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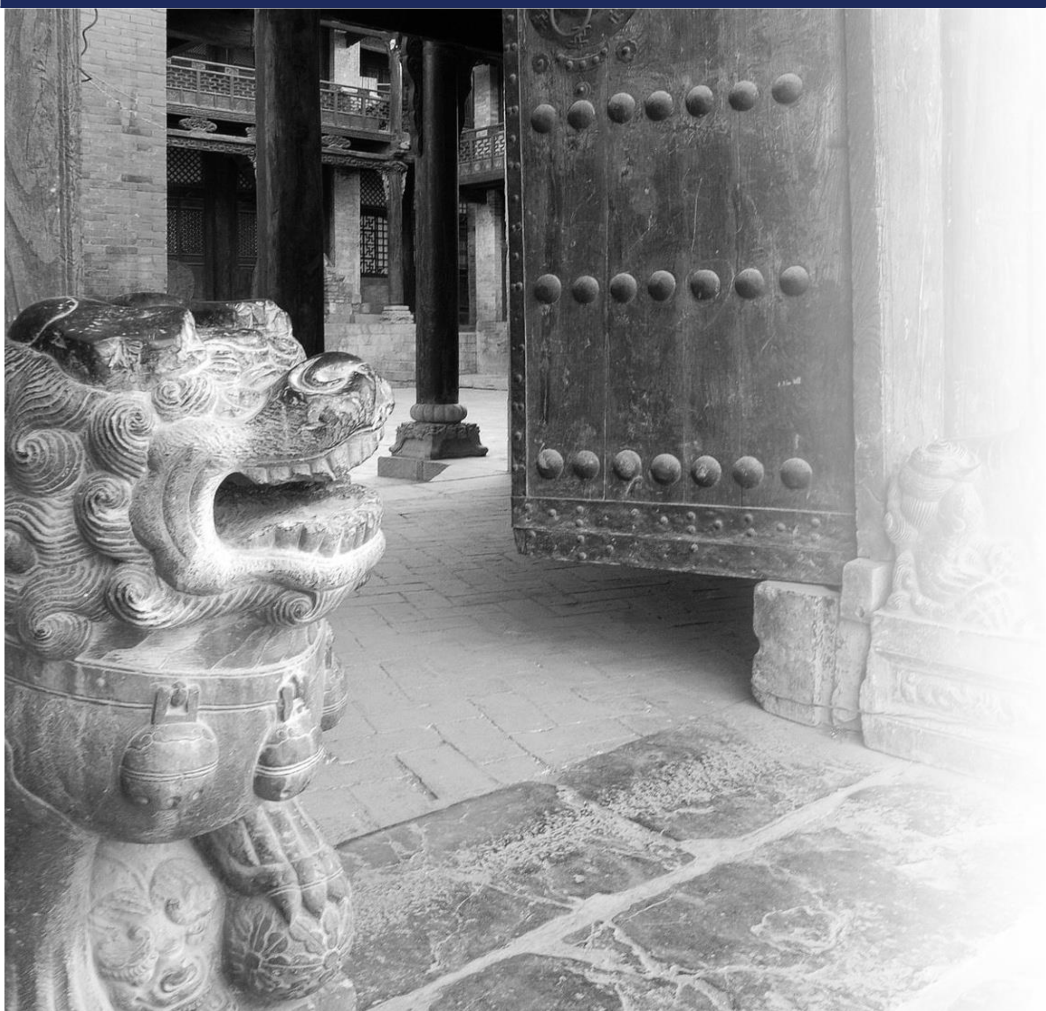
2017 Business Forecast:

China's New Business Reality & the Imperative for Change

2nd Edition

By **Jan Borgonjon, James Sinclair, Simon Zhang** | January, 2017



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The newsletter that follows represents our business forecast for 2017, and is based on interviews with 100+ China-based executives, as well as our own on-the-ground work in China. While 2016 has, in many ways, confirmed the trends of the last three years both in terms of macro environment and in terms of the business challenges and opportunities, it is worthwhile revisiting these topics. The analysis and recommendations we make are very similar to those we shared in 2016, though there are some notable shifts – e.g. an increasingly lively M&A market assisting with inorganic growth.

Against the backdrop of a slowing economy and economic transformation, we are now facing a radically different business environment in China. The change is complex and varied, but centers on the changing nature of customers and competitors. The consequent challenges posed to international companies are quite clear now, and the need to adjust to the new business reality more and more necessary.

And thus what worked so well for the last 20 years is no longer sufficient. Most companies will require fundamental changes to their business and operating models, and while lower growth and margins demand a short-term impact, the long-term challenges must also be addressed. This won't be easy, as implementation will have to overcome the organizational and managerial inertia created by the past two decades of success.

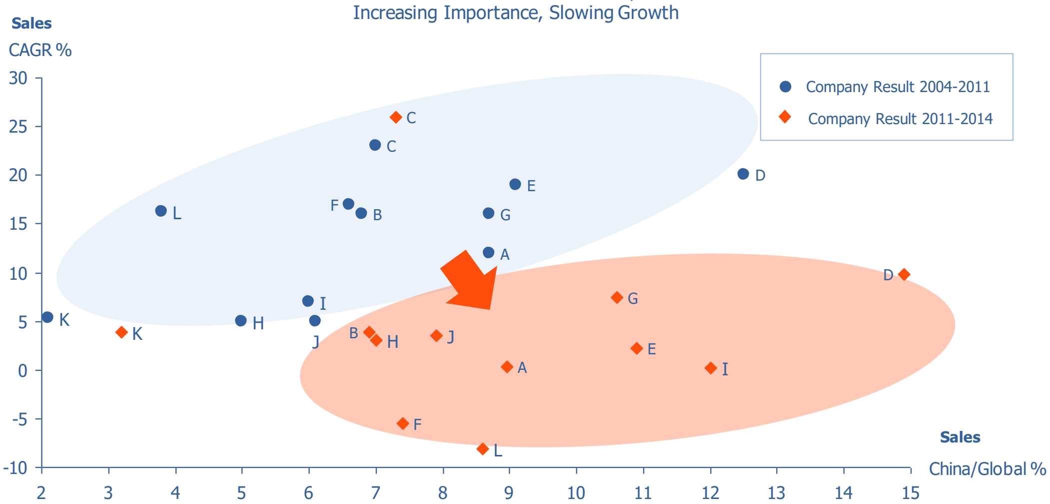
1.1 China's New Business Reality

In the cloud of dust thrown up by the economic transformation and financial volatility, the new business reality is not easy to understand. There are big differences between and within sectors, as well as between and within regions. GDP growth in early 2016 saw a continuation of trends from previous years - Northern provinces, like Liaoning and Shanxi, lagged behind China's coastal and South-Central provinces, where many provinces saw growth rates above 8%.

All the same, it is possible to identify a set of new business realities that have emerged over the three to four years, defining the day-to-day operating environment for many international companies in China:

- ***Slowdown in Sales:*** For most, the heady days of 2005-2011 are now a quickly fading memory. Companies in heavy industries or export businesses that benefited from China's old economic model are now suffering the most. But the slowdown has rippled across the economy, with a wide range of industries witnessing slowdowns or outright declines.

Chart 1 – Performance of International Companies in China: Increasing Importance, Slowing Growth



Selection of international companies from industrial and consumer sectors, all leaders in their respective fields.

Source: Annual Reports, InterChina Interviews and Analysis

- ***New Customers, New Needs:*** Whether growing or not, industries are undergoing important shifts in demand, in terms of both customer pool and customer needs. Privately owned companies have usurped their state-owned counterparts as the main market for industrial goods, while demand for new capital equipment is being replaced by the need for services and upgrades. It's often the most established players in each industry that are struggling the hardest to understand and respond to these shifts.

- ***Flight to Quality:*** We are seeing growing demand for 'quality' in many different senses. While the market for consumer packaged goods is soft, Chinese consumers' appetites for imported food and beverage products are rocketing. Chinese manufacturers expect their production machinery to have world-class reliability, and there is no tolerance for the slow provision of services. And investment in the environment remains robust, ranging from water treatment plants to industrial air scrubbers.

- ***Rerouting the Route-To-Market:*** In China's business-to-consumer industries, online sales and marketing has the potential to disrupt traditional approaches more than in the West, as a broader, deeper reach is made possible in China's huge yet fragmented consumer market. In business-to-business industries, traditional sales and distribution structures are being replaced by more direct sales or other distribution models, with an increased emphasis on service and customer care.

- ***Constant Cost Pressure:*** As China's economy matures, companies are facing higher and higher costs. This is not just the obvious inflation in labor, land and energy costs. International companies are also more exposed to costs related to social security, taxation and environmental compliance than their domestic peers. Combined with the slowdown in sales, this is putting significant pressure on margins.

- ***Competition Upping Their Game:*** Chinese players are presenting more intense competition, not just in terms of price but also speed, innovation and relevance. They have become disruptive, undermining the product technology and performance advantages previously enjoyed by established international companies. And they are starting to create new markets, not just in China but also overseas.

1.2 The Indigenous Threat

Central to the new business reality is the emergence of Chinese competitors with the ability to disrupt the status quo. That does not mean they only become dangerous when they are able to compete head-to-head in product technology and performance. They start to have an impact long before that point. For instance, the participation of Chinese competitors in bidding processes, regardless of their chance of winning, pushes down prices. And because of their superior customer understanding, they are eating away at the lower end of segments traditionally dominated by international companies, winning with cheaper products that are better suited to local needs and supported by faster services.

In addition, international companies shouldn't underestimate the ability of Chinese companies to innovate. The most obvious example is China's mobile Internet. Tencent's WeChat combines the social media functions of WhatsApp, Facebook and Twitter, and does so seamlessly, leaving its Western counterparts feeling cumbersome and dated. Mobile payments are leapfrogging debit and credit cards in China, with Alibaba's Alipay and Tencent's WeChat Wallet in common use, and soon Chinese consumers will be leaving their wallets at home. The pace of change is intense and relentless, with an ever wider range of services being integrated and made simple. Both payment platforms are now linked to money market funds, Yu'ebao in the case of Alipay and Licaitong in the case of WeChat Wallet, appealing to Chinese savers who like to check their financial gains when they wake each morning.

Innovation is entwined with an increasing depth and diffusion of entrepreneurism in China. New company registrations are surging, and many start-ups are thinking big. China has 100 million well-educated youngsters driven by the belief that they could be the next Jack Ma (founder of Alibaba). Shenzhen DJI, the world's largest commercial drone maker, is a case in point. DJI's 34 year old CEO, Frank Wang, founded the company when he was a graduate student in 2006. He pioneered systems and algorithms to distribute power among the rotors that stabilized the aircraft and its camera, and packaged them into an inexpensive device ready to fly out of its box. The result was a new consumer category, and a Chinese company that was a first of its kind. Expect to see many other Chinese companies both threaten existing industry structures and open up new spaces.

The Change Imperative

In a big country such as China, international companies used to grow by 'doing more of the same'. But with the onset of the new reality, this established model is now defunct. In fact, in many cases the established model has become a liability.

China's huge urbanization, for example, offered hundreds of cities for international companies to expand into. Consumer goods companies have long been building out their route-to-market structures to reach smaller and smaller cities. However, few have organized themselves effectively for new product development initiatives to address China's rapidly changing consumer segments and the future growth opportunities. Meanwhile, most capital equipment suppliers into China's construction sector, such as elevator and escalator makers, remain focused on new equipment sales. Now that construction has slowed across the country, they don't have the business models ready to meet the service needs of the huge installed base.

With the right sales approach, Chinese buyers of industrial goods used to provide an easy source of demand. International companies typically focused on state-owned enterprises, which had an insatiable hunger for the highest spec production machinery and manufacturing facilities. However, that hunger has now turned to indigestion, and they have stopped buying. The consequence is that the sales forces that succeeded when sales depended on relationships are ineffective in meritocratic market places. In the pharmaceutical industry, the government crackdown on corrupt sales practices spawned a new industry in retraining medical sales reps. Nevertheless, many international companies still find that their old sales forces, stuck in outmoded mindsets and practices, are not fit for purpose as they move into new customer segments with very different demands.

Frank Wang, Founder and CEO, Shenzhen DJI

The time has come to adjust to this new reality. International companies in China require important changes in their operating and business models to remain competitive – what worked so well for the last 10 or 20 years may no longer be sufficient or even adequate. While lower growth and lower margins increase the pressure for a short-term impact, it is important to also address the long-term challenges as the new reality is here to stay.

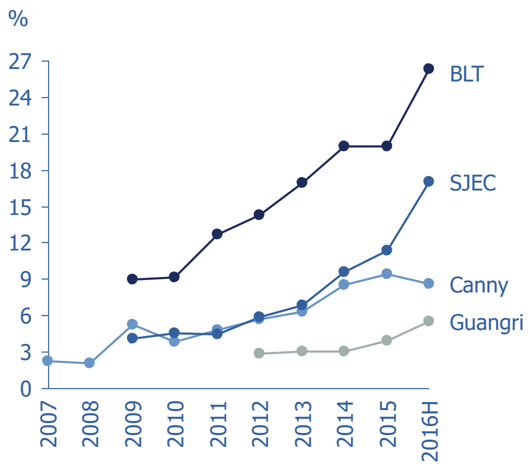
1.3 A New Approach for a New Reality

Based on our advisory work in the last four years, our ongoing research into China's transformation and implications for international companies, and a recent set of interviews with over 100 China country managers, we have identified the key initiatives that we believe international companies should consider in order to remain competitive in the new reality:

- ***Refocusing Marketing & Sales***: International companies need to identify the new growth opportunities that China's economic transformation is generating. Companies in B2B should consider shifting their sales resources towards higher growth sectors, whether dominated by state-owned customers (e.g. aeronautics, high-speed rail, automation) or private-owned (e.g. life sciences, food & beverage). Companies should consider offsetting the slowdown in new product sales with new revenue streams derived from the existing stock (e.g. maintenance services, aftermarket parts). In elevators and escalators, players like Shenyang Brilliant have already increased the service share in total revenues to 20%, a doubling over the past few years (see Chart 2). In property, developers like Soho China have managed to sustain revenues by switching their focus from build-to-sell to build-to-rent (see Chart 3).

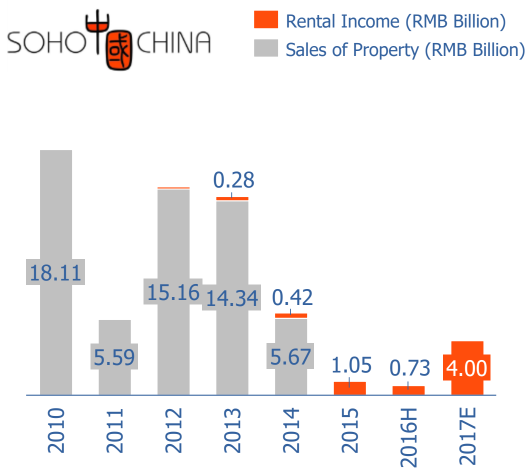
  Companies should also look again at how they segment their markets, seeking to identify emerging segments with distinct needs. In food & beverage, new product launches targeting young consumers with trendy propositions have turned into hero products. A good example is Uni-President's "Classmate Xiaoming" ready-to-drink tea, which contributed RMB 1 billion in revenues in 2015, targeting school children with its "Seriously Funny, Inconspicuously Cool" tagline (see chart 4).

Chart 2 – Chinese Listed Elevator Makers: Share of Services in total Revenues



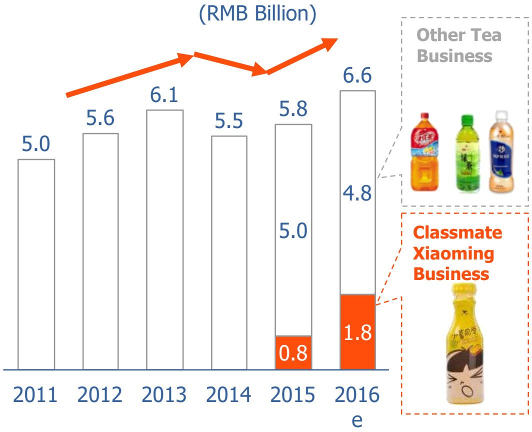
Source: Annual Reports, InterChina Interviews and Analysis

Chart 3 – Property Developer Soho China: Change in Revenue Structure



Source: Annual Reports, InterChina Interviews and Analysis

Chart 4 - Uni-President's RTD Tea Business: Contribution of New Product Launch (RMB Billion)



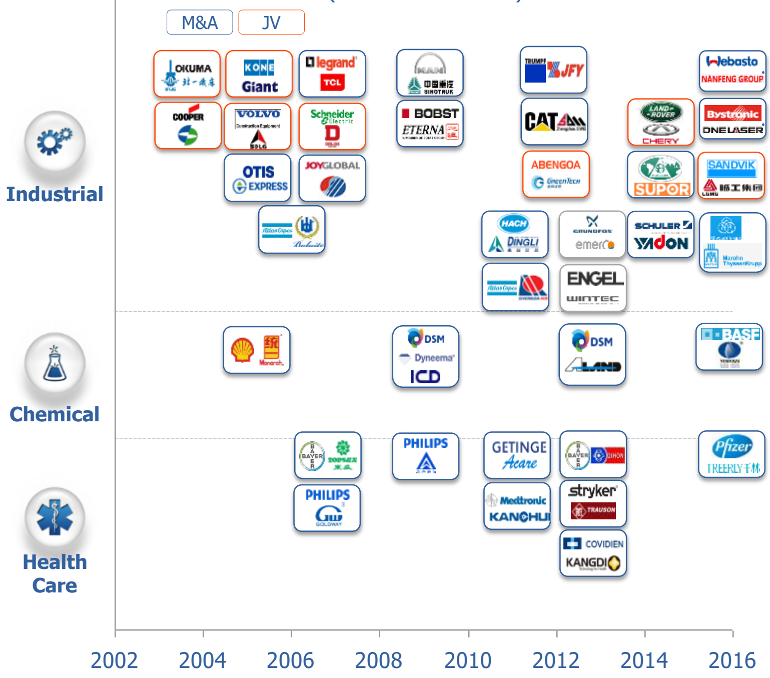
Source: Annual Reports, InterChina Interviews and Analysis

- ***Localizing Operations:*** Probably the most important initiative - and the most difficult one - is the need to become more 'Chinese' or more 'local'. This becomes particularly urgent once Chinese competitors, with their speed and flexibility, start disrupting the status quo. However, even without strong Chinese competitors, localization contributes to an international company's competitiveness in China. Being 'local' means moving core operations and decision-making processes to China, not just sales and manufacturing, but also new product development and services. In a market where local customers are developing their own distinct needs, this allows international companies to make decisions closer to their customers, developing solutions that meet their needs, and delivering at a speed that matches the pace of the market. Localization doesn't mean, however, adopting a Chinese image or giving up on global standards.

- ***Overhauling Operating Models:*** Slowing sales and rising costs mean that profitability is no longer the given that it was in the past. For companies that fixated on the top line for the last 20 years, this will require a drastic shift in mentality that will, by no means, be easy. This is not just about increasing automation or running internal operational excellence programs. Companies also need to look at whether their operating models are still fit for purpose. For many companies, their current operating models are a result of piecemeal decisions accumulated over a long period of expansion. Their organizational structures are thus overly complex, operating practices lack cohesion, and product portfolios are bloated. These will now need overhauling to boost performance, improve profitability, and see them through the period ahead. For instance, where product portfolios have suffered from proliferation, with thousands of SKUs catering to all customers in all circumstances, companies should consider portfolio optimization using a hard analysis of product-by-product profit contribution.

- ***Acquiring & Divesting:*** Slower economic growth both increases the pressure to consolidate and generates more acquisition opportunities. In most sectors, the choice is now between investment and growth on one side, and divestment on the other - International and Chinese companies alike are now accepting this reality, and are acting to avoid the default choice, which is a slow death. Stronger Chinese companies that were not for sale are coming into play, as public listings remain restricted, and succession issues become more evident. Meanwhile, international companies will continue to pursue "B-brand" strategies through local acquisitions to participate in mid-market segments (Chart 5). And we are also seeing more reasonable valuations, partly due to the economic slowdown and drop in stock market multiples, and partly due to weakening confidence and a narrowing of exit options. Thus, we expect the trend for greater M&A

Chart 5 – International Companies with "B-Brand" Strategies in China
(Selected Industries)



Source: Annual Reports, InterChina Interviews and Analysis

activity that began in 2015 to continue through 2017. Sectors that we expect to be particularly active include automotive components, healthcare, energy/chemicals, technology, consumer and services.

Overcoming the Inertia

Despite the importance and the obviousness of these initiatives to remaining competitive, they are not be easy to implement. Support will have to be secured from headquarters for the investment budgets needed to grow, and for the devolution of power to China so that decision-making chains are sufficiently short and responsive. Where international companies have 20 year histories of operating in China, business practices will be stubbornly resistant to change, and the old guard will find it difficult to develop the new capabilities required of them. And hard decisions will have to be made, perhaps related to the rationalization of manufacturing footprints, or perhaps the optimization of product portfolios. In short, organizational and managerial inertia created by the past two decades of success will have to be overcome.

Although there are challenges ahead, there is also much cause for optimism. By adjusting their business and operating models to China's new reality, international companies will remain competitive in what is one of the world's fastest growing major economies. New growth opportunities continue to emerge, and international companies are often well placed, if not best placed, to exploit them.

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