

# WARREN BUFFETT'S CHINA CAR DEAL COULD BACKFIRE

The Omaha Oracle's investment put BYD on the map, but WikiLeaks cables raise questions about the carmaker



**HEAVY-WEIGHT BACKERS:** Billionaire financier and Berkshire Hathaway Chief Executive Warren Buffett (2nd R), Microsoft founder Bill Gates (R), Berkshire Hathaway Vice Chairman Charlie Munger (2nd L) and BYD Chairman and President Wang Chuanfu (L) gesture at the national launch ceremony for the BYD M6 vehicle in Beijing September 29, 2010. **REUTERS/JASON LEE**

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AN ORDINARY AMERICAN investor would probably not put money into a foreign electric car start-up suspected of openly copying competitors, let alone one whose franchised dealers occasionally put other companies' logos on its own vehicles.

But Warren Buffett is no ordinary investor, and China's BYD is no ordinary company.

At the depths of the financial crisis, Buffett put \$232 million into BYD Co. Ltd., taking a 9.9 percent stake in the nascent Chinese auto business. Lest there be any doubt of the relationship, BYD showrooms are adorned with giant pictures of Buffett shaking hands with Chairman Wang Chuanfu.

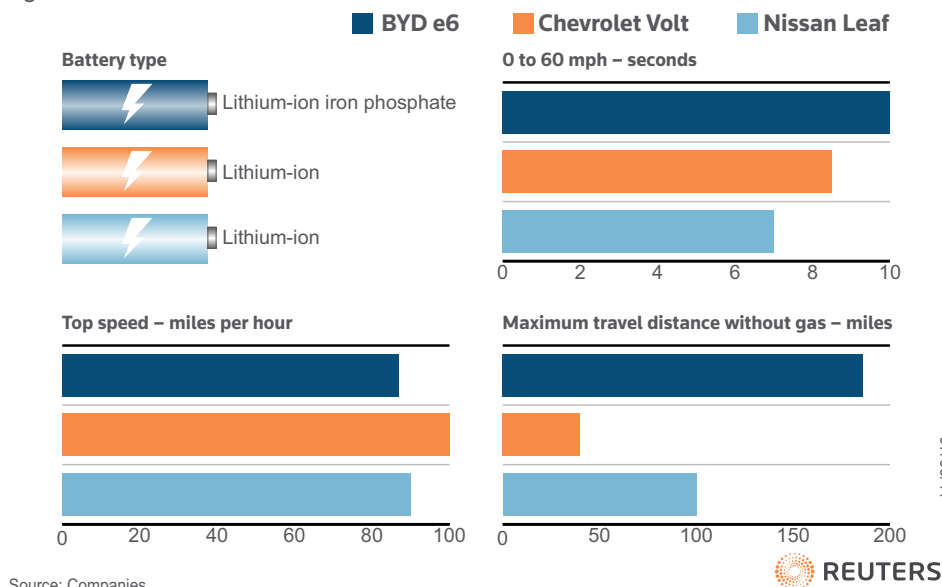
More than any winning presentation at the Detroit Auto Show, more than any statistics or innovations, Buffett's imprimatur put BYD on the map, instantly making it the most serious Chinese contender among those seeking to sell an all-electric car in



**DREAMING BIG:** BYD Chairman Wang Chuanfu speaks to media at the North American International Auto show in Detroit, Michigan, January 10, 2011. **REUTERS/MARK BLINCH**

## Electric car manufacturer claims

China automaker BYD's claims regarding its electric car e6, and how they stack up against those of GM and Nissan.



*"I DON'T KNOW HOW CARS WORK. CHARLIE MUNGER AND DAVE SOKOL ARE SMART GUYS, AND THEY DO UNDERSTAND IT."*

the U.S. market.

But diplomatic cables revealed by WikiLeaks and provided to Reuters by a third party, as well as interviews with industry consultants and executives who have examined the company's operations, raise a number of questions about the fledgling carmaker. Among other things, they describe a record of stealing designs from rivals, using those savings to undercut competitors on price and scrimping on safety.

"While BYD has certainly achieved a measure of success based on a business approach of copying and then modifying car designs just enough to convince Chinese courts that the company has not infringed on patents, it is far less certain that foreign courts will be as sympathetic," Guangzhou Consul-General Brian Goldbeck wrote in an Oct. 30, 2009 cable that was unclassified but marked for U.S. government eyes only. It was submitted just days after BYD shares hit

a new peak, driven by Buffett's backing.

BYD's questionable behavior went beyond copying designs, though. According to the consulate, the company also sold some vehicles almost at cost to boost its market share and may have advertised safety ratings for one model it did not have.

The scorching assessment of BYD by U.S. officials carried the title, "BYD seeks to 'Build Your Dreams' -- based on Someone Else's Designs." Nothing in the consulate's cable describes the motivation for the secret review of the Chinese upstart, although it notes that Buffett's bet had put BYD in the spotlight and allowed it to be seen as "one of the most promising carmakers of the future." The State Department did not respond to request for comment on the cables.

It is true that analysts view some of BYD's behavior as broadly typical of the Chinese auto industry, particularly the meticulous copying of better-known international cars. Yet analysts and industry experts in the United States say even in that context, BYD stands out, and there are questions about whether the company's much-ballyhooed -- and oft-delayed -- e6 all-electric car will ever make it to the U.S. market.

Micheal Austin, the vice president of BYD America, defended the company, its track record and the promise of its battery technology that made Buffett a believer.



**IMPRESSED:** David Sokol, chairman of MidAmerican Energy Holdings, a subsidiary of Warren Buffett's Berkshire Hathaway, speaks about their investment in BYD (Build Your Dreams) during the North American International Auto Show in Detroit, Michigan January 12, 2009. **REUTERS/MARK BLINCH**

He said in an email: "So where is the true technology and intellectual property? -- is it in wrapping of piece of sheet-metal around a car? or is the genius in creating a vehicle with ZERO emissions? Zero, Nada, Zip -- no noise, no smell, no smog. A vehicle that does no harm to the environment and can sell in Shenzhen China for \$10,800 (after Chinese National and local incentives) -- that is genius!"

"No one can match the technology in that. Should 'they' be worried, yes. Will 'they' complain that 'Chinese' cars follow World design trends and follow design best practices? Yes," Austin said in the email.

"BYD's business and intellectual property practices in China, as well all places of the World, are compliant with local and international requirements and regulations. If there are factual complaints from (other automakers), we work hard to resolve them," he said.

Buffett did not respond to a request for comment made via his assistant, who handles his press inquiries. A spokeswoman for Buffett's MidAmerican Energy unit, which controls the investment, said "we do not

## "A LOT OF PEOPLE CAN MAKE A NICE CAR. THE BREAKTHROUGH FROM OUR PERSPECTIVE IS THE BATTERY TECHNOLOGY."

Speak or comment on behalf of BYD."

### BAD BET?

BUFFETT OWNS 225 MILLION shares of BYD, which were worth \$1.18 billion on Dec. 31, 2010, according to his late-February annual letter to shareholders.

On paper that looks good, as it would mean his initial investment appreciated five-fold in just over two years. The reality, however, is far different. BYD's value on Berkshire's books was just under \$2 billion at the end of 2009, meaning he'd lost 40 percent on his stake in what was a very strong year for markets otherwise.

Buffett made no serious mention of BYD in this year's letter, other than to note the company would have a chance to show off at the April annual meeting of his holding company Berkshire Hathaway. The 2009 letter gives only passing mention of the "amazing Chinese company" and its products.

For Buffett it was an unusual investment. In an April 2009 interview with Fortune magazine, Buffett said his partner Charlie Munger talked him into the deal on the strength of his impression of BYD Chairman Wang, whom Munger described as a combination of Thomas Edison and Jack

Welch.

If the investment does ultimately sour, though, it would be a black mark for the executive who spearheaded it: David Sokol, chairman of Berkshire units MidAmerican and NetJets.

Sokol is generally held to be one of the four candidates to succeed Buffett as Berkshire's chief executive, and most consider him the frontrunner. And Sokol has also put his face prominently on the BYD deal, meeting with the industry and the press at the 2009 Detroit Auto Show to tout BYD's electric cars as the wave of the future.

The company's appearance on the main floor of the Detroit auto show was the first by a Chinese automaker and came at a time when Detroit automakers GM and Chrysler were sputtering on government life support.

"Right now, we're just limited by resources," Wang said in January 2009 as he stood outside BYD's red-and-white themed booth

illuminated with the company's ambitious motto: "Build Your Dreams."

Wang has certainly built his. A former government researcher, he founded BYD in 1995 with \$300,000 of money borrowed from a family friend, and within five years was the world's largest maker of cell phone batteries. Once China's richest man, Wang's goal is no less than becoming the world's largest automaker.

With that angle in mind, Wang courted Sokol, knowing that he had Buffett's trust.

"I don't know a thing about cellphones or batteries," Buffett admitted to Fortune in the 2009 interview. "And I don't know how cars work. Charlie Munger and Dave Sokol are smart guys, and they do understand it."

### VIBRATING MOLARS

SOKOL'S ATTACHMENT TO THE deal makes sense, given MidAmerican's commitments to renewable energy and the touted promise of BYD's battery technology, as first seen in its F3DM plug-in hybrid with range-extending gas engine.

BYD's pitch for its battery technology was so strong that the consulate, despite its concerns about the company's behavior, was willing to consider the possibility the battery itself was the real deal.

"The answer to climate change may be as simple as the chemical formula of a lithium iron phosphate battery, according to one ambitious south China company," consular section chief Michael Jacobsen said in a Jan. 2010 note to the State Department.

The only catch is that the batteries have to work.

"During a recent visit to BYD headquarters in Shenzhen, a top manager told (an embassy official) that sales of the F3DM had been slow, with only around 100 vehicles sold to date, mostly to the municipal government," the cable said, with an added note: "Media reports speculate that slow sales may also be an indication that the F3DM's battery performance falls considerably short of expectations."

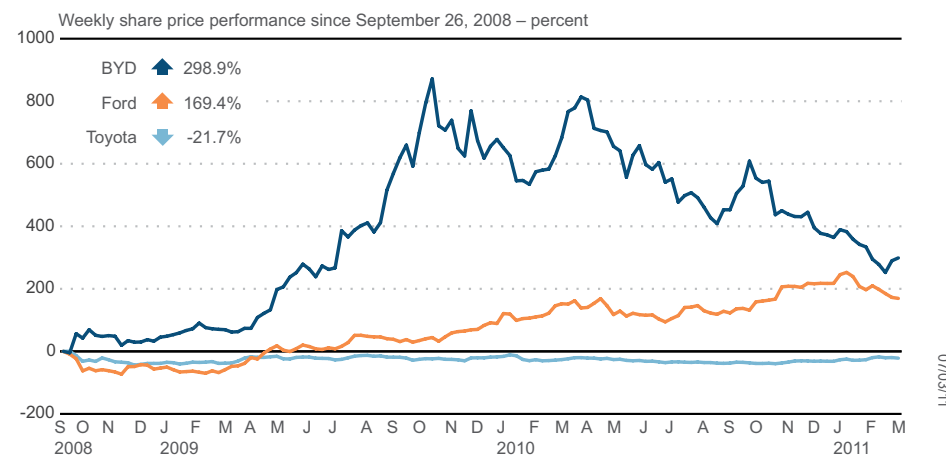
If the batteries are not all they are cracked up to be, it raises a question about the fundamental point of Buffett's investment.

"Whether or not they can manufacture their own cars isn't relevant to us, because we see their real expertise is in the development of



## BYD takes on Ford, Toyota

Since Warren Buffett invested in Chinese automaker BYD on September 2008, the company's share price has outperformed both Ford and Toyota.



Reuters graphic/Stephen Culp







**eCAR:** BYD e6 electric cars, used as a taxi in Shenzhen, are seen in a taxi company's car park in the southern Chinese city of Shenzhen May 24, 2010. **REUTERS/TYRONE SIU**

the batteries, the motors, the control systems for that," Sokol told Reuters in January 2009.

"That's not to say that they can't make a nice car, but a lot of people can make a nice car. The breakthrough from our perspective is the battery technology."

Americans curious to see for themselves have only one option at the moment: a fleet of 10 F3DMs the Housing Authority of the City of Los Angeles signed a deal for last year. The arrangement is not a formal lease, but a cost-sharing program that BYD's Austin estimated cost the authority somewhere between \$300 and \$400 per car per month.

The housing authority did not return multiple calls for comment over a period of days. But early reviews were less than positive.

"It would be easy to chuckle at the F3DM's minor flaws -- the wobbly storage compartment between the front seats, subpar floor mats, squishy handling. But the build quality and materials seem perfectly adequate for utility-oriented Americans," the New York Times wrote on Feb. 20 after a test drive.

The paper's assessment of the F3DM's dual-mode engine, and particularly the process of switching from electric power to gas, was even tougher.

"The steering wheel vibrates. The dashboard hums. You feel the vibration in your molars."

BYD's Austin told Reuters in a follow-

up interview the Times story was actually useful, in that it helped him make the case to engineers in China that BYD needed to do a better job of dampening noise for the U.S. market.

#### 'COPYING EVERYTHING'

THE TIMES REPORTER'S experience with the F3DM's workmanship goes to the heart of one of the most frequent criticisms of BYD, and of Chinese automakers in general: that their cars are simply cheap copies of other manufacturers' work.

Even in cases of active cooperation between Chinese automakers and their European, American and Asian partners, there is room for confusion on where one brand ends and the other begins.

For instance, Chinese automaker Brilliance, which has a joint venture with BMW AG, offers its own line of vehicles that rely heavily on design cues from its more famous partner. Brilliance even markets its M2 sedan as having been through the "BMV quality control process" -- one letter away from the BMW brand -- and says its car is "known as the Chinese BMW 3."

Paul Newton, London-based analyst for IHS Automotive, said that all foreign companies doing business in China know the lay of the land. Even if they sense unsavory behavior, he said, they consider it a part of the price for doing business in the world's largest car market.

"Until the law in China recognizes some kind of international intellectual property issues, companies will always be up against it. But for the most part, (Western company officials) shrug their shoulders and say it will cost us more not being involved than being involved, so let's get involved," said Newton.

In the case of BYD, the automakers most frequently cited as "inspiration" for its cars include Toyota Motor Corp and Honda Motor Co. Both are aware of the issue, though both declined to comment on it for the record.

One Honda source, who spoke on condition of anonymity, cited BYD's F3 model in particular as a known copy with Toyota Corolla and Honda Fit attributes.

"The design is such that anyone looking at the car would know it's an imitation but it's not as if carmakers are securing design rights for each individual part, so in reality it's very difficult to bring the issue to court," the source said.

Austin said he was not aware of even a single complaint for intellectual property violations.

"In China it's the standard way of doing business," he said.

The company has also used price as a lever to beat some of those same companies. The Guangzhou consulate reported that, according to one of its sources, BYD sold one model for a profit of less than \$146 per car. Ironically, for almost that same amount BYD dealers would replace all of the BYD "marks, symbols and model plates" with those from Toyota or other manufacturers, the consulate said.

Austin acknowledged the practice has happened at dealerships, which are franchised and not company owned.

"There have been isolated incidences where dealers have done that," he said. "For branding issues we felt uncomfortable about that, probably as uncomfortable as Toyota would."

Nonetheless, BYD continues to attract new partners. Just last week it said the Chinese government had approved its tie-up with Daimler AG and that engineers from the German luxury carmaker were already at work on a joint project in Shenzhen.

For Daimler, a late convert to electric car technology, the venture amounts to a low-risk way to hedge against regulations that could require all automakers to offer EVs in China because of government policy intended to reduce oil consumption.

One person familiar with Daimler's side of the talks said that the German automaker

went into the deal well aware of the cloud around BYD.

"Nobody gets so big so quickly in the Chinese market without some casualties," said the person. "It's systemic. The Chinese are famous for copying everything."

### DOES IT WORK?

WHILE BYD IS KNOWN for older copy-based models like the F3, its e6 is the next generation. It's an all-electric vehicle that, according to BYD, goes farther and charges faster than competing models from the likes of Nissan (the Leaf) and GM's Chevrolet unit (the Volt).

But skeptics remain wary of the carmaker's claims.

In May 2009, Volkswagen AG considered a tie-up with BYD but pulled back after some due diligence. A VW spokesman could not be reached to comment on those talks.

Among the concerns raised by potential BYD partners: auto suppliers complained that BYD's strategy of making everything on its cars amounted to a bid to steal their technology, according to a consultant who was brought in to study BYD as established automakers kicked its tires.

BYD, U.S. suppliers complained, would ask for an initial order of parts like door panels, then drop the business, reverse engineer the part and use it on upcoming models.

In addition, BYD was "nowhere near meeting safety standards" to export to the United States or Europe, the consultant found, and its quality was spotty in the Chinese market. "If you shut the doors too hard, they fall off," the consultant said, asking that he not be named.

The consulate noted those safety concerns as well. The Oct. 2009 Guangzhou cable mentioned a dispute over the safety rating on BYD's F0 model -- the company said it had a five-star rating from a consumer association, while that same association said it had not even tested the car. The consulate also noted a tendency toward cost-cutting through the use of plastics and lighter steel grades, all of which cut weight and expense but make the car more vulnerable.

"They passed all the U.S. safety crash test standards," Austin said of the F3DMs now being used in California.

### SLOWING SALES

THE U.S. LAUNCH for the e6 has slipped repeatedly, and is now aimed for the first quarter of 2012. But Austin conceded there was no rush, particularly as the company



**PLUGGED IN:** BYD (Build Your Dreams) President Wang Chuanfu speaks in front of an electric vehicle during press days for the North American International Auto show in Detroit, Michigan, January 10, 2011. **REUTERS/MARK BLINCH**

continued to learn what American consumers want and demand from a car versus Chinese expectations.

"I'm not going to let them launch the wrong cars. It'll be a huge nightmare from a PR and marketing standpoint, and the truth is, the market is China," he said. "If we have a branding issue, it impacts the global sales. BYD is not in a rush to come to the U.S. market."

While consultants and executives debate whether BYD will ever make it to the United States and how it might do if it gets here, there are signs it may be having some sales troubles on the homefront.

For all of 2010, BYD reported having sold 480 of its F3DM plug-in hybrids and E6 electric taxis. By contrast, GM had over 600 Chevy Volts as of February, counting just two months of sales in 2010 in the U.S. market.

The disappointing BYD electric car sales come despite generous government incentives in China. The F3DM, for instance, carries a government subsidy of about 47 percent of its purchase price.

"BYD makes a lot of claims and not a lot of them come true," said Newton of IHS.

More recently, BYD's February sales fell by half from January and nearly a quarter from a year earlier. Analysts said its low-end models were less competitive than they used to be and higher-end models were not gaining sales momentum, even with price cuts in mid-February of up to 20 percent.

Sales also fell 15 percent in January, even as the Chinese auto market was growing in the double digits at that time.

"They are in recovery mode, working on the quality of the vehicles, working on the dealership network and most importantly trying to prove to the world that they are in fact a genuine producer of electric vehicle(s). That's why Warren Buffett had invested and that's why everyone is watching," said Michael Dunne, president of consultancy Dunne & Co.

The sales declines are nonetheless showing up in BYD's stock. Even with a sharp bounce since the last part of February the shares are still down nearly 10 percent this year, suggesting that Buffett's investment has slipped below the psychologically important \$1 billion mark.

Falling sales at home would be bad

enough, but BYD's aspirations are global. If the company does make it to the world stage it could face a whole different set of problems, as the Guangzhou consulate noted almost two years ago.

"Especially as the company eyes overseas markets and gears up to export its models, including electric cars, to the United States, the likelihood of legal challenges related to intellectual property and safety or liability

issues would appear to loom larger and larger on the horizon," the consulate said.

The consulate's warning about lawsuits could serve as a caution to the 80-year-old "Oracle of Omaha." Though Buffett is a long-term investor, he may not want the hassle -- or the headlines -- of holding a stake in a company that risks years of protracted litigation. Otherwise, he may be reminded of his words in his 2008 letter about another

bad deal, this time the acquisition of shoe maker Dexter.

"To date, Dexter is the worst deal that I've made," Buffett said. "But I'll make more mistakes in the future -- you can bet on that."

(Additional reporting by Bernie Woodall in Detroit, Fang Yan in Beijing and Kentaro Sugiyama and Nathan Layne in Tokyo; Editing by Jim Impoco and Claudia Parsons)



*"I DON'T KNOW A THING ABOUT CELLPHONES OR BATTERIES ... AND I DON'T KNOW HOW CARS WORK. CHARLIE MUNGER AND DAVE SOKOL ARE SMART GUYS, AND THEY DO UNDERSTAND IT."*

**THE ORACLE:** Billionaire financier and Berkshire Hathaway Chief Executive Warren Buffett attends the national launch of the BYD M6 vehicle in Beijing September 29, 2010.  
**REUTERS/JASON LEE**

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