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DECOUPLING AND ALIGNMENT: CHINA BUSINESS FORECAST 2021

2020 has been a momentous year which will shape China's place in the world for years to come, says Jan Borgonjon.

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A year ago, when writing a review of our 2020 Business Forecast, I commented on how foreign companies faced a stark choice over whether to double down or divest in China against a backdrop of domestic and global uncertainty. Few of us could have possibly imagined the world we would be living in 12 months later, but in the wake of the huge disruption caused by Covid-19 the choice facing multinationals in China is now even starker.

Indeed while 2020 turned into a milestone year for the global economy, it was even more notable for China which emerged from the pandemic both stronger and more confident. The momentous shifts will positively impact China and its global status for years to come, and lays the basis for the country's growth over the next decade. In fact China ended this tumultuous year with economic growth among the highest in the world, and with GDP growth forecasts for 2021 averaging at around 7.8%.

Domestic growth

Much of that growth is coming from the domestic market, and the pandemic has merely accelerated the drive towards China becoming ever more dependent on domestic demand in the future.

This drive is based on sound economic reasoning. The spending habits of Chinese consumers are changing dramatically as they save less and borrow more. In addition, the average net worth of an urban Chinese household is now around US$200,000 (double the average in the US), with real estate accounting for nearly 60% of household assets. Over the next five years it is predicted that another 200 million people will join the middle class, largely because reforms to the hukou household registration system will bring millions more workers into formal social security, labour and taxation systems. This focus on domestically driven growth chimes with the government's new 'dual circulation' policy which states that China will in the future mainly rely on 'internal circulation' – i.e. domestic production, distribution and consumption - although there will still be an important place for 'external' foreign investment and trade.

More precise details of the strategy are expected when the 14th Five-Year Plan is unveiled in the spring. However a number of key elements of that plan are already taking shape which will further drive the move towards a more self-sufficient and self-reliant economy.

As well as doubling down on self-sustainability and expanding domestic demand, we can expect a massive suite of policies related to land reform and the aforementioned hukou reform, an improved social safety net, and increased spending on education. Huge investment in the green energy transition is also expected, as is widespread digitalisation and technology upgrades in areas such as 5G, Artificial Intelligence, and the Internet of Things.

Foreign investment

The dual circulation approach shows how China's relationship with the international economy is shifting. Although it is keen to maintain links with international markets, China is more determined than ever not to be dependent on any particular country in its drive to become more self-reliant.

However, as the approach dictates, foreign investment in specific areas will still be welcome and China remains very open to foreign direct investment (FDI). Indeed, despite the Covid-19 shock, China is set to be the world's largest FDI recipient in 2020, and the business environment for foreign companies is actually increasingly open and positive.

To simply decouple from the international economy is not in China's interests either. Our view, and one backed up by our 2021 Business Forecast, is that while this decoupling drive is here to stay, it will be a constructive decoupling which is both pragmatic and gradual. Foreign investors will still have continued relevance and their technology and know-how will still be needed.

But foreign investors do need to be mindful of the further fusion of Chinese government policy into the business environment. Politics has of course always been important in China, but it has taken on an international dimension now too. Companies will have to navigate carefully, and might have to make important decisions on the role of China in their global value chain. Alignment and communication between China and multinational headquarters is bound to become more challenging.

Grand challenges

Against this backdrop our annual survey of China-based executives of multinationals makes for fascinating reading.

A particularly striking finding was that almost two thirds of international companies consider that China is already, or will become, their first or second global market in less than five years. Yet at the same time the traditional advantages of these multinationals - such as brand, technology and management - are being rapidly eroded by Chinese competitors.

For these foreign companies the challenge of scale is particularly pressing across a vast swathe of sectors as Chinese national champions are now among the largest companies in the world in their respective sectors. At the same time multinationals are having to deal with the emergence of explosively growing, disruptive Chinese firms in sectors such as production automation, agricultural value chain modernisation, green tech and medtech, to name a few. Working in these sectors and with these companies often requires a totally different mindset and organisational approach. If you want to work with these companies you have to think in a very different way.

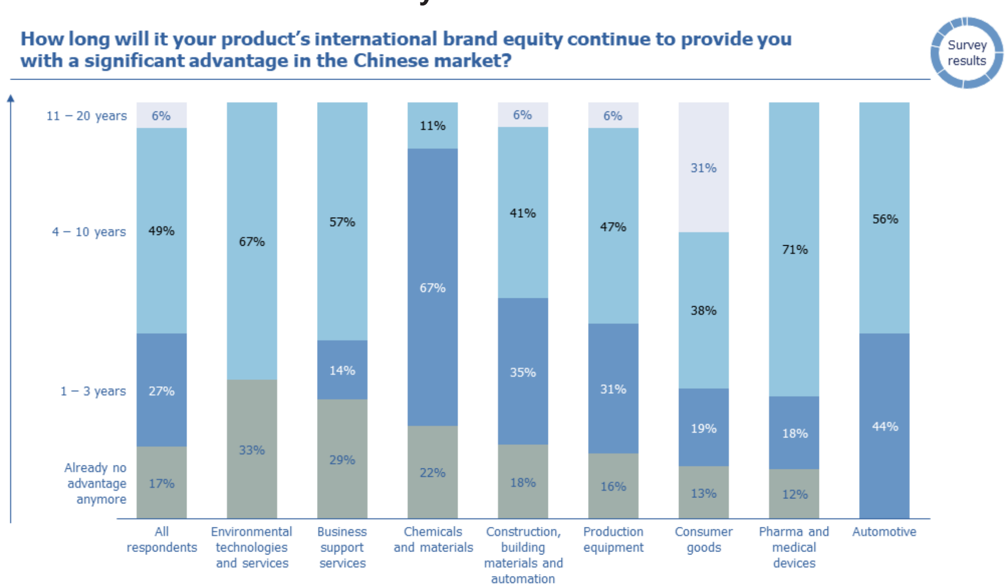
The brand challenge

The chart here perfectly illustrates how the brand equity of foreign companies is being eroded. When executives were asked how long their product's international brand equity would continue to provide them with a significant advantage in the Chinese market, some 17% said it no longer gave them any advantage at all. A further 27% said it would only last another one to three years.
In some sectors the results were particularly striking. Among respondents in the automotive industry, 44% said the advantage would last less than three years, while in environmental technologies and services a third said they already had no advantage.

Both sectors, along with business support services, chemicals, and pharma and medical devices, said that all brand advantage would be gone within a decade. As might be expected, one of the few sectors where brand value could last longer is consumer goods, but even here a third of companies said the brand advantage had already gone or would be gone within three years.

Chart #1

94% of respondents expect to lose their advantage of being a foreign brand in the Chinese market by the end of this decade



N = 229 respondents, surveyed Oct 2020, InterChina analysis.

In China for China

We also asked foreign companies about the extent to which they were doubling down in China. What is clear from their responses is that it has never been more urgent to adopt an 'in China, for China' approach.

In our survey three quarters said a fully localised Chinese operation was necessary by 2025. However, again there were some striking differences between sectors. For instance, well over half of automotive companies said such an operation was needed now. However the pace of change in sectors such as environmental technologies and services, or pharma and medical devices, doesn't appear quite as acute. In the latter sector 41% said it would be more than a decade before full-scale localised operations would be needed.

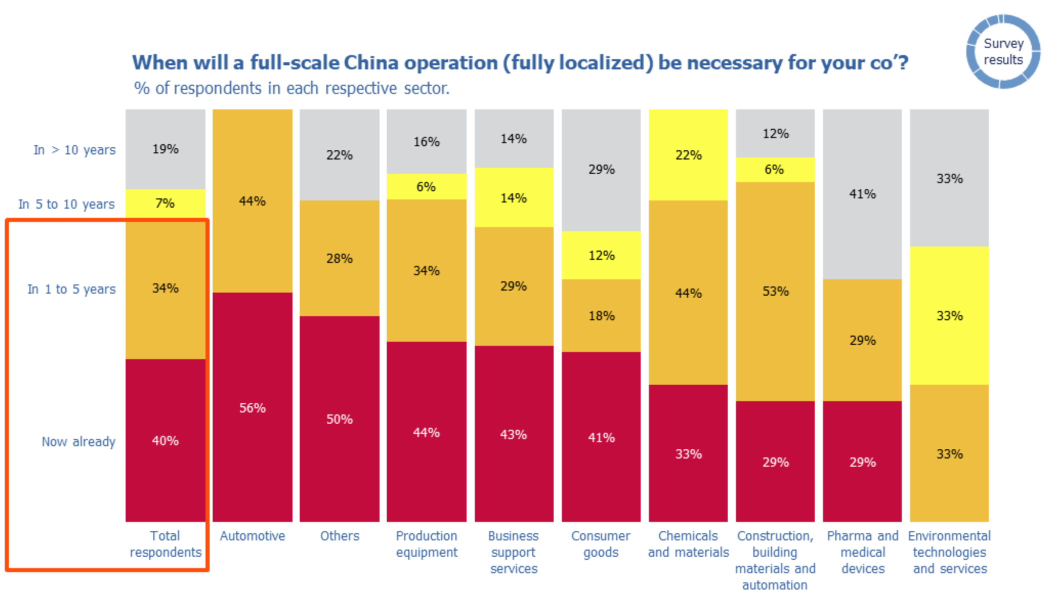
But what exactly will this fully localised approach look like? And how will multinationals achieve their localisation goals whilst maintaining alignment with global priorities?

For instance does localisation mean a completely separate Chinese operation with duplicated and independent procurement, production, sales and R&D? Does is mean moving headquarters to Shanghai, Hong Kong or Singapore? Does it mean acquiring a local company or brand, or maybe having a Chinese company as a JV partner? Or perhaps the full use of local suppliers instead of importing components, and the promotion of local product development?

Whatever strategies foreign companies decide to adopt, there is no time to delay. The pressure on them to perform and compete locally is increasing rapidly.

Chart #2

Hence, three quarters of surveyed companies strive for full-scale China operations by 2025



N = 229 respondents, surveyed Oct 2020, InterChina analysis.

M&A route

To achieve such localisation goals the acquisition route is the most obvious. Indeed, half of the companies we surveyed are considering partnering with local companies via M&A in the near future to protect their businesses.

Acquisition opportunities are on the rise as Chinese companies are facing the same competitive pressures and many become more willing to consider an exit. This is particularly the case for private companies in China, which face succession issues as their owners approach retirement, and the next generation are uninterested in taking over the reins of traditional family businesses.

Pricing has also become more realistic and China is not as expensive as it once was. For instance, a typical transaction multiple closed by InterChina in 2020 was 8–10x ebitda, and our view is that for multinationals there is definitely an opportunity in the year ahead to acquire at reasonable prices.

It is also worth noting that deals are taking far less time to complete in an increasingly sophisticated M&A market, with the average negotiation timeline now five months compared with 16 months a decade ago.

Full scale or nothing

So, as our 2021 Forecast clearly shows, the choice facing foreign companies operating in China is starker than ever.

For some companies it will be a case of heading for the exit, although those that do choose to divest may not necessarily make a full withdrawal, and instead use Chinese investment to further grow their business while retaining a stake themselves.

However, given the extraordinary potential that the Chinese market still offers, our view is that the majority will choose to stay. And given the exciting pace of change and the strengthened development of domestic consumption, why wouldn't they?

A casual glance at just a few of the major corporate events of 2021 in China gives you a taste of the future. For example, Huawei will be adding Harmony OS 2.0 on more than 200 million phones, Siemens Energy will deliver its first megawatt green hydrogen solution in Beijing, Tesla will start exporting models made in Shanghai to Europe, and ABB will open its most advanced robotics plant in Shanghai.

Yes, 2021 will be a year of stark and difficult choices. But also one of terrific opportunities in China.

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Jan Borgonjon is one of the founding partners and President of InterChina, providing overall leadership and strategic direction to the firm. Since founding InterChina in 1994, Mr. Borgonjon's vision and leadership have established it as one of the leading advisory firms in China.

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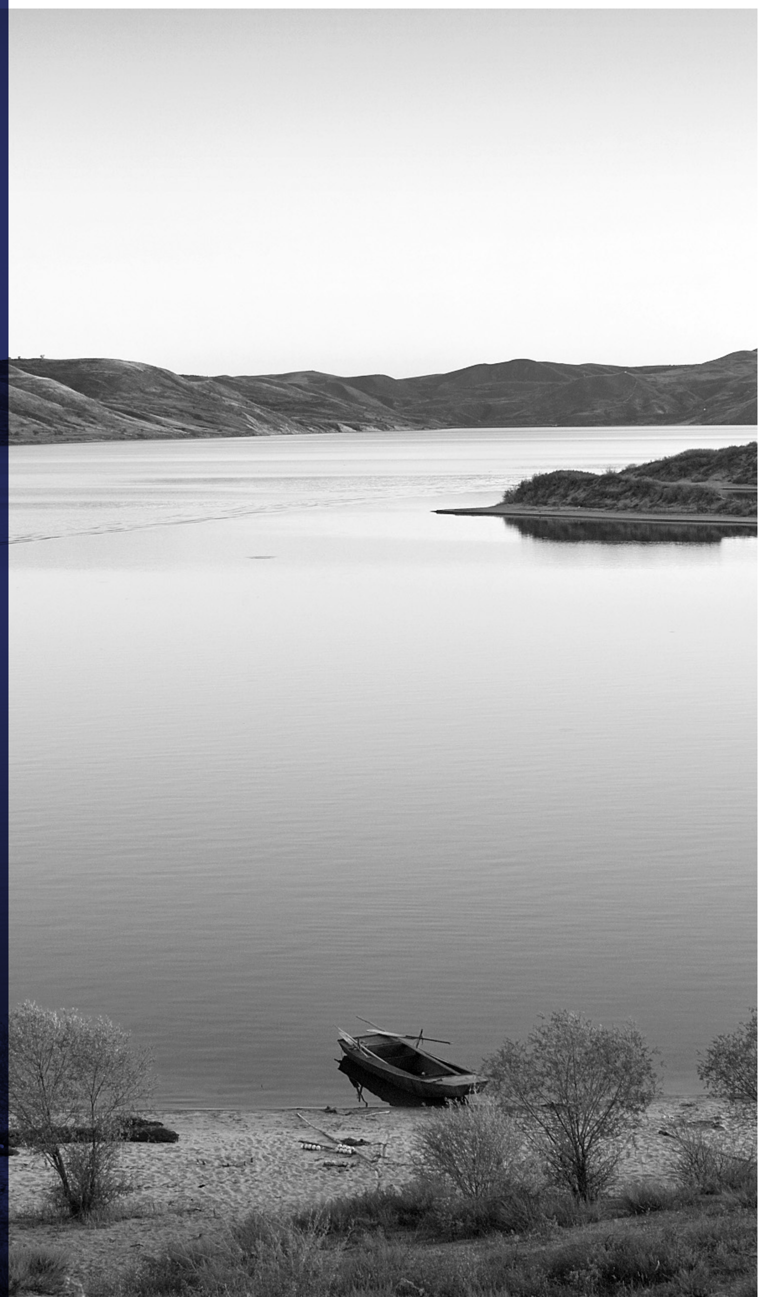

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