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## HONGXING AUTO SALES AND SERVICE CO.

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*Yuan Shi and Wei Sun wrote this case under the supervision of Professor James E. Hatch solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.*

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In February 2006, Li Nan smiled as she finished a candid and constructive conversation with her father. “Now,” she said, “I’m ready to sell the business. My time in the hot seat is over.” As she closed the file, she wondered what the business was worth, how she should go about selling it and whom she should call first to set the wheels in motion. For the moment though, she was willing just to savor the good feelings of knowing that her term as general manager might almost be over and that she had performed her duties well.

### JINHUA

Jinhua was a mid-sized prefecture-level city in the west of Zhejiang province with an urban area population of 500,000. Jinhua was an advanced and rapidly growing city, with 90 per cent of the enterprises in the city being civilian-run. Since 2000, Jinhua’s average gross domestic product (GDP) growth had been 13 per cent, well above the average for the country. The rapid growth of the economy had provided local residents with increased job opportunities and greater disposable income. The traditional high rate of family savings meant that consumers had substantial cash balances with which to purchase consumer durable goods. The expansionary monetary policy had led to more available borrowing at reasonably low interest rates. Although less than five per cent of the local families owned private cars, the number of privately purchased vehicles was growing significantly.

The city also enjoyed a convenient transportation network. The government’s heavy investment in infrastructure had enabled the building of expressways that linked Jinhua to the surrounding major cities. For example, driving to Hangzhou and Shanghai took only two hours and four hours respectively. The major expressway connecting Zhejiang and Jiangxi provinces also traversed the area. As a result, the local population was becoming more mobile.

## HISTORY OF THE BUSINESS

Hongxing Auto Sales and Service Co. (Hongxing) had originally been known as Jinhua Auto Service Workshop. Established in the early 1980s as an enterprise of collective ownership, the business had initially serviced a variety of local vehicles, from trucks to passenger cars. Li Hongxing was a key employee of the company. Although he had a limited primary school education, through hard work and demonstrated skill he had advanced from a junior mechanic at the time of the firm's inception to the position of workshop manager. In 1995, through a management buyout process resulting from reforms initiated by the government, Li borrowed money from his relatives to purchase the business and become the sole owner. He changed the workshop's name to Hongxing Auto Workshop.

The workshop began to prosper under Li's leadership. He replaced less effective workers, trained new mechanics and gradually improved the firm's reputation for service quality. He also worked hard to develop personal connections with local government officials and entrepreneurs. As a result, the workshop secured long-term service contracts for more than 30 per cent of the cars owned by the local government and approximately 20 per cent of cars purchased for other businesses. To improve profit margins, Li also decided to focus on service for passenger cars and to stop servicing trucks. Even in a small town such as Jinhua, this business provided the workshop with a substantial cash flow and healthy growth. When the workshop began to generate positive profit numbers, Li paid only modest dividends that were sufficient to repay his debt. The remaining profits were retained to fund future expansion.

Hongxing's auto service business was highly dependent on company clients from the government sector and local enterprises. Thanks to Li's well-established local network, almost 70 per cent of his service business was secured through annual contracts with organizational clients. However, to win this business, Li had to offer his clients discounts and credit terms. Depending on the nature and importance of the relationship with the client, the accounts receivable were collected monthly, quarterly or semi-annually. A few accounts receivable were collected annually.

Under Li's leadership, the firm also acquired numerous high-profit collision repairs by leveraging its technical capability and its relationship with the insurance companies. For regular repair work and maintenance service, Hongxing was able to charge a reasonable margin and avoid a price war with other local workshops due to its better overall image and carefully upheld reputation for good quality.

In 1998, after stabilizing the business, Li spent 1,200,000 yuan to acquire a piece of land next to the workshop, which enlarged the site to three times its original size. The acquired land was 4,000 square meters, which was sufficient to construct a new workshop building to hold newly purchased, advanced and high-value equipment, such as a wheel aligner, a brake tester, two air conditioning service units and a paint booth. The next year, supported by the constantly growing revenue, Hongxing replaced a series of old workshop equipment (e.g. vehicle lifts, air compressors and tools) with new, more efficient and reliable equipment. The new building and equipment, not including the land, cost Li 700,000 yuan. The workshop became the best equipped in town. In the past, many cars that had been in collisions could not be repaired in Jinhua and needed, instead, to be transported to dealers in bigger cities hundreds of kilometers away. These cars could now be repaired by Li's workshop, which had earned a reputation as the most trusted and capable auto workshop in the city. The collision repair business earned a satisfying profit.

In 1999, a new staff member joined the workshop. Luo Xi, who was born in Jinhua and was in his mid-forties, had worked for auto dealers in several big cities for nearly 15 years. Luo was not only very technically capable but also experienced in managing mechanics. Li convinced Luo to join the workshop

by offering him an opportunity to return to his hometown for an above-average compensation package. Luo accepted the invitation and was assigned the position of service manager.

In 2002, after enjoying three years of high revenue growth in the service business, Li decided to expand into the auto sales business. First, he moved the workshop's administration offices into the service building and used the vacated land to build a showroom large enough to comfortably hold several new cars and a sales negotiation area. Then, he successfully negotiated distribution deals with several big brand automobile suppliers in Hangzhou, the capital and the most developed city of Zhejiang province, located approximately 200 kilometers north of Jinhua. For his sales manager, Li recruited from one of the dealers a young but experienced salesman, who was also originally from Jinhua. Then, Li changed the workshop's name on its business license to Hongxing Auto Sales and Service Company.

Based on an agreement with the automobile distributors, Li used one-month or three-month maturity banker's acceptance bills to acquire his company inventory. Because of the high value of the cars compared with the parts, Li paid extra attention to control of the auto inventory. Usually, the showroom displayed four or five cars, which was adequate for the nature of the Jinhua market. Many customers enjoyed the convenience of being able to shop for cars at a trusted local firm instead of going to the dealers in Hangzhou. Hongxing also offered more value-adding services to promote sales. First, it contracted flat-back car carriers to safely transport the new cars from the dealers' stores to Jinhua, a cost covered by Hongxing. Second, under the agreement with the suppliers, Hongxing was able to provide all the services required during the warranty period, including maintenance services and warranty claims. All the genuine parts, technical staff training and warranty claims were supported by reliable suppliers. Therefore, customers who bought their cars from Hongxing could save hours of time and traveling cost by having their cars serviced in Jinhua. Third, Hongxing offered its car sale customers an extra discount on the labor rate when the cars' warranty expired. Similar to the branded dealers, Hongxing often offered free seasonal vehicle inspections to attract customer visits. It was expected that many customers could be retained for the life of their cars.

## **LI NAN**

In November 2003, at the age of 63, Li Hongxing had a heart attack and was forced to leave the business. His son, Li Dong, who had worked at Jinhua Local Taxation Bureau as an auditor, helped monitor the finances of the company for one month while his father was away. However, having no knowledge in managing an auto business, Li Dong was not capable of doing much more. He felt it was unwise to quit his secure job in the government sector while still in his thirties. Therefore, the family turned to the younger daughter, Li Nan, who had spent evenings and weekends in her youth helping her father in the business.

Li Nan was in her early thirties and single. She had left home to attend college in Hangzhou and had stayed there after graduation. She had held a number of jobs and was currently working as an account manager at an advertising agency, a job she had held for more than three years. During this time, she started to realize that this job was something she would like to do as a career. Li Nan had established a good network in the city and was planning to open her own agency in a few years. Taking over the operation of the family business meant moving back to her hometown, which at this stage in her life was not a pleasant prospect for her, and she resisted, arguing that her father should sell the business. In a discussion with family members, she was told that the heart attack hadn't destroyed her father's ambition. Although his poor health had kept him at home for two months, he was not prepared to give up the business. His plan was to have someone he could trust handle the business for him for one to two years until he recovered. Li Nan

understood her father's intentions and was convinced that arguing with him would not be good for his health.

After a lengthy talk with her father, the family reached an agreement. Li Nan would take charge of the business for two years with the assistance of her father, as his health allowed. At the end of two years, her father would either resume responsibility or agree to sell the business. In return for Li Nan's sacrifice of her career development, her father would finance her proposed advertising agency, using either the funds from the sale of the company or his dividends.

### **Li Nan's Experience**

Under Li Nan's management and with the support of her two key employees, Hongxing's business performed reasonably well. Much of her time was concentrated on the auto sales business. Despite being raised in a family that ran an auto business, she had a lot to learn. She focused on learning the features of the cars that mattered most to her customers, such as safety, comfort level and fuel economy. As well, she needed to learn about her suppliers and customers.

Li Nan started learning about the customers by speaking directly with them in the showroom. Sometimes she personally answered the sales hotline. She found that more and more customers started to seriously consider buying their first car for family use, whereas in the past, most cars had been sold to government and enterprise clients. Obviously, private shoppers would have different preferences for models and perhaps different expectations for service than business clients.

The dealers in Hangzhou were willing to continue to be her suppliers because they wanted to extend their brand coverage to smaller cities such as Jinhua without risking the investment in their own branches because the potential of the market remained unproven. However, Li Nan sensed that in the future, maybe not even far ahead, more and more branded dealers would emerge in her hometown. The introduction of competitors would make it extremely difficult for her to compete with those dealers on selling the same cars.

Li Nan also took on credit management as her responsibility. She set up a new policy for the enterprise clients, which provided credit terms of no longer than six months based on the transaction amount level. Those who paid their bill every month would be awarded a discount of up to two per cent. Most clients agreed to add these terms to their long-term contracts, which saved much time and trouble that had previously been spent negotiating accounts receivable collection.

Next, she developed an incentive plan for both the sales and service teams. The whole sales force shared the same compensation structure, consisting of a base salary and a bonus. The bonus was based on both sales revenue numbers and customer satisfaction as measured by questionnaires. The bonus for the service team was also based on revenue and customer satisfaction. However, Li Nan added an extra bonus incentive for Luo Xi if he could manage to reduce the inventory cost for parts.

Li Nan didn't waste her advertising expertise. She negotiated a deal with a local advertising agency for TV commercials on the local channel and a package of billboard advertisements at all the local expressway exits.

Finally Li Nan was able to negotiate an agreement with her suppliers to receive an annual rebate at the end of the year that was based on the volume of purchases.

In her first year, service and sales revenue increased 34 per cent and 23 per cent respectively (see Exhibit 1). The profit increase was slightly lower due to the investment in marketing.

However, Li Nan noticed that several branded dealers had started construction of high-standard stores. Some of them planned to open in the summer of 2005. A few other auto workshops had also invested in expansion and renovation in 2004. Although they had not planned to compete in auto sales with Hongxing, some became franchisees of well-known professional auto service chains, such as Bosch Service and ACDelco.

## THE BUSINESS ASSETS

The principle assets of the business were the accounts receivable, inventory, land, buildings and equipment. (The book values for each of these assets are presented in the 2004 and 2005 balance sheets in Exhibit 2.)

The accounts receivable were current; slow accounts had been provided for by an allowance and if necessary were written off, but they were still followed carefully by Li Nan. The main accounts receivable were from organizational clients in the service business. Retail customers paid either by cash or with a credit card.

The parts inventory was counted once a year at year-end. The count itself was carefully undertaken. Li Nan could tell from the inventory list provided by Luo that no parts in stock were older than 12 months. She was convinced that the inventory dollar amount at year-end represented fairly the current cost of the goods on hand and the recovery value of the rest.

The land owned by Hongxing consisted 6,000 square meters with approximately 100 meters of frontage on the street. A 4,000-square-meter building had been erected on this property, of which 800 square meters was devoted to showroom and the rest to service, storage and offices. The property was located on a street designated by central planners as focusing on auto service. The auction price of a parcel of land acquired by a branded dealer for a new store on the same street in 2005 had been 700 yuan per square meter.

The other fixed assets included a service van, towing truck and equipment. The depreciated book value of these assets was thought to be a reasonable estimate of their market value.

## THE FINANCING

Because Li Hongxing had maintained good relationships with several government departments and had built a good reputation, he had been able to obtain a five-year loan of 1,300,000 yuan from Industrial and Commercial Bank of China (ICBC) to finance the land he acquired and the building constructed in 1998. In early 2003, due to his good interest payment record, ICBC agreed to replace the first loan with a five-year loan of 1,000,000 yuan. The loan carried an interest rate of 5.58 per cent and was repayable in payments of 200,000 annually.

## DECISION TO SELL

Early in 2006, Li Nan sat down with her father to discuss both the firm's future and her own future. For the past two years, she had dedicated herself to the company, working on the site from 7:30 a.m. to 5:30 p.m., six days a week, in addition to using other personal time to work on business issues. She had taken almost no holidays.

Without a doubt, the local car market had been growing and would continue to do so. However, she also felt that within two years all the brands would have their own dealer stores in town. Competition would be harsh.

More importantly, her father was reaching the age of 65, and his fragile health would never again allow him to work at the same pace as he had in the past. He was considering retirement.

Li Nan needed some information. How much was Hongxing worth? Where could she get advice on how to sell the business? Confidentiality was critical. She did not want her employees to find out from third parties that she was considering a sale of the business.

## Exhibit 1

**HONGXING AUTO SALES AND SERVICE CO.**  
**INCOME STATEMENTS FOR THE YEARS ENDING DECEMBER 31, 2000–2005**  
 (All Figures in Chinese Yuan)<sup>1</sup>

	2005	2004	2003	2002	2001	2000
Sales	¥ 12,009,590	¥ 11,824,848	¥ 9,392,877	¥ 8,773,064	¥ 2,320,640	¥ 1,822,894
-Sales Revenue	8,535,166	8,448,310	6,871,857	6,539,920	208,858	200,518
-Service Revenue	3,474,424	3,376,538	2,521,020	2,233,144	2,111,782	1,622,376
Business tax (5% of service revenue)	173,721	168,827	126,051	111,657	105,589	81,119
Cost of goods sold	9,182,252	9,185,762	7,657,122	7,531,500	1,376,270	1,146,892
Gross margin	2,653,617	2,470,259	1,609,704	1,129,907	838,780	594,883
Operating expenses (Exhibit 3)	804,416	782,400	659,277	617,977	371,216	329,416
Earnings before interest and taxes	1,849,202	1,687,859	950,427	511,929	467,564	265,467
Interest	33,480	44,640	55,800	126,360	126,360	126,360
Earnings before tax	1,815,722	1,643,219	894,627	385,569	341,204	139,107
Income taxes	599,188	542,262	295,227	127,238	112,597	37,559
Net income after interest and taxes	1,216,534	1,100,957	599,400	258,331	228,607	101,548
Retained earnings (beginning)	2,235,349	1,334,392	934,992	736,660	568,053	526,505
Dividends	200,000	200,000	200,000	60,000	60,000	60,000
Retained earnings (ending)	3,251,882	2,235,349	1,334,392	934,992	736,660	568,053

<sup>1</sup> Due to rounding, numbers may not calculate to the figures shown.

## Exhibit 2

**HONGXING AUTO SALES AND SERVICE CO.**  
**BALANCE SHEETS AS OF DECEMBER 31, 2001–2005**  
**(All Figures in Chinese Yuan)<sup>1</sup>**

	2005	2004	2003	2002	2001
<b>ASSETS</b>					
<b>Current Assets</b>					
Cash & bank deposits	1,590,020	670,287	175,796	138,163	12,443
Accounts receivable	485,467	444,038	478,018	451,102	468,642
Inventories	765,188	765,480	638,094	627,625	114,689
Cars for sale	598,605	611,237	496,586	495,375	11,469
Work in progress	166,583	154,243	141,508	132,250	103,220
Prepaid expenses	149,900	146,400	119,900	119,900	44,400
Purchase rebate receivable	159,657	161,504	132,765	131,586	11,040
Deposit with supplier	17,995	17,995	17,995	17,995	17,995
Other current	5,294	3,427	15,876	59,638	14,996
<b>Total Current Assets</b>	<b>3,173,522</b>	<b>2,209,131</b>	<b>1,578,444</b>	<b>1,546,008</b>	<b>684,205</b>
Land, Buildings, Equipment					
Land	1,700,000	1,700,000	1,700,000	1,700,000	1,700,000
Net Buildings, Equipment and Other Fixed Assets					
Buildings	310,311	336,170	362,030	387,889	413,748
Equipment and furniture	8,678	20,354	31,864	40,675	42,178
Automotive Equipment	20,707	32,200	51,237	63,485	70,115
Other	389	2,736	1,225	3,905	6,584
<b>Total Land, Buildings, Equipment</b>	<b>2,040,085</b>	<b>2,091,460</b>	<b>2,146,356</b>	<b>2,195,953</b>	<b>2,232,625</b>
Goodwill	123,935	125,574	129,055	132,264	135,745
<b>TOTAL ASSETS</b>	<b>¥ 5,337,541</b>	<b>¥ 4,426,165</b>	<b>¥ 3,853,854</b>	<b>¥ 3,874,226</b>	<b>¥ 3,052,575</b>
<b>LIABILITIES</b>					
<b>Current Liabilities</b>					
Bank loan	-	-	-	-	-
Accounts payable and accruals	474,950	444,369	866,615	1,311,639	721,449
Taxes payable	810,709	746,448	452,848	267,595	234,467
Current long-term debt	-	-	-	-	-
Dividend payable	200,000	200,000	200,000	60,000	60,000
<b>Total Current Liabilities</b>	<b>1,485,659</b>	<b>1,390,817</b>	<b>1,519,463</b>	<b>1,639,234</b>	<b>1,015,915</b>
Long term debt	600,000	800,000	1,000,000	1,300,000	1,300,000
<b>SHAREHOLDERS' EQUITY</b>					
Common stock					
Retained earnings	3,251,882	2,235,349	1,334,392	934,992	736,660
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>¥ 5,337,541</b>	<b>¥ 4,426,165</b>	<b>¥ 3,853,854</b>	<b>¥ 3,874,226</b>	<b>¥ 3,052,575</b>

<sup>1</sup> Due to rounding, numbers may not calculate to the figures shown.



## Exhibit 3

**HONGXING AUTO SALES AND SERVICE CO. OPERATING EXPENSES, 2000–2005**  
(In Thousands of Chinese Yuan)<sup>1</sup>

	2005	2004	2003	2002	2001	2000
Salaries, wages and benefits	¥ 378	¥ 354	¥ 316	¥ 287	¥ 163	¥ 148
Telephone, heat, taxes	49	46	43	41	30	29
Advertising	70	74	12	11	12	5
Insurance, legal, accounting	125	123	98	99	29	22
Repairs, maintenance, tools and supplies	23	26	30	18	4	3
Office expense and travel	22	25	21	23	17	7
Truck operations	73	71	64	67	50	48
Bad debts	8	9	19	16	13	14
Depreciation	56	55	57	56	53	53
<b>Total operating expenses</b>	<b>¥ 804</b>	<b>¥ 782</b>	<b>¥ 659</b>	<b>¥ 618</b>	<b>¥ 371</b>	<b>¥ 329</b>

<sup>1</sup> Due to rounding, numbers may not calculate to the figures shown.

## Exhibit 4

## SELECTED CAPITAL MARKET INFORMATION

	12/30/2006	12/30/2005	12/30/2004	12/30/2003
<b>Long-Term Interest Rates</b>				
10-year government bond	2.86%	2.76%	4.63%	3.30%
<b>Short-Term Rates</b>				
3-month rate	1.80%	1.71%	1.71%	1.98%
<b>Shanghai Stock Index</b>	2,675	1,161	1,266	1,497
<b>Shenzhen Stock Index</b>	6,647	2,898	3,068	3,479
<b>P/E Ratios for Selected Industry Groups as of June 2005</b>				
Automobile manufacturing	35			
Auto Parts manufacturing	20			