



## Honda's Business in China

In recent years, China's economy has grown remarkably and consistently. In 2005, the country had gross domestic product (GDP) of more than \$2.2 trillion\*<sup>1</sup>, making it the fourth largest economy in the world. The economy's expansion, combined with its increasing liberalization, has prompted the growth of China's automobile market. In 2005, automobile sales totaled 5.76 million,\*<sup>2</sup> including commercial vehicles, surpassing France and Germany and approaching the size of the Japanese market. Given its rapidly growing global importance, the world's leading automakers have come to regard the Chinese market as vital, and the competitive battles among top manufacturers have grown in intensity. China also accounts for the world's largest motorcycle market, with 2005 sales of 13.14 million units\*<sup>2</sup>, and demand for general-purpose engines as power sources for generators and pumps is increasing rapidly.

Honda's first full-fledged entry into business in China came in 1982, when it began local production of motorcycles through a technical collaboration agreement. In 1999, Honda began selling its first locally manufactured automobile, the *Accord*. Since that time, Honda has expanded auto operations in China tremendously, with marketing strategies tailored to local needs. In 2005, continued strong sales of such core models as the *Accord* and the *CR-V* demonstrated the strong position Honda holds in the Chinese automobile market.

This special feature examines the development of the Chinese market, focusing particularly on automobiles, and looks at how Honda has been able to establish such a position. We will look at the country's rapid motorization, including appropriate strategies for environmental and safety issues. We will also introduce some Honda initiatives in the Chinese market that are designed to maximize the joy of customers, maintain our growth curve and contribute positively to Chinese society.



(Sources) \*1: JETRO \*2: China Association of Automobile Manufacturers  
(Photos) above left: GCCR Above right: EM5000 generator Below: Accord



# State of the Automobile Industry in China

## Openness Policy Fostering Rapid Growth in the Automobile Market

China joined the World Trade Organization in 2001. This move had far-reaching effects for the automobile market, bringing down customs duties and inviting an influx of foreign-capitalized firms. Driven by a wave of investment that expanded existing factories and constructed new ones and the entry of new competitors in China, Chinese automobile production and sales levels skyrocketed. In 2002, passenger car sales surged 54% from the previous year<sup>\*3</sup>, then rose another 71% in 2003. In 2004, concerns that the economy might be overheating caused the government to tighten monetary policy, rein in investment and institute other macroeconomic controls, causing purchases of official vehicles owned by the government or corporations to decline. With auto loans more difficult to obtain and with price reductions anticipated, consumers held back on purchases, and as a result automobile sales grew only 16% in 2004. Fueled by an expanding customer base and a flurry of new car launches, with a focus on low-priced models, the market expanded 28% in 2005, exceeding the previous year's growth.

To cultivate the domestic automobile industry, the Chinese government imposed various protectionist measures, such as levying stiff duties on vehicle imports. Further, to foster a strong and internationally competitive group of domestic automakers, the Chinese government considered consolidating the rampantly growing number of small and medium-sized automakers. To remain in the competition, automakers were compelled to continue making substantial capital investments. While the Chinese market has grown significantly faster than the rest of the world, this also led manufacturers to accelerate production faster than the rise in market demand, making overcapacity a concern. Further, numerous companies that had been unable to enter the market directly because of various restrictions entered through joint venture collaborations. This situation, along with the emergence of local Chinese manufacturers, caused competition

to become even more severe.

When automobiles first began to circulate in China, most automobiles were official vehicles owned by the government or corporations, but gradually demand from wealthy individuals emerged for medium-sized luxury vehicles of 2,000cc and larger. The next sources of demand were executives of major companies and two-income couples who owned homes in the suburbs. This progression increased demand for entry midsize vehicles, with the customer base expected to continue broadening.

However, urban roadways and other infrastructure has fallen woefully short of the demand placed on it by the rapid increase in motorization. This has had a negative impact on the environment and caused an increase in traffic accidents, bringing environmental and safety issues to the forefront.

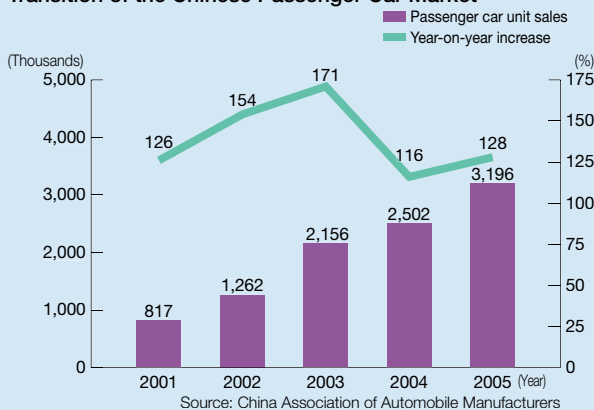
The way these concerns are addressed is the key to determining the future development of auto industry in China.

(Source) \*3: China Association of Automobile Manufacturers

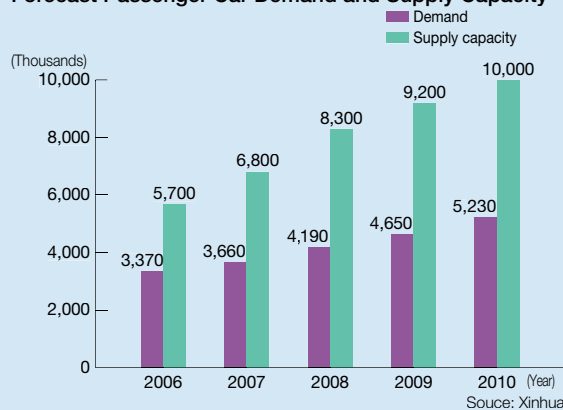


Rapidly increasing motorization in Beijing

### Transition of the Chinese Passenger Car Market



### Forecast Passenger Car Demand and Supply Capacity





Honda's Business in China

## Honda's Development of the Chinese Automobile Market

### Guangzhou Passenger Car Project Launches Local Automobile Production and Sales

Honda first entered the Chinese market in 1982, when it formed a technical collaboration with a local company and began manufacturing motorcycles. In 1992, Honda formed a joint venture to produce motorcycles and, in 1994, began manufacturing power products through another joint venture with a local firm.

Honda's first step into the automobile market came in 1994, when we established Dongfeng Honda Auto Parts Co., Ltd. to produce automobile engine parts and chassis components for sale in Southeast Asia and Japan.

Because of the way Honda's operations developed, we were able to gain a good understanding of Chinese business practices and systems through the motorcycle business. Our initiative in automobile parts served as another steppingstone toward the eventual development of a business involving finished automobiles.

In 1997, Honda signed a basic agreement to collaborate with Guangzhou Auto Group Corp., and Dongfeng Motor Group Co., Ltd., as a joint venture partner in the Guangzhou Passenger Car Project. This project culminated in the fulfillment of Honda's objective to begin the manufacturing and sales of automobiles in China. With Guangzhou Auto Group Corp. we formed Guangzhou Honda Automobile Co., Ltd. (Guangzhou Honda), as a joint venture to manufacture and sell automobiles. At the same time, Honda and the Dongfeng Motor Group Co., Ltd. established the joint venture Dongfeng Honda Engine Co., Ltd. (Dongfeng Honda Engine) to manufacture automobile engines and transmissions. Established in 1998, both joint ventures commenced operations in 1999, making Honda the first Japanese automobile manufacturer to begin full-fledged local production and sales in China.

### Establishing the Accord Brand in China's Passenger Car Market



Ceremony to commemorate first locally manufactured Accord rolling off the production line

When it came time for Guangzhou Honda to decide which model to launch first, the most important consideration was to assure that the vehicle matched the values of the target customers.

At that time, the driving force of China's passenger car market

was the growing class of entrepreneurs who were riding China's wave of economic expansion. Many of these people had frequent opportunities to travel overseas on business, and were aware of the global auto market, which raised their expectations for product value. To establish a solid base for the Honda brand in China's passenger car market, Honda believed it was important to introduce our newest model that met the same quality, safety and drivability standards as vehicles sold in other parts of the world. On this basis, we

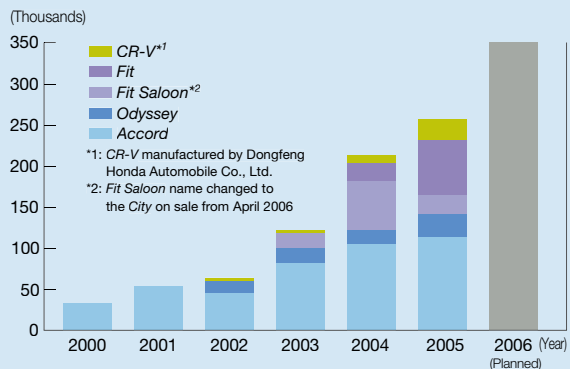
decided to introduce the new *Accord* as the first locally manufactured Honda automobile, at that time the newest model on sale in the United States, the world's largest automobile market. At that time, three versions of the *Accord* were being produced to meet specifications in Japan, the United States and Europe. We decided to base the *Accord* manufactured in China on the U.S. model because many Chinese customers were aware of the U.S. market and recognized the *Accord's* high brand image, had a strong desire for a sense of luxury in an automobile and were most familiar with the size of the U.S. *Accord*. We also offered such options as leather seats, a sunroof and high-end audio systems.

### Guangzhou Honda Extends Its Model Lineup and Expands Production Capacity

From the time the *Accord* first went on sale in 1999, customers were so enamored of the sense of luxury it offered that sales substantially exceeded our initial projections. By 2001, annual production of the *Accord* had already risen to 50,000 units. In April 2002, we also began producing the *Odyssey*, a multi-utility vehicle (MUV) that accommodated several passengers, offered the same operating performance and comfort as a passenger car and was suited for a variety of uses, such as for business during the week and for family trips on weekends. In 2003, we expanded our annual production capacity to 120,000 units, and in September of that year we began producing our third model in China, the *Fit Saloon*. This model was designed to meet demand for entry midsize vehicles with engines ranging from 1,000cc to 1,500cc, for which demand was emerging in line with the country's rapid economic growth. In 2004, we again expanded annual production capacity, this time to 240,000 units, and in September of that year we introduced the *Fit* to meet the individualistic lifestyles of customers in their 20s and 30s.

As a result, Guangzhou Honda has expanded production at a rate unparalleled by Honda elsewhere in the world. In the second

Honda Sales Results and Plans by Model



half of 2006, a second factory is scheduled to begin operations, adding another 120,000 units in annual production capacity. This capacity, added to that of the first plant, will raise total annual production capacity to 360,000 units. We expect to increase Dongfeng Honda Engine's production capacity to keep pace.

### The Basics of Building a Production System— “Small Born” Approach

Guangzhou Honda followed Honda's concept of starting small and growing along with demand, beginning with annual production of 30,000 units and expanding its capacity while keeping a keen eye on market movements. When Guangzhou Honda was established, it took over a plant from a previous manufacturer, but the facility was unsuited to Honda's production methods and nearly everything in the facility needed repair or maintenance. To overcome these obstacles, Guangzhou Honda and Dongfeng Honda Engine set up a special project team of members from Honda's development, manufacturing, quality control, purchasing and sales departments. This team brought in broad-ranging Honda technology and expertise, which it used to build new production and sales systems. From the beginning, Honda targeted a global standard for quality. Even when increasing production capacity, the dedicated efforts of the associates enabled these companies to achieve quality levels on par with production in a mature market.

To enhance its production line, the plant employed Honda's line management expertise to increase production yields from existing facilities while constantly maintaining a focus on cost reductions. Modeling its operations on the Saitama factory in Japan, which produces the *Accord*, the company worked to strengthen its

production system. As a result, now the system is flexible enough to manufacture everything from compact passenger cars to large MUVs on the same line. We have also worked to increase the local parts procurement ratio. Consequently, the *Fit* and the *City* are made from about 90% locally sourced parts, which improves cost competitiveness.

In October 2005, Honda Motor (China) Investment Co., Ltd., set up Honda Auto Parts Manufacturing Co., Ltd. (Honda Auto Parts) as

Honda Engineering China Co., Ltd.



#### Providing Local Production Technology Support and Enhancing Cost Competitiveness

To meet production increases and launch new products in a timely manner, in August 2004 we established Honda Engineering Co., Ltd. (EG China), as a wholly owned subsidiary. EG China works to advance and improve the equipment used in mass production, thereby increasing capacity utilization rates and raising production capacity at a lower cost. The company also produces high-precision stamping dies and provides other local support. In December 2005, EG China started operations at a die production plant, with the goal of speeding the introduction of new models and reducing costs.



Guangzhou Honda operates highly efficient and flexible production lines, like those at other Honda manufacturing facilities in Japan, Europe and the United States.

a wholly owned subsidiary, and this company will begin making automobile powertrain components in the first half of 2007.

This move will increase our local production capacity for powertrain components, including transmissions, drive shafts and engine parts for automobiles. By increasing local procurement we expect to further reduce costs and improve competitiveness.

### Building China's First Four-Part Integrated Dealer Network

One factor behind Guangzhou Honda's successful advancement is its four-part integrated dealer network, which combines sales, after-sales service, parts supply and customer feedback. This sort of sales system, commonplace in Japan, Europe and the U.S., was unprecedented in China when we entered the market, and eliciting the understanding of government-related institutions was no simple task. Before Honda entered the Chinese automobile market, sales locations generally had no after-sales service functions, making customers dependent on separate repair shops. Not all these repair shops had sufficient knowledge or the necessary parts for repairs, so that a not-insignificant number of customers were left with an insecure feeling after having purchased a vehicle. In line with its belief in "The Joy of Buying," Honda worked to ensure customer convenience by introducing in China the four-part integrated dealer network that was in place in Japan and the United States. The four-part integrated dealer network that met customers' needs was extremely well-received, and this later became the industry standard with competitors following suit.

The dealer function that is most important to Guangzhou Honda is after-sales service. To increase service quality, the company introduced contests in which service engineers selected from dealerships around the country are invited to compete with each other by demonstrating their repair techniques. This method has contributed greatly to improving service skills. Body repair capabilities have been added at all locations, a move that has improved customer satisfaction and contributed greatly to expanding sales. Guangzhou Honda maintains after-sales service parts warehouses in Beijing and Shanghai, so that parts can quickly be provided to dealers. In the event of a customer complaint, feedback is transmitted to Guangzhou Honda, providing quick access to market information.

Rather than treating automobiles as one-off product sales, we provide a full after-sales service system, supported by a maintenance and repair parts supply network and a customer feedback system. These systems provide customers peace of mind when driving their cars, and plays a role in helping our customers in China develop a comfortable relationship with their cars. Showing that it has taken to heart Honda's belief in "The Joy of Buying," Guangzhou Honda has succeeded in developing its network of dealers from approximately 30 locations in 1999 to a number expected to exceed 250 by the end of 2006.



Dongfeng Honda dealership (Wuhan)

### Dongfeng Honda Established as a New Stronghold in the Chinese Automobile Market



Ceremony to celebrate the first CR-V off the line at Dongfeng Honda

In July 2003, Honda established Dongfeng Honda Automobile Co., Ltd. (Dongfeng Honda), as a new local production and sales joint venture in the city of Wuhan, Hubei Province. Beginning with an existing vehicle factory that had once manufactured commercial minibuses, the facility's welding,

painting and vehicle assembly lines were renovated, and a new finished vehicle inspection line was installed. Advanced robots were introduced to the welding line to allow for highly flexible welding processes. This approach to the construction of an advanced production line reflects Honda's belief in manufacturing system innovation. The elapsed time from Dongfeng Honda's establishment to the start of production was only about six months, and a facility expansion to bring annual production capacity up to 120,000 units was completed in only one year from the start of construction. Each of these projects was completed from six months to a year more quickly than is typical for projects of this scale. In April 2004, Dongfeng Honda began production with the CR-V, one of our core models. In April 2006, the company also began manufacturing and sales of the Civic, which is sold in more than 160 countries throughout the world. Similar to Guangzhou Honda, Dongfeng Honda has introduced a four-part integrated dealer network. Comprising approximately 70 locations at the end of 2005, this network is projected to expand to more than 140 dealers by the end of 2006.



Jazz automobiles aboard a car carrier bound for Europe (June 2005)



Dongfeng Honda, which now has an annual production capacity of 120,000 units, introduced the new Civic in March 2006.

### First Automaker in China to Begin Auto Exports to Europe

In September 2003, Honda established Honda Automobile (China) Co., Ltd. (Honda Automobile China) to specialize in the production of automobiles for export. Drawing upon the production expertise, procurement network and economies of scale it has developed through its existing operations of Guangzhou Honda and Dongfeng Honda Engine, the new company was designed to take advantage of increasing competitiveness in both quality and cost, becoming the first Chinese passenger car manufacturer to concentrate on full-fledged export sales. Honda Motor Co., Ltd. and Honda Motor (China) Investment Co., Ltd., together own a 65% stake in Honda Automobile China, with the remaining shareholdings split between Guangzhou Automobile Group Company Limited, and a joint venture company of Dongfeng Motor Group Co., Ltd. In April 2005, Honda Automobile China began mass production of the *Jazz*, a compact passenger car. Shipments to Europe began with Germany in June 2005. In 2005, the company exported 9,696 units, and this number is projected to increase to 25,000 in 2006.

### Future Initiatives—Expand Production Capacity and Introduce the Acura Brand

In fall of 2006, Guangzhou Honda expects to begin operating a second plant, which will have an annual production capacity of 120,000 units. When added to the first plant, the company will have a capacity of 360,000 units per year. Further, Dongfeng Honda has an annual production capacity of 120,000 units, and Honda Automobile China 50,000 units. Combining this output, Honda should have the capacity to produce 530,000 units per year in China by the end of 2006. Through such expansions in production capacity, we will respond to the long term growth in market needs.

To respond to increasingly diverse customer needs, in 2006 we plan to introduce the Acura brand in China—which is already well received in the North American market. Launching the brand will speak to Honda's commitment to its business in China by demonstrating the willingness to introduce its strength and resources extensively. Honda Motor (China) Investment Co., Ltd., will import and sell these vehicles, and plans to establish its own dealer network. By accentuating "The Joy of Driving" through this brand, which has excellent performance characteristics, Honda plans to differentiate itself in the marketplace.



## Honda's Business in China

# Establishing the Optimum Management Structure for Local Operations

### Strengthening Our Operating Structure in the Motorcycle and Power Products Businesses

In addition to Wuyang-Honda Motors (Guangzhou) Co., Ltd. (Wuyang-Honda), in 2001 Honda established Sundiro Honda Motorcycle Co., Ltd. (Sundiro Honda), as a new joint venture for the manufacture and sales of motorcycles. In 2002, Sundiro Honda began producing and exporting to Japan an affordable small-size scooter, the *Today*. In 2003, Honda established Honda Motorcycle R&D China Co., Ltd., in Shanghai to conduct research and development on motorcycles with the goal of rapidly developing products that are designed for the Chinese market. Honda has strengthened its motorcycle production operations, with both Sundiro Honda and Wuyang-Honda relocating their plants in order to improve production efficiency. Sundiro Honda began operations at a new plant in 2005, as did Wuyang-Honda in 2006.

In the Chinese power products business, Honda has a two-company structure, with Jialing-Honda Motors Co., Ltd. (Jialing Honda) manufacturing general-purpose engines, lawn mowers and pumps, and Honda Mindong Generator Co., Ltd. (Mindong Honda) focusing on generators. Mindong Honda began exporting generators in 2003.

### Further Enhancing Regional Headquarters Functions

Since 1994, Honda has employed a matrix management structure that combines a regional headquarters with a business segment headquarters. Honda is currently developing its business in China through joint ventures and subsidiaries in the motorcycle, automobile and power products businesses. To manage the rapid growth of its businesses in this market, Honda established its sixth pillar of regional operations, for China, in April 2003. This move was intended to foster a management structure that was more deeply rooted in the local environment, in order to respond rapidly and optimally to the demands of this quickly growing market from a local perspective. To further strengthen our regional headquarters function in China, in January 2004, we established Honda Motor (China) Investment Co., Ltd. As a wholly owned Honda subsidiary, this company develops comprehensive business strategies for Honda's businesses in China and acts as its representative in such areas as government and industrial affairs, corporate communications and intellectual property management. In spring 2005, we established the Shanghai branch of Honda Motor (China) Investment Co., Ltd., to strengthen its function as the regional headquarters for Honda's motorcycle business in China. This branch supports Honda's overall motorcycle business in China in marketing, service, quality and purchasing.





Honda's Business in China

## Addressing Environmental and Safety Issues, and Contributing to Society

### Stepping up Efforts to Reduce the Environmental Burden of Factories and Products

In China as well as other locations, Honda employs the "Green Factory" approach that considers both the global environment and work environment. From an environmental perspective, we employ a water-based paint system which will reduce emissions of hazardous substances such as volatile organic compounds to one-tenth of the current level compared to conventional paints. We purify wastewater from our plants, promote recycling and work to improve the efficiency of our production processes, reducing our consumption of electric power, gas and water.

Our products clear the most stringent global environmental standards when they are launched. For automobiles, some models that are on sale now already meet the Euro4 level emission standards.\*4 Our motorcycles also feature excellent environmental performance and energy-saving features, such as China's first programmed fuel injection (PGM-FI) system. In summer 2006, we will launch a small scooter that meets the Euro3\*4 emission standards.

\*4: Based on Honda's internal test data



Second Auto Plant at Guangzhou Honda  
To reduce emissions of volatile organic compounds, water-based paints are used for the middle and top coats of paint. Paint is sprayed on with a special water-based paint gun to improve coating efficiency.

### Improving Traffic Manners through Safety Awareness Activities

In line with the growing number of motorcycle riders, traffic accidents in China are on the rise. To counter this trend, since 2003 Honda has trained safety instructors and has been dedicated to safety promotion activities at dealerships. In February 2006, Wuyang-Honda decided to begin activities to promote motorcycle safety riding with the Zeng Cheng local government. The construction of this "model traffic city" will be supported to improve motorcycle driving skills and the attitudes for traffic safety in its residents.

To promote automobile safety, we began traffic field surveys and analyses, determined educational methods based on traffic conditions, and near miss or actual accidents in 2005, then held workshops for our associates.



Competition between instructors at Wuyang-Honda, Sundiro Honda and Jialing-Honda

### Contributing to Society through Desert Afforestation

In 2000, Honda began afforestation activities in the Korchin Desert, in the Inner Mongolia Autonomous Region of China, in cooperation with the Japanese NPO, Desert Planting Volunteer Association. In addition to providing monetary support, Honda takes an active role in planning activities, such as volunteer tree-planting tours twice a year.



## Honda's Business in China

# Becoming A Company that Chinese Society Wants to Exist

The scale of China's automobile market is increasing rapidly, but ample room remains for increases in the number of automobile owners, and we expect market growth to continue. Honda will work to expand its business in China, and do so in a way that allows for the flexible response to future changes in the market environment.

At the same time, we will continue to maximize the joy of our customers, address environmental and safety issues, and contribute to society. Through these activities, Honda's goal is to become a company that Chinese society wants to exist in China.

## Honda's Business in China

Year	Business Development	Location	Function
1982	Production of motorcycles begins through technical collaboration with China Jialing Industrial Co., Ltd.	Chongqing	
1992	Wuyang-Honda Motors (Guangzhou) Co., Ltd.* <sup>1</sup> established	Guangzhou	Manufacturing and sales of motorcycles
	China Tianjin Honda Motors Co., Ltd.* <sup>1</sup> established	Tianjin	Manufacturing and sales of motorcycles
1993	Jialing-Honda Motors Co., Ltd.* <sup>1</sup> established	Chongqing	Manufacturing and sales of motorcycles
	Honda Motor (China) Co., Ltd.* <sup>2</sup> established in Hong Kong	Hong Kong	Import sales of motorcycles and automobiles
1994	Honda Mindong Generator Co., Ltd.* <sup>2</sup> established	Fujian Province	Manufacturing and sales of compact generators
	Dongfeng Honda Auto Parts Co., Ltd.* <sup>1</sup> established	Huizhou	Manufacturing of automobile engine parts and undercarriage components
1998	Guangzhou Honda Automobile Co., Ltd.* <sup>1</sup> established	Guangzhou	Manufacturing and sales of automobiles
	Dongfeng Honda Engine Co., Ltd.* <sup>1</sup> established	Guangzhou	Manufacturing of automobile engines and transmissions
1999	<i>Accord</i> production begins at Guangzhou Honda Automobile Co., Ltd.		
2001	Sundiro Honda Motorcycle Co., Ltd.* <sup>1</sup> established	Tianjin	Manufacturing and sales of motorcycles
2002	Honda Motorcycle R&D China Co., Ltd.* <sup>2</sup> established	Shanghai	Motorcycle research and development
	<i>Odyssey</i> production begins at Guangzhou Honda Automobile Co., Ltd.		
	Sundiro Honda Motorcycle Co., Ltd., begins exporting <i>Today</i> scooters to Japan		
	Jialing-Honda Motors Co., Ltd., begins production of general-purpose engines	Chongqing	Manufacturing and sales of motorcycles and power products
2003	Dongfeng Honda Automobile Co., Ltd.* <sup>1</sup> established	Wuhan	Manufacturing and sales of automobiles
	Honda Automobile (China) Co., Ltd.* <sup>2</sup> established	Guangzhou	Automobile production and export
	<i>Fit Saloon</i> production begins at Guangzhou Honda Automobile Co., Ltd.		
2004	Honda Motor (China) Investment Co., Ltd.* <sup>2</sup> established	Beijing	Functions as Honda's regional headquarters in China, conducts Honda-related investment activities in China
	<i>CR-V</i> production begins at Dongfeng Honda Automobile Co., Ltd.		
	Honda Engineering China Co., Ltd.* <sup>2</sup> established	Guangzhou	Advancement and reform of mass-production facilities, support for new model launches, and production of dies
	<i>Fit</i> production begins at Guangzhou Honda Automobile Co., Ltd.		
2005	Honda Automobile (China) Co., Ltd., begins exporting <i>Jazz</i> compact car to Europe		
	Jialing-Honda Motors Co., Ltd., changes its scope of business to concentrate on the power product business	Chongqing	Manufacturing and sales of power products
	Honda Auto Parts Manufacturing Co., Ltd.* <sup>2</sup> established	Foshan	Manufacturing of automobile transmissions and engine parts
2006	<i>Civic</i> production begins at Dongfeng Honda Automobile Co., Ltd.		

\*1: Affiliate accounted for under the equity method \*2: Consolidated subsidiary