New era of China’s opening-up

Unlocking market potential through trade transformation
Hosting the China International Import Expo (CIIE) is a significant move for the Chinese Government to show great support for trade and economic globalization, recognizing the role that it needs to play by opening up its own market. In doing so, it will strengthen global economic and trade cooperation and drive growth by facilitating a more open world economy. The CIIE also showcases the achievements to date of the Belt and Road Initiative (BRI) that have been made possible through considerable international cooperation.

CIIE, as the world’s first import-themed national-level expo, is a unique event in international trade. While China’s economy transitions from a phase of rapid growth to an era of high-quality development that will generate stronger demand for premium and customized goods and services in the country, hosting the CIIE sends a clear message to the world about the Government’s level of commitment to deepen its reforms and further open up.

The CIIE is not only an occasion to focus on goods and services trade, but is also a chance to present China to the world and create a platform to examine critical issues that have global impact. There are opportunities for the wide range of participants to voice their views, contributing to the progress of globalization and a more open, inclusive and balanced future for the benefit of all. Featuring a high-level of participation that includes the leaders from governments and world-renowned enterprises, the expo provides an extraordinary opportunity for attendees to enhance their reputation and explore market opportunities.

As a leading global professional services provider, EY has been operating in the Chinese market for 50 years. We have been deeply involved in the country’s economic development throughout its reforms and period of opening-up. We have a profound understanding of China’s strategy to strengthen holistic economic and trade cooperation. With our professional capabilities and global service network, EY offers assurance, tax, transaction and advisory services to both multinational and Chinese enterprises as we are fully committed to building an open business environment in which all may thrive.

By hosting the CIIE, we believe China is showing confidence to embrace an open market with expanded scope and depth. Recognizing the positive impact of the expo, EY has committed to participating in the CIIE for two consecutive years and has been actively promoting the event. We have also been promoting the collaborative opportunities that the event creates, leveraging our extensive experience in service, as well as our client and government networks.

For the first CIIE, EY has chosen to showcase the EY digital and innovation services, in addition to our professional capabilities across a range of sectors, and to demonstrate how we bring our technological resources into client services. We will provide insights regarding the China market to help exhibitors access the necessary resources and put themselves in the best possible position for market entry. Meanwhile, we will continue to assist Chinese enterprises that are investing globally to embrace bigger opportunities, navigate challenges and pursue innovative development.

I hope you enjoy the insights brought to you in this special publication. We focus on automotive, financial services, technology, media and telecommunications (TMT), life sciences and consumer products, which are the major fast-evolving sectors as China deepens its reforms and opens up further. These insights will help CIIE participants and the wider market understand the opportunities out there.

EY will make every endeavor to support the expo, assisting the participating overseas companies to enter the China market or domestic firms to expand globally. Through these efforts, we will contribute to the promotion of global trade and economic growth in order to realize mutually beneficial development and common prosperity for all participants.

Albert Ng
Chairman, China
Managing Partner, Greater China
EY

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Unlocking market potential through trade transformation
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China is set to overtake the US soon as the world’s largest retail market, against the backdrop of rapid and significant growth in household income and asset values, as well as support from positive measures implemented by the Government to promote consumption-led growth. This market has massive potential for a wide range of importers as Chinese families are increasingly looking for higher quality and more customized products. The first CIIE, to be held in Shanghai from 5-10 November 2018, marks an important turning point as China is shifting from being the world’s factory to a global marketplace. A more open market also introduces the competition needed to drive innovation and upgrade among domestic manufacturers. By increasing imports, China will also play a vital role in stabilizing the global economy.

The first CIIE opens on 5 November in Shanghai. As President Xi Jinping pointed out during the Boao Forum for Asia in April that it would not be just another expo. Instead, it is a major policy initiative that reflects the commitment of the leadership to further opening up the China market. As such, EY believes that in addition to the high-profile presence of the country’s leadership, the expo will also showcase China’s support in multilateral trade and its vision of building “a community of common destiny for all people”.

The China International Import Expo Bureau has reported that it received 160,000 participant registrations while more than 2,800 companies from 130 countries have confirmed their place in the commercial exhibition. This number includes more than 200 of the Fortune Global 500 companies. The National Exhibition and Convention Center, which offers total exhibition space of 270,000 square meters, is divided into seven zones, each focus on a key industry segment: high-end intelligent equipment; consumer electronics and appliances; apparel, accessories and consumer goods; automobile; food and agricultural products; medical equipment and medical care products; and services (e.g. solutions in AI, cloud computing and big data analytics).

Source: www.ciie.org
In addition, the expo takes place alongside a national exhibition where countries present their achievements in merchandizing and service trade, industrial production, investment and tourism, as well as their unique products. Preliminary indications are that the participants will present more than 100 new products and technologies as well as latest global product and service trends. In addition, the Hongqiao International Trade Forum, a Davos-style meeting attended by national, business and academic leaders, will be held during the same period.

The CIIE signals a shift in policy emphasis on the 40th anniversary of China’s structural reform. For decades, the Canton Trade Fair in Guangzhou has been the flagship trade event in the country, and it was predominantly focused on promoting China’s exports. As the level and type of demand from Chinese consumers has evolved, the 2018 Shanghai expo is seen as a milestone event that marks the transformation toward an economy driven by consumption growth.

Rising demand for imported goods and services

In 2017, China’s commodity imports increased by 15.9% year-on-year, the largest increase in six years. Exports on the other hand, despite smaller year-on-year growth of 7.9%, reversed a declining trend that had been seen over two years. China’s trade surplus has therefore been further narrowed to US$422.5 billion. While China’s trade surplus with the US remained at US$275.8 billion, trade deficits were recorded with key commodities and machinery exporters such as Australia, Brazil and Korea.

Further statistics show that import growth has been boosted by several factors. Firstly, a rebound in import prices after a consistent decline between 2012 and 2016 which falling crude oil and ferrous metal prices had contributed to. Secondly, a revival in consumption levels in developed economies has boosted the global supply chain, including China’s processing trade. Most importantly, the growth in imports has been driven by domestic demand for imported consumer goods as individuals want a wider range of quality products and services.

China’s trade balance by partners (as of 2017)

Source: Wind

Import price reversed the downward trend in 2017

Source: Wind
In terms of product type, more than half of China's imports in 2017 were industrial supplies and raw materials, while capital goods and fuels represented 23% and 13%, respectively. In comparison, consumer goods only accounted for around 6% of total imports in the same year, of which close to a third were food and beverages and another third were non-durable goods such as medicines and apparel. The share of consumer goods within China's total imports is currently relatively low when compared to other economies with similar GDP per capita and at a similar development stage, reflecting significant potential for growth.

**Share of consumer goods in total imports (as of 2017)**

Ranked from the highest GDP per capita based on Purchasing Power Parity (PPP) (Malaysia) to the lowest (India).

Source: World Bank, Wind

China's consumption upgrade

China's consumer market has undergone a significant upgrade in recent decades, as economic development in the period has led to the emergence of the middle and upper classes that have a compelling desire to spend. Wider economic development is presenting individuals with more disposable income and these consumers are looking for higher quality and more personalized products.

**Steady growth of consumption as a share of the economy**

Source: Wind
According to China Merchants Bank, in 2017 the number of high net worth individuals in China with average investible assets of over RMB31.1 million reached 1.87 million, 18.4% more than the number in the previous year. Meanwhile, He Lifeng, Director of the National Development and Reform Commission (NDRC), noted during the National People’s Congress in March this year that there were an estimated 400 million middle-income earners among China’s almost 1.4 billion population.

China’s rapidly rising high net worth population

Disposable household income has been rising steadily in China for the past decade, by 2.6 times and 2.7 times for urban and rural families, respectively. The previous surplus in the rural workforce was exhausted which has stretched the labor supply, leading to a rise in worker compensation.

But the actual growth in disposable household income could have been significantly understated, especially at the higher income level due to the widespread presence of “gray areas”, according to Wang Xiaolu, Deputy Director of National Economic Research Institute, China Reform Foundation. The economic paradigm remains that as workers earn more, they will be more willing to spend on discretionary merchandise.

Significant growth in disposable household income

Policy support for a consumer-led economy

The Government’s commitment to transitioning China’s economy to consumption- and services-driven growth is underscored by the introduction of a series of supportive policies. Firstly, the rapid pace of urbanization and the plan to create more megacities such as the Beijing-Tianjin-Hebei cluster and the Greater Bay Area (Guangdong- Hong Kong-Macao) have reduced the barriers for the resettlement of hukou (residency registration) in smaller cities near the city clusters. Newly-created job opportunities, the improvement in social welfare and incentives to move families to the cities are all contributing factors that have driven spending.

Secondly, the Government has passed legislation for a tax cut, which will come into effect on 1 January 2019. This includes a rise in the minimum threshold for income tax levy from RMB3,500 to RMB5,000 per month and allows more tax deductible items in children education, continued education, critical illness treatment, mortgage interest payments, rental expenses and elderly support. Such move is expected to benefit the middle-income groups the most.

Thirdly, on 1 July 2018, tariffs on 1,449 taxable consumer goods were reduced from an average rate of 15.7% to 6.9%, including apparel, household products, culture and sports products, home appliances, food and beverage, daily necessities, as well as cosmetics, medical and healthcare products. This is the fifth round of tariff cuts on consumer goods since June 2015. As the Government continues to curb parallel imports and overseas spending through shopping agents, further reduction on tariffs can well be expected.
More opportunities generated by increasing imports

EY believes that China will benefit from increasing its level of imports, supported by the initiatives and discussions at the CIIE. Rising imports could help diversify the country’s product portfolio. This is particularly important amid the current global tension on trade protectionism, despite which China remains fully committed to global development. As President Xi Jinping stated at the World Economic Forum in 2017, “China has not only benefited from economic globalization but also contributed to it. Rapid growth in China has been a sustained and powerful engine for global economic stability and expansion.”

In 2017, China imported US$666.1 billion worth of products from the Belt and Road countries, up by 19.8% year-on-year. The pace of growth exceeds both Chinese exports to these countries as well as China’s total import growth. With supportive policies from the Government, China can continue to strengthen its connectivity with the countries along the Belt and Road using imports to promote the flow of capital, services and commodities.

As the trade dispute between China and the US shows no sign of abating, the CIIE also provides an opportunity for importers to source products from new markets. Apart from key imports such as soy beans and automobiles recommended by the Ministry of Commerce (MOFCOM), China should also seek to import more technology products from other markets around the world.

Source of China’s technology imports (as of 2016)

China is about to overtake the US to become the world’s largest retail market, but the market to date has been protected from foreign competition through tariffs and access barriers. By providing leading global brands with opportunities in the consumer market, the latest products and new technologies that they introduce will generate competition that compels domestic brands to improve their own products and supply chain. The emerging dynamics of the market will cause restructuring that will ultimately lead to more efficient resource allocation in China’s economy.

Conclusion

To ensure the CIIE runs smoothly, the Government has implemented a series of measures to facilitate business participation, such as giving participants priority clearance at customs, simplified labelling requirements, and providing tariff guarantee for the exhibits brought to China. In particular, the Government has made special arrangements to protect intellectual property rights (IPRs) of any goods and services on show in Shanghai. For example, participants are required to sign legal documents before the expo to confirm that they will not infringe the IPRs of others, and a service center will be set up onsite to help mediate any IPR disputes as well as providing other related advisory services. In our view, these are signs of commitment to honoring the pledges President Xi Jinping made during the Boao forum to protect IPRs and align China’s practices with international economic and trading rules.

As the market continues to open up, more regulatory framework and cross-border market liberalization policies can be expected. In June this year, the NDRC and the MOFCOM released an updated “negative list”, further relaxing restrictions for foreign direct investment in China. In the spirit of President Xi’s Boao speech, we expect further market opening to take place as China deepens its reforms.
China’s economy has maintained stable and positive development in recent years with an overall focus on shifting the economic structure from high-speed to high-quality growth. During this transition, consumption has become a major driving force behind economic growth. China is already the largest automotive market in the world and boasts the highest number of new car sales. Rising levels of household income across the country, coupled with a low rate of car ownership per capita compared with developed markets, indicate there is still plenty of room for stable growth in future. Meanwhile, the “Internet Plus” national strategy is enhancing efficiency and driving innovation, bringing about a revolution in consumption, manufacturing and distribution. For both domestic and foreign automotive enterprises to compete and win in the automotive sector, the first step in realigning their market strategy is to gain a thorough understanding of the digital transformation currently defining the industry in the country.

Favorable policies to support automotive sector development

The Chinese Government has issued and implemented a number of major policies in recent years to further promote the development of the automotive industry. In February 2018, the Ministry of Finance (MOF), Ministry of Industry and Information Technology (MIIT), Ministry of Science and Technology (MOST) and National Development and Reform Commission (NDRC) jointly issued the Circular on Adjusting and Improving the Fiscal Subsidy Policies to Promote the Use of New Energy Vehicles, requiring the subsidy policy on promoting the use of new energy vehicles to be adjusted and improved.

In April 2018, the NDRC and MOFCOM jointly announced that China’s automotive industry will be opened up in phases: the restriction on shareholding will be removed for foreign equity in special-purpose cars and new energy vehicles in 2018; the same restriction will be removed for the commercial vehicle and passenger vehicle segments respectively in 2020 and 2022. In May 2018, the MOF issued Announcement on Reducing Import Tariffs on Finished Automobiles and Auto Parts. In June 2018, the State Council issued the Circular of the State Council on Several Measures Concerning the Active and Effective Use of Foreign Investment to Boost High-quality Economic Growth, optimizing the structure of foreign investment and further implementing tax policies concerning foreign direct investment and the establishment of research and development centers using profits earned from sources in China.

In addition, China is vigorously promoting the development of intelligent and connected vehicles. In June 2018, MIIT organized the compilation of National Guideline for Developing the System of Industry Standards for Internet of Vehicles (IoV) (Overall Requirements) and jointly printed and distributed this with the Standardization Administration of the People’s Republic of China. The purpose was to facilitate the product development of the IoV industrial technology.
and set industry standards to support capability building and a coordinated opening up of the IoV sector, laying the foundation for the development of self-driving vehicles. At the same time, to ensure this progress is sustainable, China is improving the relevant regulations on technology and intellectual property (IP) protection. In April 2017, the Supreme People’s Court issued Outline of the Judicial Protection of Intellectual Property in China (2016-20) to encourage normal technology exchange and cooperation between Chinese and foreign enterprises, protecting the intellectual property rights (IPR) of foreign enterprises that have legitimate operations in China. All these underscore China’s commitment to building an international business environment with prudent legal framework.

The impact of digitization on China’s automotive industry

Against a favorable policy backdrop, electrification, connectivity, smart technology and resource sharing are all developing trends that are propelling China’s automotive industry toward a disruptive transformation of the entire value chain. Supportive regulation led to a total of 550,000 new energy passenger vehicles being sold in 2017, representing year-on-year growth of 70%. Changes are taking place not only in the power source of vehicles but also in the sourcing and manufacturing that defined the traditional supply chain. When market participants consider distribution, the fast-growing sharing economy is spurring innovative business models such as ride- and car-sharing that are altering consumers’ attitude towards car ownership and driving habits.

Emerging technologies have proven to be the catalyst for digital transformation in the automotive industry. Technologies such as artificial intelligence (AI), connectivity, big data and cloud-computing, blockchain, cybersecurity, virtual reality/extended reality/mixed reality (VR/AR/MR), 3D printing, robotic process automation (RPA) & exoskeleton, advanced driver assistance systems (ADAS) and human-machine interaction (HMI) are more widely applied in the automotive sector and are delivering positive impact.

Auto manufacturers, parts suppliers, auto dealers and other industry participants all along the value chain are embracing automation and digitization in product development and manufacturing, supply chain, marketing and sales and after sales services, as well as mobility services. Digitization has enhanced operating efficiency, improved customer experience and streamlined business models.

Product innovation in the digital era is more customized, increasingly transparent and conducted over a shorter cycle thanks to the use of digital technology and the availability of 3D printing in particular. Through data analytics, product innovation can meet the changing requirements of customers, making large-scale customization possible. This will potentially encourage shifting the traditional business-to-consumer (B2C) business model to a customer-to-business (C2B) one that is consumer-driven.

Digital technology has boosted productivity and the ability to deliver consistent quality. Take a newly built plant of a luxury automotive enterprise based in China as an example, its welding workshop is equipped with more than 500 intelligent robots while the entire production process is managed by an advanced automation system that oversees quality control and monitors efficiency. Digitization allows smoother, more transparent and efficient two-way interaction in terms of information and material exchange within the supply chain. Based on data visualization, automotive enterprises can analyze historical data to predict future trends. This projection, combined with the analysis of different scenarios, can propose practicable advice and guidance for continuous improvement.

However, applying digital technologies to product development within the automotive sector will not be all smooth sailing. Driverless cars, for example, require technology that needs to manage the simultaneous development in big data, telecommunications and AI. While newer technologies may be attracting attention, it is just as crucial to develop telecommunications in lockstep to ensure high speed data transfer in order to realize a high standard of reliability and low latency.
With increasing levels of connectivity and intelligence within the automotive industry, connections will now not be limited to the car itself or car-to-people, but also car-to-car, car-to-road, car-to-service platforms and so on. Global research institute Gartner has predicted that 90% of China's autos will be connected to the Internet by 2020, with the number of car-connected users exceeding 50 million\(^2\). This trend has brought new risks and challenges to the automotive industry in terms of cybersecurity around application, physical equipment, communication, platform and management.

In China, the average age of auto buyers is falling, and traditional auto features and services can no longer satisfy their needs. This new wave of consumers tends to prefer digital experience and they are more ready to embrace new technologies. Their level of expectations will mean that future vehicles need to be equipped with automated, sharing, connected and environment-friendly features. The function of vehicles will gradually transform from simple transportation to a multifunctional mobile space.

With the application of driverless technology, drivers will become passengers. By then, the interior space will be more equipped for the interaction between human and computer or between passengers to satisfy their recreation, entertainment or business needs during the trip. Vehicle interiors will become more digital with such technologies such as AR, human-computer interface and dynamic sensing; equipment including LED light components and screens, image displaying smart glass, multifunctional leisure chairs and sensors; and the use of carbon fiber reinforced plastic, creating a connected vehicle interior and driverless space. In the future, more software will be applied to vehicles with continuous over-the-air (OTA) upgrades.

In view of this, both domestic and foreign automotive original equipment manufacturers are exploring the new C2B manufacturing model. An example of this would be a Chinese passenger vehicle manufacturer, which involved consumers in every phase of the life cycle of a vehicle, from product definition and product development to certification, pricing, features options and ongoing optimization. A data platform was created before the launch of products to build a direct relationship between consumers and the product development team. In order to help shape the product, the auto manufacturer set 18 categories for potential users to provide feedback and collected more than 30,000 suggestions. At the manufacturing phase, the auto manufacturer offered over 10,000 combinations for consumers to choose relating to how they would like to equip their car. Ultimately, customers received a more personal product in a timely manner.

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\(^2\) Source: https://3g.163.com/dy/article/DFL61U650511PFUO.html
Automotive enterprises are proactively increasing online activities such as social media marketing and online showrooms. In the digital era, the channels of car sales are shifting from physical showrooms to virtual ones. Consumers can search for cars and read reviews, place orders and make payments online. With the help of big-data-enabled AI technology, they can even apply for loans, making it possible for the automotive sector to move the whole process of car sales online.

Digitization is disrupting the traditional value chain of the automotive industry, but this is also triggering business model innovation and helping automotive enterprises to extend both vertically and horizontally with more services and enhanced cross-industry cooperation. Online car-hailing platforms have been present in China since 2012 and have substantially grown from that point. Online car-hailing services have become ubiquitous in many cities in China ever since. Changing patterns of consumer demand have given rise to new forms of services such as tailored travel, special-purposed commuting buses and time-sharing car rental in business districts. These new phenomena require significant big data capability to perform the powerful computation to precisely target clients, calculate operating costs and earnings and provide reasonable process management. Online car-hailing services collect vast quantities of client data covering travel destinations, frequency and habits. All of these provide valuable information for customer profiling. We expect to see automotive enterprises actively making greater use of digital tools and technologies to expand their service scenarios in the future.

Traditional automotive enterprises are starting to strategically shift from being hardware vendors to software and service providers. With the rise of the sharing economy and self-driving vehicles in response to urbanization, traffic congestion and pollution, car ownership will move from buy-outs to mobility-on-demand in the future. The entire automotive ecosystem will also have to shift from a vehicle-focus to an entirely customer-centric approach.

**Digitization-related transactions in the automotive sector**

A faster pace of digitization in the automotive sector has driven major industry players to rethink their business strategy. Both vehicle manufacturers and spare parts providers are exploring merger and acquisition (M&A) opportunities to strengthen their existing digital offerings and also acquire new capabilities to build up their own ecosystem, resulting in a change in the structure of the overall market.

### Digitalization-related transactions heat map (based on the number of transactions occurring in each year)

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<td>IoT</td>
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<td>Big data and cloud computing</td>
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<td>Blockchain</td>
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<td>Cybersecurity</td>
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<tr>
<td>Software systems, Internet and mobile apps</td>
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<tr>
<td>AR/VR/MR</td>
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<tr>
<td>3D Printing</td>
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<td>RPA and exoskeleton</td>
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<td>Advanced driver assistance systems</td>
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<td>HMI</td>
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<td>Others</td>
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**Notes**

1. Only major digital M&A and investments of the top 40 automotive enterprises, top 50 component suppliers and distributors are counted. Therefore, this is not a complete list.
2. Transaction statistics do not include related transactions of the venture capital funds under leading venture automotive enterprises or suppliers.
3. ‘Other’ technical areas include wireless charging, flight technology, and investment/M&A for research institutions.
An analysis of M&A and equity investments of global leading automotive enterprises, component suppliers and distributors in the past five years has shown significant activity in digital capability-related transactions, with the number of industry deals surging from eight in 2013 to 75 in 2017. It could be seen that key participants in the automotive value chain were responding to challenges and opportunities presented by the digital transformation of the industry through acquisition or investment in relevant technological capabilities.

Taking a more granular technical perspective, transactions in software systems, Internet and mobile application technologies were the most active. The related transactions included areas such as in-vehicle systems, entertainment systems, vehicle and parts trading platforms, auto finance platforms, vehicle maintenance platforms, and travel service mobile applications. Activity in the field of advanced driver assistance systems ranked second while transactions in big data and cloud computing, interconnect technology and AI were also prevalent.

What are the repercussions of this on the established value chains? While the leading automotive enterprises are strengthening both their product development and manufacturing capabilities around intelligent vehicles, they are actively engaged in the field of travel services. There is clear industry-wide interest in areas such as shared transportation, time-sharing, map planning and parking services, as automotive enterprises realize the strategic imperative to transform from traditional hardware suppliers to travel service providers, which may only be possible through investment and M&A given the competitive landscape.

Component suppliers have been the most active in product development and after-sales service related corporate transactions. In order to meet the increasing needs of automotive enterprises for digitization, component suppliers have been strengthening their own technological capabilities through both acquisition and investment to consolidate an influential position in the enhanced industrial chain. The proactive acquisitions of after-sales service and parts trading platforms, along with vehicle maintenance software and applications can be seen as a response to consumers’ increasing preference for digital services.

Auto dealers and after-sales service providers on the other hand, have been active in strengthening their position in the existing industry chain through increasing their investment in marketing and sales, automotive financing and after-sales. The related transactions are mainly in the areas of sales software systems, vehicle transactions and insurance premium comparison platforms, as well as service car maintenance platforms.

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3 Source: Capital IQ, MergerMarkets, Crunchbase, Desk research, EY analysis
China’s major automotive enterprises are comparatively less active in digital M&A and investment transactions when looking at the industry as a whole. On the product development and production side, they are more inclined to gradually improve their digital capabilities through cooperation with research institutions and technology companies. In the field of travel services, they are more inclined to use strategic partnerships and self-build solutions. Domestic component suppliers, however, are more active in M&A and investment in the digital field, strengthening product development and manufacturing capabilities through relevant transactions. They are looking to extend their range of services and ecosystem by actively deploying after-sales links, including post-service and remote diagnosis powered by an IoV platform.

**Conclusion**

Digitization has set the global automotive industry on a new trajectory. The ongoing opening-up and growth of the China market, with the support of policy and a huge consumer base, require automotive enterprises to actively redefine the industry chain, and innovate product distribution and usage. Domestic and foreign automotive enterprises in the sector should embrace the opportunities in digital transformation and consider consumer needs first and foremost when they formulate their strategies. Only by refocusing on customer needs and innovation will they continue to succeed in this market.

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The opening up of China’s financial sector is evidenced in many ways, in particular the relaxation of restrictions on the structure, location and scope of business for foreign financial institutions (FFIs). Since the second half of 2017, the Chinese Government has ramped up efforts to open this important sector. The relevant domestic financial regulators have followed this move by issuing new policies⁴, creating greater opportunities for the development of FFIs.

Since China joined the World Trade Organization (WTO) in 2001, the country has gradually relaxed restrictions on foreign financial institutions (FFIs) in particular around their structure, as well as business location and scope. The recently launched initiatives have demonstrated China’s policy commitment to further opening up, relaxing its restrictions and creating a fair and transparent environment that will help streamline the administration of FFIs and encourage their participation in China’s financial sector. This shows China’s readiness and confidence to embrace a more open financial market in the period ahead.

⁴ Source: EY’s Point of View - China further opens up financial sector, EY, 2018
Recently announced policies that support the opening up of the financial sector

<table>
<thead>
<tr>
<th>Timeline</th>
<th>Policy direction</th>
<th>Measures</th>
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<tbody>
<tr>
<td>10 November 2017</td>
<td>The Chinese Government would set policies to remove caps on foreign ownership in Chinese FIs step by step.</td>
<td>After the policies have been set and applied, foreign investors will have indicative timelines showing when they will be allowed to take controlling stakes in Chinese FIs.</td>
</tr>
</tbody>
</table>
| 24 February 2018| The Chinese Banking Regulatory Commission (formally listed as The China Banking and Insurance Regulatory Commission (CBIRC) on 8 April 2018) issued Decision on Amending the Implementation Rules of the CBRC for Administrative Licensing for Foreign Banks. | The amendments can be summarized in three areas:  
  • Provide an explicit legal basis for inbound investment by adding rules applicable to foreign banks in China, either investing in newly established domestic corporate entities or taking equity stakes in existing banks operating domestically  
  • Apply a reporting mechanism to replace the previous approval system on foreign banks' overseas wealth management business, custody services for overseas wealth management, custody services for securities investment funds and the repatriation of interest-earning assets by FFIs in the liquidation process  
  • Further standardize the market entry rules for Chinese and foreign banks, integrate the approval procedures for the establishment and opening of sub-branches, optimize the conditions for foreign banks to issue debt and capital replenishment instruments, and simplify the qualification review procedures for senior executives |
| 10 April 2018   | Substantially relax restrictions on market access through 12 measures that would be implemented in two separate phases in 2018 to further the opening-up of China's financial sector. | China’s further opening-up of the financial sector would adhere to three underlying principles:  
  • Adopt the management model of pre-establishment national treatment (PENT) subject to a negative list  
  • Promote the opening-up of the financial sector in step and in coordination with the reforms of the exchange rate formation mechanism and capital account convertibility  
  • Guard against financial risks at all times, so that financial supervision capabilities will keep pace with the development relating to opening-up |
| 27 April 2018   | The CBIRC published the Initiative of CBIRC to Expedite the Market Opening-up for the Banking and Insurance Industries, together with two related documents, the Notice of the CBIRC on Expanding the Business Scope of Foreign-funded Insurance Brokerage Companies and the Notice of the Office of the CBIRC on Further Relaxing Market Access for Foreign-funded Banks. | • Explicitly permits foreign banks to distribute and redeem (in agent capacity), as well as underwrite government bonds. It also allows the managing branch of a qualified foreign-funded bank to authorize other branches in China to engage in renminbi (RMB) business and transact in financial derivatives, and applies a bank-wide consolidated approach to the calculation of operating capital for all domestic branches of a foreign bank  
• Further opens up China’s insurance industry to the outside world and promotes development of the industry |
### Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
<th>Measures</th>
<th>Policy direction (CSRC)</th>
</tr>
</thead>
</table>
| 28 April 2018 | The China Securities Regulatory Commission (CSRC) published its Measures for the Administration of Foreign-funded Securities Companies as a further step toward implementing the central government’s strategy for “substantially liberalizing market access and further opening up the financial services sector”. | The revisions can be summarized in five areas:                                                            | The China Securities Regulatory Commission (CSRC) published its Measures for the Administration of Foreign-funded Securities Companies as a further step toward implementing the central government’s strategy for “substantially liberalizing market access and further opening up the financial services sector”.

- Allow foreign investors to gain control of joint venture (JV) securities companies and provide a legal basis for foreign investors to increase their proportionate holdings to take a controlling stake
- Phase out business scope restrictions for JV securities companies
- Improve the rules for foreign shareholding in listed securities companies
- Clarify the policies over the legal status of a domestic securities company, following a change in the actual controller of a domestic shareholder
- Improve the eligibility criteria applicable to foreign shareholders

| 23 August 2018 | The CBIRC issued the Decision of the China Banking and Insurance Regulatory Commission on Abolishing and Revising Some Rules (“the decision”) to remove the shareholding ratio restriction on foreign investment in Chinese-funded banks and asset management companies. Foreign investment is now subject to the same equity investment proportion rules as domestic investment. | The decision mainly addresses four aspects:                                                                 | The CBIRC issued the Decision of the China Banking and Insurance Regulatory Commission on Abolishing and Revising Some Rules (“the decision”) to remove the shareholding ratio restriction on foreign investment in Chinese-funded banks and asset management companies.

- Chinese investment and overseas investment are subject to consistent administrative measures for market access and licensing
- Lifting the shareholding ratio restriction on foreign investment in Chinese-funded banks and asset management companies
- Clarifying the regulatory issues and application of laws for foreign-invested Chinese-funded banks to create a fair, open and transparent rule system for Chinese and foreign investment in the banking industry, and maintain the stability and continuity of the regulatory rules and system
- Clarifying that, in addition to relevant financial prudential regulations, overseas FIs investing in Chinese-funded banks should also comply with the basic laws for foreign investors on foreign investment in China

Looking at all these policies together, the Government is sending a clear signal of its commitment to further opening up, relaxing regulations and streamlining the administration of the financial sector. There is a joined effort to encourage overseas participation by building a fairer and more transparent market for both Chinese and foreign players.

The more recent policies are a response to the new proposals outlined at the Boao Forum for Asia by President Xi Jinping. He appealed for faster implementation of the previously announced major opening-up measures in order to bring more immediate benefits to global enterprises and people of the world. EY believes that by facilitating foreign investment and expanding the allowed scope of business of FFIs, the status and environment for these institutions can be expected to improve.
## Timeline for the opening up of the financial sector

In accordance with the financial liberalization measures announced by Yi Gang, the Governor of the People’s Bank of China (PBOC), at the Boao Forum for Asia and the subsequent implementation measures in specific industries published by the CBIRC and CSRC, the timetable for China’s opening-up of its financial sector is summarized as below.

<table>
<thead>
<tr>
<th></th>
<th>By 30 April 2018</th>
<th>By 30 June 2018</th>
<th>By 31 December 2018</th>
<th>By 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commercial banks</strong></td>
<td></td>
<td>Restrictions on the establishment of branches and subsidiaries will be removed.</td>
<td>Measures will be implemented to encourage the influx of foreign capital into the banking industry, including trust business, financial leasing and consumer finance.</td>
<td></td>
</tr>
<tr>
<td>and financial asset investment companies and wealth management companies newly established by commercial banks</td>
<td>Branches and subsidiaries cannot exist simultaneously. These institutions are allowed to operate partial foreign exchange and RMB business.</td>
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<td></td>
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<tr>
<td></td>
<td>• The proportion of shares held by a single offshore investor and its affiliates controlled, or jointly controlled shall not exceed 20%</td>
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<tr>
<td></td>
<td>• The proportion of shares held by all foreign investors and their affiliates controlled, or jointly controlled shall not exceed 25%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Insurance companies</strong></td>
<td>The establishment requirements include:</td>
<td></td>
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<tr>
<td></td>
<td>• The company has an operated insurance business for over 30 years</td>
<td></td>
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<tr>
<td></td>
<td>• The company has established a representative office in China for two years</td>
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<tr>
<td></td>
<td>• The year-end total assets of one year prior to the application for establishment shall exceed US$5 billion</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>The foreign shareholding proportion in life insurance companies shall not exceed 50%.</td>
<td></td>
<td>Relaxing caps on the foreign shareholding proportion to 51%.</td>
<td>Restrictions will be completely removed.</td>
</tr>
</tbody>
</table>
Opportunities and challenges for FFIs

When China’s financial industry started opening up in the early 21st century, there was gradual progress, but now we are witnessing rapid development. The schedule of the opening up of China’s financial markets announced during the Boao Forum for Asia marks the next stage for China’s financial sector and has a positive impact globally.

EY believes that the major development opportunities for overseas investors in the Chinese market include:

- **Rapidly growing market**: China’s financial industry is currently growing quickly. The strengthening financial market, combined with top-down measures to encourage innovation mean that FFIs will have plenty of spaces to develop in China. They will also be allowed more flexibility in how they approach business growth.

- **Full liberalization of controlling shareholding ratio**: Previously limited by the requirements of related regulations, foreign-funded institutions were unable to hold controlling stakes in securities companies, insurance companies and asset management companies. For some of these companies, not being able to obtain the controlling stake has substantially limited their development.

Since 30 June 2018, this restriction on foreign ownership has become a thing of the past. Fully liberalizing the shareholding ratio means that the real global value of the China market will gradually emerge. After lifting the restrictions on the proportion of foreign shareholding, the role of foreign capital will be enhanced significantly and the further development of JV FIs is expected to usher in new opportunities.
Full opening-up in permitted business activities: The new policies have also loosened restrictions on the business scope of foreign-funded FIs. They will receive treatment that is on a par with other domestic Chinese FIs following the removal of the restrictions.

Large FFIs will enjoy the opportunity to fulfill their ambitions for development in the China market by putting in place collaborative mechanisms to develop their securities businesses in concert with other business pursuits in China.

More mature and rational investors: With the growth in disposable income per capita in China and the increase of investment diversification, the market has seen rapid growth in the investor demand for overseas assets in their portfolios. Meanwhile, the domestic market has also witnessed a change in investors’ behavior from irrational to more rational investment, such as an increased focus on the risk-to-return ratio and mid versus long-term returns. This is definitely great news for FFIs, as mature and rational investing will ensure a healthy and sustainable development of the entire financial industry.

But to balance these considerations, foreign investors should also be prepared to face some challenges while exploring opportunities in the China market:

- **Competition with domestic enterprises**: Deeply entrenched in the local financial market for many years, the local players have advantages in terms of fundraising, localized market operation and reputation. As new entrants to the China market, FFIs will first need to decide on how to make the best use of their own competitive advantages.

- **The need to cope with China's legal environment and requirements on compliance and risk control**: The legal conditions and requirements on compliance and risk control of the China market are obviously different from those of foreign markets. Therefore, FFIs will face challenges around compliance and risk control as they undertake business expansion in China.

We expect that the authorities will continue to improve the regulatory system, and implement strict and consistent supervision of both domestic and foreign capital.

- **Localization of relevant systems**: At present, China's financial industry has an established operating infrastructure in place while FFIs are yet to develop their legacy systems to a level that can be directly implemented in their Chinese operations. Thus, it will be a great challenge for foreign investors to transfer and configure overseas systems into China, and to adapt to the differences in transaction volume and speed between their domestic and foreign businesses. In addition, the Chinese Government is paying more and more attention to the issue of network security. Hence, improving the system integrity to comply with China's network security laws and regulations will become another major issue in the future.

- **Recruitment and cultivation of employees in line with local business development needs and foreign company culture**: With the increase of the controlling proportion and the expansion of business scope, overseas FIs may need to consider how to obtain talent that is not only knowledgeable about business operations in China but also familiar with the culture and language of foreign investors. In the medium and long term, it will be a new challenge to build a personnel training system for Chinese operations that will help develop both the business and corporate culture.

### Conclusion

With the acceleration of the industry, more and more overseas FIs are expected to enter the China market. They will contribute by introducing more international experience and, to a certain extent, will increase the level of competition within the industry.

EY believes that the future Chinese market will provide a broader stage for overseas FIs. Domestic and foreign FIs should pay close attention to regulatory development and market trends in order to understand better the impact of the new and future policies that are driving the opening up of the market.
With the shrinking workforce and rising labor cost in post-industrial China, innovation is becoming the new engine for sustainable economic growth. Information has become an essential resource of production going beyond the traditional elements of labor, land and capital. New technologies and new business models are also driving the digital and intelligent transformation in various industries.

Being well aware of such a significant opportunity, the State Council incorporated “Internet Plus” into the Report on the Work of the Government in 2015. Also, the Chinese Government has formulated a series of policies to support the development of new technologies, including The 13th Five-year Plan on Scientific and Technological Innovation, Big Data Industry Development Plan (2016-20), Three-year Action Plan for Cloud-computing Development (2017-19), Development Plan of the New Generation Artificial Intelligence and Guiding Opinions on Deepening the Integrative Development of Manufacturing Industry and Internet. Meanwhile, local governments at all levels have established development and advancement plans to support the growth of industry clusters across the country.

Rapid growth in China’s TMT market

China’s TMT industry has enjoyed rapid growth in recent years. Statistics from the Ministry of Industry and Information Technology (MIIT) show that revenues in the telecommunications industry reached RMB2,755.7 billion in 2017, up 76.4% compared with the previous year. Growth rate increased by 42.5 percentage points over 2016. Further underlying the strong momentum of the mobile data business, mobile Internet traffic grew by 162% year-on-year to 24.6 billion gigabytes in 2017, up 38 percentage points from the growth rate of 2016.
Besides telecommunications, other TMT sectors such as Internet, software and e-commerce have grown substantially over the past few years as well\(^5\).

The entertainment industry has also enjoyed a significant boost. According to the China Film Association, box office takings in China reached RMB20 billion in the first quarter of 2018, setting a record for the highest quarterly box office by a single market\(^6\).

The global influence of Chinese TMT firms is also on the rise. In 2018, there are 18 Chinese TMT companies among the Fortune Global 500. Moreover, CB Insights included 76 Chinese start-ups in its list of 2018 Global Unicorn Companies. On both lists, China is the second most-represented country behind the US.

According to the World Intellectual Property Organization, China filed 48,882 patent applications in 2017, second only to the US in terms of the number of applications. China also tops the league for AI patents\(^7\). Meanwhile, in the blockchain sector, the number of patent applications filed by China is well ahead of any other country.

These developments have played a crucial role in propelling China’s economy toward the New Normal of quality growth. According to the China Academy of Information and Communications Technology, the digital economy contributed 55% of China’s GDP in 2017, which means the ratio is close to or higher than the levels of many developed economies.

**Investment opportunities in the TMT industry in the next few years**

Foreign investors remain optimistic about investing in China despite uncertainties in the global economy. According to the Ministry of Commerce, nearly 30,000 foreign firms were newly established in the country during the first half of 2018, close to doubling the figure of a year earlier. The actual use of foreign capital rose 4.1% year-on-year to US$68.3 billion, of which electronic and communication device manufacturing, and computer and office equipment manufacturing increased by 36% and 32% respectively, much higher than the average\(^8\).

Driven by new technologies, the Chinese TMT industry is expected to grow more rapidly as it expands its coverage to the economic sectors. The most attractive market segments include the followings:

**5G**

China is one of the leaders in 5G development. The Chinese Government plans to bring 5G into commercialization by 2020 and has also taken an active role in developing global 5G standards. The top-down strategic development and a range of policy blueprints aim at creating a comprehensive ecosystem, including technology research and development, equipment, networks, terminals, platforms and applications. Besides, industry players throughout the value chain are also participating in the development of new application scenarios and service platforms in order to provide an international sandbox for 5G innovation.

Equipped with the advantages of ultra-high-speed data transmission, higher capacity and shorter latency, 5G presents new opportunities for applications that will change people’s lives, including 3D video and simulated media, self-driving vehicles and smart cities.

All Chinese telecom carriers have announced plans to invest in the 5G network from 2019 onward. EY expects\(^9\) China’s 5G capex to amount to RMB1.5 trillion from 2019-25 and the number of 5G connections in China to reach 576 million by 2025, representing over 40% of the global total.

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\(^5\) Source: Data from China e-Business Research Centre; “China E-commerce market enlarges rapidly, up nearly 300% by deal volume over the last five years,” www.cei.gov.cn, (Simplified Chinese), accessed 24 October 2017, via Factiva

\(^6\) Source: “What does it mean for box office takings in China surpassing that in North America,” Chinainfobank - news channel (Simplified Chinese), accessed 4 July 2018, via Factiva

\(^7\) Source: “Report on AI Development in China 2018 was officially released,” China economic and trade news (Simplified Chinese), www.chinanews.com, accessed 1 August 2018, via Factiva

\(^8\) Source: “The actual use of foreign capital reached 446.29 billion yuan in January-June, up 1.1%,” www.Toutiao.com, accessed 14 July 2018

\(^9\) Source: “China is poised to win 5G race”, EY, June 2018
Internet of Things (IoT)

According to the MIIT’s development plan, the size of China’s IoT market will top RMB1.5 trillion in 2020, with more than 1.7 billion machine-to-machine (M2M) connections within the public network. In the next few years, alongside the development of 5G, cloud computing and edge computing, the IoT technology advancement is expected to accelerate. IDC predicts that spending on the IoT platforms will reach RMB41.97 billion by 2021 in China. This will take China to a world-leading position, accounting for over 30% of the global spending.\(^{10}\)

Smart city is the fastest growing IoT segment. By April 2017, over 500 Chinese cities had started developing or planned to develop smart cities\(^{11}\), with an objective of improving city governance through smart administration, smart transportation, smart energy management and smart healthcare.

Meanwhile, the IoT technologies also support the development of new economic activities, such as sharing bikes and phone chargers, and promoting the digital transformation of the e-commerce sector, particularly smart logistics to ensure timely and rapid product delivery.

Artificial Intelligence (AI)

Since Ke Jie, China’s leading Go player, was beaten by AlphaGo, there has been an increased interest among the general public regarding AI. According to the China Institute for Science and Technology Policy of Tsinghua University, China’s AI market in 2017 reached a scale of RMB23.7 billion, growing 67% annually. The report also predicts that the breakneck growth will continue and reach 75% annually in 2018.\(^{12}\)

 Besides applications such as machine vision, speech recognition and robotics, the development of autonomous driving solutions is also speeding up in China. Following some regulatory breakthrough in 2018, many provinces and cities including Beijing, Shanghai, Fujian and Chongqing have already given out licenses to Internet or automobile firms to road-test driverless vehicles.

Cloud computing

A notable feature of China’s post-industrialization age is the restructuring of the economy from one based on commodity production to a service-oriented one. Cloud services fit this development direction. Corporates of all sizes and from different sectors can also benefit from the improved efficiency and reduced costs that are made possible by using cloud services.

According to the MIIT’s policy plans unveiled in 2017, the size of China’s cloud computing industry will reach RMB430 billion by 2019, achieving breakthroughs in core technologies and reaching an internationally-recognized level of advancement. Currently, the development of cloud computing is being led by government administration and financial services, but in the next few years, services will expand in other fields, such as manufacturing, health care and education, driving rapid and sustainable development of the Chinese cloud computing market.

Virtual Reality/Augmented Reality (VR/AR)

According to the forecast of the China Center for Information Industry Development (CCID), the market size of China’s VR industry reached RMB16 billion in 2017, with year-on-year growth of 164%. It is estimated that the market size will exceed RMB90 billion by 2020, with a compound annual growth rate of 125%\(^{13}\). AR/VR is developing rapidly in the media and entertainment sector particularly in areas such as games and live broadcast. At the same time, this evolving technology has also made progress in fields such as education, health care and marketing.

10 Source: “Chinese IoT platforms will spend US$6.22 billion in 2021,” China News Service Hong Kong (Simplified Chinese), accessed 18 April 2018, via Factiva
11 Source: “Over 500 Chinese cities clearly propose to build smart cities,” 50cncnet, accessed 19 September 2017
13 Source: Estimated market size of virtual reality industry exceeding 90 billion yuan by 2020, Database of CINIC (Simplified Chinese), accessed 23 August 2018, via Factiva
Competitive edge of future leaders

To emerge as winners in these growth sectors, EY believes domestic enterprises or foreign enterprises seeking to enter the China market need to make breakthroughs in technology, ecosystem and commercial models.

**Technological breakthroughs**

Technological breakthroughs have always been the foundation of the TMT industry. Although China has advantage in some technical fields, there is still room for development. In the future, whoever achieves technological breakthroughs first will have an edge over others, industry control rights and will take up leading positions in the industry.

**Powerful ecological chains**

Market competition in the future will be between ecosystems. The leaders of the TMT industry will be able to use their client resources, capital and technical strength - either via equity investment or commercial alliances - to continuously support the development of partnering enterprises. In this way, they will be able to heighten their control over their ecosystem while improving their overall competitiveness.

**Emerging sector leaders**

A prominent feature of the Fourth Industrial Revolution, brought about by disruptive technologies, is the blurring lines among industries and the more active integration between them. The final winners, or those who can achieve a win-win situation with a majority among other participants, are likely to be companies that can take the lead in exploring new business models, take control of customer resources and attract capital in the new industrial landscape. This means they can occupy a more advantageous position in the competition while creating a bigger market for all to participate.

Building advantage and seizing investment opportunities in the TMT industry

### Conclusion

The Chinese Government has reiterated that pursuing a trade surplus has never been its goal. Amid the escalating international trade tension, China’s strategy to proactively boost imports is significant.

Since June 2018, the State Council has unveiled a raft of measures to improve market access for foreign investors. A number of local governments are also putting in place measures to encourage high-tech sectors such as advanced equipment manufacturing. More imports from the TMT industry can bring more mutually beneficial technological transfer to China and as a result help transform and upgrade the domestic industries to be competitive internationally.

This year marks the 40th anniversary of China’s market opening-up and commencement of economic reforms. As disruptive technologies continue to propel changes in production and ways of life globally, EY believes that China will spearhead an innovation-driven growth model. The TMT industry is set to play a more important role in driving innovation as it is facing new challenges and opportunities brought about by a more open market. We hope the insights above can help participants in the TMT industry understand the new market paradigm and identify their own competitive edge in order to equip themselves for success in China’s digital economy.

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China's pharmaceutical market is experiencing a phase of rapid growth. Favorable policies and growing investment have boosted the development of original new drugs, as well as high-quality generic drugs. Eyeing the increasing demand and huge market potential, foreign pharmaceutical companies are increasing their presence in the China market through multiple channels. At the same time, the Belt and Road Initiative (BRI) is offering opportunities for countries along the route to take part in this booming sector in China.

China's pharmaceutical industry has been growing at a rate of 8%14 per annum from 2014-17. In 2017, the sector recorded impressive year-on-year growth of 11%, a rate that is about four times that of the US and at least three times that of most Western European countries. Such growth shows no signs of slowing, with an estimated 14% annual growth rate from 2017-20. An aging population in China and the pace of urbanization are some of the drivers behind this predicted growth; statistics show that by 2020, 60% of the Chinese population will be urban dwellers15. Demographic changes, coupled with shifting lifestyle and dietary habits, have contributed to a rise in the occurrence of diseases such as cancer, diabetes and hypertension. On the other hand, people in China have become more receptive to Western medicine and medical treatments and, thanks to a general increase in income levels, find them more affordable than before.

China's pharmaceutical market growth rate outpaces some developed markets

China pharmaceutical sales, 2014-2020F (USD b)

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<tr>
<td>2014</td>
<td>95</td>
<td>107</td>
<td>108</td>
<td>121</td>
<td>147</td>
<td>163</td>
<td>178</td>
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<tr>
<td>2015</td>
<td>+8%</td>
<td>+8%</td>
<td>+8%</td>
<td>+8%</td>
<td>+8%</td>
<td>+8%</td>
<td>+8%</td>
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<td>2016</td>
<td>108</td>
<td>121</td>
<td>147</td>
<td>163</td>
<td>178</td>
<td></td>
<td></td>
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<tr>
<td>2017</td>
<td>121</td>
<td>147</td>
<td>163</td>
<td>178</td>
<td></td>
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<tr>
<td>2018F</td>
<td>147</td>
<td>163</td>
<td>178</td>
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<td></td>
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<tr>
<td>2019F</td>
<td>163</td>
<td>178</td>
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<tr>
<td>2020F</td>
<td>178</td>
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Pharmaceutical market growth rate by country (2017)

<table>
<thead>
<tr>
<th>Country</th>
<th>Growth Rate</th>
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<tbody>
<tr>
<td>China</td>
<td>11%</td>
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<tr>
<td>Singapore</td>
<td>6%</td>
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<tr>
<td>Japan</td>
<td>-1%</td>
</tr>
<tr>
<td>US</td>
<td>3%</td>
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<tr>
<td>UK</td>
<td>-2%</td>
</tr>
<tr>
<td>Germany</td>
<td>4%</td>
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<tr>
<td>Spain</td>
<td>4%</td>
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<tr>
<td>France</td>
<td>4%</td>
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</table>

14 Source: BMI database, EY analysis
15 Source: National Bureau of Statistics, desktop research, and EY analysis
Favorable policies to support innovation and quality enhancement

The Government has launched supportive policies to promote innovation in the pharmaceutical sector, including offering fast-track approval for original new drugs and streamlining the approval process to support industry players. Recently, the Government has also launched policies to encourage innovation and enhance medicine quality.

Biopharma and medical technology are among the 10 strategic industries set out in the Made in China 2025 strategy. The move underscores the Chinese Government’s commitment to fostering an enabling environment for the development of original new drugs and cultivating a globally competitive biopharma industry in China.

The Notice on the State Council Issuing “Made in China 2025” Plan

<table>
<thead>
<tr>
<th>Targets</th>
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<tbody>
<tr>
<td>Produce generic drugs modeled after 90%+ proprietary drugs as patent expires (by 2020)</td>
</tr>
<tr>
<td>100+ domestic pharmaceutical enterprises acquire export certificates from the world-leading markets (by 2020)</td>
</tr>
<tr>
<td>Industrialize 20-30 innovative drugs (by 2025)</td>
</tr>
<tr>
<td>5-10 new Chinese drugs with independent intellectual property rights (IPRs) pass FDA or EMA (by 2020)</td>
</tr>
</tbody>
</table>

Key areas

Drugs for rare diseases
Including chemical medicine, traditional Chinese medicine, new biotech drugs

Targeted drugs and new vaccines
Focus on developing highly innovative drugs with independent IPR

3D printing
Explore the application of 3D printing to drug selection

Produce generic drugs modeled after brand-name drugs’ patent expiration
For rare diseases, speed up the production and launch of generic drugs

Supporting strategies

- Establish or standardize the key platform and management practices for the preclinical and clinical evaluation of world-leading new drugs
- Develop the equivalent evaluation system to improve the quality of domestic generic drugs
- Optimize and improve the priority review and fast-track approval (as a guarantee for new drugs approval)

Source: The State Council, 8 May 2015

To encourage drug innovation, the Government has accelerated the review and approval of original new drugs. The launch of policies, including the Opinions on Reforming the Review and Approval System for Drugs and Medical Devices issued by the State Council on 18 August 2015, is considered favorable to the launch of original new drugs in China. Moreover, the Government has streamlined the approval process and reduced the application backlog. These major measures have also created a positive impact on speeding up drug launch and channeling investment to the research and development (R&D) of new drugs.

The effect of these new policies can be best illustrated by the shortened approval time for the launch of Epclusa (sofosbuvir and velpatasvir) in China. Epclusa, a combined preparation of sofosbuvir and velpatasvir, is a Hepatitis C medication that was launched in China (approved in May 2018) only two years after its launch in the US in June 2016. By comparison, it took four years for Solvadi (sofosbuvir), another Hepatitis C medication, to gain approval in China (approved in September 2017) after its launch in the US in December 2013. The shortened approval time for Epclusa was mainly attributed to the reform of China’s new drug approval system, which came into effect in 2015.
In addition to promoting innovation, the Chinese Government also aims to create high-quality generic drugs in order to gradually eliminate poor-quality generics from the market. The generics quality equivalence (GQE) test for the first batch of 279 oral dosage drugs is scheduled for completion by the end of this year. Some provincial governments across China have stated that they will only allow products that have passed the GQE test to tender for contracts. The move is expected to drive integration of the pharmaceutical sector in China and benefit patients. On the other hand, it will also intensify competition in the production of LoE (loss of exclusivity) drugs to replace the branded drugs previously offered by multinational pharmaceutical companies.

Multiple channels for foreign companies to participate in China’s pharmaceutical sector

As China transforms its industries up the value chain, foreign investors are heading in the same direction. According to statistics from the Ministry of Commerce, in 2017, foreign investment in hi-tech industries increased by 61.7% year-on-year, accounting for 28.6% of the total foreign investment. The share of total investment was 9.5 percentage points higher than in 2016. In particular, investment in medical treatment instrument and meter manufacturing increased by 28% year-on-year. In the first two months of 2018, investment in this area and in drug manufacturing further increased by 321.8% and 129.6% respectively, compared to the same period last year.

Capital investment

Investments from large pharmaceutical companies and venture capital firms in the R&D of new drugs - both small molecules (SMOLs) and large molecules (biologics) - are growing. At the same time, the initial public offerings (IPO) of Chinese biotech companies at home and on overseas stock markets amounted to US$4.6 billion by the end of the third quarter in 2018, 64% higher than the year before.

Favorable top-down policy support from the Government, the return of overseas Chinese scientists and vast demand - the incidence of non-communicable diseases in mainland China is well above the global average - are some of the key factors behind the surge of venture capital/private equity funding in mainland China's biopharmaceutical market. In addition to this, Hong Kong has recently changed its listing rules with the aim of attracting more biotech companies to its stock market, providing a wider range of financing options for Chinese biotech companies. So far, Innovent Biologics, Hua Medicine and Ascletis Pharma have listed on the Hong Kong Stock Exchange.

Selected top VC/PE investments in China’s biopharma market (2017-18)

<table>
<thead>
<tr>
<th>Target</th>
<th>Lead Investor</th>
<th>Investment Value/M USD</th>
<th>Latest Round</th>
<th>IPO status</th>
</tr>
</thead>
<tbody>
<tr>
<td>CStone Pharmaceuticals</td>
<td>GIC</td>
<td>260</td>
<td>Round B</td>
<td>Not yet</td>
</tr>
<tr>
<td>Innovent</td>
<td>Capital Group</td>
<td>150</td>
<td>Round E</td>
<td>HKSE Listed</td>
</tr>
<tr>
<td>Hua Medicine</td>
<td>Blue Pool Capital</td>
<td>117</td>
<td>Round D &amp; E</td>
<td>HKSE Listed</td>
</tr>
<tr>
<td>Ascletis</td>
<td>C-Bridge Capital</td>
<td>100</td>
<td>Round B</td>
<td>HKSE Listed</td>
</tr>
</tbody>
</table>

Source: Wind, EY analysis

Introducing Chinese market partners

For large pharmaceutical companies, finding a Chinese market partner to license the approved drugs in their product portfolio is an effective means of mitigating the risks involved in new drug R&D. Statistics show that only about 11% of the clinical trial pipeline successfully obtains approval from the US Food and Drug Administration (FDA). The success rate is even lower for biologics. Finding a local partner makes perfect commercial, strategic and financial sense for foreign drug companies. By licensing approved drugs, they can then focus their resources on developing their core products and therapeutic areas. Introducing a China market partner will also help them leverage the local partner’s first-class R&D personnel to refine their product pipeline according to market demand and plan their market access strategy. Financially, launching a new drug in China requires a large amount of upfront investment, so working with a local partner will alleviate the financial commitment for foreign pharmaceutical companies.

16 Source: http://www.mofcom.gov.cn/article/aeag/201801/201801026599393.shtml
18 Source: “Clinical Development Success Rate 2006-2015”, by Bio, Biomedtracker and Amplion; the sample size is a total of 9,985 clinical and regulatory phase transitions that were recorded and analyzed from 7,455 development programs, across 1,103 companies for FDA approval.
The collaboration between BeiGene and Celgene is a case in point. The two companies co-develop and commercialize on a global scale BGB-A317 (a PD-1 inhibitor), a treatment for a broad array of both solid tumor and hematologic cancers. Celgene’s operations in China are deployed to exclusively commercialize its approved therapies such as Abraxane (albumin-bound paclitaxel), Revlimid (lenalidomide) and Vidaza (azacitidine) in China. This is expected to be a win-win deal for both sides, as BeiGene gains cash flow to fund its product pipeline, while Celgene expands its product portfolio in immunotherapy.

### Licensing approved drugs to local players

<table>
<thead>
<tr>
<th>In-license</th>
<th>Out-license</th>
<th>Product</th>
<th>Coverage</th>
<th>Phase</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zai Lab</td>
<td>Tesaro</td>
<td>Niraparib</td>
<td>China</td>
<td>NDA</td>
<td>2016</td>
</tr>
<tr>
<td></td>
<td>GSK</td>
<td>Anti-inflammation products</td>
<td>World-wide</td>
<td>Phase I/II</td>
<td>2016</td>
</tr>
<tr>
<td></td>
<td>Paratek</td>
<td>Omadacycline</td>
<td>Greater China</td>
<td>Phase III</td>
<td>2017</td>
</tr>
<tr>
<td>Hua Medicine</td>
<td>Roche</td>
<td>HMS55521</td>
<td>World-wide</td>
<td>Pre-clinical</td>
<td>2011</td>
</tr>
<tr>
<td>Ascleis</td>
<td>Johnson &amp;</td>
<td>TMC310911</td>
<td>China</td>
<td>Phase II</td>
<td>2013</td>
</tr>
<tr>
<td></td>
<td>Johnson</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hengrui</td>
<td>Tesaro</td>
<td>Rolapitant</td>
<td>China</td>
<td>Phase III (Oral); Phase I (Injectable)</td>
<td>2015</td>
</tr>
<tr>
<td></td>
<td>Oncolyse</td>
<td>OBP-301</td>
<td>China</td>
<td>Phase I/II</td>
<td>2016</td>
</tr>
<tr>
<td></td>
<td>BioPharma</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fosun</td>
<td>Kolltan</td>
<td>KTN0216</td>
<td>APAC</td>
<td>Pre-clinical</td>
<td>2016</td>
</tr>
<tr>
<td></td>
<td>AbClon</td>
<td>AC101</td>
<td>Greater China</td>
<td>Pre-clinical</td>
<td>2016</td>
</tr>
<tr>
<td></td>
<td>Genexine</td>
<td>GX-E2</td>
<td>China</td>
<td>Phase II</td>
<td>2016</td>
</tr>
</tbody>
</table>

### Entering emerging pharmaceutical sectors

The development of foreign pharmaceutical companies in China has gone through several phases in recent decades, from establishing joint ventures with Chinese companies at their first entry, and setting up manufacturing bases in China to capture the cost advantages of developing their products, to the more recent focus on M&A and product licensing. In the future, as China encourages health care innovation, EY predicts that investment will be channeled to various sectors, such as AI, medical equipment and hospital development.

In addition, with the rollout of the Healthy China 2030 blueprint - covering five major areas: drug safety, public health services, environmental management, food safety and the healthcare industry - the Government will commit further resources to improving the country’s public health and hygiene to be on a par with developed countries. Additional investment will be attracted to the areas of fundamental healthcare and health/medical training, among others.

### Developing healthcare in the Belt and Road countries

The BRI presents tremendous market opportunities for pharmaceutical companies. The BRI is expected to fuel health care demand. As an important component of the BRI, the Government aims to set up medical facilities, provide medical support and train medical personnel in the areas of telemedicine, epidemic control and traditional Chinese medicine.

A number of major healthcare projects have commenced or are being planned in Southeast Asia, Middle Asia and Eastern Europe. In these overseas markets, the new competitive dynamics, customer behaviors and regulatory and approval processes, as well as the lack of a strong distribution network, all mean that Chinese companies will need to identify local market support. This will in turn create opportunities for pharmaceutical companies in the Belt and Road countries to form business connections with their Chinese counterparts.
Conclusion

The whole health care ecosystem in China is expected to flourish with new opportunities and growth prospects. There will be multiple channels and formats through which foreign players can participate in this exciting period of growth. On the other hand, the increased level of participation by foreign pharmaceutical and healthcare companies will help boost innovation and quality among their Chinese peers. Leveraging this unique relation, Chinese and foreign players alike will be able to benefit from the growth of the sector.

China’s healthcare initiatives in the Belt and Road countries

**Eastern Europe**
1. China-Eastern public hospital network initiative
2. China-Russia medical school association collaboration program
3. Czech Chinese Medicine hospital construction project

**Central Asia**
1. Central Asia joint prevention of infectious disease
2. Kazakhstan Shaanxi village hospital construction project
3. Central Asia Chinese medical equipment promotion initiative

**South East Asia**
1. Epidemic disease monitoring in Greater Mekong Sub-region
2. China-ASEAN traditional medicine exchange program
3. China-ASEAN public health initiative

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Consumer Products

China’s domestic consumption upgrade creates opportunities for Chinese and foreign enterprises alike

The rapid development of consumption within the China market, characterized by the shifting and growing demand of its consumers in terms of brands, products, services and channels, has given rise to one of the most complex markets in the world. The good news is that China’s “consumption upgrade” will create demand for imported goods. At the same time, changes in the market landscape and increased emphasis on the dynamics of supply are expected to drive Chinese and foreign enterprises alike to rethink their business model.

Over the past five years, while China’s New Normal has taken shape, the statistical slow-down in economic growth has been in fact gradually shifting the economic structure toward high-end research and development (R&D), manufacturing, service and sales. The New Normal economic model development has been further introduced and evolved under China’s new strategic initiatives, placing an emphasis on innovation, social harmony and green development, as well as encouraging enterprises to go global and improve individual’s livelihood.

At the same time, the continued implementation of China’s Belt and Road Initiative (BRI) which advocates the idea of coordinated regional development has presented ample opportunities for economic and business progress both in China and among the Belt and Road countries.

Together these elements present a positive outlook that has been further underscored by President Xi Jinping’s announcement of significant measures pertaining to “further opening up” earlier this year. These include a substantial relaxation of market access restrictions, creating a more attractive investment environment, strengthening intellectual property (IP) protection and expanding imports. All of these are critical policy initiatives for stabilizing the economies of both China and the rest of the world. They will also serve to introduce the necessary competition to push Chinese enterprises into further reforms and industry upgrade. At the same time, these policy initiatives will provide a more level playing field for foreign enterprises in China as well as a transparent business environment for them to conduct business activities. Chinese enterprises will benefit too as they will be able to learn from their overseas counterparts about the best practices in service, management, product innovation and marketing.
Many Chinese enterprises have embarked on their own journey of transformation by breaking into new markets, when they detected slowing growth in traditional sectors and business models. There are successful instances of enterprises branching into new consumer sectors, while actively exploring neighboring markets, to develop innovative domestic and international integrated business models.

Foreign companies have their own share of challenges and opportunities when it comes to doing business in China. Super-preferential policies for foreign-funded companies have become a thing of the past. The ever-changing and increasingly complex structure of consumption through multiple channels has led to significant competition from fast-growing domestic counterparts. Despite these challenges, the new policy initiatives are in fact expected to usher in a more favorable market and operating environment offering equitable rights and opportunities, with fair rules for both domestic and foreign enterprises.

Offering products and services that meet the “upgraded” demand

The Government has made great efforts to promote a “consumption upgrade” in order to steer China’s economy from an export-reliant one to a domestic consumption-driven one. But there is a glaring gap between the supply of goods and services and the higher standard and demand of upgraded consumption. With an explicit shortage in high-value and high-quality goods and services supply, filling this gap is a huge business opportunity.

The increasing contribution of consumption to China’s gross domestic product (GDP) is one of the structural changes we have witnessed so far in the New Normal economy. In 2017, total consumption contributed nearly 60% of China’s GDP growth. It is also the most significant driver in marginal contribution which is calculated as sales minus total variable costs. Traditional areas of consumption such as food, housing, transportation, apparel and daily necessities have remained the major areas of consumer spending in China.

However, urbanization and a booming middle class in China has resulted in the pursuit of better material and spiritual wealth of its population, characterized by this upgraded demand for goods and services. There are changes in traditional consumption as individuals are buying greener and healthier food, better and smarter home appliances, stylish and customized clothing. Currently, emerging consumption areas such as culture, education, entertainment and healthcare only account for a relatively low percentage of the total consumption. This is significantly lower than that in developed countries and as such, these areas present huge market potential and a rapid growth in demand is expected.

The gap between supply and demand drives imports

Consumption in agriculture, for example, has seen a widening supply-demand gap over the years that has been growing at a high single-digit rate. The gap is predicted to increase to 500 million tons by 2020. While the overall level of demand continues to grow steadily, there will be a gradual shift from primary crops to nutritious and high-value products. For instance, driven by the changing demand and stronger purchasing power of the residents in the more developed regions in China, high-quality beef, poultry, pork, milk, other dairy products and seafood have maintained a rapid consumption growth of between 50% and 200% each year. Agricultural supply has faced some constraints, however, caused by the reduction in farmland and the farming population primarily as a result of urbanization. The increasing cost in the industry and low farming efficiency will also continue to hinder domestic supply in the near term, especially for high-value and high-quality products. Clearly, China will have to rely on imports to fill this gap.

Today, many Chinese and foreign enterprises are actively exploring innovative business models to meet the demand of the consumption sector. For example, some Chinese enterprises are making use of their quality assets and products developed overseas to meet the market demand at home. They are also optimizing their business structure to increase operational efficiency, while some foreign manufacturers are building up diversified sales and marketing channels in China. All these strategies are being implemented with the aim of creating value within the China market.

Going out and bringing in - the new model for Chinese consumer products enterprises

With the development of key initiatives and programs, including the BRI, Chinese enterprises’ strategies of bringing in and going out have further increased in depth and scale. A more sustainable pursuit of going out will leverage international resources to create closer linkage with the domestic markets, narrowing the supply-demand gap and as a result easing the burden on China’s resources and environment. This development will also increase the room for growth for Chinese enterprises. Those who are successful will solidify Chinese enterprises’ role in the global industrial value chain and enhance China’s capability to regulate product prices domestically by using enhanced access to overseas resources.

For example, a well-known Chinese private company, with a vision to diversify its portfolio and develop globally, has recently acquired over 500,000 hectares of pasture and agricultural land in a neighboring Belt and Road country.
One of the aims is to fill the gap in China's mid-to-high end agricultural product supply. The acquired asset is an area that features significant natural diversity. In addition to first-rate pasture, it has the potential for a range of agricultural purposes, especially the production of high-value and high-quality produce at controllable cost. With such a high standard of foreign asset and supply, this company has nurtured a consumer base in China as well as multiple trade and sales channels, and successfully created value for the company.

While Chinese enterprises continue to increase their influence overseas, they should not lose sight of the domestic consumption demand in their home market. Assessing the opportunity correctly and making use of the strong policy support, Chinese enterprises will have every advantage to pursue a strategy that capitalizes on both overseas and domestic markets.

Opportunities for foreign enterprises in China’s consumption upgrade

Foreign companies have always been active participants in the China consumption market and as the high-value and high-quality paradigm grows, they are looking to strengthen their presence.

In recent years, the rapid evolution of China's consumer market has created one of the world's most complex landscapes for overseas enterprises. Chinese consumers' demands for brands, products, services and channels have been constantly changing at the same time as the number of domestic players proliferated. These changes have created the impetus among foreign enterprises and brands that import goods and services to more accurately identify target consumer segments. They have to review the plans for and implementation of their China strategy in order to stand out from the competition while meeting market demands.

To support imports, China has launched a number of favorable policies. For example, the Government has reduced tariffs on a number of goods. In 2018, the tariff for household appliances was reduced from an average of 20.5% to 8%, skincare and hair products and some medical and health products were reduced from an average of 8.4% to 2.9%, and clothing, home and sports products from 15.9% to 7.1%. While China is driving consumption back to its domestic market, these measures offer overseas enterprises an opportunity to compete in the highly attractive market.

Take a European manufacturer and importer of innovative household appliances as an example, it specializes in unique, high-quality and high-tech products design at affordable price. Its product positioning meets Chinese consumers' demand. Leveraging this advantage, the company actively diversified its distribution channels in China, effectively combining the online and traditional offline channels in order to achieve great success in the market. In the five years since entering China, it has achieved extraordinary annual sales that grew from less than US$1 million to more than US$1 billion.

For China's domestic players in the consumer goods sector, the future will inevitably mean more intense competition from high-quality and high-value imported goods in terms of price, service and innovation. The ability to adapt and upgrade their own products and services will be critical for these domestic players to win in the China market.

Conclusion

For domestic and foreign enterprises alike, the BRI, as well as the national strategy of further opening up have created an unprecedented political, economic and business environment favorable for China consumption and global supply. Industry players, regardless of where they are from, need to learn from their peers’ success in product, service, market and sales innovation. The shared goal is to develop and win in China's consumption market which ultimately is big enough for all to thrive.

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19 Source: National Bureau of Statistics
20 Source: The estimation from Wind, Ministry of Agriculture and Rural Affairs of the People's Republic of China, Development Research Center of the State Council and National Forestry and Grassland Administration of China
21 Source: “Greater China Consumer Products and Retail Sector Journal,” EY, April 2018
22 Source: The General Administration of Customs of the People's Republic of China (GACC)
Conclusion

For many multinational corporations (MNCs), China has already been their largest market and key growth center, as they rode along the rapid growth of China’s consumer market in the past decade. With rising affluence and greater sophistication among the Chinese public, the “consumption upgrade” is nevertheless about to open up a range of new opportunities especially for imported goods and services. For businesses ready to explore these new opportunities, the CIIE is an excellent starting point to plan their expansion.

China is the world’s largest emerging market for overseas firms, which offers foreign brands remarkable development potential. China’s consumer demand for brands, products, services and channels has been constantly evolving while the number of domestic players has mushroomed. These changes have created the impetus among foreign enterprises and brands that import goods and services to the more accurately targeted consumer segments. In the process, they need to identify their comparative advantage and devise their China strategy accordingly in order to stand out from the competition.

Apart from the consumer market, the CIIE is also an opportunity for the world to showcase the latest technological advancement. In addition to being an opportunity for importers to source substitutes for US products, as the trade dispute between China and the US shows no sign of abating, manufacturers may also further their transformation in the digital economy with key opportunities in 5G, AI, cloud computing, and VR/AR technologies.

Last, but perhaps most importantly, it is the Government’s priority to transform the economy from being the factory of the world to a global marketplace. It is also part of the Government’s efforts to stabilize the economy through the pursuit of technology advancement and having more consumption-driven growth. On top of the income and import tax cuts and protection of intellectual rights, the State Council announced a plan on 11 October to boost residential consumption between 2018 and 2020 through:

1. Relaxing the access restriction of the service sectors, which is expected to boost the sectors of domestic tourism, elderly care, domestic help, education, and healthcare
2. Promoting consumption upgrade through the development of home rental market, green consumption, smart automobiles, and 5G adaptation
3. Accelerating the standard setting of key products and services to raise the quality of them for domestic consumers
4. Establishing a transparent credit system for manufacturers and service providers to ensure that questionable products and services can be promptly recalled and withdrawn, and businesses can be held accountable
5. Encouraging consumption through further reviews in household income tax, the retirement system, consumption credit products, and the transfer payment system
6. Increasing government guidance to consumer promotion, mainly through strengthening the use of big data and monitoring consumption statistics

In summary, the CIIE, as part of the Government’s campaign to stabilize the economy and create sustainable growth, is conducive to building a larger and more differentiated retail market to unleash the potential of consumer spending, and facilitating adaptation and showcasing technology breakthroughs to support China’s upgrade. With the second session of the CIIE already in preparation, EY expects the CIIE to become a flagship event to symbolize China’s successful transformation in the years to come.
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