China

2018

Political & economical clarity and certainty: A boost for business

Exclusive China member of CLEARWATER INTERNATIONAL

InterChina

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Strategy | Corporate Finance

www.InterChinaConsulting.com

www.InterChinaPartners.com

Sources of our analysis: Interviews with >100 senior China executives, combined with findings of our Strategy and M&A Advisory Practices

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23 years

...of doing business in China.

60

...dedicated staff members, in Shanghai, Beijing and London.

USD 8.8+ bn.

...the value of the **over 185 transactions** we have been involved in.

41

... acquisitions /divestments

7 Closings in 2017

32

...strategy projects (top-line growth) in '17.

Top 5

...independent advisory firm in China.

Overall Direction

In some case, the
“Xi Jinping Thought”
will be favorable for
foreign companies,
in others not…
Nevertheless, clarity will
help to build confidence
and drive decisions

China
2018

19th Party Congress & "Xi Jinping Thought" – a Historic Event:
Stability and clarity of direction for the next decade… and beyond

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- Consolidated Xi's leadership.
- No clear successor: not necessarily bad

Power over the institutional framework

Power over the public: Social Media/ Internet/ populist measures.

Change of Economic Model: GDP no longer the only parameter; financial stability, environment and innovation.

Global Projection: Focus ASEAN. OBOR. AIB.

Slow Reform, but not stopped. …status quo

Source: CCP reports, InterChina Interviews and Analysis

What will not change: Slow reform & “protectionism”

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Sector de-regulation in non-politically sensitive sectors (70% of all sectors). Yet, stronger role of SOEs across the board.

Sector de-regulation (non-core areas)

Market Dynamics
Gov’t allows the market to self regulate (survival of the fittest)

Negative List
JV restrictions removed:
- E-commerce
- Power TT equ.
- Cranes
- Paper.

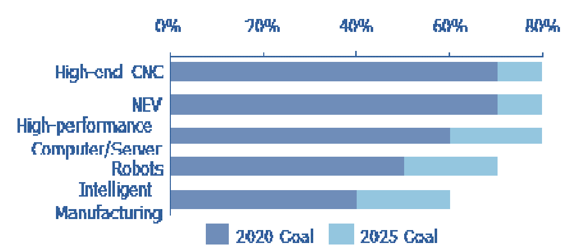
Regulatory Flexibility
Reporting not approval;
Clearer guidelines in limitations.

More Power to State-Owned Enterprises

- Increased State Control over economy
- Key role of SOE’s reinforced; increased influence over large POE’s
- Financial Debt/ leverage control

What means to be “national”?

- Made in China 2025
- Strategy outline of innovation-driven development
- Action guidelines on “Internet +”
- 13th 5-year plan on Science and Tech Development



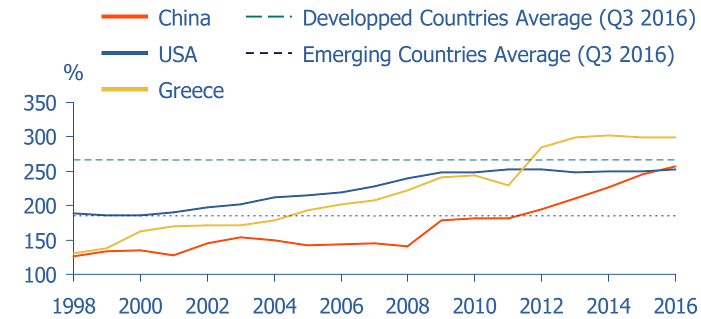
Sources: Various gov. policies, InterChina Interview and Analysis

Other aspects will dramatically reshape China in 2018:
A shock in the short term, yet fundamentally positive in the mid-term.

"Financial Deleverage"

- **Borrowing money** will become more and **more difficult**.
- **Foreign exchange control.**

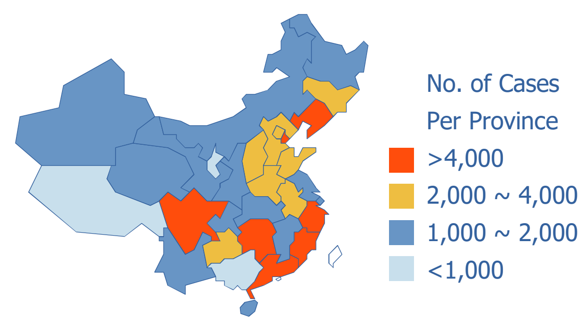
Debt/GDP Rate Of Key Countries (1997 – 2016) (Unit: %)



Stricter Environmental Protection

- **Top priority** & NOT to go away.
- **Further closure** of inefficient or polluting factories.
- **Resulted increasing costs**, as 'cheap capacity' is closed down.

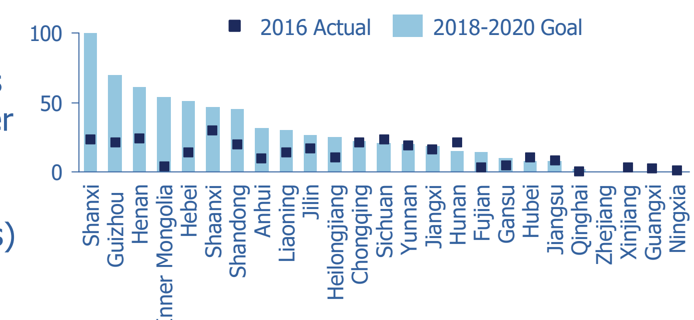
The Number of Environmental Complaint Cases Concluded Per Province, Jan. 2016 – Sept. 2017)



Capacity Decrease

- Mainly from closures of **POEs** (not SOEs) and **"idle" capacity**.
- **Price spikes, supply problems.**

Target & Progress Of De-capacity Per Province: Coal Sector (Unit: million tons)



Source: China National Statistics Bureau, MEP, EIU, Bank for International Settlements, InterChina Interviews and Analysis

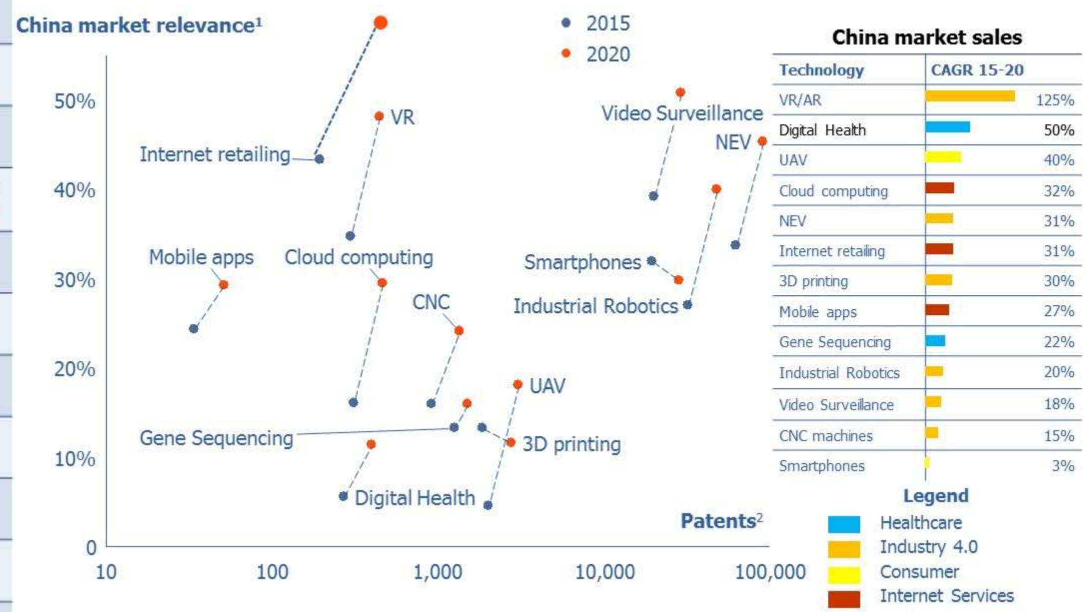
The Vision: China as Global Source of Lower-Cost and Scalable Innovation

A view encouraged by the government, but already promoted by key stakeholders (SOEs, POE and MNC, Private Equity, Funds, etc..)

Policy

- Made in China 2025 中国制造2025
- Strategy outline of innovation-driven development 国家创新驱动发展战略纲要(2015)
- Action guidelines on "Internet +" 推进"互联网+"行动的指导意见 (2015)
- 13th 5-year plan on Science and Tech Development "十三五"国家科技创新规划 (2015)

High Technologies	Policy Coverage
VR/AR	
Digital Health	
UAV	
Cloud computing	
NEV	
Internet retailing	
3D printing	
Mobile apps	
Gene Sequencing	
Industrial Robotics	
Video Surveillance	
CNC machines	
Smartphones	



Notes:

1. A technology's market relevance in 2020 is calculated by the ratio of its forecasted 2020 China market size vs. forecasted 2020 global market size (dollar value). Same method applies for 2015 market relevance. Except Industrial Robotics, NEV and Smartphone, which are calculated based on volume. Given the low-cost driven market nature, China's share, if measured by volume, could be higher than normal; on the contrary, China's shares that measured by value would be higher.
2. Measures patents published in China in 2015 and est. for 2020.

Source: InterChina Interviews and Analysis

2018 Macro Forecast: The clarity of direction provides more certainty, will boost business opportunities

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Key words for 2018

- Consumer confidence
- Less financing
- Higher Cost/ Prices:
  - Control excess capacity
  - Environmental compliance
- Consolidation
- Innovation and technological progress (China 2025)
- Globalization and outbound investment

Economic Performance

GDP Growth	Inflation	RMB Deprec.	Labor Cost
6.5 %	**2.0 – 2.5%**	**3 – 5%**	**4– 6%**

GDP Drivers…

- Consumption: Retail sales driven by middle class + urbanization will further increase
- Public inv.: Stimulus programs maintain base growth
- FDI, private inv. : Keep playing an important role
- Outbound inv.: Continuity of 2017; Forex control and more discriminate approvals.
- Efficiency: More rational behavior of local companies, profitability higher priority, the end of easy money
- Possible "Controlled Crises":
  - Internal: "Let a big co' go"; control over real estate, IPOs.
  - External: Regional tensions.

Source: InterChina Interviews and Analysis

Sector Forecast

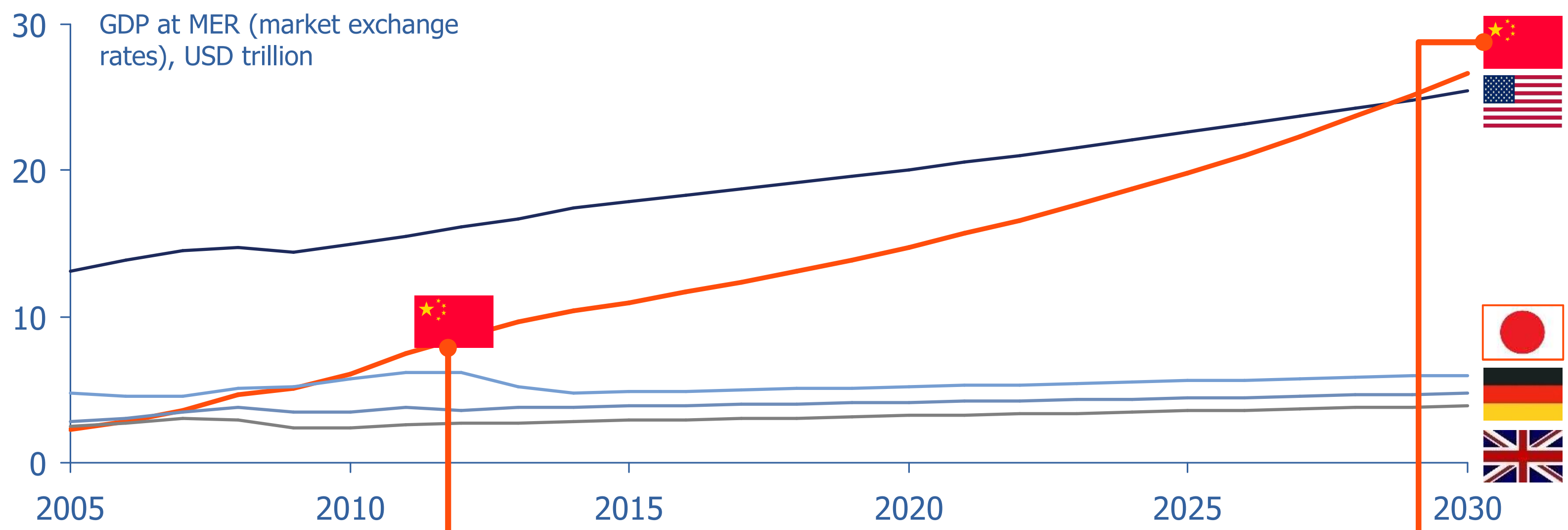
The 'One-China' strategy is over,
driving companies out
of their comfort zones
into greater complexity

China

2018

A shared Vision by most of our MNC CEO interviews: GDP, driven by consumption and urbanism, may triple by 2030 under the New Normal Economic Model

Economy growth of a few key countries (2005-2030)



China's Old Model (1990s – 2012)

- Exports
- Over-capacity
- Fixed-Asset Investment
- Low-End Manufacturing

China's New Model (2012s Onwards)

- Domestic Consumption
- Service Sector Development
- Industrial Upgrading
- Green Development
- Financial Reform
- Fair Competition

2030 Indicator

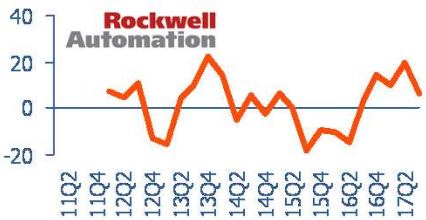
- **4% – 5%** GDP growth.
- **70%** Urbanization Rate.
- **RMB 115,000** Nominal GDP per capita.

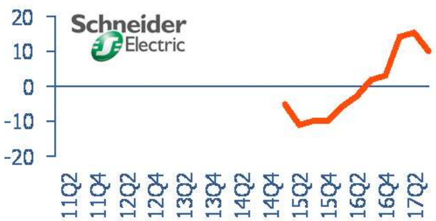
Notes: GDP at MER (market exchange rates): GDP converted from national currency to USD based on market exchange rate..

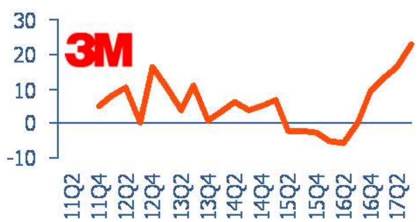
Source: World Bank, Goldman Sachs, Pwc, InterChina Interviews and Analysis

MNC's adapted well to the New Normal. A majority of MNCs report double-digit growth in 2017; are budgeting similar growth rates for '18

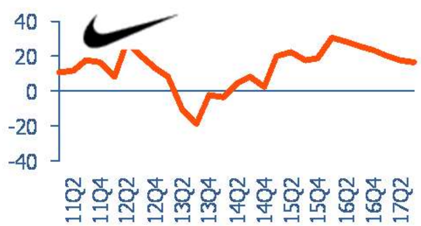
MNC in cyclical sectors: Strong rebound
Company Performance yoy Growth in China (%)*

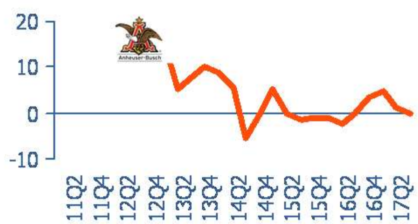






Consumer MNCs: Recovery, yet strong face-wind from local competitors Company Performance yoy Growth in China (%)*





Key Success Factors reported by interviewees:

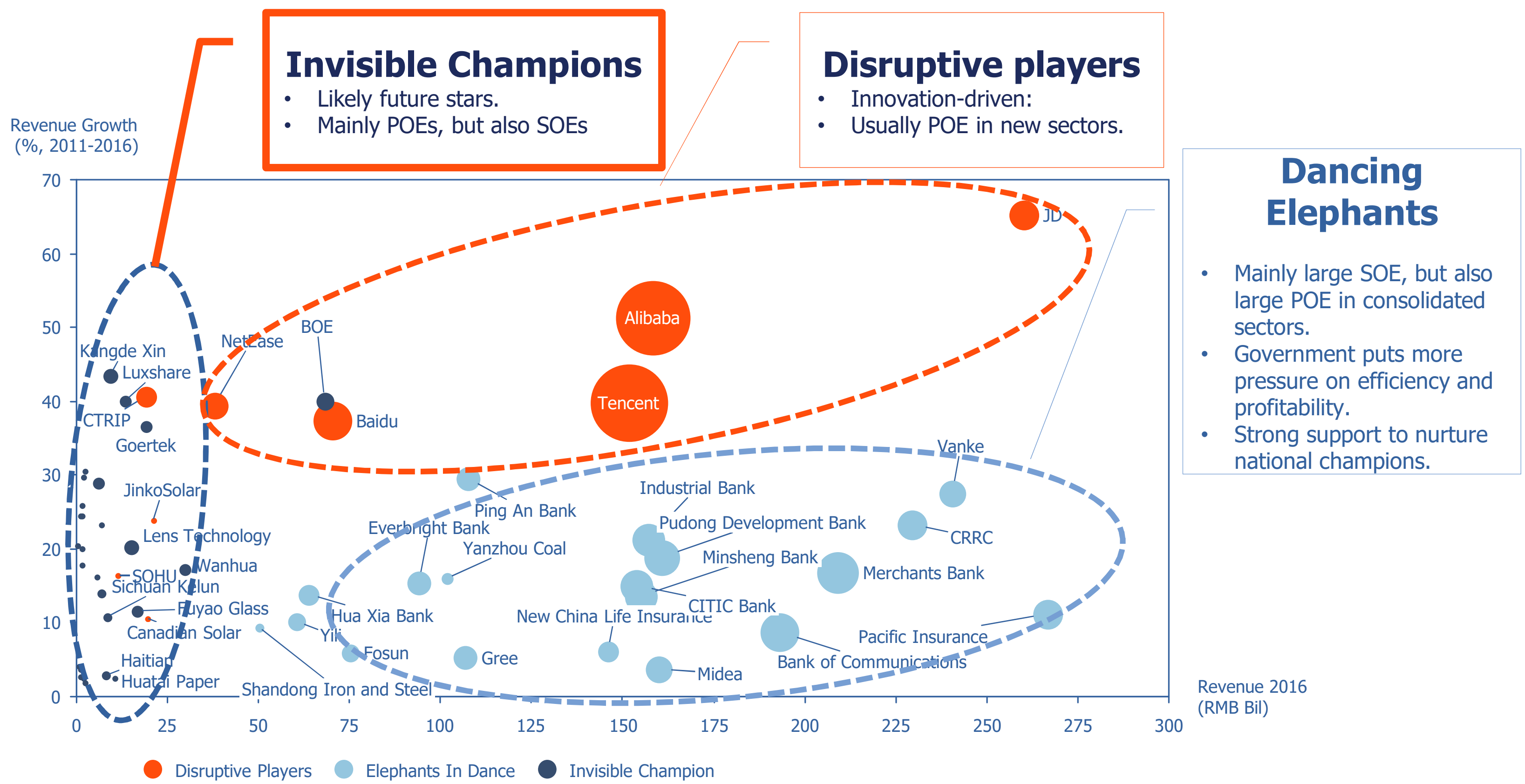
- **A new market:** "Better quality" products, **"good enough" fast growth segment.**
- **Products revamp:** Localized portfolios (simple downgrading and supply based localization) … whilst local competitors still face a high technological entry barrier.
- **Customer revamp:** New customer segments in China (regional Chinese players), compared with previous MNC large Chinese national group customers).
- **New corporate growth strategies:** A lot of this is handled in the shape of new JVs and local M&A, which brings scale, technologies and access to market to many players.

**Note: Most companies are measured by revenue growth, while some by the growth of orders and the new stores etc.*

Source: Annual Reports, CICC, InterChina Interview and Analysis

Chinese Competition is perceived as the main threat for 2018… Many local companies do not know how to compete efficiently in a high cost/ more compliant environment… however others are emerging as skillful managers in the rapidly changing environment

A more dynamic and complex competitive scenario



Source: Annual Reports; InterChina Interviews and Analysis

2018 Sectors: Generally, MNCs are forecasting quite high growth goals

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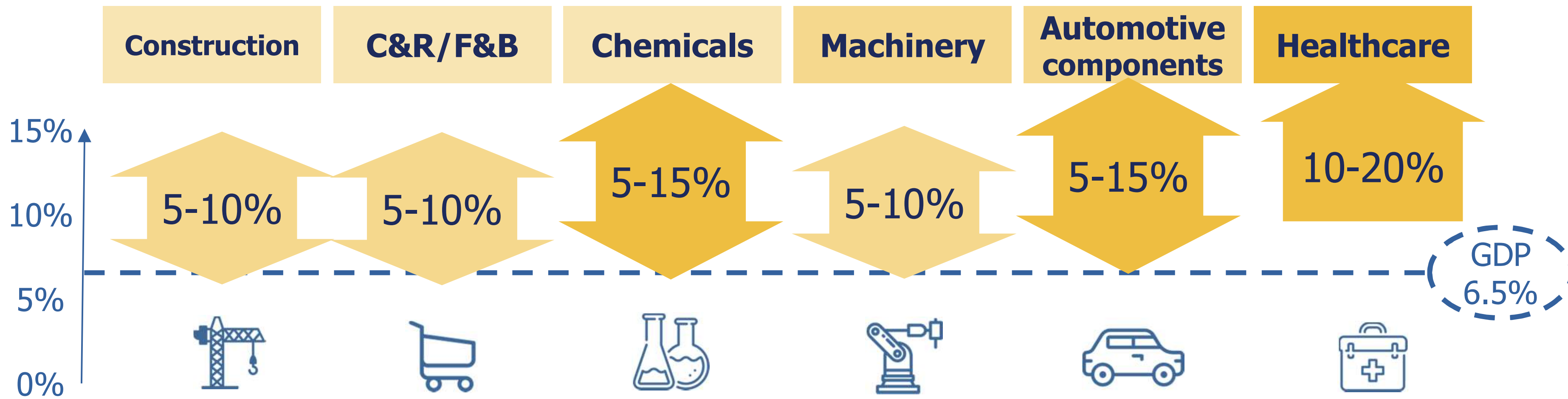

- Inventories have been reduced.
- Tackle domestic Infra-structure
- OBOR
- JV/ M&A outbound.

- Expanding product portfolios.
- Revamping Route to Market
- Revamping Regional strategies
- Developing digital capabilities.

- Consolidation
- Environ. compliance
- New local product launches
- Local R&D.
- S&D Revamp.
- JV/ M&A.

- Premium offerings.
- Services.
- Automation.
- Digitization.
- Rethink cost base (local mfct and R&D)

- Achieve scale
- New segments: EV, new materials, HMI
- Access to Chinese OEM
- Aftermarket.
- Steady Consolidation (M&A/ JV).

- Rigorous compliance.
- Focused coverage.
- Higher rep productivity.
- Localization.
- Local partnerships.

Source: InterChina Interviews and Analysis

Business Strategy

"A new pattern has emerged for doing business in China"

Dynamic China Strategies:
New KSFs are being added, whilst old ones remain equally important

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2017 Onwards

- **Service Revenue Streams**
- **Adjacent Segments & Trade Ups**
- **Route-to-Market Revamp**
- **"Good Enough" Optimized Portfolios**
- **B-brand Buffers**
- **Local Structure Empowerment**
- **China Innovation R&D**
- **M&A/Consolidation**

2000 - 2016

- **Localization**
- **Re-align with gov't interests**
- **Re-vamped strategic reviews**
- **Local decision-making autonomy**
- **Manage HQ's view**

A Second Wave of Localization: Mainly driven by market access considerations, and participation in "good-enough" market segments

Case – Medical Devices: Top reasons to produce in China (or consider local production)

	Market access (as a more "local" product)	Lower production and logistics costs for APAC	Time to market, registration speed	Local development, proximity to market	Guarantee local supply stability	Local high-end market reached an attractive size	Local competition more on par
Company A	★★★						
Company B	★★	★★★					
Company C	★★★	☆	★★				
Company D	★★★			★★	☆		
Company E	★★★			★★		☆	
Company F	★★★					★★	☆
Company G	★★★			★★			

Note: Company A-D is of Do not (yet) produce Class III devices in China locally, while Company E-G is of already produce Class III devices in China locally

Legend: ★★★ Top reason ★★ Second most important reason ☆ Third most important reason

Source: InterChina Interviews and Analysis

China as a source of global innovation: 50%+ of MNCs do R&D in China, but still need time to deliver real innovation

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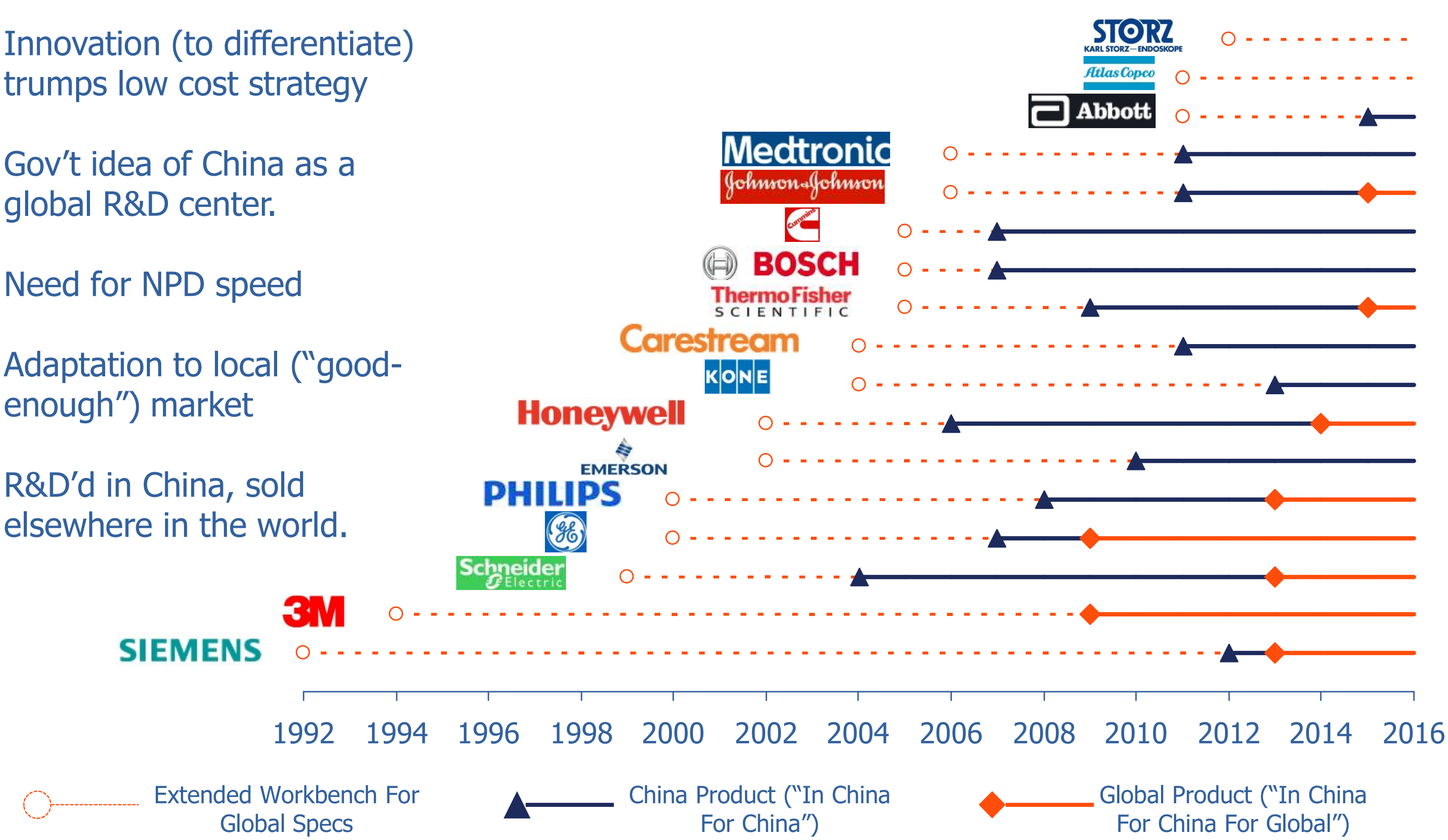
China as global center for low cost innovation

- Innovation (to differentiate) trumps low cost strategy
- Gov't idea of China as a global R&D center.
- Need for NPD speed
- Adaptation to local ("good-enough") market
- R&D'd in China, sold elsewhere in the world.



Source: Company Reports, InterChina Interviews and Analysis

M&A as a key avenue for growth

2018 will be a very strong year for both inbound and domestic deals

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What will be available for sale?

- Target rev.: RMB 0.3 - 1 bn
- POEs: Lack of competitive advantages in the “New Normal”; 1st Generation owners retiring.
- Listed companies: Due to pressure to keep multiples up and earnings consolidation.
- Sectors to further consolidate:
  - Chemicals
  - Industrial products
  - Automotive
  - Medical devices
  - Life science product distribution
  - Machine Tools

Who will be buying?

- Chinese listed companies will remain the driving force
- Increased interest from MNCs.
- PE reinvents its role, more specilized and more buyouts

What will be the main drivers?

- Scale
- Access local customer bases (i.e. car OEMs)
- B brands: Good-enough product ranges
- Local innovation and localization capabilities
- Access to distribution channels

At what price?

Varies in a large degree among sectors;
EBITDA x8-x10 in 2017

Source: InterChina Interviews and Analysis

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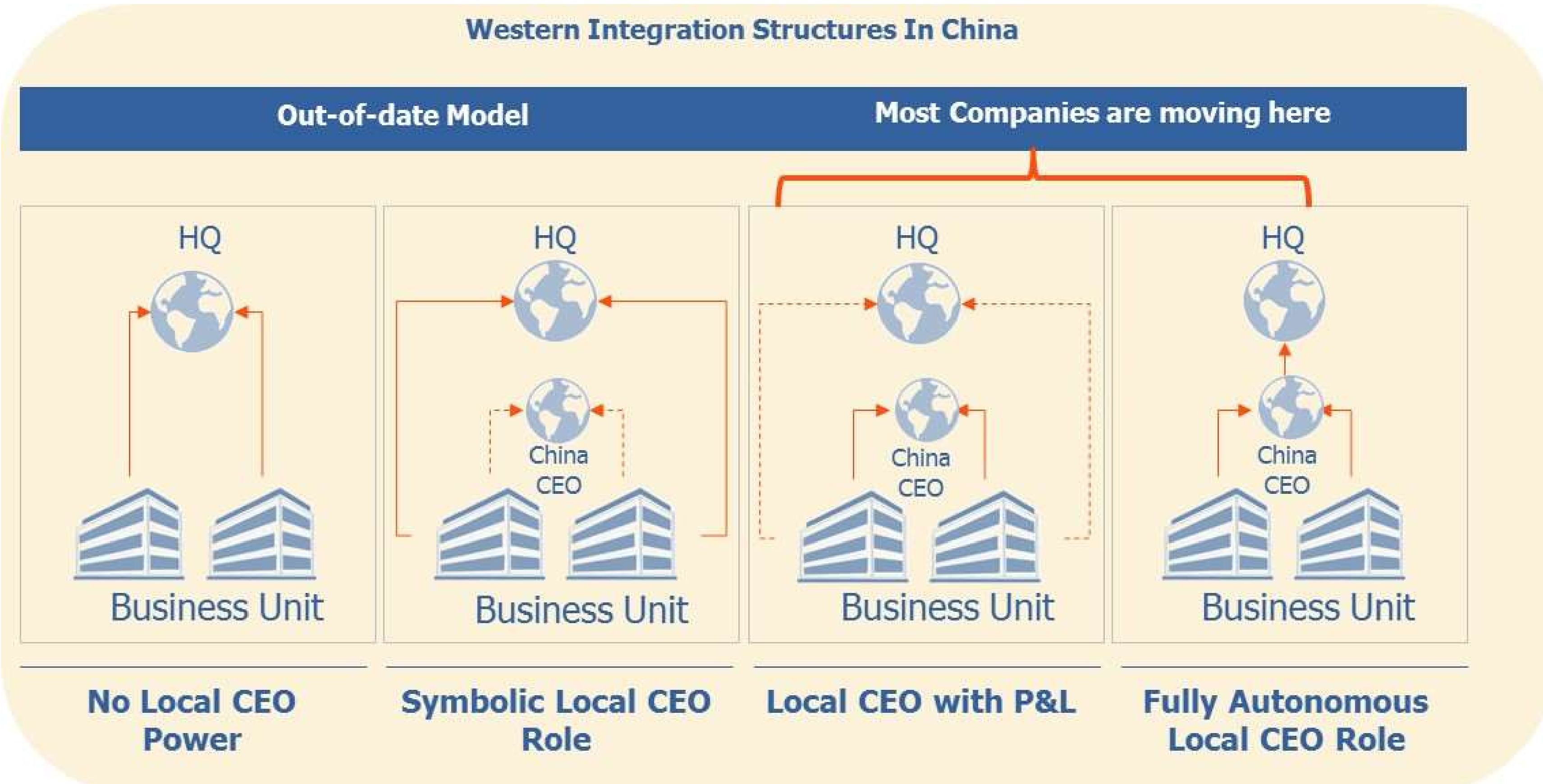
Empowered Local Structure. Struggle to become “more Chinese” in terms of governance and autonomous decision making.



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Conclusion: Opportunities under the "New Normal" a new pattern has manifested to do business in China

Transformations
- Optimize portfolios
- Revamp RTM
- Automate operations
- Divest low-performing assets

Additions
- New/adjacent segments
- New Chinese customer base
- Introduce B-brands
- Develop services revenues
- Digitalize customer relationships

Accelerations
- Restructuring
- Acquisitions

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