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Cederberg Capital Investor Day Fireside Chat – November 2020

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Dawid Krige:

Ladies & Gentlemen, it's my huge pleasure to be joined by Meidong Auto CEO, Mr Tao Ye, as well as Head of Investor Relations Winny Yip. Winny, I've known for, well over ten years, maybe even 15 years. And I'm very happy to see that she's ended up with such a fine company, Meidong. Tao, I think we've known each other for about six, seven years, and finally became your shareholder earlier this year. And thank goodness. I only waited six years, and not six-and-a-half-years because the share price has already doubled. So, I say thank you, and we're looking forward to the long-term journey with you.

Tao Ye:

Thank you very much. And it's a great honour to have you into our family. Thank you for your support.

Dawid Krige:

No, I appreciate that. So, a bit of background; Tao and his brother, Fan, the CEO and Chairman, respectively of Meidong are the majority shareholders and I believe Cederberg is the second-largest owning just shy of 5%. Tao, Luke (Hong, Cederberg Analyst) has talked about financial metrics, but I think the audience would love to learn a bit more about you, maybe starting off with your childhood; where did you grow up and what were your earliest ambitions? I'm sure you always wanted to go into cars...

Tao Ye:

Well, how should I start? I've always had the dream to be a scientist up until the mid-twenties of my life. So, I went to college, studying Applied Math at Beijing University.

Dawid Krige:

Which is extremely difficult to get into? That must've been quite a challenge?

Tao Ye:

Well at the time it was. I went to college in 1985 – I don't remember the exact stats, but maybe 5% of high-schoolers, went to college at the time. And out of that 5%, you have the top two universities in China. One is Tsinghua, the other is Beijing University. Both of which are obviously very competitive. And I was very lucky to get into Beijing to study Applied Math. I spent four years there and then went to grad school right after my undergrad, still with the intention to do research. First, I studied engineering, at the University of California, Santa Barbara campus - Material Science and Engineering, and then to MIT, to study mechanical engineering. And then I got business degree out of Sloan School as well.

Somewhere along the line, I found my calling to work for companies, to make money, not so much about starting companies, I wanted to make money. I was feeling the burden of being an adult. I went to a bunch of large companies - Eastman Kodak, Intel and Teledyne, worked briefly and then realised maybe I wanted to do companies on my own. So, in 1999 I started my first company with a classmate of mine out of MIT. And the rest, I guess, is history.

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Dawid Krige:

That's a quite a journey from China - back then very poor - taking you to California, taking you to Boston. Tell us a bit more about this company that you started in 1999. We'd also love to hear how it was to be a Chinese person in the US, in the nineties? It must've been a completely different world to you.

Tao Ye:

I got extremely lucky. I met and befriended a classmate; Doug Winter. We started a company - Objectiva Software Solutions. Well, let me tell you something about Doug. First, I am (in my good days), five feet two, and he's six feet tall. So, the two of us, when we are together, you can't really see me. I mean, you can only see Doug. We can't really do selfies together because when he's holding the camera, he can't see me, when I hold the camera, I can't see him. So, whenever we do selfies together, we have to sit down and do it properly. He and I started Objectiva, and we grew it organically - we never sought outside funding and we grew eventually to about 500 people. Along the way we merged with a small software company out of San Diego.... In 2008, I believe, three months before the financial crisis, we sold the company to EMC. So that's first part of my career starting and managing software companies in a bicultural setting; out of 600 people in the company, we had a hundred in the US, and about 500 in China, where I stayed and managed.

Dawid Krige:

So, when did you actually return to China?

Tao Ye:

In 1999, when we started the company, shortly after that I went back to China to hire engineers, to start to build what we called the Development Centre. Essentially at the time, in the beginning was an arbitraging business, of outsourcing.

Dawid Krige:

So, from 1999, you moved back to Beijing to start and run the China part of Objectiva, which you guys sold in 2008. And then you had some time out?

Tao Ye:

My brother, in about 1999, around the same time, started his first dealership business. Now, a word about my brother - he has never done anything in his life except for one thing, and one thing only because he loves cars. His biggest passion is cars. Ever since he graduated from college in 1993, I remember that at the time we were not a wealthy family, ... kind of a middle-class family at the time, but my father would occasionally get a chance to go to Hong Kong, to travel on business travel. And that was pretty treasured at the time.... My father would buy a lot of those glossy car magazines for him at the time which weren't available in China. Right now, it's very prevalent, really glossy, good looking, car magazines. And he would have a full wall of those magazines stacking up. So, he's always been a very lucky person; I would think that somebody who could work on his passion and end up making a bunch of money from it... he is a very lucky guy. He's even luckier today because I'm doing most of the work now.

Dawid Krige:

Ha-ha. You have to help out your younger brother.

Tao Ye:

In 2008 he was asking me... Come to my dinky little company and to see what you can fix, because I'm having bandwidth issues with fixing the company. So, we're the only brothers and so I came back..

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Dawid Krige:

What was the company like back then in terms of the brand you were working with, the number of dealerships, the staff?

Tao Ye:

So, it was a five-dealership company. There were two big problems:

One is that each dealership has different shareholders. In the early days in China business – it was the Wild Wild West, right? You collaborate with different people on different businesses, and then you own a small share, sometimes over 50%, sometimes far less than 50%. And then you work with five different guys on one dealership and you work with six other different guys at different dealerships. As you can see - this kind of the shareholding structure is a maze. So that's number one.

Number two, at the time, it was so early... essentially a license to print money, regardless of what cars you sell, what customer service you provide, how you run your business, you're going to make money. It's a matter of more or less. So, there's no concept of management in a modern sense. It was very interesting and I decided to come back and just spend a few months helping my brother fix the company and then go back to my IT gigs, whatever they may be.

Educated like I was and, perfectionist, like I was, I wound up in three or four months firing all his managers. And my brother said, "Well, now you have to do it because how could you leave?"

Dawid Krige:

And you fired them because they were incompetent or because there was corruption, or what was the backdrop?

Tao Ye:

Well, just make a checklist - all of the above, you tick all of them.

Then we decided to select people that we deemed culturally fit, and then we tried to train them. I'm very lucky to have a great business partner in Doug Winter, and also a great brother plus business partner in my brother, as well. Those are the only two people I've partnered with in my life, and they all turned out to be great. My brother and I have been working together fairly closely, we fight and argue all the time of course, almost daily. But the thing that I value tremendously in a business partnership, and the thing I also had with Doug and the one that I'm having now with my brother, is that we share very common value system. And those value systems stay very, very strong and steady. We are managing to pass them on to the organisation and to instill those values systems to the extent we can into the employee's behavior. But now I'm jumping ahead a little in answering your question...

I think fundamentally what's more important in business, especially in a highly competitive and in the mature business that we are in, the cohesiveness of your culture, both operationally, as well as your fundamental values in your culture is what sets people apart. With a cohesive institutionalised and stable culture you can attract the same sets of people and filter out the people that don't share the same value system. And then you wound up getting stronger and stronger as you move forward, because the people who share the same culture get to be much more productive in the same cultural setting.

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By the way, our culture is very simple. It's only: simple, direct, and data-driven. That's it.

Dawid Krige:

Those three things; simple, direct, data-driven. And was that the sort of culture, those principles, were they established on day one, or would you say it's been through being sort of battle-tested, and through trial and error that you've focused on these three?

Tao Ye:

Well, we are not geniuses, so we don't really see things from day one. We never do. We never did actually. So, everything we have learned, are learnt through trial and error. But we have a fairly rapid cycle of trial and error, meaning that instead of testing our system every year, every six months, we almost review them on a daily basis. We are always very focused and think about what we've done wrong and what you've done right and what is still in the grey areas of right and wrong. And we filter them out. The same thing happened with the culture. You can imagine somebody who's fairly well-educated like I was, coming into a company - I could certainly write books about how you should behave and how we should behave, and what is the culture of staff. So, I did that. I wrote really thick documents, thousands of lines, like I was writing a code.

Over time you find out that not only do you want to tell people what you want to say, but it's far more important realise what people want to hear as well as what they can understand. So gradually, in the cultural statement, through a very good trial and error process we gradually distilled down into only those four words, simple, direct, data-driven. It's over time distilling. In the very beginning, of course we have many, many things.

But let me talk to you a bit more about culture. I think that's fundamentally very, very important - culture is something that my brother and I, and Doug were always very aware of the fact that the number one criteria for company culture is that the owners has to live it. And so, my brother and I have to exemplify the culture. We will never write down things that we cannot do ourselves. We are both fairly simple. We're both very direct and we're very, very data-driven. So, yes, we can do it. And then we select people, sometimes ruthlessly filter people out, if they don't fit, because we only want... it's not a statement of good or bad. It's a statement of fit or unfit in the culture. If you don't fit, regardless how good you are, you should leave. If you fit, then you should stay and then we should work together to improve. So that's number two. And then if you have those two things combined it is very, very powerful. Sometimes I laugh a little bit when I see a culture statement that is too comprehensive, and too encompassing, because if you write a thick, novel on culture - you can always do that - but the question fundamentally I have to ask myself is, can I do it? if I can't live the culture, then people are smart. Employees are very smart, customers are very smart. They see through you, regardless what fancy words you put on the culture. Am I talking too much on this? Because this is important.

Dawid Krige:

No, I think culture is extremely important. We're big believers in culture, both the companies we invest in, as well as our own culture. And I think, especially in an auto dealership – something I would classify as a tough industry. Most of your competitors aren't profitable or certainly not particularly profitable.... So it becomes almost more important. Just for the audiences' benefit. I mean, Westerners, we understand simple. We understand data-driven. You said direct, what do you mean by that? Why is that important?

Tao Ye:

Well, we don't hide things. You know, the Eastern culture, sometimes you say things you don't mean to, and then you don't really say things in an honest and direct fashion. Especially in a high touch customer service environment. When you have a culture that's too convoluting, that people are not direct enough with each

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other... a lot of information gets hidden or washed out in the process.

Let me use an organisational example. We try out a lot of ideas and we tried many things. I mean, we are a 5,000 people organisation, so there's a lot of little innovations happening. So, if you don't have a direct environment, then you gonna sometimes suffer from the syndrome that the best ideas don't surface. Why? Because in a very typical Eastern culture, the boss is always right. So, you know, I'm very prolific with my ideas. I always have ideas, have all kinds of ideas, but to be honest with you, if you really chart all my ideas in history and look back, 99.9% of them are all wrong and lousy ideas. Now I am the big boss, if I have ideas and I tell people I was very excited and I was always quite sure and convincing that I was a genius when I actually tell people that idea. Now, if the culture is not direct enough to come back to me and say "Hey, um, we don't think it's right, or we've tried it, but it failed" et cetera, et cetera. If you don't have this kind of feedback loop, and that's what you see with a lot of big companies - the boss is always right, and that the boss is taking, driving everybody and the mother into the cliff and he's still right. So the power of direct is that you have an internal culture that challenge each other. The thought process, as well as the practice. Because the further we are removed from the frontline, the bigger we are as a company, the more likely that I will be wrong with my ideas. It's a simple math, right.

Dawid Krige:

That makes total sense. But I wonder how you guys were able to get that culture, if say a rural salesperson in a lower tier in rural Hubei, the big laoban (boss) who studied at MIT and Beida, I mean surely the big boss knows best? I mean, how are you able to get that culture in the company to say that the management doesn't have it all figured out. That we don't want this sort of very respectful culture. We wanted a more direct culture. It must have been quite hard.

Tao Ye:

It is hard. So it has to be very steady and stable. And then my brother and I have to be able to not consciously practice it. We have... culture has to reflect who we are subconsciously. So we are very very lucky to have the upbringing in a more of a research type of environment, upbringing where, you know, only data tells the true story. And sometimes, in lack of data, debate tells the true story. So Winny could probably tell you a story of her first day, showing up at work in the headquarter, and she walked into a meeting where my brother and I were swearing at each other, calling each other names and then cursing each other's mother. Of course, we were fully aware that we have the same mother...! Anyway, so it's a practice that we do.

Now, for example, we are openly talking about that Meidong is going to look more intensely at mergers and acquisitions. For example, in some cases, when I fall in love with a certain target... For example, there was one particular case two months ago, my CFO and bunch of my directors just kept on calling me and say, no, you shouldn't do it. And here's why. And then you can imagine me being the big, wealthy, you know, successful MIT, you know, applied math boss. I got the first phone call. My intuition is, Hey, who are you to tell me that I'm wrong? Of course I was right. You know, just look at me how smart I am. Now, by the time you get the third phone call, you start to think, Hmm. Maybe they are right. Well, it turned out they are right. So I think those are the cultures that, that we need to be consistent and keep very steady and stable.... The working environment that enables people to challenge each other. Now, the bigger we are, the more perceived success we have, the more important it is.

Dawid Krige:

Absolutely. Yeah.... How, I mean, obviously you've said lead by example, we talked about manuals... incentives, I mean, how important is that? I can imagine that on the shop floor... or where they fix the cars. I mean, that must be incredibly, important?

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Tao Ye:

We, our business is of a few characteristics. Number one, it's a really tough business. I mean, if you, if you look at how many companies are unhealthy in our business, if you define unhealthy as no cash, no profit, that's truly unhealthy. And there's what we call the pseudo healthy: there's profit, but no cash. If we really slice out the people who can generate profit, as well as cash, I'm talking about in the sustainable way, it's really small slice of our industry. So, it says a couple of things. One is I believe, up until maybe two or three years ago, I think the nature of the industry probably was somewhat misunderstood. That's number one, that's the financial side of the statement.

Number two it's a very high touch environment. For us, sitting on the top, looking at selling 60,000 cars it looks like numbers, but to the salesperson, each car is a project and he or she has to work really hard on it. Because, after all, customers are paying a lot of money to buy this gadget, and to a service person, each repair is individual problem that he or she needs to solve. It's a very high touch environment. So that's the number two.

Characteristic number three, it's a fairly lowly educated workforce. Because it's a low entry level is an easy, low entry barrier job. You wind up having a lot of 18 year-old, 19 year-old, right out of the rural cities, rural areas in China, coming to the larger cities or metropolitan, that's kind of the first job, you know. They stay a while and then they move on.

So, in that context, two things become fundamentally important. One is culture that we talked about. Another is the true sense of attentiveness... to employees' compensation. Because it's a low entry drop it is also a low entry, low barrier job for people to leave. So, they kind of come to the city, find a job, selling cars, make enough living, and then try to get another degree and then move on. To truly keep the good people in this industry, you essentially have to think carefully about what companies you want to build, and then what kind of people you want to keep and then how you're going to compensate them. So, we have worked really hard, my brother and I...

Instead of giving you general statement, let me give you stories of what we do. From the very beginning, since I came back until today, my brother and I still have the habit of reviewing each manager's pay in a post-mortem on a monthly basis. So our financial department will provide something in a chart. If a particular person got his salary and bonus in September, let's say and compare with August and compare with last September, if he is decreasing his total comp, our financial department is going to mark the cell red. If it's increasing, they're going to mark the cell green for us. So my brother and I are busy, and then there's a lot of people. So we're looking at the big chart and then we see, Oh, there's a lot of green. Okay, good, no more discussion, and then move on the next subject. But if there's a lot of red, we will then spend time sitting down analysing and say that the key question is, you know, why are people's pay decreasing and how can we help improving it? So we do that on a fairly regular basis. And we also do that, in a special way, for some large uncontrollable events. For example, 2012, when the Island incident happened between Japan and China, there was roughly one month that we couldn't sell anything. Couldn't sell any cars...

So the corona virus, if you're standing in February of this year, it's very scary because we would literally have to plan out for zero revenue - not zero profit - for how many years and for how many months that we can sustain as a company, without selling and servicing a car. So, our HR department (I was in the US with my family at the time). My HR director in our emergency business meeting, proposed something to me that truly reflected our culture. She said, now that we know as a company that we could sustain ourselves for quite a long time without selling anything, can I propose that we pay full bonus and salary for employees for February. Now that was a

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very profound statement, if you put yourself in the shoes of February... Scary time. And the local government actually does not mandate you pay full salary anymore. They basically said you could just pay a bare minimum, like 20% of your base salary, and then you're legally okay. But we're not only paying the base, we're paying the full bonus as if people are hitting all the KPIs.

Now I will say that we don't really publicise it internally, but over time people understand it. And they've learned to appreciate that. So coupled with the fact that they live in a very simple and direct culture environment, and also coupled with the fact that we're a fast growing company, which creates a lot of opportunities for people. Those couple of things probably enable us to manage to keep and retain and grow a group of very, very good managers out of the industry that is very, very loyal and very, very effective and very, very productive. I could talk about this...

Dawid Krige:

This is stuff that we love to talk about. And then it's really interesting how that loyalty has translated into long duration amongst your senior management team. But also, something that's very apparent is how many of your management team are women. I don't think I've ever seen a Chinese company, actually I think (even) a Western company with so many women. Is that just purely random, or why do you think a lot of women in particular have thrived at Meidong and they've ended up at the top?

Tao Ye:

Well, in this particular case, it's not by design. We are very meritocracy based. But I've always appreciated the US education I got, part of which is to pay special attention to groups of people where they get prejudiced against. ... I still believe that Chinese society in general women get prejudiced against, you know, some of the verbiage in business world is horrific. For example, people talking about, how can you get pregnant? We're so busy! That kind of thing...

Some people talk about things like that as if it's nothing. And I think we certainly have our share of duty, not going beyond the meritocracy requirement – we should never sacrifice that. But we should at least view gender, view for example education, view people's natural rights of human beings, like giving birth and getting pregnant, getting married. Taking one or two days sick leave because of your period. I mean, those are very natural things that we should pay special attention to in China. After all, we are serving customers whose gender profile and background profile, it's very diverse. So, we should treat our employees the same way. Now as the 11 corporate managers, the senior managers that you saw in the picture, nine of them are women - that's pure coincidence. But it's a happy coincidence. And of course, another coincidence that we didn't specifically mention in the shareholder letter was only two of them, two of the 11 having four year college degree. We are a true meritocracy, we don't even look at educational background. Now, I'm very highly educated, probably one of the highest, most highly educated in the auto industry. But we're truly looking at people's culture fit and their KPI performance.

Dawid Krige:

Yeah. And it comes back to that data driven approach.... Maybe just one or two final questions. One is, just the vision, you know, that you mentioned: not much talk about wanting to be the biggest dealership in China. I haven't seen or hear you say that. But I have seen you want to be the most efficient operator in the world. Just talk us through a little bit about the vision for the company that you and your brother have. If we were to go fast forward 10 years into the future, what would make you feel you've done a good job. What does success look like to you and to Meidong?

Tao Ye:

Yeah, I think I need to wear my management hat on rather than my shareholder hat, meaning that I always view

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myself as a manager hired by my shareholders, regardless of how many shares you own.... So if you think from that lens, you want to give the biggest possible return to your shareholders. So, the biggest possible return to me in this industry means to be the most asset efficient operator. Now our size and our growth should be the result of the fact that we are efficient rather than the other way around. So mathematically, that should mean this. If I have an ROA of 10%, with let's say, RMB20 billion of sales, the next RMB10bn sales... My shareholders should ask me the question: is it going to be diminishing return in terms of my asset efficiency? The answer is that I should try my best to maintain or increase my return, which means my overall profile as I grow, should at least maintain the same level of efficiency or even higher. And that is the only financial metric that makes the growth valuable and necessary and incrementally creating value rather than diminishing value. Because as a shareholder, I don't want my company to grow, but have a diminishing efficiency.

A lot of myths in our industry have been centered around how big you are, but if you keep on growing, keep on diminishing your asset efficiency or whatever efficiency you have, ... what is the value? What is the point of growth? I mean, fundamentally, that's the question I ask. Now it's completely different if you're Amazon, or if you are an IT company that when you reach critical scale, that you're going to suddenly see your efficiency jumping up. We are a fairly linear industry in the sense that the more you grow, you want your incremental sales growth to be at least the same level of efficiency, you know, in a reasonable time. So as long as I believe that Meidong has that level of efficiency, all you need to do is watch other people fail, meaning that in a very sales driven or scale driven mentality, the more the growth, the less efficient they get, the more burden they get on. And one of those days, because our industry is very asset heavy and debt heavy. So you and I both know debt. Once you get into a debt hole, very rarely people climb back... That's almost impossible because people, once they get into a financial balance sheet hole, they just keep on working harder by digging harder, then the hole gets deeper. They couldn't get out. So we see that in asset heavy industries, all around the world. So Meidong have all the tenacity and discipline to keep the efficiency metric that whatever we are. So that's what brought us to where we are today. And I believe that to maintain the discipline will get us to where we will be tomorrow.

Now, to answer your question directly, do I have the view on 10 years? Probably not that much. I just basically try to get the compounding mathematics to work, meaning that if you grow double digit every year steadily, you're going to become very big over time. And all focus is to have some view of the future horizon, some view... hazy, but some view, and then, really focused on next one or two years, you know, have a solid footing of growth, both in terms of efficiency, as well as in terms of scale.

I said a lot, but not directing as it directly answers your question. Cause I don't know.

Dawid Krige:

Well, we don't know what the future holds, but I think focused on efficiency, focus on after-sales, focused on luxury, focus on single city single store. These are all building blocks that you can compound.

I mean, just out of interest, I think you said when you joined his five stores, now you guys are around 65,

Tao Ye:

65, yes.

Dawid Krige:

And then there are over 30,000 stores in China.

Tao Ye:

Yeah. About 25,000.

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Dawid Krige:

Okay. So, there's still a lot of growth runway for you and for Meidong.

Tao Ye:

Yes. And also, the industry is entering a very disruptive phase. A lot of people see challenges and I do see challenges as well, but we also see a lot of opportunities. When you have disruptive forces, all you need to do is to be deep embedded in the industry with a model of knowledge and then have strong financial power as well as executional power and be alert, be ready, and have sandboxes going on.

Dawid Krige:

Exactly. You've got your data, your nimble decision-making processes and direct approach.

Wonderful, Tao and Winny, thank you so much. It was great catching up with you and we look forward in 10 years from now, well, we'll have this conversation again. It will be interesting to hear how things have worked out. Best of luck. And thank you very much.

Tao Ye:

Thank you for having us on and all the best luck with your conference.

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