

Reflections

Summer 2013

Headwinds and Tailwinds

Navigating China's Transition

Business Take-Aways

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1 China's economy is undergoing evolutionary change or "churn" at a pace that is challenging for MNCs from mature markets.

2 The changes are modifying the patterns of business risk. Risk assessment and management need to be adjusted accordingly.

3 Companies and business units should accommodate to the new competitive environment for future success. Greater flexibility and agility to adapt to changing market conditions are required.

4 Internally, business units should realize, "No more business as usual". Given the present political and economic situations, and given the ongoing anticorruption campaign, companies should bolster existing governance and compliance systems.

5 Costs are rising across the board and maintaining previous levels of profitability will be increasingly difficult. Productivity gains are now a priority.

6 Environmental protection will entail greater compliance

burdens and investments.

7 There will be more frequent antitrust investigations.

8 Successful companies will find a balance between necessary flexibility and agility for the Chinese market, and the rigor of corporate processes and compliance demanded of global governance and China.

China's Xi-Li leadership change and latest round of State Council administrative reforms are part of a changing business environment. There has been certainly a change of style. It has also been a season of new labels: the Chinese Dream, "mass line" campaigns and Liko-nomics. But it remains unclear the true substance of change.

Government reform has so far concentrated on instituting effective anticorruption measures. The healthcare industry has felt the brunt. Anti-trust investigations are more frequent. Industrial policy remains interventionist, with the forced closures of excess capacities in 19 industries. Autumn's Third Plenum of the Central Committee should bring more clarity to the direction, pace and ambition of economic reform.

Business seems split between those calling for less government involvement in markets and those advocating more effective regulation for product and food safety, consumer protection and environmental remediation.

Yet, opportunities still abound in high growth central and western China, as well as in strate-

gic emerging sectors and for companies feeding the shift to consumption. For companies, especially MNCs, it is a time of transition. Navigating changes, the mixed weather pattern of both threats and opportunities, is the topic of this Reflections.



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Prevailing Currents and Market Trends



Urbanization

Government policies are driving growth in small- and medium-sized cities. Residency permits (*hukou*) and land rights reforms will facilitate migration to urban centers, but governments will direct this away from first-tier cities. With an estimated additional 380 million people moving into cities before 2030, urbanization will create a larger consumer base and increased demand for consumer goods in central and western markets. Success depends on being attuned to the consumption patterns of these cities, and distribution channels should be adjusted accordingly.

Environmental Remediation

Increased focus on the environment (termed “ecological progress”) has become a political imperative. The government is committed to spend RMB 3.7 trillion (USD 604 billion) countering air and water pollution, in addition to RMB 4.1 trillion (USD 670 billion) for energy conservation and renewable energy. Local officials will increasingly be evaluated on measures of environmental stewardship, and environmental regulators will have greater authority and capacity. Production facilities will be impacted by closer oversight, and in some cases their continued license to operate (LTO) questioned.

Existing facilities in coastal provinces and first-tier cities may come under pressure to relocate; at the same time, environmental impact assessments for new facilities will become more burdensome than in the

past. Inconsistency of enforcement among different locales will be an irritant and sometimes challenging.

More Competitive Markets

As sectors restructure and consolidate, officials are looking to build domestic champions. Competitive advantages of multinationals are less pronounced than previously and they are under more pressure to demonstrate ongoing positive impacts for development of local capabilities.

Chinese competitors are ramping up their technology, and the middle class is burgeoning, prompting some MNCs that have traditionally occupied the high end market segments to reassess their positioning. A number are introducing products for the mid-segment. Motivations are a mix of defensive efforts to not cede the high growth middle segments, while protecting their high end positions. They are also seizing new opportunities. Having a mid-segment product portfolio is useful not only for China, but for other high-growth emerging markets as well.

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R&D and Indigenous Innovation

The past five years has seen the rapid expansion and transformation of R&D facilities and capabilities. Given that China is now the second biggest R&D market with 12 % of global expenditure and 20% annual growth, there is a shift in MNCs’ attitudes to innovation in China. A preference for internal proprietary IPR is giving way towards open innovation models. Success depends upon the ability to develop local partnerships that are productive and meaningful.

Emergence of Civil Society

The formation of NGOs is being promoted, including for charity, community services and environmental oversight. Registration

requirements are being eased and restrictions on fundraising lowered. The emergence of vibrant civil society organizations has the potential for profound effects on business operations. This is especially so with respect to environmental impacts, consumer affairs and community relations. Businesses should expect more systematic scrutiny from the public, and a concomitant rise in consumer activism.

Foreign Investment

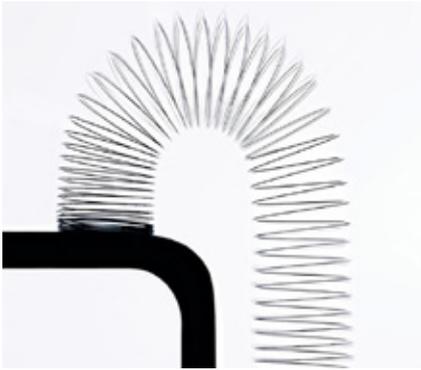
There is a more critical attitude to foreign investment, emphasizing “quality”, rather than quantity. Government officials are no longer solely concentrated on GDP growth, and policies towards foreign investment have become less favorable than some years ago. Anticipate progressively less flexibility for MNCs to interpret the implementation of regulations. There will be less latitude to negotiate. In such a manner, risk profiles are changing.

The announcement that China will negotiate bilateral investment treaties (BIT) with the U.S. and EU is an initiative that may offer relief from this trend. It should also be welcomed by Chinese companies currently facing hurdles when investing outbound to these markets.

Increasing complexity

Previously, companies were able to focus on managing growth. This masked most deficiencies. As growth has tempered, many challenges have been exposed. Additionally, there are now requirements for cost containment and increasing productivity, both novel management objectives for China. They require changes of managerial mind-sets.

Businesses are accommodating this complexity by additional investments for productivity. Those providing automation of manufacturing, solutions and equipment for process and control systems are flourishing.



Growth levels vary and are segmented by geography and sectors. The seven strategic sectors of the 12th Five-Year Plan plus others such as logistics, healthcare and other

services are still experiencing double digit growth rates and above. Services catering to an aging population will prosper. Central and western provinces continue to operate at ambitious growth trajectories.

Flexibility and Agility

Many MNCs are progressively sensing that they lack the flexibility of their Chinese competitors, especially those from the private sector, to adapt to rapidly changing consumer and market trends. They are looking to shorten product cycles, build systems to enhance China customer intimacy and develop a firmer grip of all parts

of the company value chains. Extending distribution to cater to third- and fourth-tier cities is a priority for many and this entails building more robust logistics infrastructures.

For greater agility in the market, a shift toward becoming Chinese competitors requires a delegation of decision making. This exacerbates internal tensions between China managements and corporate headquarters and brings a different set of risks.

Charting New Bearings for Business

Anti-trust

There is increasing enforcement of China's anti-monopoly law, particularly by the NDRC with regards to monopolistic pricing. Cases have been more frequent, and of a larger scale than in years past. Pharmaceuticals, infant formula and LCD are recent cases. They have targeted both foreign and domestic companies, and investigated behavior outside of China for the first time. This is in part due to increased staffing for the NDRC's anti-trust enforcement department. The SAIC has also become more active, particularly in a notable investigation of Tetrapak for uncompetitive behavior in packaging.

As staff resources continue to expand, greater regulatory oversight of business operations can be expected. Anti-trust enforcement in China is increasingly influenced by developments overseas as Chinese regulators monitor cases abroad for possible links to China. Authorities are applying a definition of "market dominance" distinct from other jurisdictions.

Cost of Labor

Across China labor costs are increasing due to a combination of demographic factors coupled with stricter regulations. In the past year, Chinese authorities have raised the minimum wage in many provinces and localities, including the Pearl River delta, where minimum wages rose 19% in 2013. The government has also passed stricter regulations regarding dispatch labor and social security costs, further raising costs for employers. Noting that China's working-age population fell for the first time in 2012, labor cost pressures will be exacerbated by a shrinking labor supply in coming years. Labor productivity gains will become a higher priority than at present.



Cost of Environmental Compliance

An increased focus on environmental protection, from both the government and the public, will lead to more detailed, burdensome regulations with stricter enforcement. This will raise compliance costs as factories are required to upgrade existing production processes. Increased energy costs are also a likely outcome. These will translate to accelerated pressure for capital expenditures for equipment upgrades. For plants operating in eastern China, there will be pressures to either upgrade or relocate operations. Businesses that move production early to central and western regions will likely have the advantage in negotiating with local governments.

Tax Burdens

The tax situation is becoming more complex with the widening of the tax base. Where previously companies only needed to pay corporate income tax, they are now often required to pay property and social security taxes, with environmental taxes possibly on the horizon. Many local governments are short of funds and have been raising revenues through new fees and energetic enforcement of current regulations. Furthermore, as China's bureaucracy becomes more professional, expect less room to negotiate tax deals with local officials.

Government Relations

Traditional business development and GR strategies based solely on relationships (*guanxi*) are increasingly obsolescent. There is a growing segmentation of government roles as policymakers, administrators and regulators.

As China's bureaucracy becomes more professional, political capital must be accumulated in a systematic way. Companies interact across a broad range of government departments and levels, and should seek to influence government perceptions in a comprehensive manner. Corporate social responsibility, community-outreach and thought leadership are necessary complements to cultivating personal relationships.

Storm Clouds and Corruption

During this transition phase for the Chinese economy there are heightened challenges for all market operators, none more so than those relating to governance, bribery and corporate compliance.

The new administration of Xi Jinping has placed anticorruption among its top priorities. The government has stepped up investigations on domestic and transnational commercial bribery. This has led to a spike in anticorruption investigations and heightened the risk profile for companies. In the first half of 2013, Chinese prosecutors received over 600,000 inquiries related to bribery, a 77% year-on-year increase. More than 830,000 enterprises and institutions, and over 1.11 million individuals were subject to requests for investigation.

Official and media attention has recently focused on pharmaceutical and healthcare MNCs. Other sectors will undoubtedly follow.

Past business practices for China may have already exceeded their "use by date" and now entail unacceptable risk. Local management should not take the special conditions of the Chinese market as an excuse for exceptionalism condoning non-compliant business behaviors. Conversely, corporate headquarters may need to temper their growth targets.

With the present political and market environments, companies need to reassess and bolster existing management oversight systems. Unrelenting efforts are required to build effective integrity and compliance systems. Undoubtedly they will evolve over time to practical

programs suited to the specificities of the Chinese market.

Effective communications are an integral component for compliance. Special efforts and attention need to be paid to consistent internal communications, as well as communications with third party suppliers, distributors and professional services companies.

The China Business Leaders' Forum (CBLF) hosted at Renmin University has published its Business Integrity Handbook II. This is a useful resource for MNCs and local companies.



About Us

North Head is a strategic communications and public affairs consultancy with a clear China focus. It specializes in partnering with multinational companies operating in this dynamic but challenging market, and supporting Chinese companies extending their reach globally. To receive future issues of China Reflections, please send an email to info@northheadcomms.com

Check our website for tracking trade: www.asiatradewatch.com

The Business Integrity Handbook II can be downloaded at: www.northheadcomms.com

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