LETTER TO SHAREHOLDERS

Dear shareholders,

We delivered good results in 2018. We grew revenue by 44.1% to RMB11.07 billion and profit by 31.6% to RMB363 million. We generated an operating cash flow of RMB419 million. Our operational efficiency is high with ROE and ROA at 26.0% and 8.7% respectively. We grew store counts 25.6% to 49 stores, adding 6 new stores (2 Porsche, 3 BMW and 1 Toyota) and acquiring 6 BMW stores in 4th and 5th tier cities in Anhui all with internally generated cash.

We achieved all these in possibly the worst and certainly the most confusing economic year in a decade. 2018 started with economic policies geared towards cooling a hot economy. Then a trade war came and policies swung to stimulus. While policies gyrated and the trade war lingered, consumers lost confidence and delayed buying. The auto market dove into negative growth and, while the luxury sector still recorded a respectable growth, those of us operating on the ground felt the headwind in ways we had not for many years.

We won't, however, dwell on the macroeconomics or predict policies in this letter. What we have learned over the years is that our predictions are more or less like trying to read into crystal balls. The inherent randomness in economic events makes predicting economical or policy trends a difficult exercise: akin to reading into crystal balls or anticipating the next move of a drunken man. You as shareholders already have access to thousands of crystal ball readers on Internet and TV, as well as in business journals and conferences. You certainly don't need another one.

What we can do instead as managers is build a company that is more robust and agile than its peers in all potential economic uncertainties. In other words, though we may not be able to outrun the tiger, we may and should outrun others. Over the years we have developed a strategy and a set of operating principles to do just that. And we plan to devote much of this letter to, besides the typical 2018 operational summary, a detailed discussion of strategy and operating principles.

Let us start with our 2018 operational summary.

OPERATIONS IN 2018

We explained in the 2017 letter that we planned to pay close attention to M&A. We turned the attention into action in Q3 of 2018 by acquiring six BMW stores in Anhui province. All six are small sales/services outlets in 4th/5th tier cities and all are single city/single stores. All were originally losing money, which enabled us to acquire them at a reasonable price. All are in promising markets. This acquisition fits well with our M&A strategy — familiar locations, familiar brands, and fast returns enabled by reasonable acquisition prices. We will continue to pay close attention to M&A in 2019 though there will be no deadline by which we will pull the trigger next time. Like almost everything else in business, good targets at reasonable prices are few and far in between.

Our rate of store openings kept up its pace in 2018. We opened 6 stores (2 Porsche, 3 BMW and 1 Toyota) in 2018, which, combined with the acquisition, gave us a store count growth of 25.6%. Given new store openings and the maturation of existing stores, our growth will not subside in the foreseeable future. Furthermore, this past year, our revenue mix continued to get better: luxury brands, single city single stores, and services constituted increasingly high percentages of revenue.

Our revenue grew 44.1% to RMB11.07 billion with passenger vehicles sales revenue and after-sales revenue increasing by 44.2% to RMB9.78 billion and 42.9% to RMB1.3 billion respectively. The net profit attributable to shareholders amounted to RMB363 million, a year-on-year growth of 31.6%. The margin pressure of new BMW car sales did exert pressure on our net margin in 2018, resulting in a decline to 3.3%. We won't predict the new car margin for BMW in 2019 (or any other brands for that matter), but we do consider a net margin of 3.3% to be within a safe and healthy range. (We will discuss more on how to improve our net margins in the next section).

Cash from operating activities increased to RMB419 million. At the end of 2018, our net gearing ratio stayed low at 21.8%. Our inventory level also hit a historic low of 28 days. Both the reasonable gearing ratio and strong cash flow enabled us to declare dividends at 40% of 2018 profit (RMB145.2 million), another year of high dividend payout.

2018 has been a challenging year for us — probably the most challenging ever. We survived the year relatively well because we stayed on course with our strategy and operating principles. As long as we can execute our strategy and principles, we remain confident about our company's future in 2019 and beyond.

OPERATING PRINCIPLES

We went public in December of 2013. In the 5 years since, we grew revenue from RMB3.48 billion to RMB11.07 billion, an almost 3-fold increase at a 26% annual compounding rate. Profit increased from RMB106 million to RMB363 million, a 27.9% compounding annual growth. We paid out 41.9% of all profit, lowered net gearing ratio to 21.8% and grew ROE to 26.0%. And we did all the above with mostly internal cash flow. We attribute this success mostly to our culture, strategy, and operating principles.

Let us dissect the principles in details. And when applicable, we will discuss how these principles will be applied in 2019 operations.

We live or die by inventory turns. Fast-turns make us a cash-printing machine; slow-turns turn us into a cash-sucking black hole. 10% of the cost of buying new cars is covered by our capital, 90% by 30-to-90-day bank notes from banks or manufacturers' captive finance arms. Assuming that, in the worst margin case, we sell cars at 1% gross margin and turn the inventory 12 times a year, we make 10% on our capital each turn and 120% every year. Not a bad return on capital even at a low sales margin. On the other hand, if we don't sell cars quickly and they become aged inventory, we would have to redeem banknotes constantly. 90% of the cost of cars is not a small chunk of change and will turn our parking lot into a cash sucking black hole (do you hear the huge sucking sound?). Hence the dichotomy of auto dealership business: a few fast-turn companies become money-printing machines and the other slow-turn companies bleed cash, suffer low capital returns, and even get into troubles. Inventory-turns was and will continue to be our number one operational priority. Our company's history of high ROE and cash flow is a direct result of the continued emphasis and improvements on inventory-turns.

Let's look at a 2019 hypothetical. Assuming the margin pressures of some brands stay the same as in 2018, what should we do in 2019? The answer is to turn the inventory even faster. Though we only have partial control over the new car sales margins (factors such as macroeconomics, new product life cycles, and supply management are not entirely within our control), we do have full control over how fast we sell. To sell quickly, we sometimes have to offer discounts. But in reality, if we don't sell quickly we will eventually have to discount deeper when inventory mounts and cash tightens. Over time and on average, selling quickly and discount earlier is better than selling slowly and discount later. Even at the same margin, selling quickly holds big advantages in terms of return on capital: doubling the inventory-turns doubles the return on capital. Most of our BMW stores were profitable in 2018 because we turned inventory quickly. The concept of "selling more quickly means more profit" is sometimes counter-intuitive but is always true, just like when golf coaches say, "Want the ball to draw left? Shoot to the right".

The second important principle is to grow services revenue on par with or faster than overall revenue. Compared with new car sales, services revenue is stickier and of higher margin: the larger the services revenue, the higher and more stable our overall margin. Increasing a single percentage point of services revenue adds roughly 0.4% of pretax margin to our bottom-line (assuming services and sales at roughly 45% and 5% gross margin respectively). In 5 years' time, we have grown services revenue as a percentage of total from 10.5% to 11.7%. This is very good considering that we have many new stores with service revenues that take more time and effort to scale. We know that we should accelerate this growth even more. As we become more mature as a company — smaller percentages of new stores vs total and existing stores maturing naturally — our services revenue as a percentage should increase, as should our overall margin. The effect of maturation on our margin is powerful and accelerating this maturity is a key principle.

In 2019, we want to achieve “absorption coverage”, in which the gross margin from services alone covers the total store costs. Beyond the coverage point, the store would be considered “mature”: its profit is relatively “safe” and does not rely on new car sales profit. How quickly we can mature a store is a key capability and therefore a key focus of our operations. Absorption coverage is especially important for those brands suffering from sales margin pressure.

The third operational metric we track and manage is the return of new store investment (ROI). We build many new stores every year, and, as in any retail business, stores take time to mature and can initially be a drain on cash and profits. Therefore, the key challenge is how to pull forward the breakeven point for profitability and cash flow. Overcoming this challenge requires a careful consideration and management of many factors — brand, location, investment (minimize within reason), rapid construction, and, most importantly, a swift ramp-up of services revenue. Over time, we have managed to get our new store average ROI to approximately 3 years. This has been key to our growth model. Fast-maturing new stores quickly contribute to cash and profitability, which, in turn, fund more new stores.

Our IT system/data is a cost item on our financial statements but, in reality, is as valuable as any asset we have. We served 37,895 new car customers and 186,657 services customers in 2018. A prospective customer on average comes to our stores 3 times before he/she makes a purchasing decision; a services customer on average comes back 2 times and interacts with us in various ways 10 times every year. In total, we have millions of customer interactions per year. Every one of these interactions is a data point and an opportunity for us to learn about our customers, to reflect upon our services, and to improve with the goal of eventually turning every customer into a life-long one. Without data, we would be making decisions in the dark. Data (and analysis of data) has served us well in the past, and in 2019 and beyond, its importance will only grow — accordingly, so will our focus and investment in data.

Let us move onto a discussion of financial discipline. We believe that a healthy cash flow is of ultimate importance, so we always focus on things that generate cash and minimize cash burn: fast returns on new stores, quick inventory turns, high services revenue, low account receivables, and minimal capital expenditures when possible. In addition, we focus on smoothing out cash flow: long term debt with regular and predictable paybacks, low inventory to avoid chunky redeems, and rented (not purchased) land when payment is installed over a period of time. More importantly, we pay much attention to asset and capital efficiencies — ROA and ROE are just as important as absolute profit. We want to maximize not just profit per se but also profit at a given level of assets and invested capital. Over time, financial discipline in these areas resulted in our high efficiencies and rate of cash flow. Our ROE, ROA, and cash flow (which has largely funded our growth and dividends) consistently rank among the best in the industry.

Our operating principles only work well in conjunction with our strategy — focusing on luxury and single city single stores. Going forward we still believe in the validity of this strategy despite short-term economic fluctuations and uncertainties. Luxury cars will be in demand wherever cars are bought: longing for better products is human nature, whether people are living in Beijing or a small Anhui town. All we need to do is find these customers and serve them well. In single city single store locations, we serve them in an environment with less intense competition and fewer distractions.

Let us wrap up this letter with a discussion of our culture — Simple, Direct, and Data Driven. We strive to build a simple business, and to simplify problems and operations — or at least to communicate them clearly. Operationally, this means we focus on a few things at a time and do them really well — far better than anyone else in the industry. This also means that we are cautious in getting into businesses whose logics we don't fully understand or in whose markets we don't have competence or experience — such as auto financing out of our balance sheet, independent service shops, or manufacturing. We communicate in a direct fashion: we say what we know with conviction and, for what we don't know, confess ignorance. We respond to investors' questions directly without beating around the bush, and we admit mistakes readily and correct them quickly. We manage our employees with honesty — promote and reprimand in a clear manner. And finally, we make decisions with data and logic. We stick to decisions that are consistently supported by facts and change quickly when data indicates otherwise. Whenever there is a lack of data or facts or logic, we plan for and communicate the worst-case scenario. These cultural traits are the most treasured aspects of our working lives and we hold them dear to our hearts. We hope that these traits come through during our interactions with you and that you will come to appreciate that what truly sets us apart as a company is our culture.

As always, thank you for your support.