China in transition
Insights for global companies
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Foreword

After more than 30 years of high-speed economic growth, China has joined the US as a major world economic power. Already the world’s second–largest economy, China is projected to be the largest within the next decade.

Corporate China is growing by leaps and bounds as well, counting 73 companies in the Global Fortune 500 in 2012, up from 16 in 2005 according to an analysis by Fortune and Ernst & Young. This represented 76% of the Global Fortune 500 companies from the BRIC (Brazil, Russia, India and China) countries in 2012. By 2020, corporate China could represent close to one-fifth of all Global Fortune 500 companies.

Sustaining the momentum of China’s economic development will remain the primary goal of China’s new leader, Xi Jinping, and the leadership team emerging from the 18th National Congress of the Communist Party of China, held in November 2012 (the “18th CPC Congress”).

China's new leadership team will continue to drive China’s economic development and transformation following the directives set forth in China’s 12th Five-Year Plan (adopted in 2011). Companies that do business in China or operate in markets outside of China that are attractive to Chinese companies will benefit from understanding the business implications of China’s national economic development strategy.

In this document, the Ernst & Young organization’s China Business Network offers insights on what global companies can expect from China’s new leadership team and how to respond. The purpose of this document is to outline for readers how the long-term strategy of China’s economic development policy and its intersection with China’s issues has significant implications for the business plans of global companies in China. Over the next 10 years, China will approach a critical strategic crossroad, which will present an entirely new set of opportunities and challenges for global companies doing business in or with China. Understanding the inner logic of China’s developmental issues will allow a company to align its business plans with China’s growth trajectory. A common pitfall in formulating any China strategy is to rely on outdated assumptions, and then assess those issues in isolation, without comprehending the larger context that will drive long-term success or failure within this rapidly evolving emerging market.

C.Y. Wang
Americas Area Leader, China Business Network

Rise of corporate China vs. developed economy

Source: Fortune 500
Changing of the guard

Last November, the Communist Party of China (CPC) revealed its new leadership team (the seven members of the Standing Committee of the Politburo). Led by Xi Jinping, the team features a diverse group of senior officials with backgrounds in law, economics and history and a broad portfolio of administrative experience. Importantly, most have run two or more large provinces with populations and economies equal to those of European nations and are experienced in dealing with foreign investors and commercial matters.

Many of them came of age during the Cultural Revolution. Xi himself was among the urban youth sent to live and work in the countryside (a mountain-side cave village) while his father was purged from the party elite. Some believe that this experience will influence Xi and his leadership team to lead China’s reform and development in a pragmatic and moderate manner.

Xi laid out his vision for China in a speech called the “China Dream,” saying that the nation would achieve its goal of creating a “comprehensive and moderately prosperous society” (i.e., an established middle class) by the 100th anniversary of the CPC by 2021. He also said that the goal of building a prosperous, strong, democratic and socialist modern state would be achieved by 2049, the 100th anniversary of the formation of New China.

To keep China’s economy and society moving toward these goals, however, the new leadership team will need to aggressively tackle the challenges facing China. While observers have documented many of those challenges, few have grasped how interconnected they are and the true level of complexity facing China’s new leadership. In his first speech to party members, Xi said that ending corruption would rank as one of his major priorities. Corruption reduces government efficiency and effectiveness, which makes it a necessary and logical first step for Xi’s leadership team. In the eyes of the people, a key responsibility of the CPC and the government is the delivery of concrete economic and social results. The continued success of China’s economic development will depend on how well the government orchestrates all aspects of China’s economic development and implements its policies in an effective and efficient manner.

Most observers expect Xi and his leadership team to continue pursuing China’s economic development in accordance with the policy directions set forth in China’s 12th Five-Year Plan, adopted in 2011. Compared to his predecessor, however, Xi and his leadership team inherit a significantly more compact time frame for accomplishing China’s development goals. Most, if not all, the reforms can no longer be deferred and must be addressed simultaneously since the success of one has a direct impact on the others.

For one, increasing internal consumption cannot be remedied solely by lifting income and changing consumer behavior among the existing middle class in wealthy coastal areas. This increase must be matched by a corresponding progress in urbanization – the process by which China will transform the ratio of its rural to urban populations and thus expand its consumer base.

At the same time, the speed of the urbanization will in turn be influenced by whether the economic transformation in urban areas can create more manufacturing and service jobs, as China migrates from low-end to high-end manufacturing. Furthermore, the success of the urban economic transformation is heavily dependent on China’s ability to modernize its agricultural industry and rural communities, thereby shifting the labor force from the vast countryside to the urban area.

Addressing all these interwoven challenges for a country with 1.3 billion people is a complex endeavor. In China’s case, a strong and effective government is needed to keep these myriad parts moving forward in a fast, coordinated and coherent fashion as Xi and his leadership team strive to achieve the goals he set forward in his “China Dream” speech.

Achieving the China dream

Achieving the goals set forth in the “China Dream” speech will require China to succeed on a number of interdependent efforts, starting with a core set of actions that include urbanization, agricultural modernization and the structural transformation of the economy.
“No single individual will have greater impact on American companies than Xi Jinping ... The reason is what I call a ‘politico-strategic framework,’ which seeks alignment between the policies of leaders and the strategies of companies.”

— Robert Lawrence Kuhn
“What China’s New Leader Means for Business,” Chief Executive, May-June 2012

Moving forward to 2020

Global companies need to understand the unique Chinese concept of “comprehensive national power” (CNP). While there is no official definition for CNP, the concept generally translates as a comprehensive national development strategy that measures the state’s well being based on the attributes of its soft and hard power and ability to exert influence internationally. In every area of human endeavor – economic, business, finance, culture, science and technology – China intends to be among the best in the world. Global companies that appreciate this will be better positioned to manage their operating models in China. The CNP concept gives China’s policies a high degree of continuity and consistency despite leadership changes, even though each new leadership team is bound to initiate its own subtle shifts in direction.

Recognizing and understanding both the continuity and the shifts are critical for foreign businesses seeking to gain a competitive edge in China. The fundamental reality is that economic development has been and will continue to be the core focus of China’s leaders as they seek to achieve China’s long-standing goal of developing a “comprehensive and moderately prosperous society by 2020.” The Work Report released in connection with the recent leadership change highlights five policy goals that must be accomplished in order to achieve that overall goal.

1. Economic transformation. China is extremely conscientious about its position in the global economy. The new leadership is expected to continue driving China’s transition toward a more sustainable economy that fully leverages information technology; doubles the GDP and income per capita; completes China’s industrialization and improves the quality of urbanization; modernizes the agricultural industry and redevelops rural communities; and furthers the globalization and international competitiveness of Chinese companies.

2. Governance. China will continue to develop its rule of law and enhance the credibility of the judicial systems.

3. Culture industry. An area that has been further emphasized is China’s commitment to develop its “culture soft power” by making the cultural industry a major pillar of the national economy.

4. Enhancement of living standards. Social stability is the foundation for China’s economic development and has been China’s comparative advantage over other emerging markets. Observers expect China to continue investing in public services such as education, healthcare and housing.

5. Sustainability. The Chinese leadership realizes the importance of controlling pollution, developing a sustainable economy and protecting the country’s ecosystems. We anticipate that China will continue to invest in these areas.

The way these goals interconnect reflects China’s CNP concept. Chinese leadership realized long ago that it could not achieve a higher level of CNP through a growth model based on low-cost labor, low value-added manufacturing and energy-intensive industries. The latest five-year plan already outlines the strategies for transformation.

Companies that have based their China strategies on this old growth model will see a quick erosion of their competitive position in China if they do not proactively adapt to this new business environment. Higher labor costs are already eroding profit margins for manufacturers and other labor-intensive industries. In a recent Ernst & Young survey, 59% of manufacturers in China reported a decline in EBITDA. On the

Reshoring

In a survey of US-based manufacturing companies, approximately 40% reported that they were planning to reshore manufacturing operations or were actively considering the plan. Nearly half, 48%, of executives at companies with more than US$10 billion in revenue said they were considering that move. Executives cited rising labor costs (57%), product quality (41%), ease of doing business (29%), and proximity to customers (28%) as reasons for moving manufacturing back to the US. In addition, 92% said they believed that labor costs in China “will continue to escalate,” and 70% agreed that “sourcing in China is more costly than it looks on paper.”

2 President Hu Jintao’s Work Report during the opening ceremony of the 18th CPC National Congress on 8 November 2012.

3 More than a third of large manufacturers are considering reshoring from China to the US, The Boston Consulting Group, press release issued 20 April 2012.

4 Rethinking profitable growth: the productivity imperative in China, Ernst & Young, 2012.
other hand, in that same survey, 53% of companies that focused on providing consumer products to the retail sector reported stronger margins. Supply chain management will be even more important for companies operating in China. The economic transformation actively pursued by the new China leadership will have a profound impact on offshoring and reshoring decisions.

Even though the economic transformation pursued by China’s new leadership may adversely affect certain companies operating in China, the new policy will open up new opportunities for other companies. Technological innovation will play a central role in the new growth model. Recognizing that innovation can only result from a system that protects and respects IP rights, the Chinese leadership has stated that further steps will be taken to strengthen IP protection. Expanding internal consumption will also play a key role in adjusting the strategic structure of the Chinese economy. In defining China as a potential consumer market, foreign multinationals should recognize that the vast China market can be subdivided into multiple geographic segments. The urbanization policy will result in the rise of the so-called Second Tier cities, with more than 100 million people moving from rural to urban areas by 2020.

The significant increase in urban population and greater purchasing power will create a new market for consumer products and services. At the same time, this rapid urbanization will rapidly transform rural areas, accelerating the mechanization and modernization of China’s agriculture industry. Foreign companies that want to access these new markets will need to carefully analyze the market segmentation, which will feature significant regional differentiation.

China’s regional development plan is summarized below:

1. Promote a new round of large-scale development of the western region.
2. Comprehensively revive the old industrial base in the northeastern region.
3. Vigorously accelerate the rise of the central region.
4. Actively support the eastern region’s leading position.
5. Increase support for development of the old revolutionary base areas, ethnic minority areas and border areas.

Source: China’s 12th Five-year plan
“The Chinese government is opening up a number of sectors. It will be gradual, not like the big bang we had 10 years ago, but foreign companies will have a chance for much broader participation in sectors that were previously closed.”

— Yew-Poh Mak
Asia Pacific Operational Transaction Services Leader, Ernst & Young

Structural reforms

Industry consolidation

The new leadership is expected to accelerate plans to consolidate industries by removing inefficient businesses, open previously closed sectors for investment and encourage more outbound investment.

In pharmaceuticals, chemicals and retail food distribution sectors, the government will continue to encourage consolidation due to oversupply or to reduce the risk of breakdowns in quality. In food distribution, for example, national distributors will likely replace small and regional suppliers – especially those with outdated processes and less rigorous quality-control procedures that could compromise food quality.

The same is true in petrochemical and manufacturing industries, particularly steel. A concerted effort will likely be made to liquidate undersized producers that do not have critical mass.

And in the pharmaceuticals industry, the industry consolidation is being driven by the Chinese equivalent of the FDA, the SFDA. As the organization continues to tighten standards, companies that don’t comply or lack the capital to invest in improvements will be shut down.

Expanding China’s global footprint

China’s “Going Out” strategy is a high-priority of the new leaders, encouraging Chinese leaders to expand internationally. In 2012, Chinese direct investment in the United States totaled a record US$6.5 billion, a 17% increase from the previous high of US$5.5 billion in 2010, with a significant focus on commercial and residential real estate. Moreover, the Ministry of Commerce released a comprehensive series of overseas investment guides in 2009, which was updated in 2012. The guide covers 165 countries and regions, and represents a significant undertaking that reflects China’s commitment to expanding its global business footprint. In particular, Chinese enterprises will look to grow market share and acquire technology and IP assets.

For example, China – already the largest auto market in the world with sales of some 19 million vehicles in 2012 – seeks to become a global power in the auto industry. China has multiple automobile manufacturers and hundreds of auto part suppliers, which make everything from hydraulic systems to electrical systems. As the industry evolves and becomes more competitive globally, they will need to bring in new technology to improve productivity and energy efficiency, particularly as labor costs rise. And rather than forming joint ventures with large automotive companies that will put more restrictions on sharing IP, the focus has shifted to encourage China’s auto manufacturers to acquire or start joint ventures with parts suppliers in Germany, the US or other nations. This would enable them to migrate IP back to China so Chinese companies could manufacture parts on their own.

Licensing and joint ventures

China’s leadership has long recognized the value of joint venturing with foreign companies. The Work Report, in addressing the economic transformation, emphasized the importance of increasing the synergy of sino-foreign joint ventures. Going forward, forming joint ventures will continue to be the most effective way to enter China. Foreign multinationals with existing joint venture agreements will need to continue exercising vigilance about whether or not the agreements are achieving their objectives. The key to success for both global companies and Chinese enterprises will be to drive economies of scale and add value through creative partnerships. Foreign companies need to get several crucial steps right during the pre-deal planning stage in order to set the transaction on a reasonable path to success.

China in transition Insights for global companies

Opening sectors up to investment

Certain sectors previously dominated by state-owned enterprises, including aviation, oil and gas and transportation, will likely be opened up. The transition will be gradual, with an emphasis on encouraging businesses to be more competitive and receptive to private sector investment.

Two areas under consideration for greater foreign investment are transportation and energy, specifically, railroads and nuclear power. While foreign investors would not be allowed to buy controlling interests, they might be able to buy stakes in return for technology or other measures that upgrade productivity and efficiency.

China is also opening up its financial services markets, particularly to firms that can offer expertise in currency trading for the Renminbi (RMB). The RMB has experienced rapid growth in cross-border trade settlement, expanding four-fold from RMB 500b in 2010 to RMB 2,080b in 2011. That’s a small fraction of the trillions that are traded in foreign currency each day, but China is taking small steps toward making the RMB more attractive as an international currency as demand increases.

Other sectors, such as media and entertainment, remain restricted to foreign investment. However, global companies can still work with Chinese enterprises to take advantage of the significant opportunities in those markets.

Open for foreign investments

New sectors where foreign participation will be encouraged include:

- **Oil and gas**
  - Exploration of unconventional natural gas resources (e.g., shale gas and seabed gas hydrate, JV only)

- **Power and utilities**
  - Nuclear power plant construction and operation (controlled by Chinese party)

- **Clean technology**
  - New energy power station (e.g., solar, wind and geothermal energy, tidal power) construction and operation

- **Telecommunications**
  - The wireless local area network (including WAPI) and WAN equipment manufacturing

- **Engineering and construction**
  - Railway and airport construction

- **Professional services and education**
  - Venture capital, consulting services in relation to logistics, intellectual property right services and “household” services

Restrictions limiting the proportion of foreign shares in the following industries have been lifted:

- **Retail and consumer products**
  - Carbonated drinks production

- **Life sciences**
  - Disposable syringes, infusion sets and blood transfusion sets

- **Industrial products manufacturing**
  - Rubber products (old tires refurbishment)

- **Financial services**
  - Financial leasing companies

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6 China Monetary Policy Execution Quarterly Report, Monetary Policy Analysis Group of the People’s Bank of China.

How to stay relevant in China

Global companies seeking to remain relevant and succeed in China will need to adjust their strategies and operating policies. Quite simply, companies that are viewed as aiding the emergence of Chinese enterprises will be rewarded. Next, we highlight five areas that present opportunities and challenges for global organizations.

Strike a chord with China’s culture industry

The Chinese term “culture industry” has no Western counterpart, encompassing not only the conventional Western definition for “media and entertainment” but also philosophy, social science, literature and arts. The Work Report highlighted the development of the culture industry as one of the five policy goals of China. China’s rapid economic growth is generating huge demand for media and entertainment products and services.

Already the second-largest film market in the world after the US, China’s box office revenue is expected to exceed that of the US by 2020. China also boasts the largest internet market in the world, with more than 570 million users and the market for digital entertainment, particularly online games, continues to grow exponentially. While China’s media and entertainment (M&E) market is still heavily regulated, several sectors are liberalizing and providing more opportunities for both domestic and global M&E companies.

Upgrade manufacturing operations

The days when China was viewed as a low-cost manufacturing center are gone. Foreign multinationals that plan to continue manufacturing in China should take steps to upgrade their operations to manage costs and improve productivity.

To offset higher labor and resource costs, for example, companies will need to adopt strategic and cross-functional approaches, such as targeting specific market segments and then delivering products with greater efficiency. They should also be ready to abandon activities and operations that are no longer viable.

To respond to market opportunities and competitive threats faster, companies will also need to localize decision-making authority. This localized control, however, should be balanced with a rigorous approach to risk management and governance to ensure that local decisions are aligned with global priorities.

As China’s labor market matures, companies will need more effective management capability and must take steps to implement training and development programs. To that end, they should create processes that maximize labor productivity and offer stronger incentives to motivate and retain staff.

Refine IP strategy

Foreign multinationals need to take a long-term view of their China IP strategy. While China is embracing stronger IP protection measures as corporate China develops more IP assets on its own, any global company that intends to share significant IP within a joint venture or a China subsidiary still needs to take steps to protect themselves.

However, we’ve found that relying strictly on legal measures to protect IP is a shortsighted approach that may do more harm in the long run. A far more effective IP approach is to mix legal, operational and strategic activities.

Educating customers and business partners often does more to protect the company’s value proposition and position than traditional IP protection strategies. IP protection policies and strategies must be communicated and enforced throughout the organization.

— C.Y. Wang
Americas Area Leader,
China Business Network

Media and entertainment

China’s M&E market is expected to significantly outpace economic growth as a whole. To succeed in this market, companies should focus on four core areas:

- Build strong brands: align brand identity with core market segments
- Succeed in digital: select partners that support digital distribution goals
- Form and operate effective partnerships: choose joint venture partners that align with strategic objectives
- Navigate the regulatory landscape: make regulatory considerations a core pillar of the growth strategy

8 Spotlight on China: Building a roadmap for success in media and entertainment, Ernst & Young, 2012
Help modernize the agriculture industry

China’s urbanization plan requires more than 100 million people to move from rural to urban areas by 2020. This massive shift could pose a threat to its food production capacity. To meet anticipated food consumption needs in 2020, for example, China will need to increase grain production capacity by 10% over current levels. China will also have to accomplish this with significantly less arable land than the US. Approximately 40% of the US is arable, compared with only 7% in China, with much of that land distributed among family farmers tending to small plots.

As a result, China must rapidly modernize and mechanize its agriculture industry. This “crisis” also presents an opportunity for global agri-businesses, biotech companies and equipment manufacturers that can help improve its agricultural sector with more advanced seed technology and animal health practices, higher-quality feed supplies and more efficient use of fertilizers and pesticides. Companies that can help China improve its water conservation practices and streamline its food distribution network will also benefit from the drive to modernize China’s agriculture sector.

Develop a China strategy for emerging markets

There’s another issue to consider in China’s rise as an economic power. Even companies that have no plans to sell or market services there will need to pay attention to what corporate China is doing. As a result, having a “China strategy” is necessary not only for those companies that want to enter the China market, but also for those who may encounter Chinese companies in their home or overseas markets.

Take the emerging markets in Latin America and Africa. China’s investment in those countries far outpaces investment in Europe and the US. Any construction company active in these emerging markets may find itself in direct competition with Chinese firms. Chinese construction companies may enjoy a clear edge in negotiations for large engineering projects in Africa, for example, as they can also bring to bear necessary project financing options.

Next steps

China’s economic growth will continue to create opportunities for global companies. Those global companies seeking to make the most of those opportunities will be best served by taking a long-term view and asking four key questions:

1. Is your strategy based on a sufficiently bold vision for China, and have you updated your business plan assumptions given China’s transition?
2. How will China’s long term national economic development strategies described in this document affect you: in terms of operating models, market segmentation, sector focus, and geographical positioning?
3. Do you have the right human capital strategy for China – given the likelihood of talent wars – to enhance people development and deploy talent for high-value opportunities?
4. Do you have the right governance infrastructure to mitigate risks while achieving your market goals in China?

Looking forward, we recommend that executives closely monitor new government policy announcements that will provide further clarity on the direction of China’s economic and social development. We also recommend that executives develop a long-term strategy to address the rise of Corporate China, in markets both inside and outside the country.

Ernst & Young can help

Working with our global network of firms, the China Business Network will help to connect you with Ernst & Young professionals who can offer you in-depth insights and potential solutions on a wide array of issues – from forming joint ventures to revamping your strategy for doing business in China. Our understanding of the trends and nuances in emerging markets enables us to share the breadth of our knowledge through a wide range of initiatives, tools and applications.
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EYG no. CE0771

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