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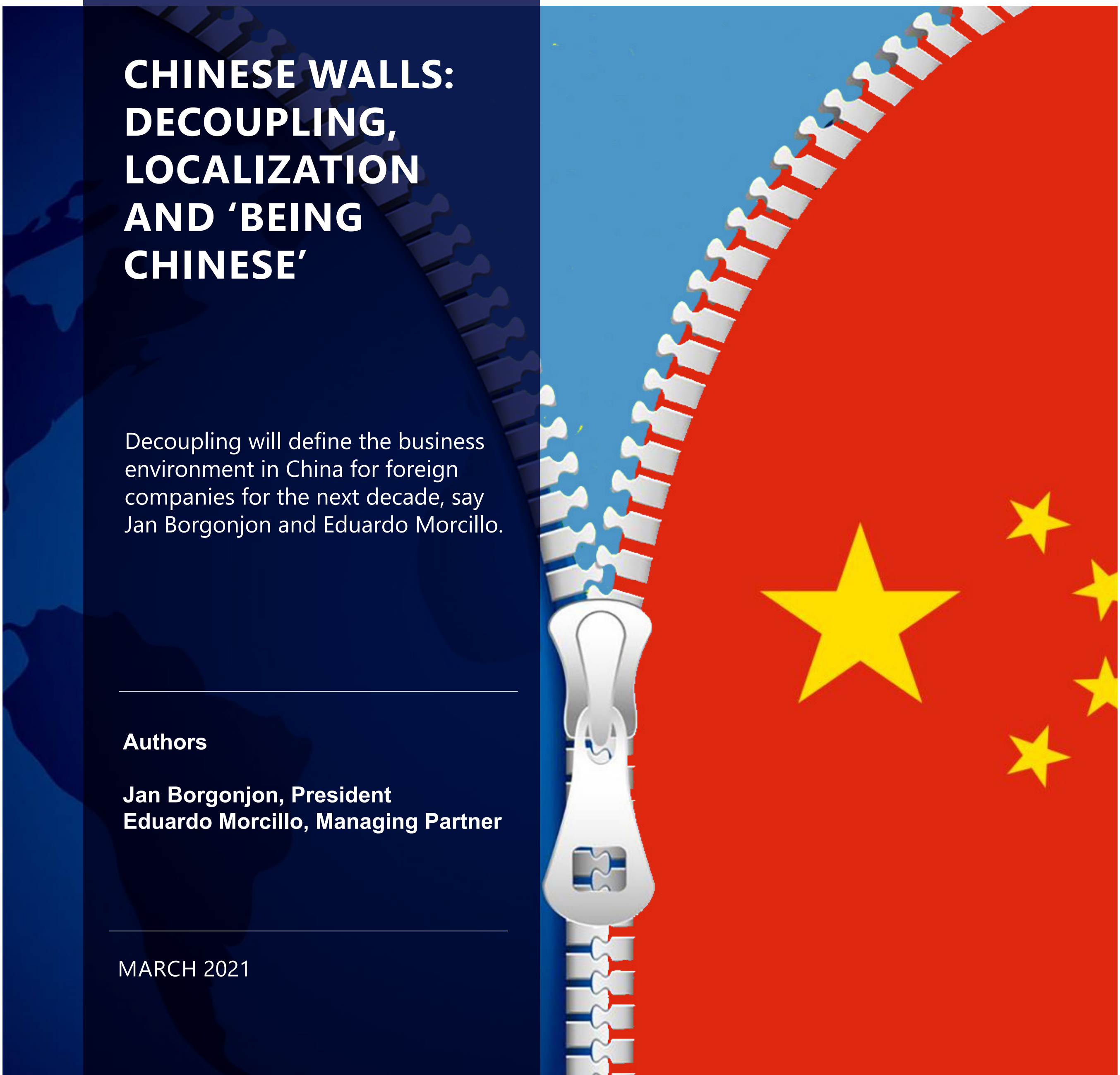

CHINESE WALLS: DECOUPLING, LOCALIZATION AND ‘BEING CHINESE’

Decoupling will define the business environment in China for foreign companies for the next decade, say Jan Borgonjon and Eduardo Morcillo.

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Strategy I Corporate Finance

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Overview

2020 may have been the year of Covid-19, but it was also the year in which it became clear that the changing relationship between the US and China is going to be both profound and enduring.

Both sides consider each other now more as rivals than partners, a situation which impacts commercial, technological and political relations. Both countries, for different reasons, are now strongly committed to insulating sensitive industries and sectors from the other, in other words they want to 'decouple' certain industries and sectors to higher or lesser degrees. This trend will define the business environment in China for foreign companies for the next decade.

The impact will be profound not just in China, but globally, and might affect supply chains, R&D, innovation and IP, decision making, financing, production location, branding, partnerships, and legal structures.

And it is not just about semiconductors, artificial intelligence and other sensitive hi-tech sectors. Based on our recent work, it is clear the impact is very wide and also affects the supply chain of more general sectors such as automotive, construction equipment and even domestic appliances.

Separation of activities

Decoupling broadly relates to the separation or disengagement of activities between China and the rest of the world.

But it is important to stress at the outset that commercial drivers have been pushing this drive for more autonomy for many years already, creating a landscape where local players are increasingly occupying the traditional space of multinationals. Indeed, some 90% of respondents to a recent InterChina survey expected the traditional advantage of 'being foreign' to disappear within this decade. But what has changed more recently, and it is a trend only accelerated by the pandemic, has been the geo-political situation which reinforces the need to decouple and further localize.

Yet in our experience many international players are confused and uncoordinated in their response to this challenge. Indeed we have never seen such a big misalignment between global HQ and China operations. Closing this gap will be the precondition for making change happen.

The reaction of foreign companies to the new China situation is hampered by a lack of awareness, a lack of internal consensus, and a high level of confusion about the nature of the impact of decoupling and localization. Many companies do not yet seem to be fully aware of the enormous impact of the changed environment on their future business in China.

Confusion

Covid-19 and the ensuing difficulty of international travel and visits to China is just one of the reasons for this situation. Western boards, even those that are the most knowledgeable about China, find themselves more detached from the situation on the ground, and therefore inevitably more influenced by their own country's views on China, often negative.

As a result, in most companies there is no consensus on the decoupling impact and the precise actions to be taken. They find themselves stuck in a confusion of different opinions across different levels of management, brought about by fragmented events and shifts in the China market.

Yet respond to this challenge they must. Why? Because multinationals still have an important role to play in China, not only because the government wants to retain international investment and know-how, but because they have a strong advantage in three key areas.

Firstly, Chinese companies are still learning how to survive in a higher compliance landscape. Secondly, they will need to invest heavily to catch up on building sustainable innovation and service driven models. And thirdly, multinationals can leverage other synergies, such as their exposure to global markets, that will take years for Chinese players to develop.

But the only way for multinationals to continue to leverage these synergies is to become more Chinese. 'What does being more Chinese means for me' is the key question for every CEO operating in China over the next five years.

"We have been losing business to Chinese companies because they wanted a local alternative, yet at the same time winning business from clients who have shifted from American suppliers to us. What is happening here, and how will this develop over time?"

European chemical producer

"We are in a very sensitive sector in China which is currently affected by US sanctions and might be affected more in the future. We have been approached by several Chinese companies, both state-owned and private, who want to buy into our global company 'in order to safeguard our China business'. Should we do that? Will this actually work?"

European production equipment manufacturer

"We currently have a clear technological and reputational advantage in China. But on the one hand we see Chinese competitors becoming stronger, and on the other our sales more controlled by the government through centralized purchasing. Is our current model of selling imported products viable in the medium to long run, and how should we prepare for future changes?"

US medical equipment supplier

Understanding decoupling

An excellent reference for an understanding of the China decoupling process is a recent report from the European Chamber of Commerce in China which provides a detailed overview of the various aspects of decoupling and the drivers behind it.

What is clear from the report is the inevitability of decoupling. On the one hand China has decided to double down on its self-sufficiency in strategic sectors in the wake of the US technology sanctions in 2020. In several high-level political statements during 2020, among which was an announcement of the new 'dual circulation' objective, China made it clear that it wants to strengthen further its industrial policy and continue developing strong local champions, with minimum strategic reliance on the US.

The US on the other hand, even with the new Biden presidency, considers China as a strategic competitor which should not be given unconditional access to its technological and other resources.

Political decoupling

In our experience a useful and effective way to look at decoupling is to make a distinction between political decoupling and commercial or business decoupling.

The former is driven by political drivers which result in Western value chains becoming decoupled from dependence on China (sales, sourcing) and vice versa. For relevant international businesses, that will necessitate an outcome where their China businesses become more independent, local entities.

Political decoupling applies where there is an immediate political interest and commitment from China and/or the US to decouple supply chains. This political decoupling is a relatively new development and applies to a limited number of sectors, albeit very important ones. These include: hi-tech (in particular semiconductors); Artificial Intelligence, 5G, and internet and data management; and traditional strategic sectors such as energy, finance, telecoms and railways.

In these sectors the pressure to decouple is intense. Timings can be short, and often companies have to consider drastic solutions, such as completely separate supply chains including separate IP and R&D, partnerships with Chinese companies, or sometimes even giving up on the China market altogether.

Commercial decoupling

By contrast commercial decoupling is driven by factors which result in Western businesses in China needing to achieve better scale and sustainability. Again, this necessitates an outcome where their China businesses become more local and autonomous.

Commercial decoupling applies to a wide range of industrial and consumer sectors and, as we say above, is not a new development. But the increased commitment of the Chinese government to self-sustainability will only accelerate this process across all sectors.

Localization
The common outcome from both political and commercial drivers is localization. In response, international companies need to develop larger and more independent or complete China operations for three key reasons.

Firstly, because of the enormous local market growth. Secondly, due to the emergence of very strong local competitors even in mid-premium segments. And thirdly, because of the erosion of the traditional brand equity advantage of Western companies.

The solutions may be gradual but they are far-reaching. They are about establishing full local operations, including R&D, while still leveraging global strengths. They are about local decision-making to match the speed and customer focus of local competitors. And they are about developing specific and limited partnerships, or perhaps even acquiring local competitors.

Scenario planning

Assessing the specific impact of decoupling is challenging. The basic decoupling trend is clear, but the specifics are fluid and to a large degree unpredictable over time. In addition, the impact is, in our experience, very different from company to company - and even among business divisions within the same company. All of which creates a high degree of confusion.

In this environment the right approach is to adopt scenario planning whereby you assess the potential impact of different global scenarios and then propose specific action plans relating to your business. This might include stark and costly choices, such as partially or even fully decoupling value chains for certain businesses. However in nearly all cases an increased degree of localization will be required, a challenging process which requires long-term commitment and planning.

Based on our recent work with international and Chinese companies we have developed three scenarios detailed here:

	Constructive Decoupling 70% Base scenario, most likely	**Hardcore Decoupling** 20% Unlikely	**Conflict** 10% Very unlikely, but not impossible
Description	"Practical China" is back Semi-friendly, gradual, pragmatic decoupling … Cooperation and unilateral development simultaneously	Aggressive decoupling, with constant crises and antigonism	Reached "point of no return" Aggressive decoupling, not just with antigonism, but also with military crisis and conflicts
Political Action	• Good Global Citizen and using multilateral institutions for long-term goals (globalisation, green) • Focused actions based on domestic politics ("face")	• Using multilateral institutions for short-term goals • Continuation of Wolf Warriors • Strategic and diverse actions, including actions against MNCs	• Both China and USA push zero-sum approach: you're either with me or against me • Aggressive and widespread sanctions (financial, debt).
Role of Multinationals	Continued key role and involvement in China, as (a) technology and know-how is needed (b) provide Chinese government with leverage over US foreign governments	Continued key role, but increased uncertainty and risk, as MNCs might become political targets	• Meltdown, with MNCS targeted or boycotted
Trade Barriers	• Continue, focused increase	• Aggressive increase	• Trade blockade
Technology Transfer & Standards	• Slow regionalization. • China 2025	• Accelerated regionalization. • China 2025 faster	• Radical disruption (e.g. different standards)
Local IP (China/US)	• Beneficial, but not key	• Key requirement	• Incompatibilities
Local Capex (China/US)	• Key requirement	• Key requirement	• Possible conflicts or incompatibilities
Southeast & East Asia	• Regional tensions controlled • Economics trump politics: China is #1 trade partner of all SE Asian countries	• Regional tensions grow • More difficult choices: Some countries might align more with USA	• Conflict with Taiwan, Japan, India • Hard choice: Korea, Japan and most SE Asian nations choose USA

Constructive decoupling

By far the most likely scenario is 'constructive decoupling' where both the US and China will take a pragmatic approach in which they simultaneously cooperate. This is in China's interest as total decoupling would carry a huge economic cost, and would be stifling for China's economic development.

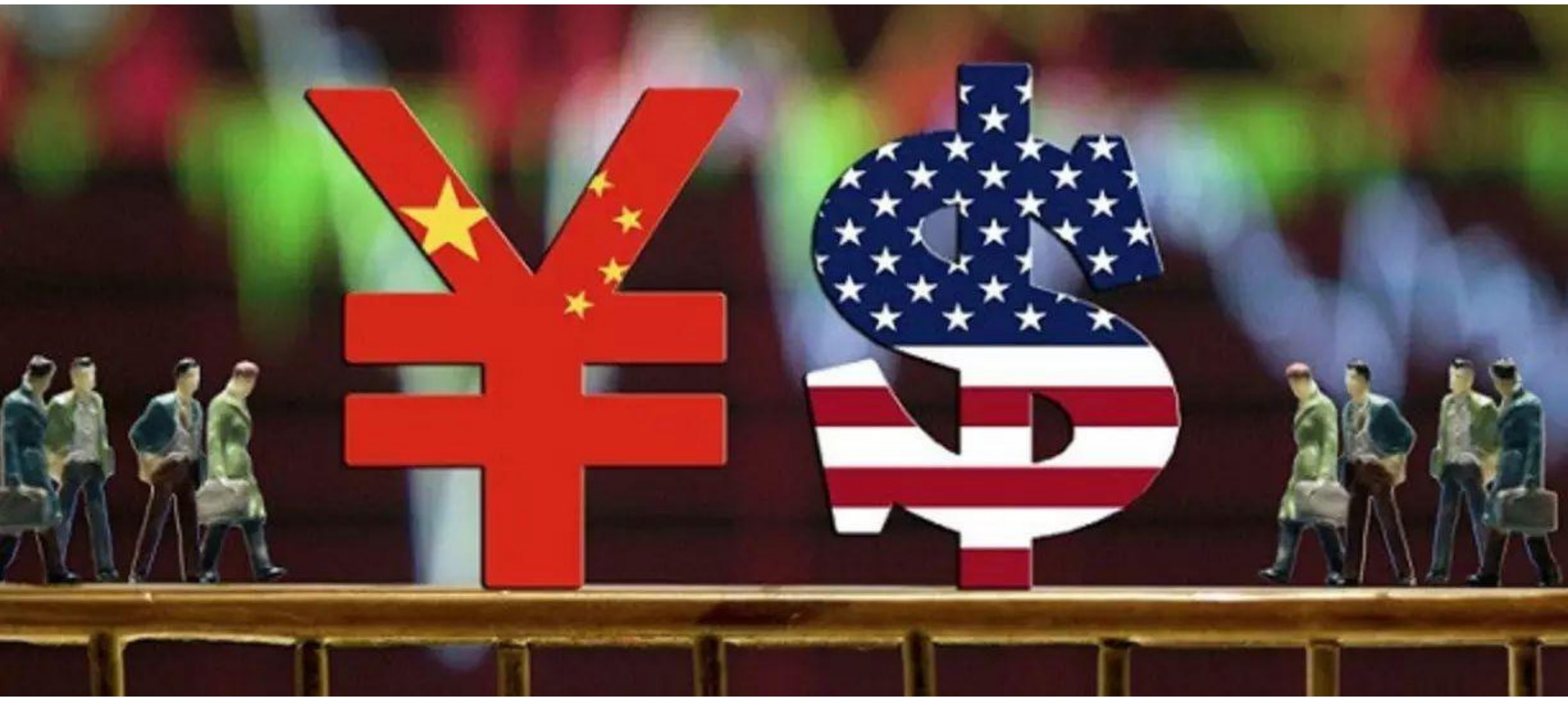
It is also in the US's interest given the huge economic interests of US Inc. in China and the need for political cooperation with China. We consider the alternative scenarios of 'hardcore decoupling' (more or less what we saw in 2020 in the last year of the Trump presidency) and 'conflict' as currently very unlikely. However within a five- to ten-year time frame these scenarios are not impossible, and should be considered. Note that we do not include a scenario of 'business as usual' as we consider a return to the situation of the past impossible.

The company perspective

One of our key findings in the decoupling process has been that it is extremely important to go beyond the rhetoric of political statements and press reports, and assess what is exactly happening on the ground at company level. Indeed in spite of strong rhetoric, Chinese companies - and often also the government - are in practice quite pragmatic. Given the global integration of supply chains, decoupling comes at considerable cost, both financial and in terms of time.

The Chinese government gives direction and wants to increase its self-reliance, but at the same time does not fully control the actions of companies, even large SOEs. These companies have to balance government requirements with their commitment to profitability, quality and shareholders.

Based on our research the key concern for Chinese companies is actually supply chain security and making sure that they can source local components and receive local service and support. It is not so much about the nationality of the suppliers either, but rather about the strength of their local operations and whether these operations are US sanction-proof. However, in the medium to long term, the overall trend will be towards more local supplies, possibly from Chinese suppliers, if their offer is competitive.



Localization and 'being Chinese'

As we stress, the decoupling process is not new in China. China has used market access and industrial policy as a tool to protect the local market and develop strong local competitors for many years, and with a great deal of success.

China wants to become less dependent in strategic industries and at the same time upgrade its industry, while there are government instructions to large SOEs to buy more local, and at local government level there are high levels of support and incentives.

Strong competition

All of these factors have produced strong Chinese competitors which are faster, cheaper, closer to the customer and more flexible than most of their international competitors.

In addition, many Chinese companies are cash rich and have easy access to credit, in particular in strategic industries. The recent shift of the Chinese government in terms of self-sustainability will only reinforce this trend across all sectors, and not just in the politically sensitive hi-tech or data sectors.

This is all happening in a market with increasing opportunities as China continues to stimulate its internal market (a key part of the dual circulation policy), and as a continuous upgrading takes place across industrial and consumer products.

Western response

In response Western companies should assess how long - and how - they can maintain their traditional advantages in terms of brand, know-how and technology.

In most cases these advantages will expire or become less relevant within the short and medium term, and the only answer then is becoming local and more Chinese, while still leveraging differential synergies to the China operation (such as integrated global innovation, global sourcing synergies, and access to global markets).

In broad terms this means matching or trying to match Chinese competition in their key strengths:

- Having a full local value chain
- Local decision-making
- Local speed, local cost, local design
- Strong 'customer touch', closeness to the customer
- Local innovation and product development, and knowing the local customer

This is easier said than done. What it means to be Chinese will differ from company to company and will depend on the sector and competitive situation. The only clarity is that with more than 50% Chinese ownership and full operations in China, a company will be considered Chinese for most purposes.

In other cases we enter a grey zone where the perception of the 'Chinese-ness' of a company will be different depending on the client or partner, or related government department. It is also a perception which could change over time.

Helpful elements in order to be perceived as a Chinese company include minority Chinese ownership, Chinese management, local decision-making, security of supply chain (including localization), and full local value chain including ideation and R&D.

Local governments might look at local employment and taxes too. In general terms, IP registration is not a key issue in itself as it is more a consequence of local R&D. However IP is important in certain sensitive sectors such as the semiconductor industry in the wake of US export control rules.

At the same time it is important that China operations are aligned with global objectives, and that companies can continue to be able to leverage global corporate resources, as this might make a real difference when

Next steps – What to do?

Having a clear decoupling and localization road map should be the top priority of any global CEO and company board with an interest in China. This requires a structured approach with key stakeholders in the company involved to ensure buy-in across different levels of company management.

In our experience the most effective way is a two-level approach. The first is about the corporate perspective (the company as a whole), more general, and longer term. The second is business specific. Both levels can run in parallel as the findings from each are likely to impact or contribute to the other.

Level One: The Direction - A corporate perspective with a five- to ten-year time frame
The people involved in this approach could be the top China related management such as the global CEO, board members with a China focus or interest, or global business heads with important China business. Here we look at long term direction and create a shared framework for future decision-making.

Specific issues and points of interest to be covered will depend on the sector and specific company situation, but could include:

- China scenarios for the next five to ten years
- High level impact on your sector: To what degree should your value chain be 'decoupled'? What does 'being local' mean exactly for your company?
- Specific impact on the value chain: product flows, branding, governance, IP, R&D, data management, etc
- Corporate finance, alliances and M&A

The key goal in this exercise is to achieve alignment between the global board/CEO and the local senior leadership. In our experience, especially at senior global level, these issues should not just be run by an internal team. They should also be checked and benchmarked with a selected number of external senior, experienced executives, both foreign and Chinese, in related sectors, and then discussed with the stakeholders in the company.

This is not about data and long powerpoint presentations, but about the sharing of relevant insights by people with extensive executive China experience. In this way it is possible to provide the basis for a decision framework for the next five to ten years, providing direction on key China related issues such as where to locate innovation, how to brand globally and in China, and on partnerships with Chinese companies.

Level Two: The Road Map & Resources – A business or division perspective with a three- to five-year time frame

The actions to be taken can be very different even within the same company. In a recent example one of our clients, a medium-sized company with €1bn global sales, decided for the first time in its approach to China to take very different approaches for its four business units.

One unit would be fully decoupled, one would see some adjustments in terms of location of R&D and IP, and the remaining two would continue as before. This approach increases complexity but it ensures a level of flexibility that will be an important success factor in the years to come.

The key goal in Level Two work is to ensure alignment between global executives, business unit leaders and the China leadership team. It is important therefore to go down to a granular level in order to prepare a practical road map. This process should answer questions such as:

- If there is a need to decouple, partially or fully, how will this happen?
- Is my specific portfolio of services and products sustainable? Should I exit for some products, and focus on others?
- Do I have the right management capabilities in China?
- Do I need to prepare for any contingencies such as a client suddenly requiring local products or sanctions?
- How do I structure R&D in China? How do I maximize synergies between R&D in China and other parts of the world?
- Do we need a local partner in terms of data management and global integration?
- Are there specific M&A targets for our growth plans?
- Should I rethink my strategy about joint ventures and alliances?

Those involved should be from the business unit management, China management and other relevant departments (e.g. R&D) depending on the issues at hand.

This level requires detailed interviews and understanding of clients, competitors, sometimes suppliers, benchmarks from other sectors, and government departments. The output is a specific road map with actions, commitments and investments, and might be followed by a second phase with more detailed plans such as an M&A target search.

Summary

For the multitude of reasons explored in this article, the most important China task for global CEOs and boards in 2021 will be to come up with a clear decoupling and China localization road map, and be prepared to commit the resources (such as specific task forces) to execute this road map.

The implications of this process are likely to be far-reaching across both China and the company's wider global operations, and it is therefore imperative that the strategy is given the careful time and thought that it demands.

Decoupling extensive and complex value chains is no easy task. Most value chains are very integrated globally, and decoupling is costly and takes up time. Decoupling inevitably carries risks around alignment and control too.

In an ideal world most companies would prefer not to have to make such wholesale structural changes. But as we make clear, maintaining the status quo is simply not a viable option because the world has changed.
In 2021 it is no longer business as usual. In fact, the rate of change we are currently witnessing in China, driven by new business models, exciting technologies, and high growth from new patterns of consumption, is unprecedented.

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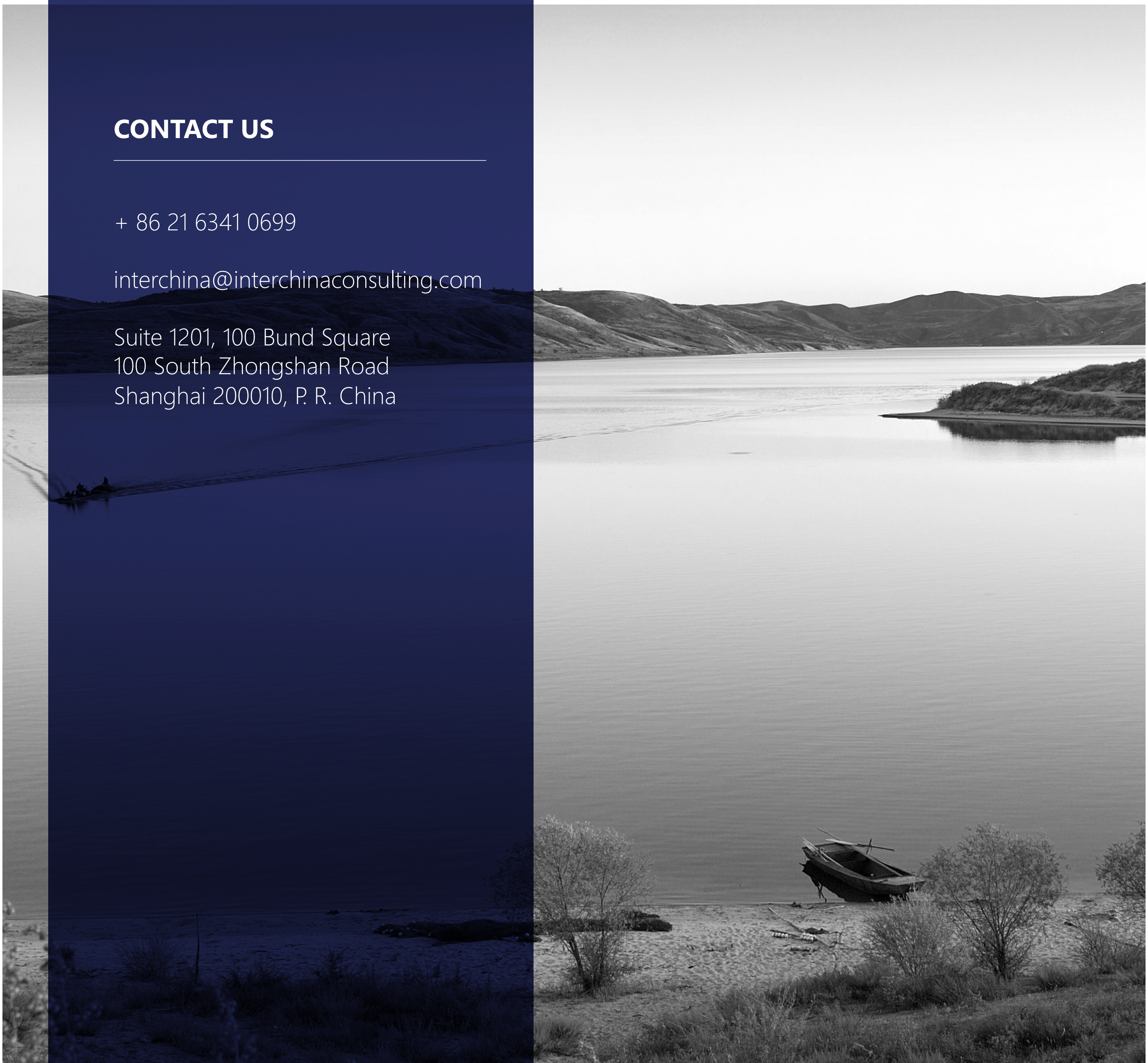

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