

Autos & Auto Parts: Global Insights

Global Autos & Auto Parts
Manufacturers Group

Industry Overview

February 17, 2004

Chinese Auto Market: Reading the Tea Leaves

- **China is significant for all auto and auto-related investors, in our view**
China is a significant source of global automotive unit demand and is currently a significant source of profit for several major manufacturers, including Honda, GM, and Volkswagen. Currently, profit margins are more reflective of high prices (relative to global levels) than low costs.
- **The Morgan Stanley Automotive team recently visited China**
This report is both a guide to the Chinese auto market and a recap of our trip. It incorporates the perspective of our US, European, Korean, Chinese, and Indian Automotive teams.
- **Demand growth is likely to be significant in China**
Economic growth, better availability of consumer financing, and deflationary prices are likely to spur unit demand growth.
- **Supply growth is also rapid, suggesting the risk of excess supply is increasing**
We forecast 27% annual unit capacity growth through 2006. Chinese government promotion of auto industry development could make capacity closure more difficult if overcapacity becomes a problem.
- **Exports are likely in the long term, but costs must come down**
We believe that an export market can develop, and is likely to be a 'Plan B' if excess supply hits the market and domestic Chinese demand does not materialize as projected. Currently, component costs are above global levels and quality concerns linger, offsetting the labor savings relative to mature markets.
- **Our investment view: Honda/GM appear well positioned; VW has a lot to lose**
Honda and GM appear to be competing with product that meets global standards, spurring Chinese consumers to pay a premium for these products. VW is currently the market share leader but is losing share, and some of its product appears dated.
- **In-Line view on the China Auto & Auto Parts industry**
The surge in domestic demand is likely to be offset by price cuts from fierce competition. However, we believe that most China auto companies' overall profits will improve in the next few years.

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Exhibit 1

Morgan Stanley Global Automotive Coverage Universe

	Company Name	Industry	Industry Rating	Price Target	Stock Rating	2/12/04 Price (local currency)	Close Price / EPS		Market Capitalization (in USD)
							2003	2004	
Auto Parts : Japan Industry									
7259.T	Aisin Seiki	Auto Parts	In-Line	NA	Equal-Weight	1,731	12.2	10.8	4,587
5108.T	Bridgestone	Auto Parts	In-Line	NA	Equal-Weight	1,566	16.2	16.9	12,796
7248.T	Calsonic Kansei	Auto Parts	In-Line	1,000	Overweight	784	10.4	9.3	1,565
6902.T	Denso	Auto Parts	In-Line	2,550	Overweight	2,155	16.0	14.1	18,075
7251.T	Keihin	Auto Parts	In-Line	NA	Equal-Weight	1,022	9.5	9.1	717
5991.T	NHK Spring	Auto Parts	In-Line	NA	Underweight	535	19.0	17.5	1,239
7240.T	NOK	Auto Parts	In-Line	NA	Equal-Weight	3,400	19.1	17.5	5,436
6923.T	Stanley Electric	Auto Parts	In-Line	2,400	Overweight	1,832	17.4	15.7	3,272
5110.T	Sumitomo Rubber	Auto Parts	In-Line	NA	Equal-Weight	598	12.6	10.0	1,376
7282.T	Toyoda Gosei	Auto Parts	In-Line	NA	Equal-Weight	2,685	19.5	16.8	3,167
6201.T	Toyota Industries	Auto Parts	In-Line	NA	Equal-Weight	2,260	19.4	17.6	6,986
Median Japan parts							16.2	15.7	
Automobiles : Non Japan Asia Industry									
ASOK.BO	Ashok Leyland Ltd.	India Four-Wheelers	Attractive	371	Overweight	244	13.4	9.4	642
BJAT.BO	Bajaj Auto Ltd.	India Two-Wheelers	Attractive	979	Overweight	1,010	13.7	12.0	2,267
1114.HK	Brilliance China Auto	China Auto & Auto Parts	In-Line	4	Equal-Weight	4	14.9	10.8	1,912
2204.TW	China Motor Corp.	Taiwan Auto & Auto Parts	In-Line	60	Equal-Weight	68	11.7	11.3	2,761
0203.HK	Denway Motors	China Auto & Auto Parts	In-Line	6	Equal-Weight	9	21.6	13.6	3,709
HROH.BO	Hero Honda Motor Ltd	India Two-Wheelers	Attractive	555	Overweight	505	14.2	12.7	2,230
012330.KS	Hyundai Mobis	S. Korea Auto & Auto Parts	Attractive	62,750	Equal-Weight	57,000	8.2	7.3	4,166
005380.KS	Hyundai Motor Co.	S. Korea Auto & Auto Parts	Attractive	60,000	Overweight	47,650	6.3	5.5	9,013
000270.KS	Kia Motors	S. Korea Auto & Auto Parts	Attractive	NA	NAV	10,550	5.8	5.3	3,270
MAHM.BO	Mahindra & Mahindra	India Four-Wheelers	Attractive	545	Overweight	463	16.9	12.4	1,188
MRTI.BO	Maruti Udyog Ltd.	India Four-Wheelers	Attractive	480	Overweight	481	19.6	15.1	3,076
1122.HK	Qingling Motors	China Auto & Auto Parts	In-Line	1	Underweight	1	20.9	15.1	218
TAMO.BO	Tata Motors	India Four-Wheelers	Attractive	587	Overweight	542	23.8	15.9	3,832
TVSM.BO	TVS Motors	India Two-Wheelers	Attractive	81	Underweight	112	15.2	12.8	57
Median Non-Japan Asia							15.2	12.7	
Autos : Japan Industry									
7270.T	Fuji Heavy Industries	Autos	In-Line	630	Overweight	482	10.3	NA	3,580
7205.T	Hino Motors	Autos	In-Line	NA	Underweight	661	19.4	NA	3,603
7267.T	Honda Motor	Autos	In-Line	5,250	Overweight	4,500	9.4	NA	41,600
7202.T	Isuzu Motors	Autos	In-Line	NA	Underweight	207	3.8	NA	1,470
7261.T	Mazda Motor	Autos	In-Line	NA	Equal-Weight	298	10.8	NA	3,456
7211.T	Mitsubishi Motors	Autos	In-Line	NA	NAV	249	***	***	3,504
7201.T	Nissan Motor	Autos	In-Line	1,560	Overweight	1,070	9.1	NA	45,891
7269.T	Suzuki Motor	Autos	In-Line	1,980	Overweight	1,587	16.3	NA	8,170
7203.T	Toyota Motor	Autos	In-Line	NA	Equal-Weight	3,490	13.6	NA	119,528
Median Japan Autos							10.8	12.7	
Autos & Auto Parts : European Industry									
ALV.N	Autoliv	Autos & Auto Parts	In-Line	NA	Equal-Weight	44	17.0	15.8	5,411
BZLG.DE	Beru	Autos & Auto Parts	In-Line	65	Overweight	NA	NA	NA	753
BMWG.DE	BMW	Autos & Auto Parts	In-Line	42	Overweight	34	11.2	10.0	29,374
BRBI.MI	Brembo	Autos & Auto Parts	In-Line	NA	Equal-Weight	6	17.3	15.8	536
CONG.DE	Continental	Autos & Auto Parts	In-Line	34	Overweight	32	9.5	9.0	5,591
DCXGn.DE	DaimlerChrysler AG	Autos & Auto Parts	In-Line	NA	Equal-Weight	37	18.6	13.3	48,304
EPED.PA	Faurecia	Autos & Auto Parts	In-Line	NA	Underweight	61	45.5	25.5	1,869
FIA.MI	FIAT	Autos & Auto Parts	In-Line	NA	Underweight	6	(4.7)	(20.5)	5,989
GKN.L	GKN	Autos & Auto Parts	In-Line	NA	Equal-Weight	268	10.9	9.6	2,504
MICP.PA	Michelin	Autos & Auto Parts	In-Line	NA	Equal-Weight	37	10.5	9.5	6,776
NOR1V.HE	Nokian Tyres	Autos & Auto Parts	In-Line	NA	Underweight	61	19.1	18.6	855
PSHG.p.DE	Porsche	Autos & Auto Parts	In-Line	NA	Equal-Weight	435	12.4	NA	9,761
PEUP.PA	PSA Peugeot-Citroen	Autos & Auto Parts	In-Line	45	Overweight	40	7.5	7.2	12,339
RENA.PA	Renault	Autos & Auto Parts	In-Line	NA	Equal-Weight	54	6.1	5.9	18,373
SCVa.ST	Scania AB	Autos & Auto Parts	In-Line	NA	Equal-Weight	237	NA	NA	13,378
SCVb.ST	Scania AB	Autos & Auto Parts	In-Line	NA	Equal-Weight	240	NA	NA	13,378
VLOF.PA	Valeo	Autos & Auto Parts	In-Line	40	Overweight	35	24.0	13.9	3,700
VOWG.DE	Volkswagen	Autos & Auto Parts	In-Line	NA	Underweight	39	NA	9.1	19,138
VOLVb.ST	Volvo	Autos & Auto Parts	In-Line	NA	Equal-Weight	240	22.9	17.3	14,115
Median Europe							11.6	9.6	

Source: Company data, Morgan Stanley Research 2003-2004 P/E's based on Morgan Stanley estimates or actual reported results

Autos & Auto Parts – February 17, 2004

Please see analyst certification and other important disclosures starting on page 29.

Exhibit 2

Morgan Stanley Global Automotive Coverage Universe (continued)

	Company Name	Industry	Industry Rating	Price Target	Stock Rating	2/12/04 Price (local currency)	Close Price / EPS		Market Capitalization (in USD)
							2003	2004	
Autos & Auto Parts									
Manufacturers :									
American Industry									
ATAC.O	Aftermarket Technology	Autos & Auto Parts	In-Line	NA	NAV	15	NA	NA	373
AXL.N	American Axle and Mfg.	Autos & Auto Parts	In-Line	45	Overweight	41	11.2	10.6	2,180
ARM.N	ArvinMeritor	Autos & Auto Parts	In-Line	NA	Equal-Weight	23	11.9	10.6	1,588
AN.N	AutoNation Inc.	Autos & Auto Parts	In-Line	NA	Equal-Weight	17	12.6	11.8	4,751
BDG.N	Bandag	Autos & Auto Parts	In-Line	NA	Equal-Weight	45	14.7	12.1	459
BWA.N	BorgWarner Inc.	Autos & Auto Parts	In-Line	NA	Equal-Weight	96	15.0	13.6	2,642
CTB.N	Cooper Tire & Rubber	Autos & Auto Parts	In-Line	NA	Underweight	21	19.1	15.8	1,514
DCN.N	Dana Corp.	Autos & Auto Parts	In-Line	NA	Equal-Weight	22	19.8	14.4	3,316
DPH.N	Delphi	Autos & Auto Parts	In-Line	18	Overweight	11	17.6	11.4	6,068
DRRA.O	Dura Automotive	Autos & Auto Parts	In-Line	NA	Equal-Weight	14	8.0	7.6	265
F.N	Ford	Autos & Auto Parts	In-Line	NA	Equal-Weight	15	13.5	11.7	26,806
GM.N	General Motors	Autos & Auto Parts	In-Line	NA	Equal-Weight	50	NA	8.6	27,925
GPC.N	Genuine Parts Co.	Autos & Auto Parts	In-Line	NA	Equal-Weight	34	16.7	15.4	6,065
GT.N	Goodyear Tire & Rubber	Autos & Auto Parts	In-Line	NA	Equal-Weight	9	(7.3)	25.4	1,571
GPI.N	Group 1 Automotive	Autos & Auto Parts	In-Line	NA	Equal-Weight	38	12.2	11.4	859
JCI.N	Johnson Controls	Autos & Auto Parts	In-Line	NA	Equal-Weight	60	16.6	14.5	10,757
LEA.N	Lear Corp.	Autos & Auto Parts	In-Line	70	Overweight	66	11.8	10.4	4,453
LAD.N	Lithia Motors Inc.	Autos & Auto Parts	In-Line	NA	Equal-Weight	28	14.9	14.1	519
MGA.N	Magna Intl Inc.	Autos & Auto Parts	In-Line	85	Overweight	81	13.9	12.0	7,748
SNA.N	Snap-on Inc.	Autos & Auto Parts	In-Line	NA	Underweight	31	19.8	15.7	1,831
SMP.N	Standard Motor Products	Autos & Auto Parts	In-Line	NA	Underweight	14	(255.2)	25.2	172
SRI.N	Stoneridge Inc.	Autos & Auto Parts	In-Line	NA	Underweight	16	16.7	13.8	358
SUP.N	Superior Industries	Autos & Auto Parts	In-Line	NA	Equal-Weight	36	13.2	14.4	963
TBCC.O	TBC	Autos & Auto Parts	In-Line	NA	Equal-Weight	30	20.5	17.8	659
TEN.N	Tenneco	Autos & Auto Parts	In-Line	NA	Equal-Weight	13	24.1	15.3	528
TWR.N	Tower Automotive	Autos & Auto Parts	In-Line	NA	Equal-Weight	6	95.7	15.0	342
UAG.N	UnitedAuto Group Inc	Autos & Auto Parts	In-Line	32	Overweight	31	15.1	13.0	1,324
VC.N	Visteon Corporation	Autos & Auto Parts	In-Line	13	Overweight	12	(6.6)	16.5	1,511
Median North America							15.1	15.0	

Source: Company Data, Morgan Stanley Research

Chinese Auto Market: Reading the Tea Leaves

Summary and Investment Conclusion

We believe the Chinese auto market is an important consideration for all auto and auto-related investors. China currently accounts for a high portion of profits for several car-makers, including Honda, Volkswagen, and General Motors. In addition, as one of the fastest-growing markets in the world, China will likely be a significant source of incremental auto demand and profits globally. Finally, we believe China has long-term potential to serve as a significant export base for vehicles.

Currently, the Chinese auto market has low barriers to entry and high profitability. Profit margins on vehicles sold in China typically are much larger than in the rest of the world, based largely on high prices rather than low costs. China's auto industry currently lacks the scale to be significantly low cost. Demand growth has been very strong (2003 sedan sales grew +75.1% year over year) and supply is tight. As many as 15 foreign manufacturers have entered the Chinese marketplace through joint ventures or partnerships with domestic auto companies. *We estimate that profits from China operations accounted for about 40–50% of total 2003 auto net profits at GM and roughly 15% of total profits (including GMAC), more than one-third of Volkswagen's pretax profits (nine months 2003), and 17% of Honda's 3Q03 net profit.*

Looking ahead, growth should continue, but at a slower pace. Looking ahead, we believe China will continue to be a profitable source of growth for foreign original equipment manufacturers (OEMs). Despite low reported per capita income, *there still appears to be room for Chinese demand to grow*, particularly if prices continue to fall, the Chinese economy continues to grow, and vehicle financing grows. The pace of growth, however, is likely to subside down the road. The current low barriers to entry suggest that competition will intensify — capacity additions are being announced virtually every month, as major OEMs race to establish future market-share positions. *This increased competition, investment in new products, and greater supply*

relative to demand longer term should lead to profit margin compression.

The three biggest questions many investors currently have about the Chinese auto market are:

- Are there likely to be significant vehicle exports from China?
- Will margins in the region fall to more normal levels in the near future?
- Is there a bubble in the vehicle market?

The answers, in our opinion, are yes, yes, and maybe.

Investment Implications

Honda and GM appear well positioned; VW has a lot to lose, in our view. Honda's product line has a lot of component commonality. This should keep Honda at the low end of the cost curve relative to its peers. GM's strategy of introducing new products on par with global models appears very solid — the Buick brand is well positioned against VW and Honda. GM (like Honda) is competing with very fresh product.

Volkswagen appears to have the most to lose — it was the first major foreign OEM to enter the market, but it is losing market share in China, and its product strategy (containing more dated product) appears less competitive. While the overall market may expand rapidly, if Volkswagen's profit per vehicle declines at a more rapid rate, overall profitability could suffer. We believe VW also has issues on the distribution front.

See *Potential Winners and Losers* later in the report for more detail about the major players in the Chinese auto market.

Overview: Key “Leaves” to Read

The Morgan Stanley Global Auto team recently visited China and South Korea. This report encompasses the perspective of analysts from the US, Europe, Japan, Korea, China, and India. It is intended to be both an investor’s guide to the Chinese market and a recap of our trip.

This report is intended to be both an investor’s guide to the Chinese market and a recap of our trip.

Our investment view is as follows:

China is important for all auto/auto related investors, in our view. From a demand perspective, China is potentially the largest and one of the fastest-growing automotive markets in the world. As recent earnings reports from various manufacturers indicate, profit margins remain high (estimated at 9.2% on average for 2003) in the region. In fact, for carmakers such as Honda, Volkswagen, and GM, China accounts for a growing portion of profits and is a significant source of incremental growth globally.

China is not a low cost model....yet. High industry profit margins appear much more related to high prices than low costs. Car prices in China, while currently deflationary, are as much as 40% higher than comparable models in other parts of the world. If, as expected over time, Chinese car prices fall to world levels, profit margins could contract.

Demand growth should continue as the Chinese consumer comes of age. Despite low reported per capita income, there still appears to be room for Chinese demand to grow. Morgan Stanley’s Asia/Pacific economics team forecasts that Chinese real GDP will grow at 7.8% in 2004 and 7.5% in 2005. Projected economic growth, deflationary vehicle pricing, and growth in vehicle financing should all aid demand.

The prospect of excess capacity, however, remains high, as significant capacity expansion plans continue to break news. While capacity does not currently appear to be in excess, we estimate that demand will need to grow by roughly 25–30% per annum to absorb currently announced capacity additions over the next three years. We caution, however, that this may be a conservative estimate, as capac-

ity additions are being announced just about every month as major OEMs race to stake out future market-share positions. As in the US and Europe, excess capacity in the industry does not necessarily mean automakers cannot earn profits. Rather, it typically favors companies that are low cost and deliver product that consumers are willing to pay for.

Low barriers to entry suggest that competition will intensify. The Chinese capacity model differs greatly from its more mature Western counterparts. On our plant visits we witnessed much less automation but, in many cases, greater vertical integration than is typical for automakers in more developed regions. Low labor costs are a central reason for the high degree of labor input. The low level of automation creates low entry barriers, especially for those automakers that choose to outsource components, and is one reason why there are more than 100 car and truck manufacturers in China.

Surviving the competitive maze. Competition is occurring on a number of levels, making winners and losers particularly difficult to sort out. What makes the market structure particularly difficult to decipher are the various partnerships that each Chinese entity has with one another, with state governments, and with foreign OEMs. We believe this creates the potential for significant conflicts of interest between joint venture companies and their foreign partners over manufacturing, technology, and human resource allocation. The market is also quite fragmented, with over 36 sedan and light truck producers (with sales of at least 1,000 units per year).

Different product strategies. GM and Honda appear to be manufacturing the latest product designs, such as the Regal, Accord, and Odyssey, in China, while VW appears to be relying in part on manufacturing more dated product, such as the Santana. While the GM/Honda strategy may be higher cost in the near term, this should support their brand image longer term.

Honda and GM appear to be well positioned. While VW leads in market share, the company seems to have legacy issues that we believe will need to be resolved for it to be successful in China longer term. Honda and GM, which have introduced vehicles with the latest technology, appear to have an advantage. Whether this advantage is sustainable remains to be seen. Toyota, Nissan, Ford, and Hyundai are

just getting started. Nissan's strategy of owning a portion of its partner (vs. most other players' joint venture strategy) gives it more control over its destiny, and perhaps less risk of losing proprietary technology. On the other hand, it gives Nissan ownership of businesses that are not necessarily core (i.e., tooling and components companies). Growth in the Chinese market provides modest support for our Overweight rating on Honda (¥4500, price target ¥5250), while the threat of market share loss/reduced profit per vehicle in China provides support for our Underweight rating on VW (€39).

Component sourcing is likely to accelerate. Significant finished vehicle exports likely are several years away.

While manufacturers have said little about any potential export opportunity, we believe that exports are an important part of the overall OEM manufacturing strategy. Many of the new car facilities are near the coast and have easy access to ports. While current domestic demand is too strong to allow for any significant exports, we believe that as production costs come down, exports will be an option if domestic demand slows. For example, Shanghai VW recently announced its intention to export a modest 600 Polo sedans to Australia in an effort to test acceptance of Chinese-built sedans in mature markets. Currently, auto parts comprise

the bulk of automotive-related exports from China to the US, with significant exports of radios, drive-train components, and brake parts.

Risks, in our view, include a significant economic slow-down/tightening of credit, excess capacity, more significant price pressure, and potential government policy risk. While most dealers/manufacturers suggested that consumers generally do not buy cars on credit (around 10% of total car sales), there does appear to be a lot of real estate-related credit in the Chinese economic system. If real estate prices were to fall, this could negatively affect consumer confidence, and household net worth would decline. The impact of a strengthening (revaluation) of the Chinese renminbi (RMB) against the US dollar is difficult to assess, but could be a risk for the auto market. While Chinese auto/auto-related exports would become more expensive, imported parts would become cheaper for manufacturers in China. This could bring down vehicle costs for those intended to be sold domestically. A revaluation, however, could diminish demand for Chinese exports in other product categories, which could in turn limit consumer demand for autos.

Chinese Auto Market Outlook

China is important to global OEMs

- The Chinese sedan market is growing rapidly.
- China contributes a high percentage of current profits for several OEMs and is a source of potential growth for many others.
- The level of profitability could be volatile as the race between supply growth and demand growth continues.
- The pricing environment leaves more questions than answers — prices are declining even on vehicles where capacity is constrained.

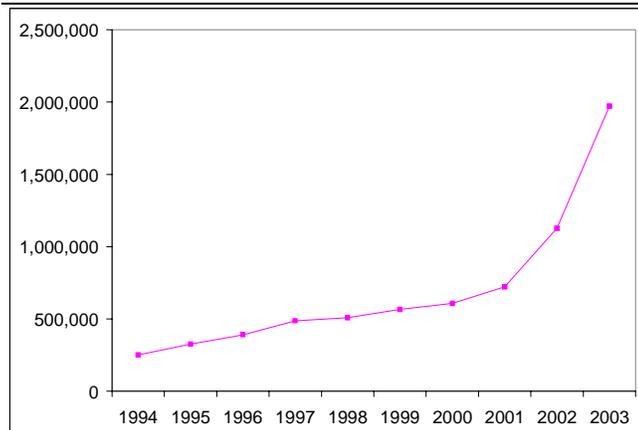
Current Conditions

Market Growth Has Been Rapid

In 2003, sedan sales in China rose 75.1%, to 1.972 million units, versus 1.126 million units in 2002. The 75.1% growth represented acceleration from the 56.1% year-over-year growth in 2002 and the 18.8% growth in 2002. The Chinese sedan market has grown at a 31.2% compound annual rate over the past five years. China is the single largest source of incremental global auto demand.

Exhibit 3

Chinese Sedan Market Unit Sales



Source: Company data, Morgan Stanley Research

Exhibit 4

China Sedan Market vs. Other Major World Markets

	2002	2003	2004E
United States *	16,812,776	16,670,424	16,800,000
Japan	4,964,880	4,972,967	4,957,000
Germany	3,252,898	3,235,960	3,365,398
China	1,126,029	1,971,601	2,500,000
U.K.	2,563,631	2,579,050	2,475,888
Italy	2,279,612	2,251,307	2,228,794
France	2,145,071	2,009,254	2,009,254
Spain	1,331,877	1,383,017	1,410,677
Canada	1,699,469	1,629,243	1,653,467
S.Korea *	1,225,210	1,001,874	1,180,000

* Total Light Vehicles

E = Morgan Stanley Research estimates

Industry Profit Margins Have Been High

Morgan Stanley China auto analyst Jerry Lou estimates that the average net profit margin for the major manufacturers in China from January–November 2003 was 9.2%, up from 7.8% for the same period in 2002. By contrast, automotive net profit margins at the US-based manufacturers in North America were an estimated 1.5–2.5% last year.

High margins appear more related to high prices than low costs. While China is a low-cost manufacturer of a number of products, such as electronics, apparel, and furniture, that is not currently the case in the car business. Labor costs are lower than other parts of the world, but the supply base in China is in its infancy and lacks the scale needed to significantly lower costs. This leads to a high level of imported components, which have tariffs, and thus, higher costs.

Exhibit 5

High Profit Margins for China's Automakers

	2002	2003	YOY	Average Size	
	RMB Mn	RMB Mn		%	2002
Revenue	301,653	426,259	41%	100.0%	100.0%
COGS	239,643	339,097	42%	79.4%	79.6%
Sales Tax	7,187	11,296	57%	2.4%	2.7%
Gross Profit	54,823	75,865	38%	18.2%	17.8%
Selling Expense	9,421	13,305	41%	3.1%	3.1%
Admin. Expense	31,128	24,985	-20%	10.3%	5.9%
Financial Expense	2,877	2,410	-16%	1.0%	0.6%
Other Income	12,247	4,054	-67%	4.1%	1.0%
Net Profit	23,644	39,219	66%	7.8%	9.2%
Dupont Analysis					
Net Profit Margin	7.8%	9.2%	17%		
Asset Turnover	89.9%	101.8%	13%		
ROA	7.0%	9.4%	33%		
Asset/Equity	231.4%	235.9%	2%		
ROE	16.3%	22.1%	35%		
Total Assets	335,565	418,700	25%		
Total Liabilities	190,568	241,176	27%		
Total Equity	144,997	177,524	22%		

Note: Key auto companies including BAIC; SAIC; FAW; Dongfeng; NAIC; Chongqing Auto; Harbin Auto; Hefei Jianghuai; Southeast Auto; Jiangling; Qingling; Chang'an, Jinbei and Guangzhou Auto.

Source: China Auto Info; Morgan Stanley Research.

Tight supply/demand and high component costs are keeping vehicle prices well above average international levels. For example, a Hyundai Sonata has a manufacturer's suggested retail price (MSRP) of \$25,400 in China, compared with \$18,400 in the US, although less than the \$28,260 in India. A VW Polo in China sells for 25% above what the car would sell for in Germany. Even the second-generation Accord in China, which has had its price cut 10–15% from the previous model, is priced an estimated 5–12% above its international counterpart (taxes account for some but not all of the price difference).

Exhibit 6

Example of Products/Product Pricing China vs. US

OEM	Model	China Price (\$US)	Price In US	Diff.
GM	Buick Regal	27.1	23.2	16.7%
Honda	Accord	27.8	26.4	5.2%
VW	Passat	27.1	23.4	15.9%
Hyundai	Sonata	25.4	18.4	38.0%

Source: Company data, Morgan Stanley Research, Edmunds.com
Prices in thousands of US\$. All Chinese models are 2.0 L engine size. Price in US is MSRP of comparable model and includes cash rebates, if they apply to all customers

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China Is Significant to Several OEMs

As a percentage of total profits, China is most important to Honda, General Motors, and Volkswagen. For example, per 3Q results, Honda's equity earnings in China, the majority of which were generated by its China automotive operations, according to management, accounted for 17% of its global net profit.

GM generated roughly 15% of its 2003 total company net profit from China. We estimate that the majority of GM's \$577 million of Asia/Pacific earnings were from its Chinese ventures, versus a total company profit of \$3.175 billion in 2003.

Volkswagen, through the first nine months of 2003, earned 33.8%, or €166 million, of its total pretax profits of €1,378 million from its China operations.

Ford, Daimler-Chrysler (DCX), Toyota, and Hyundai have smaller shares but are looking to this market for growth.

Exhibit 7

Share of Major OEM Total Profits from China

Company	Metric	China Ops
VW	% (9mos 03) Total Pretax Income	34%
Honda	% 3Q03 Total Net Income	17%
GM	% FY03 Total Net Income	15%

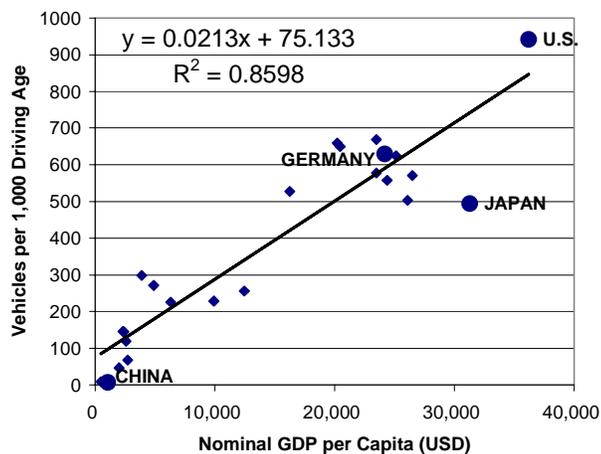
Source: Company data, Morgan Stanley Research

Market Outlook**Demand: Staying Strong**

Demand for cars remains very strong, despite the relatively low per capita income. Changes in the car buying process, pooling of household income, and the increased availability of credit are some reasons demand is strong. Given the low average per capita income in China, the obvious question is whether the market can continue to grow at this accelerated pace.

Per capita annual income in China is roughly \$900, according to the China Economic Information Center (CEIC). This compares with \$27,729 in the United States. Despite the low reported per capita income, Chinese light vehicle demand could be the fourth- or fifth-largest in the world this year. Economic data in 2002 show a very high correlation between GDP per capita and vehicle density (vehicles per 1,000) in the 24 largest auto markets. This suggests that vehicle demand is likely to follow growth in GDP per capita.

Exhibit 8

GDP / Capita vs. Vehicle Density: Top 25 Auto Markets

Source: International Monetary Fund, LMC J.D. Power, Global Insight, Morgan Stanley Research

Note: GDP per capita is nominal; data from 2002

Jerry Lou expects Chinese car demand to grow 25% annually over the next few years. He currently forecasts Chinese passenger car sales of 2.5 million in 2004.

We see the following reasons why demand can be so strong:

Chinese income statistics may be under-reported. There appears to be a significant underground economy in China. The key reason for income under-estimation is that the income tax system may result in under-reporting of income in order to shield earnings from taxes. China's individual tax system is not yet well established. People who under-report their income and pay less taxes are not necessarily punished. In the meantime, a large proportion of the average person's income is tax-exempt, including housing, meals, transportation and education subsidies. Since this income is not reflected in the tax filings, government income statistics tend to understate per capita income.

Distribution of income in China is skewed. Much of China's wealth is concentrated in urban populations. For instance, the annual per capita income in Shanghai is roughly \$5,000. Savings are also skewed — as of 2002, the average urban resident had savings of 12,471 RMB (roughly \$1,500), compared with only 1,737 RMB for the average rural resident, according to CEIC.

Chinese families typically pool their resources. China's urban population is estimated at 480 million, according to the China Urban Development Report, and about 140 million people live in cities with populations of more than 1 million. In considering demand for cars, using household income can be more helpful than per capita income, as household earnings typically are pooled to buy a car. This may also be why sedans are more popular than smaller, cheaper mini-cars. Jerry Lou estimates that 15 million Chinese households currently have the means to purchase an automobile.

The savings rate is high. The gross savings rate in China is estimated to be as high as 40%, according to the CEIC. This compares with the US, where the personal savings rate in 2003 was 2.0%, according to the US Commerce Department's Bureau of Economic Analysis; Germany, where the savings rate was 10.8%; and India, where it was 23%. Consumers are able to tap into savings to purchase vehicles that would appear unaffordable based on income alone.

Availability of credit is rising. Car manufacturers and dealers suggest as many as 90% of Chinese consumers pay cash for cars. This compares with less than 20% in the US, 30% in Germany, and 25% in India. The Chinese government recently gave GMAC and Volkswagen permission to begin offering car loans to consumers in China. The amount of credit used to purchase cars has been difficult to track. Borrowing from banks is relatively inconvenient, as individual bank loans in China are difficult to get, require a specific use, and the borrower does not receive the cash. Instead, the car seller, for example, would receive the cash directly from the bank. In any case, the availability of credit is rising, particularly with the approval of companies such as GMAC.

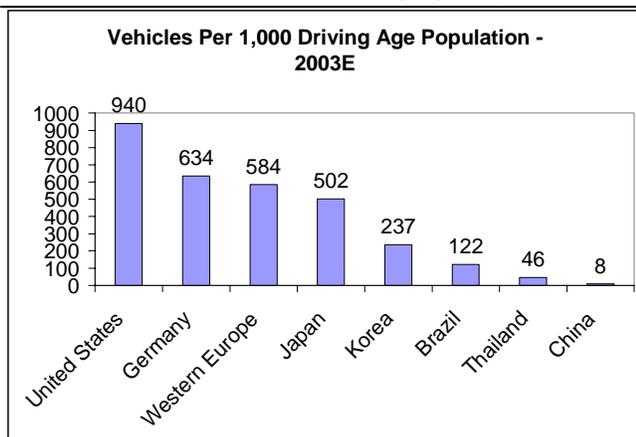
Purchasing cars has become easier. The car purchase process has become much easier, thanks to a more extensive distribution network, more experienced car sales teams, and a more developed market for auto insurance. In addition, auto companies are going to great lengths to introduce consumers to autos. For example, VW has an exhibition store in a posh Beijing shopping mall. Jerry Lou estimates that 90% of auto buyers are first-time buyers. Thus, moves to help consumers understand product features could help increase demand.

Entry into the World Trade Organization (WTO) is leading to lower prices and an acceleration in the num-

ber of models offered. China promised lower import tariffs on both automobiles and parts under the WTO agreement, which should lead to lower import car prices and also lower domestic production costs. According to the China Association of Automobile Manufacturers (CAAM), passenger car prices declined an average of 9.05% in 2003, and the CAAM expects them to fall another 10% in 2004. In addition, the number of models offered has increased substantially. There were roughly 15 new sedan models introduced in 2002 and 30 in 2003, compared with fewer than 10 models in 2001.

Exhibit 9

Personal Vehicles Per 1,000 Driving Age Population



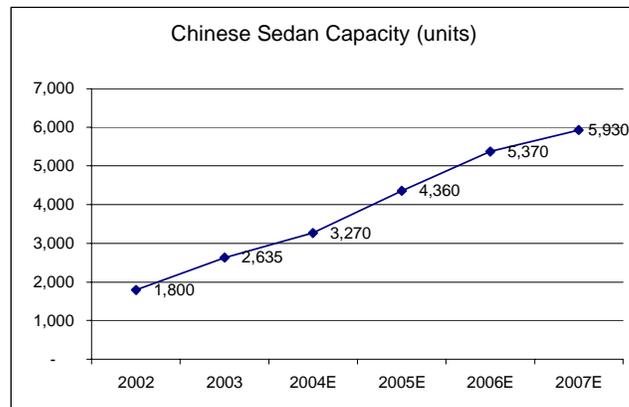
Source: JD Power - LMC

Supply: Growth Continues Unabated

The industry continues to add capacity at a rapid rate. Morgan Stanley estimates that the industry will have capacity for 5.370 million light vehicles by 2006, up from 2.635 million today. Based on current estimates, as long as sales growth is 30% or more per year, excess capacity is likely to be limited. But we caution that capacity additions are being announced almost every month as manufacturers race to establish future market share positions.

Exhibit 10

Projected Chinese Auto Capacity



E = Morgan Stanley Research estimates

Among the capacity additions, Honda's new facility in Guangzhou is the first one dedicated to exports, with planned capacity of 50,000 units. Honda plans to build its Jazz model, the European version of the Fit, at this facility and export it. The company also plans to produce this same model for domestic consumption at a second facility in China. Total production is expected to hit 120,000–150,000. This should enable Honda to ramp its local supply base much faster than if it were to build different products. We note, however, that recent reports in the *Japan Automotive Digest* suggest that Honda is likely to continue manufacturing most of the Fit units destined for Europe in Japan.

The Pricing Conundrum — Why Are Prices Falling if There Is a Significant Wait List to Buy Many Cars?

It seems unusual that car prices are falling in China when many models are in very tight supply. There are two main reasons for the long wait lists. 1) Niche / specialty products have inherently low absolute capacity. Examples include Toyota's Vios and Prado, Mazda's M6, Hyundai's Sonata and Elantra (all newly launched in China in 2003). All three of those OEMs entered China's market in late 2002, each with annual capacity of less than 50,000. 2.) Demand for certain new and popular products exceeds supply, such as GM's Regal and Excelle, and Honda's Accord and Fit.

Both GM and Honda have strategies of manufacturing new-model product in China. Their strong supplier bases also help them enjoy a relative cost advantage and to price models at a competitive level.

We believe that the downward pricing trend is unavoidable in China, given the fast pace of new model launches (more

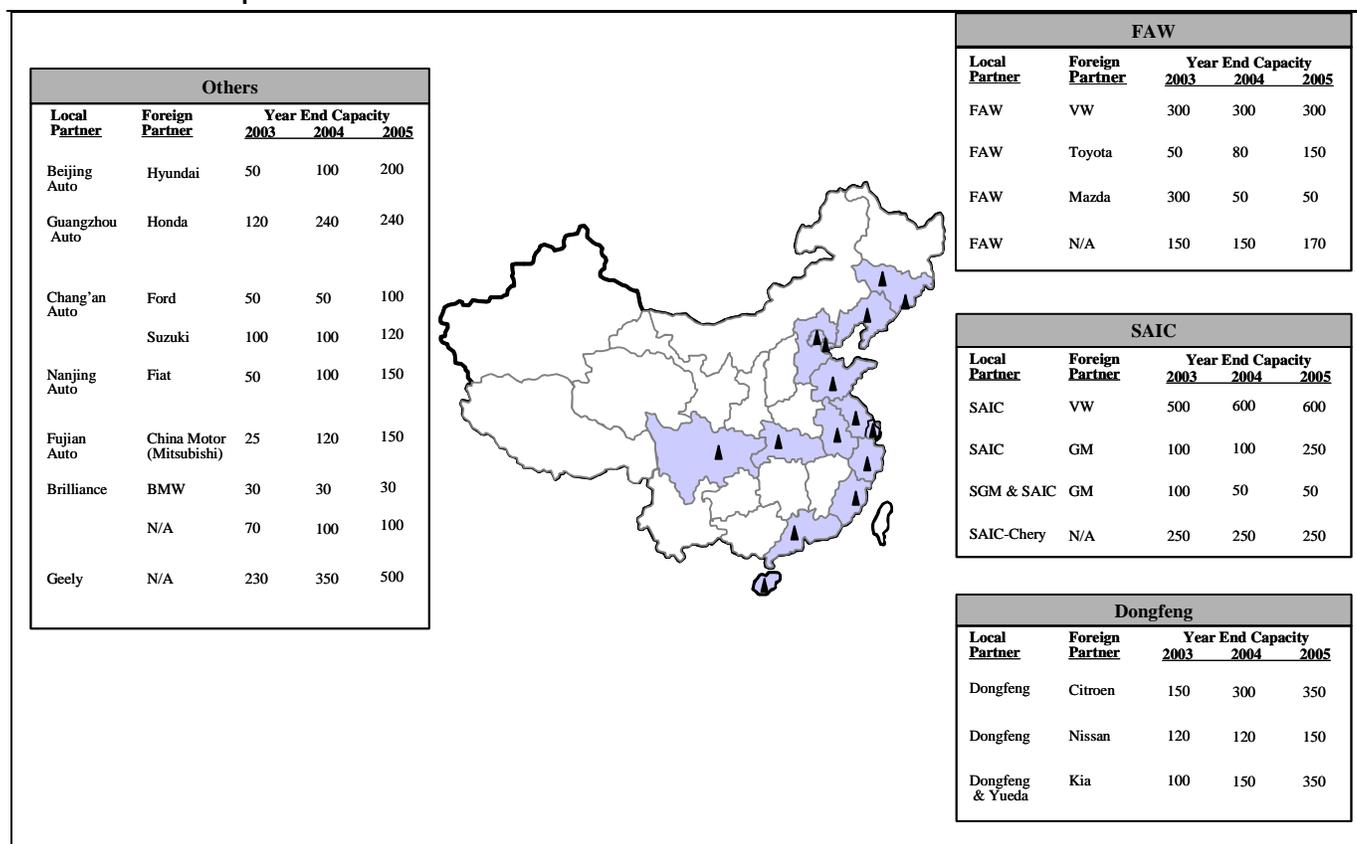
than 30 models were launched in 2002, over 40 in 2003). New models usually have lower costs due to declining component prices and greater scale, and are priced competitively versus older models. This slows the sales of the older models, forcing price cuts to remain competitive with new models.

Honda is leading the price cuts. The company has an advantage in that its local content appears to be the highest among the major companies (70–80%). Honda believes that Chinese car prices will ultimately fall to world levels, and its planning reflects this convergence. Declining import duties should accelerate the move to world price levels.

Honda has experience in this area, having dealt with price competition with Chinese local manufacturers in the motorcycle business. Management initially believed higher quality/strong brand image would justify a significant price premium over local motorcycles. This did not work, however, and local players undercut Honda and gained share. Seemingly, Honda is trying to avoid the same mistake in the automotive business. Cost reduction expertise from the motorcycle business may give Honda an advantage in lowering its vehicle manufacturing costs in China. Also, given Honda's apparent plans to produce the same models for export and domestic consumption (common platform), it may be cutting prices to facilitate ramping up scale on those models.

Exhibit 11

China Auto Landscape



Source: Company data, Morgan Stanley Research Data as of September 23, 2003 2004-05 data are Morgan Stanley estimates

Exhibit 12

Sedan Production Capacity

Country	Foreign	Local Partner	2002 Capacity	2003 Capacity (YE) (000 units)	2004E Capacity (000 units)	2005E Capacity (000 units)	2006E Capacity (000 units)	2007E Capacity (000 units)
Germany	VW	SAIC	400	500	600	600	800	800
Germany	VW	FAW	300	300	300	500	660	660
U.S.	GM	SAIC(SGM)	100	100	100	250	300	400
U.S.	GM	SAIC/SGM(Yantai)		100	50	50	50	50
Japan	Honda	Guangzhou Auto	60	120	240	240	240	240
Japan	Nissan/Renault	Dongfeng Fengshen	50	120	120	150	220	220
China	N/A	FAW Cars	60	30	60	80	80	80
Japan	Mazda	FAW Cars		30	50	50	50	50
Japan	Mazda	FAW Hainan	30	30	50	50	50	50
Japan	Toyota	FAW		50	80	150	200	200
China	N/A	FAW Xiali	150	150	150	170	170	170
Korea	Hyundai	Beijin Hyundai		50	100	200	250	600
France	Citroen	Dongfeng	150	150	150	150	300	300
Japan	Suzuki	Chang'an	100	100	100	120	120	120
U.S.	Ford	Chang'an		50	50	100	150	150
Taiwan	China Motor(Mitsubishi)	SouthEast Motor		25	120	150	180	240
Italy	Fiat	Nanjing Auto	50	50	100	150	150	200
Korea	Kia	Dongfeng/Yueda	100	100	150	350	550	550
China	N/A	Brilliance		70	70	70	70	70
Germany	BMW	Brilliance		30	30	30	30	30
China	N/A	SAIC Chery	100	250	250	250	250	250
China	N/A	Geely	150	230	350	500	500	500
		Total	1,800	2,635	3,270	4,360	5,370	5,930
		% Change Y/Y		46%	24%	33%	23%	10%

E = Morgan Stanley Research estimates

Competitive Structure

The competitive environment in China is intense and more complicated than in many other emerging markets.

- **China's market differs from others because of low barriers to entry and complex ownership structures.**
- **The result is a fragmented market. Consolidation and/or market-share battles seem likely.**
- **Product strategies vary among players.**

Brief Background: The Chinese Car Industry

The Chinese auto industry began roughly 50 years ago with the establishment of the government-controlled First Auto Works in Changchun. It has since evolved into several government-controlled enterprises, led by three state-level auto groups (directly owned by the central government) — First Auto Works (FAW), Second Auto Works (Dongfeng Auto), and Shanghai Automotive Industry Corp (SAIC) — and followed by a number of regional-level auto companies (owned by provincial governments), including Beijing Automotive Industry Corp. (BAIC), Changan Auto, Guangzhou Auto, and Fujian Auto. These companies can partner in joint ventures with foreign manufacturers (for a more detailed explanation, please see the Appendix). In addition, there are other indigenous private Chinese carmakers, which like the state-owned enterprises are able to produce their own vehicles or partner with foreign OEMs.

Please reference Exhibit 16 for a depiction of these relationships.

Surviving the competitive maze. Competition is occurring on a number of levels, which makes winners and losers difficult to sort out. For example, the three main government-sponsored entities compete on one level. Originally set up to produce vehicles in their own regions, these companies, along with their partners, are starting to venture out. For example, SAIC is now developing capacity in three sites other than Shanghai, increasing the level of competition. Although it appears that these government-sponsored entities no longer get special favors relative to other players, being among the first vehicle manufacturers in China, they typically have advantages in scale, technology, distribution, and financial resources. Their disadvantages often include poor corporate governance and redundant staff.

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Each of the government-sponsored entities has multiple multinational partners that compete in the marketplace. Some of them also have their own domestic (Chinese) ventures. For example, FAW has ventures with Volkswagen and Toyota; SAIC with Volkswagen and GM; and Dongfeng with Honda, Nissan and Peugeot, Kia, and Honda. Thus, VW, in a sense, competes with itself through its two ventures, both of which have their own distribution network. Allocation of product/technology across the ventures creates the potential for significant conflicts of interest.

Exhibit 13

China Market Share: Top Five Players

OEM	2003 Share
VW	32.2%
GM	9.3%
Honda	5.4%
Tianjin	5.3%
Peugeot Citroen	4.8%

Source: Company data, Morgan Stanley Research

There are indigenous private manufacturers, some of which also have multinational partners. These include Geely and Great Wall. The indigenous players represent 15–18% of the market and have developed their own products, which in some cases can look very much like some Western models. These companies can purchase high-quality components from outside suppliers and build cars that appeal to some segments of the market even if they are not the most sophisticated vehicles.

The low-automation model suggests that barriers to entry are very low and should decline further as the local supply base develops. As an example, Brilliance Automotive, one of China's indigenous manufacturers, outsources the design of its Zhonghua sedan to Italdesign of Italy, purchases an engine from the Mitsubishi affiliate SAME, sources most of the other components from Chinese or multinational suppliers, such as Delphi, and puts a sedan on the market for roughly Rmb 170,000, or a 21% discount to Honda's Accord and 15% to Hyundai's Sonata. While the Zhonghua may not have the best fit and finish compared with other vehicles (it did not appear to match the Honda Accord) and does not have the latest technology (such as dual-side airbags), the car appears reasonable for the market and is priced significantly lower than the Accord. A more devel-

oped local supply base could encourage the development of similar models.

Some Western manufacturers have cited indigenous manufacturers like Chery Corp. or Geely for copying their designs. VW and GM claimed that Chery had copied their designs of the Santana and Matiz, respectively. Toyota sued Geely for 14 million yuan (US\$1.7 million) in damages, alleging intellectual property rights violations. Toyota claimed Geely's Merry compact car logo was very similar to Toyota's and that Geely had used Toyota's name in its publicity campaigns. In response, the Chinese carmaker said it registered the trademark with the State Trademark Administration in 1996. It also said it mentioned Toyota's name in advertisements because Geely used 8A engines purchased from Toyota's engine subsidiary, Tianjin Toyota. The judge concluded that the logos were "obviously" different and would not cause confusion and misunderstanding among buyers.

Honda is reportedly seeking 25 million yuan (US\$3 million) from the Chongqing Lifan Motor Factory and the Chongqing Lifan Industrial Group for alleged economic losses caused by trademark violations. Thus far, attempts by established players to protect designs/technology have met with little success.

Exhibit 14

Logos - Geely (left) vs. Toyota (right)



Source: Company data, Morgan Stanley Research

The fate of the indigenous Chinese players is a source of much discussion. It is unclear whether the smaller manufacturers, some of which produce 5,000–10,000 units annually, will be able to acquire the scale and technology necessary to compete effectively in the future, or whether local/regional politics, low barriers to entry, and demand for low-priced vehicles will keep them afloat.

Before writing off the smaller indigenous players, it is important to note that a number of established motorcycle companies entered China thinking that their better product

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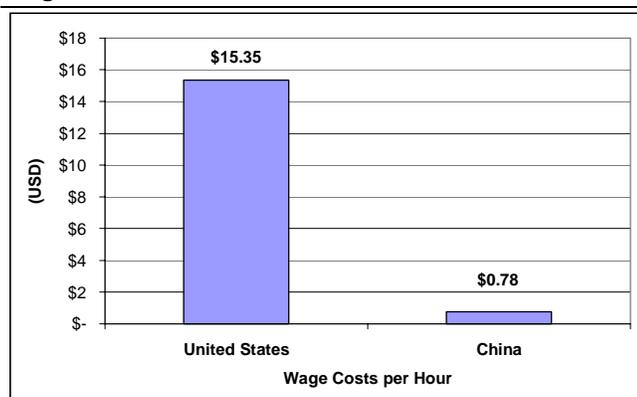
and technology would push the indigenous players aside. But the locals were able to acquire the technology to improve their product and continued to effectively supply the market.

The fate of the indigenous Chinese manufacturer is unclear. Can they acquire the scale and technology necessary to compete effectively? Will politics, low barriers to entry, and demand for low-priced vehicles keep them afloat?

A different production model keeps barriers to entry low. The Chinese assembly plants we visited differ significantly from those in more mature auto markets. In general, automation is much lower (40% or less in China vs. 85% at Hyundai Motor in Korea, for example). Lower labor costs are of course one driver of this phenomenon. However, in some cases, vertical integration is much greater. Modular assembly appears much more limited in China than elsewhere, and processes typically outsourced in Western facilities, such as machining, are usually performed in-house at Chinese assembly plants. Going forward, however, the level of automation in new capacity will likely be higher than in existing capacity, particularly for manufacturers that might want to export, as global quality standards could demand more automation.

According to Morgan Stanley economist Andy Xie, China's vast labor force of 750 million is larger than the total in all the OECD countries. Only half of the labor force has left their rural agricultural lands, and urbanization may take another three decades to complete. Until then, the constant flow of migrants looking for work is likely to hold down wages in China. In any industry where China chooses to compete, product prices will reflect China's rather than Western wages. In order to stay abreast of pricing trends, investors should monitor international prices for manufactured goods.

Exhibit 15

Wage Differences: U.S. vs. China

Source: BLS, Ministry of Labor and Social Security
 Based on average annual Chinese wage of 12,869 Yuan in 2002. Assumes 2,000 annual work hours

Government data suggests that Chinese workers in general earn only 5% of what U.S. hourly (nonfarm) workers earn,

and our discussions with Chinese auto companies suggest the difference between the two countries is even greater in the auto industry.

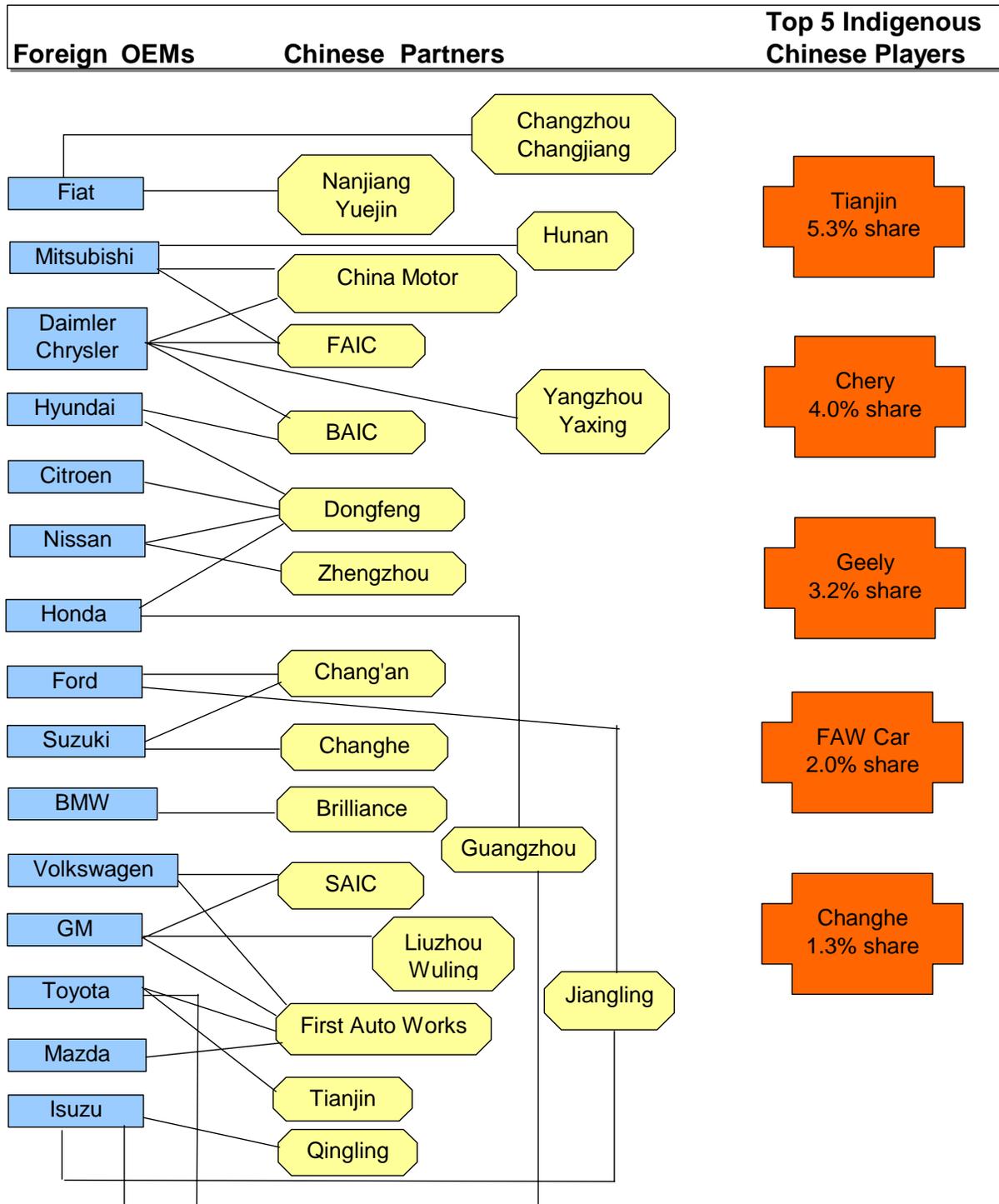
Product strategies are very different among OEMs.

Honda and GM have taken the approach of bringing relatively new product into the market. For example, Honda's second-generation Accord, built with Guangzhou Auto, is an identical model to the US Accord. Another example is the Buick brand, which is positioned near the top of the market, rivaling Audi, VW, and Honda. GM builds an Ex-celle that is the same model as the Daewoo Leganza. In other cases, companies may modify the brand or product for the local market. Honda modified its Fit, turning a mass-selling hatchback model in Japan into a sedan body (the most popular style in China).

VW, on the other hand, appears to be producing more dated product in China, including older versions of its Jetta and Golf model, as well as its Brazilian Gol. Little local market modification is made. The VW strategy may be lower cost in the near term, but could create brand risk longer term.

Exhibit 16

China Automotive Relationships



Source: Company data, Morgan Stanley Research

Note: BAIC = Beijing Auto Industry Corp; FAIC = Fujian Auto Industry Corp; GAIC = Guangzhou Auto Industry Corp; SAIC = Shanghai Auto Industry Corp

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Please see analyst certification and other important disclosures starting on page 29.

Potential Winners/Losers

- **Honda and GM appear well positioned.**
- **VW has a lot to lose — particularly if overall market demand were to slow, in our view. VW is losing market share, as many of its models are either outdated or not as competitive in the Chinese market.**
- **Outcome less clear for Ford, Toyota, Daimler-Chrysler, Nissan, and Hyundai**

Everybody Cannot Be a Winner Forever

Several automakers with the foresight to enter the market early have benefited from the rapid growth in demand. In the future, just being in China will not be enough to lead to increased earnings growth. **As per-unit profit declines (which we expect) and market share battles intensify with more competitors entering, not everyone will emerge a winner.**

Potential Winners

Honda and GM Appear Better Positioned Than VW.

Honda. We believe Honda has a strong product and production position. Its product line has a lot of component commonality, which should help it ramp its local purchas-

ing and enable its local suppliers to grow scale faster. Its newly launched Fit model shares most suppliers with its Accord and Odyssey and achieved 85% local content ratio upon launching. This should keep Honda at the low end of the cost curve relative to its peers.

Honda may face a distribution problem (similar to VW) with multiple partners, Dongfeng and Guangzhou Auto. However, Honda's partners are both in the same region within China. Thus, a merger is not impossible and could be a solution. Honda could also utilize its multiple partners to produce SUVs and Acura models through one channel and Honda sedans through the other.

GM. GM's strategy of having a single major partner avoids many of the conflict issues that VW and Honda face (GM technically has a joint venture with First Auto Works, but it is relatively small). In addition, GM's product strategy appears very solid. The Buick brand is positioned against VW's Audi and Passat brands in China, as well as against the Honda Accord. GM is planning to bolster the presence of the Chevrolet and Cadillac brands in its Chinese lineup. GM's products appear to be better-received than Chrysler's and Ford's, as evidenced by GM's 9.3% market share in the Chinese sedan market.

Exhibit 17

China Car Industry Market Share (2003)

	Company	Sales Volume			Market Share		
		2003	2002	YoY %	2003	2002	Inc./Dec. %
Top 10	SAIC VW	396023	301095	32%	18.4%	23.7%	-5.4%
	FAW VW	297995	207700	43%	13.8%	16.4%	-2.5%
	SAIC GM	201188	110763	82%	9.3%	8.7%	0.6%
	GZ Honda	117129	59151	98%	5.4%	4.7%	0.8%
	Tianjin Auto	113706	95433	19%	5.3%	7.5%	-2.2%
	DF-Citroen	103126	85088	21%	4.8%	6.7%	-1.9%
	Chang'an Suzuki	100018	65018	54%	4.6%	5.1%	-0.5%
	SAIC Chery	85349	50155	70%	4.0%	4.0%	0.0%
	Geely	69289	43500	59%	3.2%	3.4%	-0.2%
	DF Nissan	65120	41060	59%	3.0%	3.2%	-0.2%
	Total Top 10	1548943	1058963	46%	73.9%	83.5%	-11.6%
Runner Up	Hainan Mazda	54406	18515	194%	2.5%	1.5%	1.1%
	BAIC Hyundai	52128	1002	5102%	2.4%	0.1%	2.3%
	FAW*	51266	26634	92%	2.4%	2.1%	0.3%
	DF Yueda Kia	51008	20754	146%	2.4%	1.6%	0.7%
	Tianjin Toyota	49457	2040	2324%	2.3%	0.2%	2.1%

Note: FAW has a technical license with Mazda. 50% of FAW's sales volume is Mazda 6.

Source: Company Data; Morgan Stanley Research.

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Potential Losers

Volkswagen (Underweight): VW was the first foreign auto company to establish a joint venture in China, first with FAW and subsequently with SAIC. FAW and SAIC were by far the largest Chinese auto companies, giving VW a sedan market share as high as 90% in the 1980s. While VW leads in market share in China at 32.2% in 2003, we believe it must improve its product and distribution strategies.

The company also has the most to lose, with its market share having fallen to 32% in 2003 from 40% in 2002. VW currently derives an estimated 30–40% of its profits from its Chinese operations. In our view, its current product strategy is less competitive than its peers. While the overall market may expand rapidly, if Volkswagen's profit per vehicle declines faster, overall profitability could suffer.

We believe VW needs a fresher product lineup. Its brand is currently positioned near the top of the market, but with GM and Honda competing with fresh product, VW will need to launch more competitive models or risk seeing its brand image fall.

We believe VW also has issues on the distribution front. Its venture with FAW produces models that include the Jetta, Bora, Golf, Audi A6, and Audi A4. Its venture with SAIC produces the Santana, Passat, Polo, and Gol. Each of these ventures has its own dealer network. Thus, instead of being able to go to any Volkswagen dealer, Chinese consumers must go to a specific dealer for each venture. VW would like to consolidate the distribution network, but its Chinese partners are highly competitive with each other and have not allowed it to do so. The separate distribution channels are inefficient and can confuse the customer.

Exhibit 18

Volkswagen — China profit per unit



Source: Company data, Morgan Stanley Research

PSA Peugeot-Citroen (Overweight, €39.52, €45 price target): PSA is an incumbent in the Chinese market with the Citroen brand and is one of the top five market-share holders. But its market share has been under pressure, as the current model lineup is increasingly outdated relative to new competition. Peugeot finished 2003 with 4.8% of the sedan market, down from 6.5% at the start of the year. PSA is in the process of introducing a range of models under the Peugeot brand, as well as launching more updated Citroen models, which should help stop the share slide. PSA has one joint venture partner, Dongfeng, in Wuhan. However, we believe that Dongfeng's multiple partnerships with several other automakers could potentially relegate Peugeot to second-tier status. In addition, Dongfeng is 50% owned by Nissan, which is in turn 44% owned by Peugeot's arch French rival, Renault. This could potentially leave PSA in an awkward strategic position. Also, Wuhan is approximately 500 miles from the coast, a disadvantage from an exporting perspective.

Dongfeng-Peugeot-Citroen is spending €600 million to double manufacturing capacity to 300,000 units by the second half of 2006. We expect PSA to benefit from market demand growth, but will have to increasingly fight against foreign rivals to defend share. PSA appears to be spending far less for its capacity expansion on a per-unit basis than VW — roughly €4,000 per unit, compared with VW at €6,250 per unit. According to PSA management, Chinese margins are in the low double-digit range.

Unclear

Toyota, Nissan, Ford, Daimler-Chrysler, and Hyundai Motor are all just getting started in China. These companies have an advantage in that they can learn from others' mistakes. On the other hand, they are several years behind in establishing manufacturing, brand image, and distribution. Toyota's strategy is likely to turn more aggressive. The company plans to add 150,000 units of capacity in the next three years. In addition, discussions with Chinese consum-

ers suggested that Japanese brands have high perceived quality.

Asian-oriented OEMs, including Japanese and Korean firms, are quickly catching up in China. In 2003, the top three share gainers among JV operations were all linked to an Asian manufacturer – BAIC Hyundai, Tainjin Toyota, and GZ Honda.

Auto-Related Impact

Growth in the Chinese market should be a modest positive for many (though not all) major OEM suppliers.

These suppliers have an opportunity to both gain business in the domestic Chinese market and use China as an export base. For tire, aftermarket, and wheel companies, the outlook is less clear — with China both a potential threat and an opportunity.

The key to gaining domestic business for OEM suppliers, in our view, will be growth in the overall market and increased efficiency versus local players. Large multinational suppliers should be more efficient than local Chinese suppliers. From an export perspective, global OEMs are likely to continue to push their supply base to move to China in an effort to reduce parts costs (on a \$45 tire).

Domestic Market Opportunity Is a Modest Positive

Major US and European suppliers are already operating in China. For example, Delphi generated \$650 million in consolidated sales (about 2.3% of sales) from the Chinese market in 2003. In addition, Lear and Johnson Controls have developed joint ventures to serve this market. Lear currently generates about 1% of its sales, or \$150 million, in China through both consolidated (\$100 million) and non-consolidated ventures (\$50 million). Johnson Controls has said that it has more than \$800 million in non-consolidated sales from China. We estimate Autoliv generated 2%, or \$100 million, in 2003 sales from China, an amount likely doubling by 2006.

The impact thus far is less substantial for Japanese companies, but they are also investing for growth. Currently, Japanese suppliers are seeing only a limited earnings impact from their China operations. Denso's sales from its China operations currently total about ¥20 billion, a tiny 0.8% of its aggregate sales. Denso is reinforcing its six existing China plant operations and constructing new plants in places like Guangzhou, Shanghai, and Tianjin. It plans to achieve sales of ¥100 billion by 2010 and to become the No. 1 auto parts maker operating in China. Its main customers in China are Toyota and Honda.

Aisin Seki is expected to generate China-based sales of slightly more than ¥10 billion (based only on auto parts) and operating profit of around ¥1.4 billion in F2003, or 0.6–0.7% of its total sales and just under 2% of its total operating profit. From F2003, Tangshan Aisin, which makes

manual transmissions, has been added to consolidated accounts. We expect Keihin's China operations, which are involved in making Honda-related motorcycle parts, to generate F2003 sales of around ¥8 billion, some 3% of total company sales. Koito Mfg expects its China subsidiary, Shanghai Koito, to see sales of ¥15.7 billion and operating profit of ¥1.2 billion in F2003. These amounts correspond to just under 5% of total sales and just under 9% of total operating profit — high ratios, but an isolated case.

OEMs Are Pushing for Chinese Sourcing

Ford and GM have both been very public about their desire to purchase more components from low-cost countries, China in particular. For example, GM recently stated that it intends to purchase \$4 billion of components from China (for GM assembly plants outside of China) annually in the next five years. GM also plans to purchase \$6 billion of Chinese parts annually for its China operations. We note that this compares with a total global material buy of roughly \$80 billion annually. Ford said that it aimed to source \$1 billion of auto parts from China for its overseas operations in 2003.

Exports started with basic commodities, such as castings, forgings, tires, batteries and glass, and over time will include more sophisticated parts. In addition to parts that do not ship well, such as seats, the last parts to be exported are likely to be low in labor content and heavily electronic in nature, such as engine electronic control units.

We believe tires are a good example of an area ripe for greater sourcing from China. Hankook, a Korean tire manufacturer, has set up a big tire manufacturing facility in China, with the goal of developing significant exports. Ford is purchasing Chinese-made Hankook tires for the F-Series pickup in the US and the Mondeo in Europe. With labor representing roughly 30% of the cost of a tire, we estimate that a tire can be produced and landed in the US market roughly \$7–9 cheaper than a tire made in the United States. Other areas that could be ripe for greater Chinese sourcing include radios and electronics.

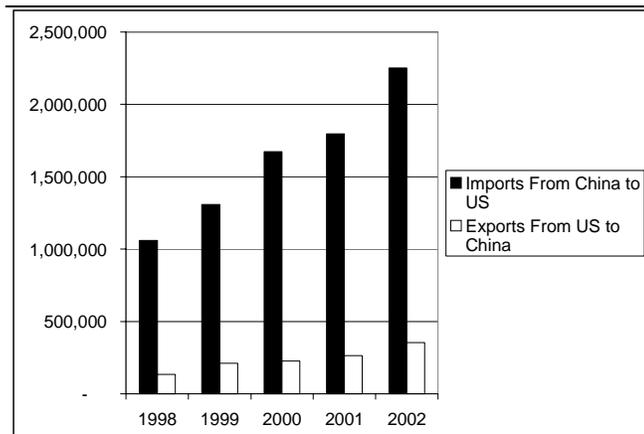
Aftermarket Impact Is Significant

Chinese sourcing has affected the aftermarket and is likely to continue to do so. The US imported \$2.25 billion of auto parts from China in 2002 (we estimate a substantial portion

went to the aftermarket), a 112% jump from the \$1.07 billion imported in 1998.

Exhibit 19

Trade Deficit With China Grows — Auto Parts



Source: Department of Commerce

China was the fifth-largest source of automotive parts imports to the United States, but remains well behind Mexico (imports from China were 11.6% of those from Mexico in 2002), Canada, Japan, and Germany. Some of the bigger components exported from China were radios, drivetrain components, and brakes.

Auto parts retailers should also benefit from increased production of aftermarket parts in China, as this should reduce the cost of parts purchases (and should help expand gross margins if the companies can keep some of the savings). AutoZone (rated Overweight by Greg Melich, \$90.39, \$100 price target) and Advance Auto Parts (rated Equal-Weight by Greg Melich, \$42.07) are potential beneficiaries.

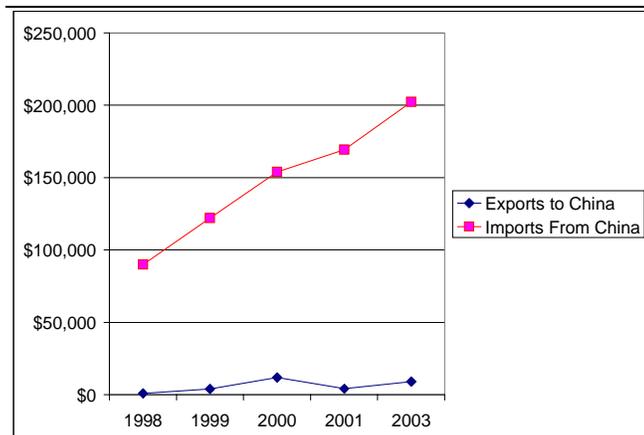
China Could Be a Threat to Tire and Wheel Companies

This is not to suggest that all suppliers are beneficiaries. Suppliers unable to move product to Chinese sourcing as rapidly as competitors could be at risk of both negative price and/or volume implications. Tire and wheel companies fall into this category. For example, Superior Industries recently announced a disappointing forecast. The company blamed pricing pressure from Chinese competitors as a significant reason for the forecast.

We have previously highlighted tire companies with substantial production capacity in high labor-cost countries as examples of companies that face risk if they do not move their sourcing to low-cost locations (particularly for low cost tires). Underweight-rated Cooper Tire & Rubber is one of those companies.

Exhibit 20

Trade Deficit with China — Brakes



Source: Dept. of Commerce. In \$000.

Where Do We Go from Here?

The three biggest questions investors currently have about China are:

- Are there likely to be significant vehicle exports from China?
- Will margins in the region fall to more normal levels in the near future?
- Is there a bubble in the vehicle market?

The answers in our opinion are yes, yes, and maybe.

Exports Are Likely

We believe that all manufacturers have at least a “Plan B” to export cars from China if domestic demand does not absorb domestic capacity. We would point out that most OEMs have located manufacturing facilities near the coast and, thus, have easy access to shipping. To be an efficient exporter, manufacturing costs need to come down and quality needs to improve. With domestic volume ramping up rapidly, and more supplier investment coming into China (reducing the need for imported components), we would expect costs to fall sharply in the near term.

We estimate that direct labor at the OEM level for Western companies, including benefits, is \$1,500–\$2,300 per car. If labor in China were one-tenth of Western levels and shipping were roughly \$400–500 per car, the economics would clearly favor exports.

Currency revaluations could change the economics of exporting at the margin.

Margins Are Likely to Compress

While unit volume should continue to grow, we expect increasing competition, increased investment in new products, and greater supply relative to demand longer term to lead to margin compression.

In the words of Morgan Stanley economist Andy Xie, the important themes to remember are (1) whatever China *cannot* produce is likely to become dearer, (2) whatever China *can* produce is likely to become cheaper, and (3) competition may keep profits low even if growth is high.

Bubble?

While we do not think the Chinese auto market is being directly over-inflated by cheap capital, there does exist the possibility that the Chinese consumer, in general, is at risk of a contraction. If real estate prices were then to fall, there would be less equity in housing against which to borrow. As previously mentioned, purchasing cars on credit currently appears limited to roughly 10% of the market. However, if such consumers are borrowing against possibly over-inflated real estate and using that money to buy a car, the car market may be indirectly inflated.

Appendix

Background: The Chinese Car Industry

The Chinese auto industry as we now know it began life roughly 50 years ago with the establishment of the First Auto Works in Changchun. It has since evolved into several government-controlled enterprises, led by three state-level auto groups (directly owned by the central government) — First Auto Works (FAW), Second Auto Works (Dongfeng Auto), and Shanghai Automotive Industry Corp. (SAIC). These were followed by a number of regional-level auto companies (owned by provincial governments), including Beijing Automotive Industry Corp (BAIC), Changan Auto, Guangzhou Auto, and Fujian Auto. These companies can partner in joint ventures with foreign manufacturers (in addition to their own production). There are also other indigenous private Chinese carmakers, which like the state-owned enterprises are able to produce their own vehicles or partner with foreign OEMs.

In 1994, the Chinese government issued the first version of its auto policy to regulate and encourage the development of the auto industry. Key rules for foreign investment included:

The 50% rule: Foreign automakers cannot own more than 50% of any automobile and engine joint venture in China, which means they have to ally with local automakers. This rule is designed to protect local automakers. The domestic car industry was in its infancy when the policies were established and relied heavily on imports. Most auto companies made only commercial vehicles, including trucks and buses, and were not competitive in car manufacturing.

Partnerships: Foreign automakers cannot have more than two local partners within one segment (commercial vehicle vs. cars). This does not apply to local automakers, so they can team up with more than two foreign OEMs. This rule is also aimed at protecting local auto makers. When this rule was established, local carmakers were eager to team up with foreign OEMs, which could bring in capital, models, technology, expertise, employment, and profits. If foreign OEMs were able to partner with more than two domestic companies, the local carmakers' bargaining power likely would be hurt as they would compete with each other for capital, models, etc.

In summary, the purpose of this auto policy was to employ foreign investment in the China car industry while also protecting local automakers.

Right now, the industry can be characterized as high growth with low barriers to entry and low capital intensity. As an example, Brilliance Automotive, one of China's indigenous manufacturers, outsourced the design of its Zhonghua sedan to Italdesign of Italy; it purchases an engine from Mitsubishi affiliate SAME, and puts a sedan on the market for roughly Rmb 170,000, or a 21% discount to Honda's Accord and 15% to Hyundai's Sonata. While the Zhonghua might not have the best fit and finish compared with others and does not have the latest technology, such as dual/side airbags, the car appears reasonable for the market. Other indigenous players have gone so far as to build cars that closely resemble established products. This includes Chery, which VW and GM have cited for copying the designs of the Santana and Matiz. There have been several legal battles, but attempts by established players to protect designs and technology have met with little success thus far.

China's New Auto Policy Discussion

New auto regulations are expected to be announced by the Chinese government in the near future. Some existing regulations are not expected to be changed. These include the rules that foreign automakers cannot own more than 50% of joint ventures and cannot have more than two local partners within one segment.

The rules that may change include:

A push for localization: The concept of a 40% local content ratio will not only apply to the total value of a car but also to a number of key parts, which we believe will be difficult to accomplish. Due to the hot demand and intensifying competition, OEMs quickened the launch of new models, relying heavily on imported parts when localization work lagged. If the Chinese government wants to be a global car parts supply and automobile export base, we believe the upstream car industry needs to quickly scale up and rely less and less on imports.

Encourage industry consolidation: Foreign automakers will be allowed and encouraged to merge or acquire Chinese partners to tap and develop the market, rather than create greenfield projects (plants started from scratch).

Protect domestic OEMs: China does not want to be the next Brazil, which has very few domestic automakers. We expect that the government will include a number of measures to protect local and joint-venture OEMs. Split brand management — where a dealer can distribute only one brand — will likely be a key measure. VW is an example — Shanghai VW, FAW VW, and imported VW are considered as three brands, so their distribution networks cannot be integrated. This measure means that imported cars could not share a network with local cars, even if they belong to one global brand.

Chinese Auto Credit

Foreign auto financiers were granted the right to set up operations in China under the WTO accord signed in 2000, but

the government was slow in releasing relevant regulations. Recently, further details were released that establish the regulations for setting up auto financing companies (AFCs). Details included items such as stipulations that minimum registered capital must be Rmb 500 million (roughly \$60 million). Foreign companies including GM and Ford have moved to set up AFCs. GMAC has been granted approval to set up an AFC and is in the midst of establishing one with its partner SAIC. The venture expects to be making loans in mid-2004. These new auto finance companies will compete with Chinese banks and will be allowed to offer items such as subvented loans (loans where the interest rate is subsidized by the automaker).

Exhibit 21

China Automotive Partnerships by Foreign OEM

Foreign OEM	Chinese Partner	Joint Venture
General Motors	SAIC Liuzhou Wuling First Auto Works	Shanghai GM, Shandong GM, Wuling GM Wuling GM Shenyang GM
Toyota	Daihatsu First Auto Works Guangzhou Tianjin	FAW Xiali, Tianjin Toyota FAW Xiali, Tianjin Toyota, Sichuan Toyota Guangzhou Toyota Tianjin Toyota
Volkswagen	SAIC First Auto Works	Shanghai VW FAW VW
Ford	Chang'an Jiangling	Chang'an Ford Jiangling Auto
Nissan	Dongfeng Zhengzhou	Dongfeng Nissan Zhengzhou Nissan
Suzuki	Chang'an Nissho Iwai Changhe	Chang'an Suzuki Chang'an Suzuki Changhe Suzuki
Isuzu	Qingling Jiangling Itochu Guangzhou	Qingling Motor Jiangling Isuzu Jiangling Isuzu Guangzhou Isuzu
Honda	Guangzhou Dongfeng	Guangzhou Honda, Honda Export Base Dongfeng Honda, Honda Export Base
Hyundai	BAIC Dongfeng Yuida Investment	Beijing Hyundai Kia Yueda Kia Yueda
BMW	Shenyang Gov't Brilliance	Brilliance BMW Brilliance BMW
Mitsubishi	FAIC China Motor Hunan Auto Group	Southeast Motor Southeast Motor Hunan Changfeng
DaimlerChrysler	BAIC Yangzhou Yaxing FAIC China Motor	Beijing Jeep, Beijing Benz Yaxing Benz Fujian Benz Fujian Benz
Fiat	Nanjing Yuejin Changzhou Changjiang	Nanya Auto, Nanjing Iveco Changjiang Iveco
Citroen	Dongfeng State Development Bank Shina Oriental Asset Mgmt Societe Generale BNP Paribas	Dongfeng Citroen Dongfeng Citroen Dongfeng Citroen Dongfeng Citroen Dongfeng Citroen
Mazda	First Auto Works	Hainan, FAW Car

Source: Company data, Morgan Stanley Research

Exhibit 22

China Automotive Partnerships by Chinese Partner

Chinese Partner	Foreign OEM	Joint Venture
BAIC	Hyundai DaimlerChrysler	Beijing Hyundai Beijing Jeep, Beijing Benz
Brilliance	BMW	Brilliance BMW
Chang'an	Ford Suzuki	Chang'an Ford Chang'an Suzuki
Changhe	Suzuki	Changhe Suzuki
Changzhou Changjiang	Fiat	Changjiang Iveco
China Motor	Mitsubishi DaimlerChrysler	Southeast Motor Fujian Benz
Dongfeng	Nissan Honda Hyundai Citroen	Dongfeng Nissan Dongfeng Honda, Honda Export Base Kia Yueda Dongfeng Citroen
FAIC	Mitsubishi DaimlerChrysler	Southeast Motor Fujian Benz
First Auto Works	General Motors Toyota Volkswagen Mazda	Shenyang GM FAW Xiali, Tianjin Toyota, Sichuan Toyota FAW VW Hainan, FAW Car
Guangzhou	Toyota Isuzu Honda	Guangzhou Toyota Guangzhou Isuzu Guangzhou Honda, Honda Export Base
Hunan Auto Group	Mitsubishi	Hunan Changfeng
Jiangling	Ford Isuzu	Jiangling Auto Jiangling Isuzu
Liuzhou Wuling	General Motors	Wuling GM
Nanjing Yuejin	Fiat	Nanya Auto, Nanjing Iveco
Qingling	Isuzu	Qingling Motor
SAIC	General Motors Volkswagen	Shanghai GM, Shandong GM, Wuling GM Shanghai VW
Shenyang Gov't	BMW	Brilliance BMW
State Development Bank	Citroen	Dongfeng Citroen
Tianjin	Toyota	Tianjin Toyota
Yangzhou Yaxing	DaimlerChrysler	Yaxing Benz
Zhengzhou	Nissan	Zhengzhou Nissan

Source: Company data, Morgan Stanley Research

Note: BAIC = Beijing Auto Industry Corp; FAIC = Fujian Auto Industry Corp; GAIC = Guangzhou Auto Industry Corp; SAIC = Shanghai Auto Industry Corp

Exhibit 23

Foreign OEM Products in China by Joint Venture

Foreign OEM	Joint Venture	Products
General Motors	Shanghai GM Shandong GM Wuling GM Shenyang GM	Buick Regal, Excelle, Buick GL8 Sail & SRV Spark, Wuling Minibus Chevrolet Blazer, S-10 Pickup
Toyota	FAW Xiali Tianjin Toyota Sichuan Toyota Guangzhou Toyota	Xiali, Yakoo, Vitz, Terios, Vios Vios Coaster Bus, Prado, Land Cruiser Camry
Volkswagen	Shanghai VW FAW VW	Santana, Passat, Polo, Gol Jetta, Bora, Golf, Audi A6, Audi A4
Ford	Chang'an Ford Jiangling Auto	Fiesta, Mondeo Transit CV, Jiangling CV
Nissan	Dongfeng Nissan Zhengzhou Nissan	Bluebird, Sunny, Dongfeng Trucks Paladin, Nissan Pickup
Suzuki	Chang'an Suzuki Changhe Suzuki	Alto Wagon Minibus
Isuzu	Qingling Motor Jiangling Isuzu Guangzhou Isuzu	N-Series, F-Series, Rodeo Jiangling light trucks Isuzu long bus
Honda	Guangzhou Honda Dongfeng Honda Honda Export Base	Accord, Odessey MPV, Fit CR-V Fit
Hyundai	Beijing Hyundai Kia Yueda	Sonata Pride, Qianlima (Accent)
BMW	Brilliance BMW	325, 5 series
Mitsubishi	Southeast Motor Hunan Changfeng	Freeca, Delica, Lancer Pajero IO, Cheetah
DaimlerChrysler	Beijing Jeep Beijing Benz Yaxing Benz Fujian Benz	Cherokee, Pajero Sport, BJ Jeep2500 Benz C&E Yaxing brand long bus, Benz brand long bus Sprinter
Fiat	Nanya Auto Nanjing Iveco Changjiang Iveco	Palio, Siena Iveco CV Iveco long bus
Citroen	Dongfeng Citroen	Citroen, Elysee, Xsara, Picasso SMPV
Mazda	Hainan FAW Car	Familiar, Premacy Mazda 6, Red Flag, Luxury Red Flag

Source: Company data, Morgan Stanley Research

Note: BAIC = Beijing Auto Industry Corp; FAIC = Fujian Auto Industry Corp; GAIC = Guangzhou Auto Industry Corp; SAIC = Shanghai Auto Industry Corp

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Equal-weight	823	46%	285	46%	35%
Underweight	396	22%	96	15%	24%
Total	1,808		621		

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