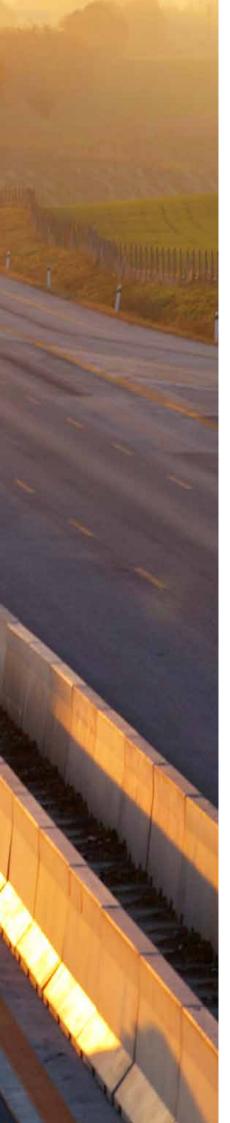


Excelling in China's auto leasing industry

In association with RVI Group

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Contents







Executive summary

Auto leasing is a common approach to acquire vehicles in many developed markets, accounting for 15-30% of new vehicle retail sales.¹ In China, although equipment leasing is already common, auto leasing is still a market in its infancy. In 2016, we estimate that auto lease penetration in China was about 2.5%, with the majority being loans signed in the form of leasing (referred to as "lease-loan" in this publication). However, the China leasing market is projected to have strong momentum; we forecast the penetration to reach about 20% by 2026.

The benefits of auto leasing are manifold. First and foremost, it boosts new car sales by offering competitive pricing and expediting consumers' car replacement cycle. Further, off-lease cars can become a source of premium quality used cars, enabling expansion into the used car business, which is also a rising market in China. In addition, leasing companies have more opportunities to engage with the customers throughout the leasing process and subsequently boost retention rates.

Key drivers for the growth of the leasing market are rising consumer awareness, a maturing used car market, and the development of a residual value forecasting model. In the next decade, a significant portion of car buyers will be millennials, who are typically considered to be open to new concepts and westernised consumption behaviours. Concurrently, the used car market is evolving into a more transparent and regulated market under government decree. As such, increasingly advanced residual value forecasting based upon more transparent data becomes possible.

The current market in China has a very different competitive landscape from mature markets where original equipment manufacturer (OEM) captives dominate. In China, three types of players are now competing in the market: OEM-affiliated, dealer-affiliated and internet-affiliated. The last mentioned is a rising star, with internet conglomerates BAT and JD.com each extending their investment arms into leasing companies. Each of the three types possesses a unique skill set to be leveraged, and whether China's market landscape will evolve similarly to other mature markets remains an open question.

^{1. &#}x27;Automotive Finance Study 2016', NextContinent, 2016, http://www. nextcontinent.net/publications/ automotive-finance-study-2016/download

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In this report, we identify three key points to enable a winning strategy in the auto leasing space:

- Distinguish lease-loan from standard leasing and define a clear product strategy
- Take a holistic approach to residual value management
- Seek to realise potential tax savings from finance leasing contracts.

A leasing company should carefully study this checklist and ensure a clear vision is in place in each aspect, to underpin a winning position.

Leasing in mature markets has also been employed as a key method to drive electric vehicle (EV) sales in recent years. By offering competitive monthly payment and vehicle return options, leasing compared with other purchasing methods significantly eases consumer concerns around EV cost and technology obsolescence. In the US, 75% of EVs were sold via leasing in 2015.² Facing urgent government pressure on EV sales, OEMs in China can learn from overseas practice and consider leasing as an additional channel to push sales and meet government mandates.

To better understand the auto leasing industry, the terms below are defined as follows:

Figure 1	Definition of terms	
Perspective	Term Definition	
Product design	Lease-loan	Leasing with residual value set significantly below market fair value
	Standard leasing	Leasing with residual value approximating market fair value
Operation	Direct leasing	Lessor purchases the vehicle and leases to the lessee
	Sale and leaseback	Lessee purchases the vehicle and encumbers to the lessor, who then leases it back to the lessee
Accounting	Finance leasing	A type of leasing in which the lessor shoulders an insignificant portion of the residual value risk (e.g. less than 10% of the vehicle value)
	Operating leasing	A type of leasing in which the lessor shoulders a significant portion of the residual value risk (e.g. 10% or more of the vehicle value)

Source: KPMG analysis

 'Electric vehicle leasing activity "slips" to 75%', Chicago Automobile Trade Association, 23 October 2015, http://www.cata.info/electric_vehicle_leasing_activity_slips_to_75/

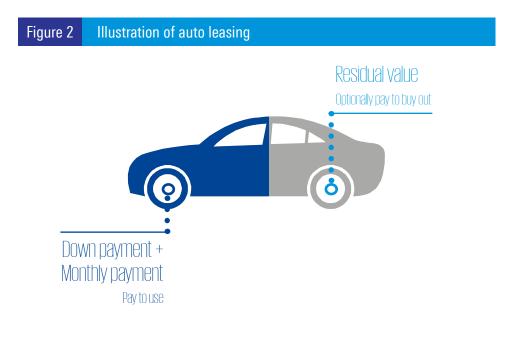
Port I

What is leasing & Why leasing?



Leasing is not a new concept. However, when it comes to automobile leasing, the term's definition often lacks clarity, and interpretations can differ by country. In this publication, we align the definition with that of the US market where the leasing industry flourishes most, namely that auto leasing refers to a contractual arrangement where:

- The lessee pays the lessor on a regular basis for the use of the vehicle
- By the end of the lease term, the lessee has the option to buy out the vehicle by paying the contracted residual value
- The contracted residual value is usually a locked value set by the leasing company, which will take any consequential gain or loss from the actual disposal price
- The lease contract can be signed in the form of operating leasing or finance leasing.

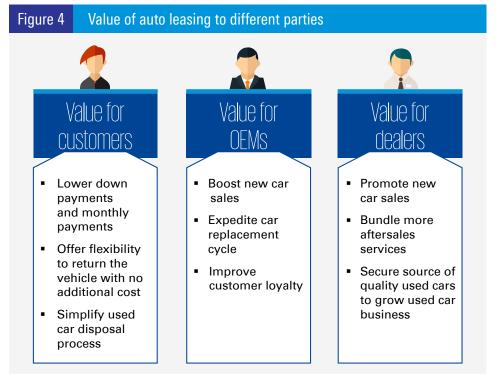


Source: KPMG analysis

Figure 3	Comparison of leasing and other car usage methods			
	Leasing	Rental	Loan	
Car ownership	Consumers do not own the car unless they buy out in the end	Consumers do not own the car	Consumers own the car	
Option	Yes, can return or buy No, only return		No, only buy	
Down payment	Flexible	Flexible	Minimum 20% for combustion engine and 15% for EV, required by China Banking Regulatory Commission	
Monthly payment	Low	High	Medium	

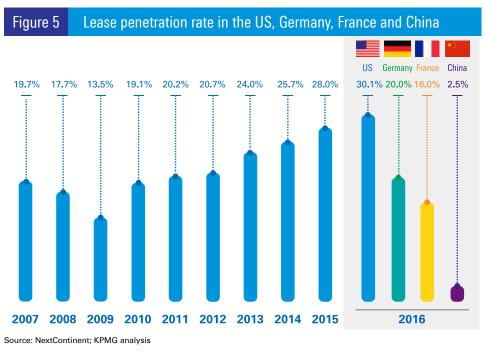
Source: KPMG analysis

With an extra component called 'residual value', leasing offers a financing alternative with appealing monthly payments. More importantly, by going beyond a pure method of financing, it redefines the vehicle ownership accord for customers. Additional value is brought to customers, dealers and OEMs by promoting a more dynamic and interactive vehicle use cycle. For customers, it means flexibility and hassle-free solutions for car usage such that vehicle changes and disposals become handy and low-cost. For dealers, customers under a lease contract often have a much higher return rate to the dealership for aftersales services and new vehicle purchases. OEMs can benefit substantially, using leasing as one of the most efficient tools to boost car sales and to retain customers.



Source: KPMG analysis

Auto leasing has become an important vehicle purchase mode in many developed countries. In mature markets, leasing usually contributes over 15% of new vehicle retail sales. In the US, lease penetration climbed from 19.7% to 30.1% over the past 10 years, with lease originations reaching 4.4 million units in 2016.³



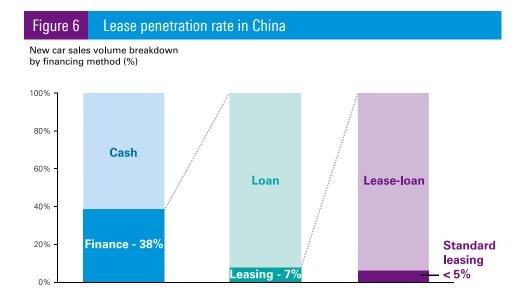
3. Source: JD Power database

Part II

Where are we now?



Despite being the world's largest market for auto sales, China is still in the early stage of development in terms of its auto finance industry. With a finance penetration rate of 38%, China lags significantly behind developed countries, where most have penetration rates between 50% and 80%. In this underdeveloped auto finance environment, leasing has only started to emerge as an option for auto consumers in the past few years. In 2016, the China auto market is estimated to have generated some 600,000 leasing originations, indicating a penetration rate of 2.5%. Nevertheless, of these originations, over 95% were essentially auto loans signed in the form of a lease-loan contract, resulting in an actual lease penetration (hereafter "standard leasing") less than 0.1% based on our estimation.⁴



Source: KPMG analysis

Auto leasing relies substantially on three fundamental pillars that underpin the growth of this market: consumer awareness, remarketing channel and residual value management.

From the market side, for new products the first priority is always to raise consumer awareness of the innovation and communicate its value to the consumers. Auto leasing, as a new term to many Chinese consumers' vocabulary, requires considerable effort on consumer education.

From the operational side, the growth of leasing business highly depends on the development of remarketing channels and residual value forecasting models. Since auto leasing encourages customers to return the vehicles by the end of the term to expedite the vehicle replacement cycle and stimulate new purchasing, it consequently leads to a high volume of returned vehicles

^{4.} Source: Expert interviews; KPMG analysis

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for leasing companies to dispose of. Therefore, a developed remarketing channel is needed to allow efficient disposals. The used car market, as the most commonly used remarketing channel, is now depicted as fragmented, regional and non-transparent in China. Used car sales are often handled by individual dealers and take place in offline markets with one-on-one negotiation. This is clearly not an optimal way for leasing companies to dispose of their large volume of vehicles.

Further, the underdeveloped used car market also results in higher volatility in residual value, challenging the setting of contracted residual value. We have shown that contracted residual value is the most important component of leasing, and an accurate and systemic residual value forecasting system would mitigate losses on returned vehicles. In developed markets, advanced forecasting models have already been built on comprehensive data sets. For example in the US, ALG⁵ has been the industry benchmark for providing historical and forecasting data of residual value, and managed to achieve high accuracy. In contrast, residual value forecasting is still in a trial-and-error stage in China, and leasing companies have to cope with the risks and uncertainties underlying the residual value. Since the Chinese car market has not traversed any significant cycles yet and the used vehicle market is just taking shape, historical Chinese market data is unlikely to provide much insight for future residual value trend.

Despite the low market readiness today in China for leasing business, we see big potential going forward. As a fast-evolving market, China is believed to be rapidly developing these three pillars to enable the growth of auto leasing. Millennials, rising as the largest group of auto consumers, have developed a westernised and 'live for now' attitude that corresponds well with the concept of leasing. The market and government policies are at the same time steering the used car market to a more regulated and standardised market, which in turn drives the development of residual value management.

^{5.} ALG is a US company specialising in used car residual value publishing and forecasting

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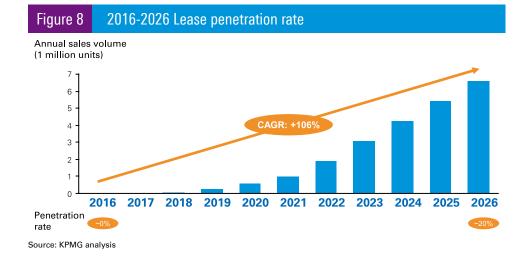
Figure 7	Drivers of leasing market			
	Current status	Trend	Key driver	
Consumer awareness	 New to consumers, lack of consumer understanding and awareness 	 Higher consumer awareness and market reception around leasing 	 Rise of millennials, who are more open to new financing options and place less emphasis on private ownership Consumer education by companies 	
Used car market	 Car circulation mostly restricted to small regions Low transparency Dominated by small individual dealers 	 Nationwide car circulation High price transparency Increasing market concentration, led by large dealer groups 	 Government policy around used car market transparency, used car tax standardisation, and digitisation of vehicle profiling 	
Residual value management	 A number of residual value (RV) forecasting start-ups with underdeveloped models and limited data sets Lack of risk mitigation measures 	 Forecasting companies setting industry benchmarks Improving RV management system 	 Development of used car market to enable access to full data Reducing market volatility Increasing awareness from the leasing market 	

Source: KPMG analysis

This year in particular, a number of leasing products have sprung up in the China market. For example, Souche.com, an online used car platform invested in by the Alibaba Group, launched its leasing product Tangeche ("flick a car" in Chinese) in November 2016. The product created a buzz in Tier 1 cities via waves of advertising, and by July 2017 it had achieved over 20,000 lease originations nationwide.⁶ With the infrastructure in place, by 2026 the leasing market in China (lease-loans not included) is projected to achieve over 20% penetration, or roughly 7 million originations.

^{6. &#}x27;Tangeche, the ultimate "hoax", Sohu news, 24 August 2017, http://www.sohu.com/a/166894752_628797

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Lease-loan, a unique leasing product in China

Reviewing the current leasing offerings in China, it is apparent that the majority deviate from a standard leasing product:

- They set the contracted residual value far below fair market price, usually at 10-20% of the manufacturer's suggested retail price.
- Most of them mandate the consumers to make the tail payment and purchase the vehicle at the end of the term.

In this report we introduce a new term, 'lease-loan', for this particular type of leasing in China in order to highlight the difference between this and standard leasing. The emergence and growth of lease-loans is a result of the regulatory environment in China, which allows more flexibility in down payment ratio and consumer credit rating for leasing compared with regular loan application. Nonetheless, it is important to bear in mind that lease-loan offers a very different set of propositions from standard leasing, and the two need to be differentiated when devising strategies.

Figure 9	Comparison of standard leasing and lease-loan		
	Standard leasing	Lease-Ioan	
Option	Customer can return or buy	Customer can usually only buy	
Residual value	Close to used car market value	Significantly lower than used car market value	
Core proposition	Low monthly payment Flexibility to dispose	Low down payment Easy to apply	
Target customer	Those who are uncertain about vehicle ownership and/or want to change cars regularly	Those who need to finance the car but have no access to loans	

Source: KPMG analysis

The unique leasing product proposition in China entails a very different competitive landscape from mature markets. Three types of players constitute the majority of the market, with backgrounds affiliated to OEMs, dealers and internet conglomerates respectively.

	Figure 10 Players in China leasing market					
	OEM-affiliated	Dealer-affiliated	Internet-affiliated	Other		
Type of players	 Herald Int'l (~BMW) Toyota Leasing VW New Mobility Mercedes-Benz Anji (~SAIC) 	 All Trust Leasing (~CGA) Yongda Finance Leasing 	 Yixin Capital (~JD, Tencent, Baidu) Huashen (~JD) Souche.com (~Alibaba) 	 Ping An Leasing Shenzhou Maimaiche 		
Market entry rationale	 Boost new car sales Expedite replacement Target to promote specific car model Strengthen customer loyalty 	 Add new revenue stream Increase revenue by boosting new car sales, bundling more aftersales services and securing quality used cars 	 Complete its mobility ecosystem Gain access to consumer data 	 Vertical integration along the value chain 		
Competitive advantage	 Deep knowledge of the auto industry OEM subventions OEM management around residual values 	 Experienced in car sales and disposal Expansive offline coverage 	 Low customer acquisition cost by leveraging online portals Big data analysis skills 	 Related knowledge Low cost of funds 		

Source: KPMG analysis

While OEMs' captive leasing companies dominate the mature markets, in China the market is far more diversified. Of the top 5 leasing companies in 2016, only one – Anji Leasing – had an OEM background.



Source: Literature research; respective company websites; KPMG analysis

OEMs are not latecomers to the China leasing market. Apart from Anji, other companies that entered the leasing business from 2011 to 2015 are (in order) VW, Mercedes-Benz, Toyota and BMW. However, they all appear to have taken a patient approach to growing their businesses, to date limiting respective leasing scales to several thousand a year. The slow progress in expansion taken by these OEMs indicates their cautious attitude towards this market. Facing this unique market landscape, OEMs can be caught in the dilemma of whether to:

- Align with the current mainstream and focus around lease-loan, or
- Advance, putting more effort into introducing standard leasing.

Their current portfolios suggest that Anji, VW, Toyota and BMW are now adopting the **Align** strategy, with a focus on lease-loan. Mercedes-Benz, on the other hand, is **Advancing** with its leasing product that sets a high residual value and grants the return option to customers.

	Figure 12	OEM leasing strategies				
Time of entry		Approach	2016 originations	Product	Coverage	US penetration
2011	VW New Mobility Services	Build new entity	2,000- 5,000	Lease- loanRV ~0%	Nationwide	51%
2012 🔿	Mercedes- Benz Leasing	Build new entity	5,000- 10,000	 Standard leasing RV ~market value 	Nationwide	50%
2013 🔿	Toyota Leasing	Build new entity	2,000- 5,000	 Lease- loan RV ~0- 10% 	Mainly in Tier 1-2 cities	24%
2015 🔿	BMW – Herald Int'l	Acquire (Herald Int'l)	5,000- 10,000	 Lease- loan RV ~0- 30% 	Mainly in Tier 1-2 cities	58%
•						

Source: Edmunds.com; respective company websites; KPMG analysis

Dort III

How to win?



In the next decade, auto leasing in China is likely to grow to a trillion RMB market. The competition is intensifying as more players step into the arena, each equipped with unique skill sets to be leveraged. Although it is hard to foresee the ultimate winners, a list of essentials that ought to be in place for a winning strategy can be drawn as follows:

- Distinguish lease-loan from standard leasing and define a clear product strategy
- Take a holistic approach to residual value management
- Seek to realise potential tax savings from finance leasing contracts.

Distinguish lease-loan from standard leasing and define a clear product strategy

As discussed in Part II, leasing and lease-loan are two types of products addressing different sets of customer pain points. Should a leasing company offer lease-loan products? There is no quick answer.

Although lease-loan is not an actual leasing product, we believe it will still command a significant share in the China leasing market in the coming years, considering the unique market environment there. Besides the larger immediately addressable market, in today's market, lease-loan also has lower entry barriers considering the limited residual value risk exposure of the leasing company. Lastly, lease-loan and standard leasing do share a number of basic capabilities required from the leasing company, such as asset management and client management. Therefore, the leasing company should carefully review its strategy to see whether lease-loan fits in and how it could be leveraged for standard leasing business.

On the operational side, leasing can be further divided into direct leasing and sale and leaseback. From a cost perspective, sale and leaseback slightly outperforms direct leasing, with lower tax rates and lower branch operating costs. Nonetheless, consumer preference also makes a significant impact on which to choose. Prior to determining the product portfolio, the leasing company ought to know its target consumers and their respective preferences as input for product design.

Figure 13	Comparison of direct leasing and sale and leaseback				
	Direct leasing	Sale and leaseback			
Definition	Leasing company purchases and registers the vehicle, and then leases it to the consumer	Consumer purchases the vehicle and encumbers it to the leasing company, which subsequently leases it back to the consumer			
Car & plate ownership	Leasing company	Consumer			
Branch	Requires setting up branches in each operating city	No requirement on branch setup			
Repossession	Easy to handle the repossession process	Difficult to handle the repossession process because vehicle ownership belongs to the consumer			
Тах	17% VAT	6% VAT			

Source: KPMG analysis

Summarising from the above, we lay out the four types of leasing in the following matrix. In China, current mainstream products reside in the lower right quadrant, namely lease-loans originated in the form of sale and leaseback. To define its product strategy, the leasing company should decide which of the following it is entering, and possibly in what order.



Source: KPMG analysis

Take a holistic approach to residual value management

The importance of residual value cannot be overstated. In a nutshell, it is the key determinant of the leasing company's profitability. Residual value management encapsulates three key areas:



- How to set the contracted residual value?
- How to mitigate the risk of its market value volatility?
- How to fund the remaining market value risk?

In mature markets, residual value in the leasing contract is usually set close to the forecast of market value. The main reason is to ensure its pricing competitiveness. In these markets with high transparency, it is easy for consumers to have a good understanding of market fair values. Therefore it leaves limited room for leasing companies to deviate from it. In China, while the used car data lacks transparency, leasing companies can have more flexibility in setting the residual value. Nevertheless, it is always a top priority to ensure the price is competitive enough for consumers.



The next question is, how do we mitigate the volatility risk? It is common for the market value of residuals to fluctuate. A used car may be worth RMB 150,000 last month and drop to RMB 120,000 this month. Hundreds of factors will influence the value of a used car. Some of these are uncontrollable, such as petrol price, new regulations, technological obsolescence, general economic recessions, consumer preference shifts and geopolitical turmoil. However, it is important for a leasing company to grasp those that can be controlled or foreseen, such as the following:

- Off-lease volume: Once lease originations reach a substantial volume, off-lease cars flooding into the used car market can create an oversupply that leads to residual value downfall. To avoid a situation of oversupply, leasing companies must closely monitor their own lease origination volumes, as well as that of their competitors and other used car suppliers, and try to avoid supply peaks by smoothing out off-lease dates.
- OEM promotions: If the OEM raises discounts of one particular model, its used car price would also decline. Knowing these OEM actions can help the leasing company plan ahead and be prepared for the potential impacts.

It is essential for leasing companies to build awareness around residual value management and take a holistic approach to tackle this challenge. For example, to avoid potential off-lease peaks, leasing companies need to build the residual value factor into their sales planning and consider the risk of future losses.

Residual value risk can be mitigated, but the risk cannot be eliminated without a risk finance plan. Residual value risk needs to be funded properly to avoid catastrophic consequences to a company's financial resources. In the US, many lessors were forced to exit the business because of the lack of funding of residual value risk.

There are different ways of funding residual value risk. We can classify residual value funding into two categories: self-insuring and risk transferring. If a lessor/ lessee decides to self-insure the risk, then the company needs to build a loss reserve fund to pay unexpected high residual value loss in the future. If a company decides to transfer the risk to a third party, residual value insurance is an option. In China, there is currently no insurance product in the market for residual value. RVI Group, a Bermuda-domiciled speciality insurance company headquartered in the US, has been working with Ping An P&C Insurance Company to bring the residual value insurance product to China in 2018.

What is residual value insurance?

If a company decides to transfer the risk to a third party, residual value insurance is an option. Residual value insurance indemnifies the insured against a loss that might occur if the sale proceeds of a properly maintained asset are less than the asset's insured residual value at the point specified in the policy. Residual value insurance offered by insurance companies intends to cover the residual value loss caused by adverse market movement. A residual value insurance policy is designed to underwrite the risk of the asset values at the date of termination of a lease or other type of financing arrangement. Potential beneficiaries of such policies are predominantly providers of asset finance or manufacturers. However, business owners and shareholders may also be potential beneficiaries as shareholder value can be protected or enhanced if balance sheet asset values are protected in this way. In other words, residual value insurance provides confidence in financial arrangements, and can be used as a form of financial support to leasing operations by limiting residual value volatility. Residual value insurance is considered by some as a financial hedging instrument rather than a typical insurance policy, and its primary purpose is to support asset financing transactions.

The biggest risk associated with passenger vehicle leasing business is the risk that realised residual value at lease end is lower than the contract residual estimated at lease origination. Residual value insurance is the best tool for a lessor to transfer residual value risk.



A brief history of residual value insurance in the automotive industry

In the US, residual value insurance offered by many insurance companies in the 1980s and 1990s played a critical role in gradually growing passenger vehicle leasing business, from an arcane business only for celebrities to a business benefiting ordinary consumers. However, the performance of residual value insurance companies in the automotive industry has been poor.

A number of large insurance companies such as AIG rushed into this field. Most of these companies lacked a full understanding of some of the fundamental differences between residual value risk and traditional property & casualty risk, and the complexity of the used vehicle market. As a result, most of these companies did a poor job of underwriting residual value insurance policies and subsequently lost large sums of capital during the residual value downturns from 2001 to 2003 and then from 2008 to 2009.⁷ Following the 2008 recession, the only company still actively underwriting passenger vehicle residual value risk is RVI Group located in Stamford, Connecticut.

Potential tax savings from finance leasing contracts

From an accounting perspective, there are two types of lease contracts: operating leasing and finance leasing. In the US, the majority of auto leasing contracts are signed as operating leasing, except for certain commercial banks that prefer to sign as finance leasing to align with their core businesses.

In China, special circumstances arise as finance leasing contracts are eligible for additional tax benefits, and therefore the two types of contracts have different cost implications. Finance leasing can save the leasing company 2-5% of the cost via tax deduction allowances. However, to be qualified as finance leasing, intricate treatment might be needed. The accounting rule in China stipulates that a leasing company needs to transfer the underlying asset's residual value risk to third parties in order to be recognised as finance leasing. The same accounting rule applies to leasing companies in the US, and some banks choose to resolve the issue by purchasing residual value insurance to meet the requirement. Leasing companies in China can further investigate the domestic accounting rules around this area and explore the options to satisfy the requirement.

^{7.} Source: 'Casualty Actuaries in Reinsurance', Swiss Re, 2001

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Part IV

Leasing + EV, a '1+1>2' strategy

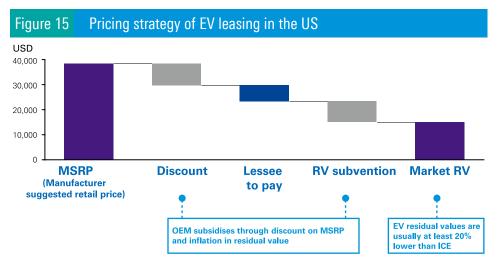


OEMs in China are experiencing an imminent urge to boost EV sales. The government has set the target of 2 million EV sales in 2020 and has further launched an EV credit system policy that stipulates the minimum EV to ICE (internal combustion engine) ratio for OEMs to realise. However, at the same time, Chinese consumers also have significant doubts regarding EVs. Under these circumstances, leasing could be one solution to the challenges faced, by offering consumers competitive pricing as well as the option to return the vehicle. This has already been a proven strategy in developed markets.

In the US, 75% of EVs were sold via leasing in 2015.⁸ The high ratio is not unexpected considering how the value propositions of leasing resonate with EVs. Top common concerns around EVs include the following:

- An EV model costs more than an ICE with similar specifications.
- Relevant technology may undergo major upgrades in the near future, making the current model obsolete.
- Batteries proffer limited mileage, along with the inconvenience of battery charging.

Although leasing is not a panacea to all problems, it does address the first two pain points. To alleviate the concerns around price and future residual value, OEMs in the US choose to benchmark the monthly payment against its ICE equivalent. That is to say, OEMs will intentionally inflate the contracted residual value or drop the transaction price to make the monthly payment appealing. Consumers who lease an EV can return the car after two or three years depending on their selected contract terms, with little consideration of technology obsolescence. In fact, an industry expert estimates that over 95% of the lessees in the US have opted for returning the EV.



Source: Expert interviews; KPMG analysis

Nonetheless, to support such an aggressive pricing strategy, OEMs are heavily subsidising their captive leasing companies. Near-term loss is almost inevitable. However, during this transitional period of combustion engine to EV, it is certainly one effective way to start building the consumer base for EV models.

 'Electric vehicle leasing activity "slips" to 75%', Chicago Automobile Trade Association, 23 October 2015, http:// www.cata.info/electric_vehicle_leasing_activity_slips_to_75/

Dort V

Key takeaways





The next 10 years will likely be the golden decade for auto leasing.



The current leasing market in China is very different from mature markets, but will eventually follow in step.



Always be clear about what you want to sell and to whom – a lease, or a loan?



You can never dedicate too much effort to residual value management – residual is the key to a profitable leasing business!



Find a way to satisfy finance leasing (as opposed to operating leasing) accounting requirements to enjoy tax benefits.



For OEMs, leasing can be effectively exploited to drive EV sales.

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