# LETTER TO SHAREHOLDERS

**Dear Shareholders:**

If you wanted to drop by our Zhengzhou store in June or our Lanzhou store in September last year, eager to buy a Porsche or Lexus, you would have left empty-handed—or never been able to visit at all. For one, two, or even three months in some cities, cars collected dust as quarantines prevented our sales teams from working and our customers from visiting. While customer leads in 2022 grew by 16%, store foot traffic reduced by 15%—meaning that roughly 30% of our potential customers couldn't drop by our stores, couldn't test drive our cars, and couldn't leave with keys in hand.

Due to unparalleled disruptions in basic commercial activities, throughout most of 2022 we were either without employees or without customers. This challenge was so extreme that it overshadowed another seismic change that occurred in 2022: the growth of electric vehicles. The year 2022 witnessed electric vehicles taking close to 30% of the new car market share. The year 2022 also saw great product improvements by many electric vehicle makers and significant struggles by others. The year ended with electric vehicles facing more supply than demand, leading to rapid price wars.

What do we predict for 2023 and beyond? We don't know how quickly or by how much consumption is going to recover. We believe that the oversupply is likely to continue, resulting in an escalating price war. We should be prepared to survive in an environment as difficult as, if not more than, that of 2022. We need to quickly become much more efficient—even though we are already known for our efficiency. We will discuss our vision for increasing our efficiency in great detail in this letter.

Let us first review our 2022 operations.

## OPERATIONAL SUMMARY 2022

In 2022, our profit went down by 54.2% to 556 million RMB from 1213 million RMB in 2021. The biggest reason was the drop in the new car sales margin, from 6.8% to 3.4%, caused by the severe macro-condition and the resulting oversupply. This drop occurred across all our brands, with BMW suffering the most. The reduction in new car profit, coupled with the non-cash and non-operating expenses from the StarChase acquisition, has produced the biggest decline in our profit since we went public.

We did have some bright spots in 2022. We grew services revenue and services gross profit both by about 22%. Even without considering StarChase services revenue, we still would have grown services revenue and gross profit by about 7%. Our inventory at the end of the year was 11.5 days, a healthy level, though substantially higher than the 5.8 days recorded last year. We sold 10% more and serviced 9% more cars with 13% fewer employees than our peak level in April.

The StarChase integration has been a reasonable success. If we were to annualize 8 months of operations since April, we would have improved sales units, sales revenue, services revenue, and operating profit by about 5.4%, 12.6%, 24.0%, and 8.3%, respectively. These approximate results, though short of our original goals, offer us confidence that our efficiency did work for M&A, even under the most austere conditions.

Profit in 2022 was bad. Our experience in 2022 was painful. Yet we survived with low inventory, a healthy balance sheet, plenty of cash, and a strong team. We believe that we survived last year due to our efficiency. To survive future challenges, we need to become even more efficient.

## EFFICIENCY: PAST AND FUTURE

Our vision is to become the most efficient company. Our culture and people were built upon this vision. Our strategies and operations evolved around this vision. We define efficiency as optimizing returns at a given level of invested capital, time frame, risk, and effort. We optimize the ratio of a numerator over a denominator, not just the numerator or the denominator—output over input, profit over sales, results over effort, etc. This logic is essential because it has guided us into fundamentally different principles and strategies compared to the rest of our industry.

Let us review how we applied this logic to our strategies and operations.

Low inventory (fast turns) is our most important principle, and it aims to optimize profit over invested inventory—not just profit. Suppose we sell 100 cars from our inventory and make 10 thousand RMB each; we would make a profit of 1 million RMB. If our goal is to maximize to a 2 million RMB profit, the intuitive way to achieve this goal is to buy 200 cars into our inventory and sell them. However, if our purpose is to optimize the ratio of profit over inventory, the logic is different. We would avoid increasing inventory as it dilutes the ratio. How do we get to a profit of 2 million RMB then? The answer is to turn the 100-car inventory twice as fast. Both roads lead to Rome, but the road with faster inventory turns is more efficient, though not as straightforward and somewhat counterintuitive. This example, as simple as it may be, illuminates the logical difference in ratio-based and absolute-number-based optimization and the resulting divergence in actions.

A third way to get to 2 million RMB in profit is to simply increase the gross margin per car from 10 thousand to 20 thousand RMB. Yet it is difficult to achieve this in practice because the gross margin depends on factors partially or completely out of our control: macroeconomics, industrial policies, OEM's supply and demand, competitors' inventory levels, etc. As these factors are often structural in nature, designing strategies around them is often more realistic. For example, we focus on luxury cars because they carry high margins and will probably continue to do so in the future. We mostly work with Porsche, Lexus, and BMW because they manage supply and demand better than other brands. A good balance between supply and demand enables high and stable margins. We have grown organically with Single-City-Single-Store locations because these locations face less competition and enable structurally better margins. Interestingly, having a low inventory should in theory help margins. Having a lower-than-industry inventory means having a better balance between supply and demand, enabling better margins. To turn this theory into reality, we need clear and practical logic between inventory turns and gross margin, a data system with a high level of granularity, and a decentralized decision-making organization. These tasks are among our primary focuses going forward, and we are excited about their potential.

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Our other operating principles, such as the services absorption ratio, new store ROI, and brand selection in M&A, all stem from the logic of efficiency. The services absorption ratio measures the degree to which services gross profit covers the totality of a store's cost. New store ROI gauges the ramp-up success of a new store by measuring the years the store takes to fully recover the initial investment. Our brand selection in M&A is mostly based on the brand's inherent efficiency—the historical new car margin, the scale of services revenue, the services gross margin, etc.

Efficiency is a constrained optimization, not an unbounded optimization at any cost. The latter sounds exciting and grandiose, yet often produces disasters, like most utopian dreams. These constraints include the macroeconomic environment, industrial policies, evolutions and disruptions, etc. They also include our capabilities, limitations, and financial resources. For constraints over which we have little control, we set them as boundary conditions akin to engineers' assumption that apples fall from trees to the ground, not the sky. For constraints we can influence or control, we change them to benefit us. Understanding and respecting these constraints allows us to be grounded in reality and to act with purpose. It keeps us humble, rational, and sane.

Let us discuss examples of how we made decisions in a constrained environment. At a given ROA, increasing leverage enhances ROE and makes our balance sheet more efficient. Yet, leverage is a risk that is amplified by economic fluctuations. After experiencing 2022, we decided to be more prudent and took on less risk, even if it meant that we were less efficient and optimized with the balance sheet. In this case, being sensitive to the macroeconomic condition, a constraint over which we have little control, allows us to balance the tradeoff between ROE and risks. As another example, our competency was not in luxury when we went public because only six out of our fourteen stores were luxury. This was a constraint we could change and, in the pursuit of efficiency, we decided to focus on the profitable luxury market. Today, we have probably one of the best luxury portfolios. The last example is the closing of our two Hyundai stores. The revenue from Hyundai is no longer efficient, as the brand faces increasingly stiff competition from electric vehicles and other brands. We decided that the most efficient action to take under this new constraint was to close our stores.

Constraints sometimes change swiftly and disruptively. The electric vehicle revolution, for example, fundamentally disrupted the operating boundaries of the automobile market. This uncontrollable constraint demands we improve efficiency at a faster pace. If we can provide sufficient returns to shareholders even in the worst-case scenario, we can happily ride into the sunset to play golf or operate hole-in-the-wall restaurants (you can guess which hobby belongs to which of us). More importantly, the motivation to become more efficient stems from our belief that the electric vehicle market requires companies to be far more efficient. Our belief was validated by the rapid transition in 2022 from demand over supply to supply over demand. The numerous price cuts and stock excesses foretold only one story: a hyper-competitive electric vehicle market on the horizon. Surviving players need to be incredibly efficient. We will be one of those players.

Now let us talk about efficiency in the context of our people and culture.

Firstly, the pursuit of efficiency makes us act with purpose and discipline.  We ask for objectives before the start of any meeting.  We measure employee productivity before and after adding headcounts.  We project returns before investments and rigorously track returns after.  We treat assets as responsibilities—even liabilities—because they must be productive.  Many years ago, I tracked the frequency of our Chairman's visits to his numerous offices.  At the time, every store installed a fancy Chairman's office with splendid—yet lonely—furniture.  The Chairman never visited his offices, but dust did.  We did away with all the Chairman's store offices, leaving him with only one office at our headquarters.  Our Chairman gets a bit upset reminiscing about my prank.  He really shouldn't get cranky, in my opinion, because he still has one more office than his brother.

Secondly, the pursuit of efficiency minimizes the friction of our interactions.  We speak with data and persuade with logic when data is difficult to obtain.  We believe that the best process is no process and the next best process is still no process.  We focus on results and empower frontline employees to use methods they see fit (within the boundaries of ethics and legality). We despise unnecessary complications and pretentious grandeur.  We view fancy presentations stuffed with big words and little content as hollow, wasteful, hypocritical, and the quickest way to get fired.  We believe in direct, simple, and no-nonsense interactions—the only exception being making bad jokes.  Our people inundate each other with spontaneous, bad jokes.  They are well trained in this regard, thanks to their bosses' utterly tasteless sense of humor.

Lastly, and most importantly, sharing our efficiency vision enables us to become unified and cohesive.  This unity and cohesion become stronger as the outside environment gets tougher, as testified by 2022.  To conclude this shareholder letter, I attach a happy New Year note we wrote to our employees.  This note describes how we united as a team to persevere in 2022.  Hopefully, after you read this note, you will agree that Henry Ford's quote exemplifies our team: "If everyone is moving forward together, then success takes care of itself."

Thank you for your support.

Ye Fan/Ye Tao

**Attachment: 2023 Happy New Year Note**

Hello, Team:

Happy New Year.

In the past, Ye Fan and I rarely wrote anything to you to mark the new year. We would simply rain the chat groups with red packets and be gone. This passing 2022 is different. You endured so many tough and challenging moments that we felt we owe you this note. As always, you should collect your well-deserved red packets. It is up to you if you want to read our gibberish.

The biggest challenge in the past year stems from COVID-19. Each of us could probably write a book of personal stories regarding our perseverance. A tough experience certainly belongs to Pan Hong Ming's team (Beijing BMW) and Wang Wenju's team (Langfang BMW), both quarantined for over 70 days. The champion medal probably goes to Wang Xuejian (Lanzhou Lexus) for close to 80 days in quarantine. We all were caged birds at one point or another and my heart goes out to all of you who endured. I was quarantined for 28 days in April when I returned from abroad, with the last seven days in a small hotel in rural Dongguan. I have gained a new appreciation for the ferocity and tenacity of spring mosquitos.

In this unprecedented difficult environment, our team displayed tremendous resolve, toughness, and creativity. When a Covid-positive customer wanted to buy a car, our Covid-positive colleagues served him. Marketing teams switched to sales when sales teams got infected. With stores shut down, online sales teams continued by carrying the video equipment home and using their own cars as demos. We signed contracts with customers in Starbucks; we delivered cars to customers' offices; we performed services at customers' homes; and we were, in one case, three times more productive than in our workshops.

We demonstrated the strength of our culture repeatedly. When our Wuhan #1 store was shut down, all 100 employees continued serving their customers without missing a beat at our Wuhan #2 store. (Unfortunately, and ironically, #2 was shut down shortly thereafter). Li Zhaowang (Bazhou BMW) ran out of food in confinement and fed himself with chilies and rice for days. Zhaowang is not as lucky as Pan Hongming (Beijing Lexus), who quarantined with his colleague Tan Guojun (Beijing BMW). Tan turned out to be a great cook—and can be blamed for Pan's enhanced waistline. Chen Xinren (Wuchang Porsche) was quarantined alongside his beloved tofu and sausages. Safe to say that tofu and sausages are no longer his love.

The year 2022 is finally over. Let us rejoice. Let us remember the difficulties and the harshness. Let us also never forget the creativity and resourcefulness we have improvised, and the toughness and tenacity we have displayed.

2022 also saw us integrating StarChase. In hindsight, the integration was quite successful. We have become a far more important member of the Porsche family and our product portfolio has become more luxurious. Luckier yet was that many wonderful colleagues joined our team.

When I first met Wan Ping (Chongqing Porsche), she avoided eye contact and was so nervous that she did not know where to put her hands. She is now among our most efficient managers—quick to think and take action. I suspect that she was born a Karate Kid. Chen Yuxiong (Qingdao Porsche) was and still is a thinker. He analyzes things to death and watching him is like watching a chess grandmaster compete. Thank God his moves prove to be right most of the time. We thank colleagues like Chen and Wan because it is they who enabled a smooth transition.

If you have read thus far, congratulations. Don't miss your red packets, because your efficient colleagues are fast-handed when they see money. As for 2023, what do we predict and what can we see? Is the market going to be less challenging? Are we going to return to normalcy? We don't know the answer. If we were to learn a thing or two in 2022, it would be that we should always prepare for the worst.

This is why Ye Fan and I write to you. Remember the past year—the challenges and the difficulties. More importantly, remember how we dealt with them successfully.

If we internalize how we managed to survive last year, no difficulties in the future can deter us.

Happy New Year and thank you.

Ye Fan/Ye Tao