, leading to the production of an estimated USD 56 billion worth of parts in 2006. Sales could grow to USD 161 billion by 2010, according to one recent market study.25

Foreign companies have established a major presence, including filling more than half the ranks of the country’s top 100 auto components businesses.26 Domestic companies — with a few notable exceptions, such as Hangzhou-based Wanxiang Group (see page 10) — continue to struggle with quality and technology issues. Despite government efforts to raise standards, including establishing a China Compulsory Certification System in December 2006, covering key automotive components, the domestic industry has focused on increasing low-end capacity rather than raising standards, with low investment in research and development being a key reason for this weakness. According to a report published by just-auto.com, most Chinese companies devote less than 2 percent of their annual budget to R&D, compared to a global norm of 5-10 percent.

In July 2006, average tariffs on imports of components were cut by 25 percent, in line with undertakings made in China’s World Trade Organisation accession terms. This, combined with the widespread presence of foreign component makers, should encourage local companies to raise their standards. The growth in exports by domestic car manufacturers should also help, especially as they start to target developed country markets with stricter safety standards.

Further stimulus should come from the after market, particularly as a second-hand market forms. The after market is forecast to reach USD 5.2 billion in 2008, up from USD 3.2 billion in 2004.25

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Wanxiang Group

Wanxiang Group, headquartered in the eastern city of Hangzhou, established itself as China’s largest private automotive components manufacturer, first by focusing on realising a dominant share of the domestic market for its principal product, universal joints, and then through an aggressive programme of acquisitions overseas to make itself a global company.

In the 1980s and 1990s, Wanxiang’s main emphasis was on increasing quality and lowering its costs. In the process, it acquired a market share of some 70 percent for universal joints, and started supplying parts to China’s leading automotive joint ventures, including GM and Ford. But it was initiating its overseas purchases — with its main goal being acquiring technology. In 1998, for example, it bought US auto components maker Schiller for USD 9 million, and followed this with the acquisitions of Universal Automotives Industry (2001) and Rockford Powertrain (2003), among a host of others.27

With revenues of USD 3.3 billion in 2006, the company is now among the global elite of auto components makers, and is looking to further strengthen its position with more acquisitions. In April 2007, it acquired Ford’s steering shaft manufacturing division, and has been in discussions to buy parts of Delphi, the former components arm of GM, though no agreements had been reached at the time of writing this report.28

The second-hand car market

Despite the youth of China’s car market, second-hand sales are growing even faster than new sales — up 34 percent in 2006, to 1.8 million units.\(^29\) With the used car market set to keep growing at an even higher rate than the new car market, automotive-related internet businesses have become a target of investment. According to Hong Kong’s South China Morning Post, venture capital firms have invested around USD 60 million in online car sales businesses, with the biggest single investments being USD 25 million from a Goldman Sachs-led group into Chinacar.com. This was followed by a USD 10 million investment by Nippon Venture Capital Corp and Doll Capital Management in bitauto.com\(^29\)

The government has forecast that total second hand car sales would reach 5.3 million units in 2008, and in 2005 released regulations aimed at ensuring the development of an orderly market.\(^30\) The number of retailers permitted, however, remains severely restricted: in February 2007, for example, Beijing had just two used-car dealers, making it unlikely that the government’s target would be met.\(^29\)
The export car market

China’s total vehicle exports, dominated by Chinese developed models, doubled in 2006 to 340,000 units and are expected to rise to 500,000 units in 2007. Passenger cars accounted for around one quarter of this total, or 90,000 units, last year.31

Chery claims to be China’s biggest single car exporter, with overseas sales of more than 100,000 units. It sells its cars mainly in developing country markets in other parts of Asia, Eastern Europe, the Middle East and Central and South America. Honda exported 24,000 of its Jazz model from its Guangzhou joint venture, Honda Motor (China). Its target for 2007 was to lift this total to 43,000, according to the company.32

In 2007 DaimlerChrysler’s Chrysler division signed an agreement with Chery to have the Chinese company assemble small cars for export under the Dodge brand. Sales to Latin America could start as early as 2008, with exports to the United States possibly following by the end of 2009.33

The biggest challenge facing exports of domestically developed cars is safety. In recent years several manufacturers have performed poorly in safety tests by European automotive associations, such as ADAC in Germany.34

32 “Honda will boost Jazz exports from China to Europe,” Automotive News Europe, April 2007.
34 “Another Chinese car flunks German crash test,” Reuters, 22 June 2007.
Key challenges

While the overall growth and development of China’s car industry looks assured — even the government’s current round of macro economic tightening is unlikely to dent growth in passenger car sales, according to most observers\(^\text{35}\) — the industry’s major players face some severe challenges.

Pricing pressure is the most immediate of these, with the rise of Chery and Geely in particular forcing most of the Sino-foreign joint ventures to cut prices on their models. Given the number of companies already involved in production, and the plans for continued expansion of capacity by almost every one of them, price cuts and low or zero interest financing packages will remain a key element of the industry, as companies fight to claim market share. It is hard to envisage a return to the levels of profitability enjoyed by Volkswagen in the 1990s and GM more recently.

Increasing the quality of domestic component production is another major challenge, as noted earlier in this report. Any push to raise standards could be hindered to some degree by the emergence of independent domestic car makers looking to challenge the giant international incumbents on price. The export sector could also be hindered if the quality of components is not lifted sufficiently to meet the safety and environmental requirements of overseas markets, particularly in developed countries.

For foreign companies, the government’s efforts to encourage the development of national brands could also prove a major challenge, especially if it raises questions over the commitment of their partners to their joint ventures. The government shows no sign of considering allowing foreign companies to increase their holdings above the current 50 percent limit.

Perhaps the biggest single question mark over the industry’s future will be how attitudes towards environmental protection evolve. The industry grew through the 1990s and early 2000s with little consideration of the impact that bringing millions of cars on to the country’s roads would have on the environment. There are signs, however, that the government may move towards embracing a more sustainable view of economic development. Combined with rising pollution levels and concerns over China’s increasing reliance on oil imports, this could result at some point in officials reconsidering the kinds of cars made and used in China.

Conclusion

China continues to be home to the world’s most dynamic car industry — not just in terms of growth, but also, and more significantly, in the pace of structural change.

In both the short and the medium term, the most important developments are likely to be the changes in market share between the various manufacturers, in particular whether the independent domestic manufacturers, Chery and Geely, can maintain their rapid growth, and then whether brands developed by the large state-owned companies can emulate their success.

The global manufacturers will not concede the China market without a fight. As Volkswagen has demonstrated, it is possible for a company to recover rapidly if it can rethink its strategy and overhaul its operations. Elsewhere, GM is continuing to invest to build on its success of the last half decade, and Japan’s two market leaders, Toyota and Honda, both look well-positioned to maintain the momentum they have developed from their factories, particularly those in the southern city of Guangzhou.

The even bigger story for the long-term, however, looks as if it might turn out to be China’s movement towards embracing cleaner car technology. Wan Gang, appointed the head of the Ministry of Science and Technology in April 2007, has made it clear that developing a new generation of “clean” cars is now a priority for the country’s automotive industry. “Fuel Cell Vehicles (FCVs) with zero emissions are one of the important technologies for the future development of the automobile industry in China” Gang said in a keynote speech made in early November.36

With clean air becoming a priority for China, and especially its capital, Beijing, in the run-up to the 2008 Olympics, perhaps the most intriguing development the country’s automotive industry could witness over the next decade is a decisive switch away from the role of oil-based internal combustion to power the tens of millions of cars that will appear on the country’s roads.

Norbert Meyring
Head of Industrial Markets
Shanghai
KPMG in China and Hong Kong SAR

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KPMG in China and Hong Kong SAR

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37 Bloomberg, KPMG Analysis 31 July 2006.
Contact us

KPMG in China and Hong Kong SAR

Nelson Fung
Partner in Charge
Industrial Markets
KPMG in China and Hong Kong SAR
Tel: +86 (2) 222 2801
e-Mail: nelson.fung@kpmg.com.cn

Norbert Meyring
Head of Industrial Markets, Shanghai
Tel: +86 (2) 222 2707
e-Mail: norbert.meyring@kpmg.com.cn

Melvin Guen
Head of Industrial Markets, Beijing
Tel: +86 (10) 8508 7019
e-Mail: melvin.guen@kpmg.com.cn

Ronald Sze
Head of Industrial Markets, Guangzhou
Shenzhen and Macau
Tel: +86 (755) 2547 1063
e-Mail: ronald.sze@kpmg.com.cn

Andrew Thomson
Partner
Member of KPMG’s Global Automotive Steering Group
KPMG in China and Hong Kong SAR
Tel: +86 (2) 2212 2877
e-Mail: andrew.thomson@kpmg.com.cn

Paul Brough
Partner in Charge
Financial Advisory Services
KPMG in China and Hong Kong SAR
Tel: +852 3121 9800
e-Mail: paul.brough@kpmg.com.hk

Stephen Lee
Partner in Charge
Risk Advisory Services
KPMG in China and Hong Kong SAR
Tel: +852 2826 7267
e-Mail: stephen.lee@kpmg.com.hk

Honson To
Head of Transaction Services, Shanghai
Tel: +86 (2) 222 2708
e-Mail: honson.to@kpmg.com.cn

John Lee
Head of Tax, Shanghai
Tel: +86 (2) 2212 3402
e-Mail: john.lee@kpmg.com.cn

Thomas Stanley
Head of Commercial Due Diligence Unit
KPMG in China and Hong Kong SAR
Tel: +86 (2) 2212 3884
e-Mail: thomas.stanley@kpmg.com.cn
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## Northern China

**Beijing**  
8th Floor, Tower E2, Oriental Plaza  
1 East Chang An Avenue  
Beijing 100738, China  
Tel : +86 (10) 8508 5000  
Fax : +86 (10) 8518 5111

**Qingdao**  
4th Floor, Inter Royal Building  
15 Donghai West Road  
Qingdao 266071, China  
Tel : +86 (532) 8907 1688  
Fax : +86 (532) 8907 1689

**Shenyang**  
27th Floor, Tower E, Fortune Plaza  
59 Beizhan Road  
Shenyang 110013, China  
Tel : +86 (24) 3128 3888  
Fax : +86 (24) 3128 3899

## Eastern and Western China

**Shanghai**  
50th Floor, Plaza 66  
1266 Nanjing West Road  
Shanghai 200040, China  
Tel : +86 (21) 2212 2888  
Fax : +86 (21) 6288 1889

**Chengdu**  
18th Floor, Tower 1, Plaza Central  
8 Shuncheng Avenue  
Chengdu 610016, China  
Tel : +86 (28) 8673 3888  
Fax : +86 (28) 8673 3838

**Hangzhou**  
8th Floor, West Tower, Julong Building  
9 Hangda Road  
Hangzhou 310007, China  
Tel : +86 (571) 2803 8000  
Fax : +86 (571) 2803 8111

## Southern China

**Guangzhou**  
38th Floor, Teem Tower  
208 Tianhe Road  
Guangzhou 510620, China  
Tel : +86 (20) 3813 8000  
Fax : +86 (20) 3813 7000

**Fuzhou**  
25th Floor, Fujian BOC Building  
136 Wu Si Road  
Fuzhou 350003, China  
Tel : +86 (591) 8833 1000  
Fax : +86 (591) 8833 1188

**Shenzhen**  
9th Floor, China Resources Building  
5001 Shennan East Road  
Shenzhen 518001, China  
Tel : +86 (755) 2547 1000  
Fax : +86 (755) 8266 8930

## Special Administrative Regions

**Hong Kong**  
8th Floor, Prince’s Building  
10 Chater Road  
Central, Hong Kong  
Tel : +852 2522 6022  
Fax : +852 2845 2588

**Macau**  
23rd Floor, D, Bank of China Building  
Avenida Doutor Mario Soares  
Macau  
Tel : +853 2878 1092  
Fax : +853 2878 1096