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Staying one step ahead

Hot topics on investing in China

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A compilation of the Chinese Services Group's monthly commentary on cross-border investment with China

Preface

From the desk of
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2010

With the global economy less predictable than ever, U.S. executives are looking for innovative strategies to "stay one step ahead" and maximize their investments in China.

Sound strategy requires timely intelligence but executives often find it difficult to isolate the most relevant information from the crush of China-related news crossing their desks each day.

Each month, the Chinese Services Group (CSG) issues a commentary on the cross-border investment environment with these executives in mind. Each write-up focuses on a single development or emerging trend within China's vast, fast-moving marketplace and sets out the implications for U.S. investors in succinct, actionable terms. Whether analyzing regulatory changes or tracking the emergence of a new class of strategic partners (or competitors), each topic was specifically chosen for its potential to change how U.S. companies do business in China.

This volume, **Staying one step ahead**, is a collection of our most recent monthly commentaries. We believe that the key messages will continue to resonate with those seeking to generate sustainable value in China, and look forward to bringing you the developments truly worth understanding.

For further information or to explore the broader implications, please contact us at uscsg@deloitte.com or visit www.deloitte.com/us/csg/

Contents

Urbanization in China — Another 280 million people by 2030

May/June 2010

Foreign executives visiting China's huge coastal cities are sometimes surprised to learn that China is still a predominantly rural country. According to China's National Bureau of Statistics, China had 622 million urban residents at the end of 2009 — a population well over twice the size of the entire U.S. but still just 47% of China's total. China's urbanization rate is still below the global average and much lower than what executives are accustomed to seeing in U.S. and European markets. China's current plans to achieve a 67% rate by 2030 — *shifting 280 million people to cities within two decades* — is set to become a signature event in shaping the global economy this century.[1]

Sources: Population Division of the U.N.'s Department of Economic and Social Affairs (which estimates China's urbanization rate to reach 62% by 2030 vs. 87% in the U.S. and 60% global)

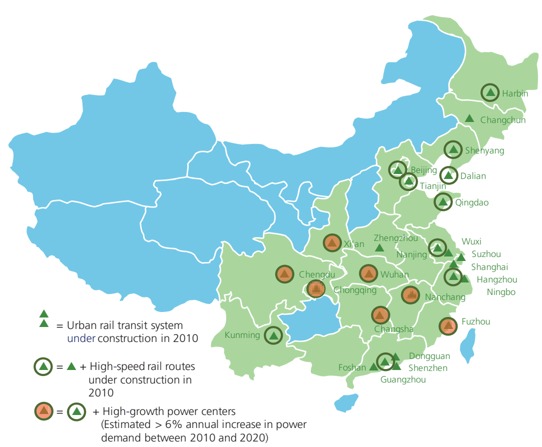
Chinese economic development for the past three decades has been closely tied to rural-urban migration. From just 18% in 1978, China's urbanization rate has increased at .9% on average each year. Natural population growth has been essentially flat since the 1970s, so almost all of this increase has come from the flow of millions of rural workers to Chinese cities each year. On paper, China's 50 year-old system of urban-rural household registration was meant to strictly control this movement. In reality, migrant workers have come to represent nearly 30% of China's urban population today, even though lack of permanent urban status denies them many of the rights and privileges of city life (i.e., property ownership, access to services etc.).

In recent months, China has begun signaling that it is preparing to wind down the household registration system, removing the primary barrier to much faster rural-urban migration. For example, in his remarks before the National People's Congress (NPC) in March, Premier Wen Jiabao pledged to begin phasing out restrictions on permanent residency in smaller cities by year's end. What has already been the most remarkable urbanization experiment the world has ever seen — the only comparable event is the leap in U.S. urbanization rates from 20% to 40% during the second half of the 19th century — now seems poised to move into hyper-drive.

U.S. businesses have already been deeply affected by the urbanization of China's workforce — first in terms of low-cost production and more recently, in terms of top-line revenue growth — but what are the implications of acceleration? Tens of millions of new permanent residents will generate tremendous demand for housing and modern infrastructure of every kind — transport, power, water & sewer systems etc. Higher disposable incomes associated with urbanization will also be critical to finally unleashing latent consumer demand. China's Academy of Sciences recently estimated that for every 1% increase in urbanization, China can expect a 1.6% increase in the contribution made by domestic demand to China's GDP. So as urbanization helps rebalance the Chinese economy, U.S. investors will discover vast new reservoirs of potential customers for their goods and services, from basic consumer items to advanced healthcare services and financial products.

On a very practical level, U.S. investors face the challenge of choosing where to focus their future investments in this expanding urban landscape. From just 198 cities in 1978, the number of Chinese cities — defined as population centers with at least 100,000 inhabitants not engaged in agriculture — has risen to 655 and is expected to climb to over 1,000 as urbanization accelerates. Of these 655, China's National Development and Reform Commission estimates that over 120 have populations exceeding 1 million, with a similar number claiming 500,000 to 1 million inhabitants. Given this complexity, which of China's urban centers are best poised for short-term takeoff?

As a rough illustration of how a U.S. investor might tackle the problem, consider the three-step approach below. By avoiding reliance on historical data, we've tried to peer around the corner by tracking where investments are currently being made — sort of a "follow the money" approach.



Sources: PRC State Council, Ministry of Railways, Ministry of Transportation and State Grid

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[1] Chinese Academy of Social Sciences, Blue Book on Micro Economy, April 2010

[2] Established in 1958 to control internal migration and rationalize the distribution of scare resources, the hukou system (城乡户籍制度) strictly classifies China's population according to non-agricultural and agricultural status, roughly corresponding to urban and rural residency. Status is determined at birth, with few avenues for change. In the latest example of growing pressure to end the system, thirteen state-owned newspapers ran front-page editorials on March 1 calling for its abolishment.

- The map above depicts the 26 cities that China's Ministry of Transportation reports will either break ground or add track to urban mass transit systems during 2010. In December, China's State Council approved US$130 billion funding for these projects, an effort critical to enabling growth in China's most promising urban centers. To qualify, Chinese planners set three criteria — population in excess of three million, GDP of more than RMB 100 billion (~US$15 billion) and fiscal revenue of more than RMB 10 billion (~US$1.5 billion). All are suggestive of favorable markets for goods and services, so it seemed like a good place to start.
- We next compared these 26 cities against the Ministry of Railway's grand plan to build a high-speed rail network across China. China plans to invest approximately US$300 billion over the next five years to connect 70% of Chinese cities with populations exceeding half a million. Again, we were only interested in rail lines under construction during 2010 — the 20 to make that cut are circled in green. So if urban transit gives us a pretty good indication of where markets may be set to take off, cities slated to become major high-speed rail hubs may signal that Beijing is targeting a location for deeper integration into the national, as well as global, economy.
- Finally of the 20 cities with subway systems under construction in 2010 and soon to be located on high-speed rail routes, we looked at estimates by State Grid, the largest electric power transmission and distribution company in China, of where they expect demand for power will grow fastest between 2010 and 2020. Of the 20 cities, seven emerged as locations where demand is anticipated to grow more than 6% annually. China is weighing plans to invest nearly US$600 billion to meet rising urban power demand through 2020. Whether the electricity is ultimately used to power homes or industrial plants, these projections can serve as an excellent barometer of the future vitality of an urban economy.

So from a dizzying universe of 655 cities, in this example, we have managed to quickly winnow it down to just seven — Changsha, Chengdu, Chongqing, Fuzhou, Nanchang, Xi'an and Wuhan. All are provincial capitals, all but one are located in China's interior and all have populations that would easily place them among the top five largest cities in the U.S. And when we compared several recent indicators, such as growth in urban disposable income, against national rates and those of the four Tier I cities familiar to most U.S. investors — Beijing, Guangzhou, Shanghai and Shenzhen — we found strong validation for our selections.

This is obviously a simple example and every business will have its own criteria for developing a short-list of potential locations for its next investment. Yet for many U.S. executives, such exercises will become increasingly commonplace as companies try to get out in front on one of the most critical business opportunities of the 21st Century.

Is the China game getting tougher?

January/February 2010

After one of the most difficult years for cross-border investment on record, the verdict on China is in. Following a surge of foreign direct investment (FDI) in December, China's Ministry of Commerce reported last month that China attracted US$90 billion in FDI in 2009, down just 2.6% from 2008's US$92.4 billion and China's second best showing since opening up in 1978. Overseas investment by Chinese companies fared even better, managing a 6.5% increase in a year when the United Nations Conference on Trade and Development (UNCTAD) reported a 39% decline in cross-border investment worldwide.

Sustained investor confidence in China should come as no surprise. As market demand in country after country evaporated in the West, the decade-long trend that saw more U.S. companies turning to China not just to cut costs, but for top-line growth, understandably held firm. Polling results of U.S. investors from our own webcast series over the past 18 months tell a similar story, revealing persistent confidence in China even during the darkest days of early 2009.

Yet it is difficult to reconcile what the numbers tell us with what we have been reading in the press lately. Reports of U.S. and other foreign investors experiencing a souring of the investment climate paint a very different picture of investor confidence than suggested by the statistics. Among recent examples are the following:

- February 2010 – Four executives, including an Australian national, representing one of the world's largest iron ore suppliers, are formally charged by China for engaging in bribery and industrial espionage. The four were first detained as sensitive negotiations on pricing broke down last July.
- January 2010 – After the Obama administration announces plans to sell billions in advanced weaponry to Taiwan, China for the first time threatens to impose "limited sanctions" on the U.S. companies involved.
- January 2010 – The world's largest search engine operator threatens to quit China after suffering a sophisticated cyber-attack on its networks.
- December 2009 – Nineteen U.S. business associations join 15 European counterparts in a joint letter warning China that its new government procurement rules will force multinationals to either abandon the China market or run intolerable risks to their intellectual property if they remain.
- May 2009 – All six multinationals fail to survive the first round of bidding for 25 contracts to supply wind turbines worth US$7 billion as part of China's stimulus package – accusations of local favoritism are denied by Chinese authorities.
- March 2009 – In one of the first tests of China's new antitrust regime, the world's largest soft drinks company finds its US$2.4 billion bid to acquire a local juice maker is rejected on competitive grounds.

Accordingly, a prominent Western storyline around China over recent months runs something like this – as a result of the economic crisis, an emboldened China is taking advantage of its new-found leverage to extract terms more favorable to it on every front. Foreigners, or so the story goes, must now adjust to a new era of diminished leverage, not just within China but across the globe. In other words, the game is getting tougher.

Many company executives will find themselves being questioned along these lines. The ability to put these events in proper perspective may therefore be critical to avoid having your China strategy pushed to the back burner.

Some companies may indeed be experiencing a loss of leverage. However, to more fully understand the relevance of these reports to your business, one might consider other plausible interpretations. Given the challenges of investing in China, for example, some may reflect efforts by China-based executives to gain internal leverage by adjusting expectations back at U.S. headquarters. Others may actually be an indication of increased leverage, resulting in greater confidence to engage the Chinese government in a more mature and open conversation. To take this further, if we just look at six of the multinationals involved in these reports, an interesting composite picture emerges:

- These six companies, on average, have 39 years on the ground in China.
- Together, these companies have announced more than 100 major investments in China, either greenfield or M&A – investing more than US$5.5 billion in the past decade alone.
- The six employ more than 65,000 people across China.
- Three of the six companies responded to the setback by announcing very significant new commitments to China within the space of weeks.

What we find is a group of very seasoned investors in China who presumably understand the rules of the game very well. Conversely, the Chinese government knows them very well too. Both parties are apparently confident that their long-term relationships will not be jeopardized by short-term hiccups, no matter how public.

The China game may or may not be getting tougher but as we mentioned earlier, we detect no perceivable reduction in interest in the China market. To play the game well in China, however, you need sustainable leverage, both internal and external. Given the rapid pace of change and the complex stakeholder environment, leverage can be lost

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overnight. But it can also be gained from many different sources, particularly if you align your strategy with where China may be headed. In our last commentary, we pointed to China's five-year planning cycle as one such opportunity in 2010. Others will no doubt present themselves to companies that stay sharp and opportunistic.

2010 – Engaging China's five-year planning cycle

November/December 2009

Although it has yet to attract much attention outside government circles, 2010 will find Chinese policymakers increasingly focused on formulating the country's 12th Five-Year Plan for Economic and Social Development (2011-2015) (12th FYP). As a blueprint for laying out China's national policy priorities for the coming five years, the final 12th FYP to emerge will be invaluable to any U.S. investor seeking to understand where China may be headed. Yet the most appropriate question to ask ourselves at this stage is whether the policy-making process now under way offers U.S. executives any extraordinary opportunities? Might it be possible, not just to align investment strategy to China's priorities once they have been announced, but to actually partake in the process and help shape the future business environment itself? After a review of recent changes to the planning process, it appears that a trend toward greater openness may indeed offer more opportunities for engagement, although the complexity of the process will require considerable skill at navigation.

Before sharing some observations from our research, let's take a quick look at how the process is likely to unfold in the year ahead. Since an official calendar has not made public, the timetable below is largely drawn from reviewing the major milestones leading up to the final approval of China's **11th Five-Year Plan** (2006-2010) (11th FYP) in March 2006.

As in past years, work on the 12th FYP will be spearheaded by the Strategic Planning Department of National Development and Reform Commission (NDRC), China's lead planning agency. With the research phase of the process under way for over a year, the NDRC announced that drafting had begun this fall. The next major milestone, in early 2010, will be approval of high-level areas of policy focus, first by the State Council, China's highest executive authority, and then by the 11th National People's Congress (NPC), China's highest legislative authority, in March, after which more detailed drafting can proceed. By mid-autumn 2010, a mature draft will be submitted to Chinese party leadership for review and approval, with the ultimate goal of presenting the 12th FYP for final approval by the NPC in March 2011. While we plan to update this calendar as more information becomes available, as of this stage, it seems to suggest that the window for engagement will close sometime late summer.

Looking at China's planning policy process today it is much more open compared to just a few years ago. The arrival of Hu Jintao and other "Fourth Generation" leaders on the scene in 2003 — just as planning for the 11th FYP was getting under way — greatly accelerated the evolution of the process from its Soviet command economy origins to

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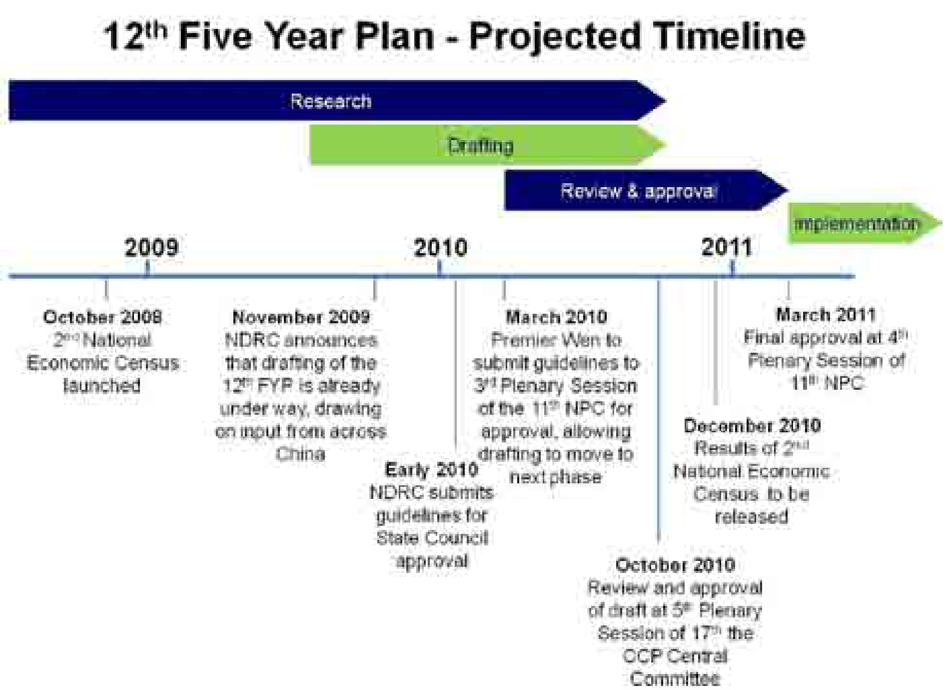

Source: Deloitte research, PRC government and media sources

a modern tool for economic development and consensus-building. The 11th FYP was a clear expression of the new generation's vision for China, focusing on long-term economic sustainability and placing much greater emphasis on openness and accountability in form. Some changes were largely symbolic – for example, referring to the 11th FYP as a "program"
(规划) rather than a "plan" (计划) to signal an appreciation for limitations of the process – but many others represented significant departures from past practice:

- Expert opinion – Experts from inside and outside of government, domestic as well as foreign, were widely consulted on both the substance of the 11th FYP and the planning process itself – more than 150 separate studies were undertaken during 2003-2005
- Public consultation – Efforts were made to bring Chinese citizens directly into the process, most famously in 2005, when more than 4 million Chinese were surveyed about their views on environmental protection
- Monitoring and evaluation – In consultation with multilateral organizations, a mid-cycle review process was introduced, offering the possibility for reflection and course-correction
- Accountability — The performance evaluation of officials responsible for implementing the 11th FYP would reflect the plan's new sustainability goals, rather than merely rewarding high growth

The overall effect was to open what had been a very narrow conversation, with the practical effect of sensitizing Chinese policymakers to the perspectives of a greater range of stakeholders.

To get a sense of how the increasing pluralism of the process might expand the number of entry points for U.S. investors into the conversation, consider the complex task ahead for the NDRC's Strategic Planning Department in 2010, a team consisting of no more than a few dozen officials among the NDRC's total staff of about 1,000. In addition to incorporating data and other research pouring in from dozens of directions across China, their work must be closely coordinated with the more than 6,000 national, provincial and local bodies engaged in similar planning exercises this year across China. Proposals and recommendations flowing upward must be reviewed and assimilated into the main 12th FYP. As the process unfolds, emerging priorities must then be communicated back so that provincial-level Reform and Development Commissions and lower-level planners can ensure that their plans are consistent and complementary with China's national goals. The NDRC must also ensure that the 12th FYP encompasses the many recent cross-sectoral and regional plans involving different central-level ministries and provincial groupings — i.e. China's **National Medium & Long-Term Plan for Science and Technology Development (2006-2020) or Plan for the Reform and Development of the Pearl River Delta (2008-2020)**. The sheer scale and diversity of input flowing throughout this multi-level process opens a wealth of opportunity for engagement by U.S. investors in the year ahead, especially for those who take the time to understand how the Chinese stakeholders with the greatest influence over their investment strategies fit in.

A quick aside about the challenge of identifying emerging policy priorities for the 12th FYP, especially with the planning process only now gaining steam. Generally-speaking, we expect a great deal of continuity. Many of the fundamental imbalances targeted by the 11th FYP – income disparities between regions and between urban and rural China, for example, are long-term challenges requiring sustained effort and China itself concedes uneven progress. One source of insight worth consulting is the World Bank's **Mid-Term Evaluation of China's 11th Five Year Plan**, prepared at the invitation of the NDRC and released publicly in December 2008. This document praises China, for example, for raising per capita GDP, maintaining a strong fiscal position and extending health insurance coverage. China receives lower marks, however, for its efforts to narrow income gaps, reduce its dependence on investment as an engine of growth, restructure major industries and reduce its carbon footprint. Look for these and other hold-over issues to take center stage during the 12th FYP period, although U.S. executives closely attuned to the process are in line to receive a wealth of intelligence from their own conversations in the meantime.

Getting China right has probably never been as critical to U.S. companies as it is today, making the ability to see around corners invaluable. But by taking a more proactive stance, U.S. executives may be able to achieve more. The increased openness of the process gives U.S. executives a ready excuse to get out and talk to Chinese policymakers, not just about common priorities but about the type of business environment their investments require if they are to enjoy mutual success. (For those engaged in these discussions, by the way, we'd love to hear of your experience – please feel free to **shoot me a quick note.**) For executives following the dynamics of these conversations and the wider planning process from afar, consider the following pair of questions for your China-based team — "how does what we are learning affect our operations in China today?" and "how does this information sit with the basic assumptions we are making about China over the long-term?"

Chinese outbound investment — Now a headline story

October 2009

Just before boarding a flight to Shanghai last week, I happened to pick up the latest issue of Fortune. Since most of my trip would be spent discussing investing in the U.S. with Chinese executives, I was no doubt drawn by the cover "China Buys the World" and after all, who can resist a good prop? Journalistic license is clearly at work here — a related article inside was titled "It's China's World (We Just Live in It)" — but nonetheless, there does seem to be a growing sense that China is turning yet another corner. This January, we marked the 30th anniversary of China opening its doors to foreign investors – will 2009 be remembered as the year that the world recognized that Chinese investors were walking through themselves?

The feeling that China has reached a new inflection point is supported by the data. According to China's Ministry of Commerce, Chinese companies invested a record US$55.9 billion overseas in 2008, up 111% over 2007. China's cumulative total was reported at US$184 billion since 1979, indicating that almost a third was invested in 2008 alone. Because so much investment is flowing through third jurisdictions, hard data on Chinese investment in the U.S. is difficult to come by but our research suggests that Chinese companies may have invested US$7-10 billion in the U.S. already. Recent Chinese acquisitions in the U.S. span the economy (see Table I) and shed some interesting light on how Chinese executives are viewing opportunity in today's marketplace. This insight has implications for U.S. executives as well, since Chinese investors can now be expected to play an active role in shaping the "reset economy."

So what's driving Chinese executives to look at the U.S. as a market for acquisitions? The most attractive valuations in years, for starters. Just looking at the five year period up to Q2 2009, median enterprise value to EBITDA multiples for mid-market deals in the U.S. peaked in Q2 2007 at roughly 11X cash flows but had fallen to approximately 6X in Q2 2009. On an industry basis, with few exceptions, median EV/EBITDA multiples are down substantially in Q2 2009 from one year earlier (see Table II). Just reviewing the recent activity of mid-market Chinese buyers, it is clear that signs of undervaluation (i.e. telecoms, healthcare deals) are not being overlooked. After all, few would dispute the knack of the Chinese businessman for spotting a bargain, even during today's unusually murky market conditions.

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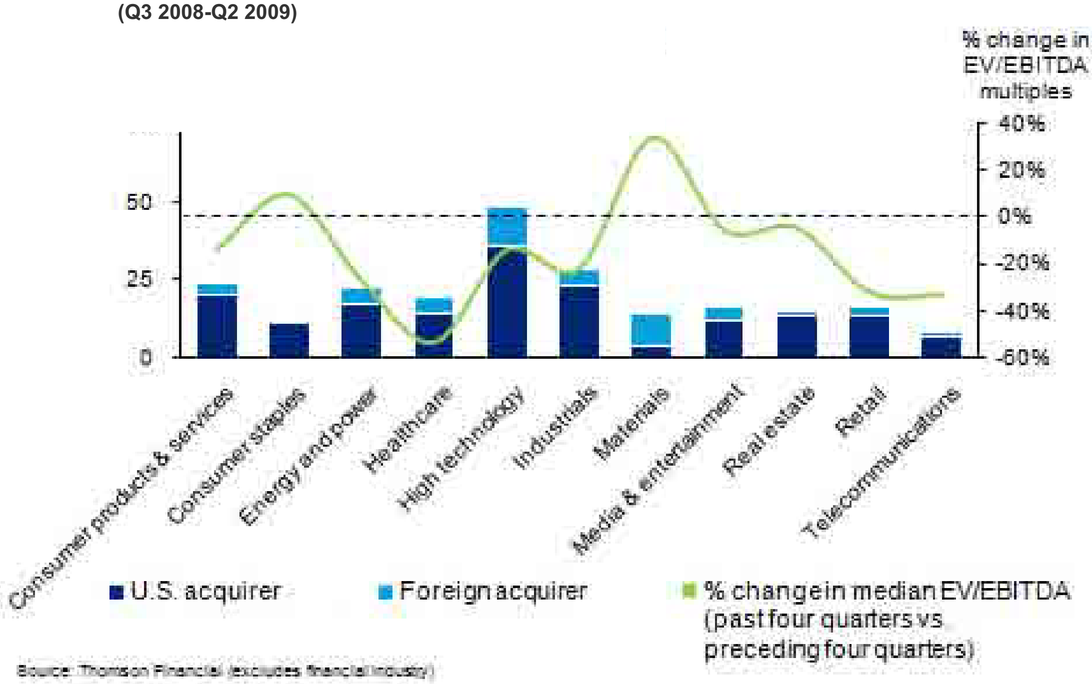
Table I
Largest Chinese mid-market[1] deals into the U.S. (2007-2009, by disclosed deal value)

Date/Deal Status*		Acquirer	Value (US$M)	% Acquired/ Sought	Target	Target Sector
9/07	W	Huawei Technologies Co. Ltd.	363	16.50	3Com Corp.	Telecommunications
10/07	C	China Minsheng Corp.	317	10.00	UCBH Holdings Inc.	Financials
3/08	C	China Life Insurance Co. Ltd.	300	N/A	Visa Inc.	Financials
3/08	C	Mindray Medical International Ltd.	209	100.00	Datascope — Patient monitoring business	Healthcare
1/08	C	WuXi Pharmatech Inc.	163	100.00	AppTec Laboratory Services Inc.	Healthcare
6/09	P	Sichuan Tengzhong Heavy Industrial Machinery Co.	150	100.00	General Motors Corp. – Hummer division	Industrials
6/08	P	COFCO Ltd.	139	4.95	Smithfield Foods Inc.	Industrials
5/07	C	Jiangxi Greatsource Display Technology Co.	95	70.00	I/OMagic Corp.	High technology
3/09	P	BeijingWest Industries Co. Ltd.	90	100.00	Delphi Corp. — Brakes and suspension business	Industrials
11/07	C	Spreadtrum Communications Inc.	76	100.00	Quorum Systems Inc.	High technology

C = Completed | P = Pending | W = Withdrawn

[1]Mid-market = deals with disclosed value > US$5 million and < US$500 million

Table II
U.S. mid-market deal volume (and foreign buyer involvement)
(Q3 2008-Q2 2009)



From my conversations with Chinese executives, however, I get a strong sense that many are beginning to think beyond price. One of the key messages we have been delivering to Chinese investors is that today's marketplace affords them an exceptional opportunity to use M&A to reposition themselves in the global marketplace. For example, some Chinese companies have come upon unexpected opportunities to move downstream, driven, for example, by the need to rescue a U.S. customer in sudden financial difficulty. The immediate motive may be to secure a future sales base but the net effect is U.S. market entry. Other Chinese companies are capitalizing on divestiture opportunities as more U.S. companies redefine their core businesses to gain agility in a new competitive environment. Still, others are coming to realize, not unlike their U.S. counterparts, that if the U.S. and China are their biggest markets longer-term but not yet their largest revenue generators today, something needs to be done and done fast. Regardless of their motive, they are coming.

Now that the world is coming to recognize the potential of the Chinese cross-border investor, U.S. companies must consider their response. Some will seek to defend the status quo. Others will compete for their investment. Still others will seek to find ways to collaborate with the Chinese in pursuit of synergies in both markets. Regardless of their chosen strategy, long-term success will favor those companies that fully appreciate this new China dynamic and act quickly.

Partnering with Chinese provinces — Why the timing is right

September 2009

Back in February, as part of our on-going discussion about leveraging the right partners in support of corporate expansion strategies in China, we identified provincial governments as especially promising. After noting the proliferation of memorandums of understanding (MOUs) between provincial governments and foreign investors, we suggested that the basis for their appeal stemmed from the critical role that provincial officials have come to play vis-à-vis Chinese industry – as owner/managers of large state-owned enterprises (SOEs), as regulators of local economies and as investors in key enablers of industry competitiveness, including infrastructure and human capital. Recent developments, including the delegation of approvals for most foreign-invested projects under US$100 million to provincial-level authorities, seem to underline the growing importance of provincial governments to foreign investors.

In this month's commentary, we consider why the timing may be particularly good today for approaching provincial governments about collaboration. We will also address the challenge of identifying which among China's 31 provincial-level governments — 22 provinces, five autonomous regions and four provincial-level municipalities — may be most receptive to your investment strategies.

As China has yet to allocate most central-level funding associated with its US$586 billion stimulus plan, competition among provinces for project approval is intensifying. At the end of the day, provincial governments face the same constraint on their investment goals as foreign investors – all projects must be fully aligned with central-level development goals while still generating sufficient economic return. Throughout 2009, project scrutiny has intensified and more are being rejected due to flawed or incomplete feasibility studies. Since central-level financing was never meant to provide more than seed capital for provincial projects, the onus is also on the provinces to come up with projects that are strong enough to attract additional sources of funding.

For U.S. executives, the current climate therefore presents some interesting opportunities. Provincial officials may be highly receptive to a proposal to join in a project of mutual interest if it can enhance or differentiate their sales pitch to Beijing. By providing a commercial endorsement to a project and strengthening prospects for implementation, a foreign investor wins key allies and lays the foundations for a longer-term partnership. These relationships can also come in handy as planning for the 12th Five-Year (2011-2015) period gets under way across China next year.

This still leaves open the question of how to identify which province or provinces to approach. Here, U.S. executives have some surprisingly robust tools at their disposal. As noted above, every province in China draws up its own Five-Year Plan, designed to translate China's national goals into local objectives. These documents lay out general investment objectives but usually also contain detailed information regarding specific targeted industries, including goals for consolidation, plans to develop industry clusters, strategies for boosting competitiveness, even the role expected of foreign investors. In addition, many provinces have put industry-specific policies in place. A review of these policies is critical, not just for understanding a province's competitive position today, but to understand where it wants to be tomorrow – a key insight into its potential as a strategic partner.

Henan province, for example, is one of China's top grain producers and a leading base for the non-ferrous metals sector. The province is not well-known for its automotive industry, and in fact, ranked among the bottom third of provinces last year by some industry measures, including vehicle output. Yet Henan's current Five-Year Plan (2006-2010) clearly expresses the province's intention to emerge as one of China's leading automotive economies. Earlier this month, the province released new industry guidance that explicitly welcomes foreign cooperation in achieving the province's objectives for its auto sector. So in addition to looking at provinces traditionally strong in your industry, consider others where your global strengths may be especially valued.

Once a suitable province has been identified, many foreign investors have found it advantageous to execute a MOU with the provincial government as a first step. Our research has shown that while the agreements themselves can often be vague, they can be an effective way to tap into the multiple roles that provincial governments can play in an investment strategy (as owner/managers, regulators and investors). They can recast your plans as a priority for leadership and help exert downward pressure for collaboration across sprawling organizations, including local SOEs. Potentially, they might anchor more complex partnerships, drawing in multiple stakeholders including SOEs, financial investors, and even neighboring provinces. After signing a MOU, however, companies must take the initiative. They must be quick to follow up with implementation plans and then monitor their progress closely if they are to extract full value.

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From green collaboration to sustainable shareholder value

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July/August 2009

Across the broad expanse of the U.S.-China economic relationship, few areas exhibit greater promise for close cooperation than clean tech and renewable energy. Both countries have seized upon the economic crisis to advance their plans for greater sustainability, uncovering strong mutual interests along the way. To take a recent example, U.S and China officials announced the establishment of a new joint research center on clean energy in late July.[1] There is still much to be worked out, but for companies looking for new ways to create value from green initiatives unfolding on both sides of the Pacific, the overall direction is clearly positive.

For U.S. and Chinese executives seeking to exploit emerging synergies in this space, a comparative look at the U.S. and Chinese stimulus plans can be a very useful place to start. In our August 13 webcast on the subject, we suggested that once the parallels have been identified, all manner of strategic alliances can then be considered to enable a company to simultaneously pursue opportunities in what, more often than not, are the world's two largest markets. According to a report by HSBC Global Research, the U.S. and China will account for no less than 70% of the US$430 billion allocated to green spending among the world's twenty largest economies.[2] A large chunk of this spending is on infrastructure like high-speed rail and smart electric grids, but as the table below shows, both countries are committing billions to achieve remarkably similar goals in clean tech and renewables as well. In the U.S., for example, US$6 billion will be spent on waste treatment and water infrastructure, while China plans to invest US$40 billion on similar initiatives. For any company touching on clean water, teaming to go after business in both markets might be an option worth looking at, especially while war chests and shareholder tolerance for risk are still low. Given the recent protectionist sentiment creeping into the bilateral relationship (see our June commentary), the ability to put a local face on an investment can also be very welcome.

There are already numerous examples in the marketplace of U.S. and Chinese companies seizing on cross-border opportunities related to green spending. Consider the following cases covered in the press during the past six months:

- A California-based company has lined up a series of Chinese partners with the intention of producing electric vehicles for both markets and beating more established players to the punch. The vehicle itself will be built by a state-owned auto company in China, while the lithium-ion batteries will be produced in the U.S., based on a design by another Chinese partner. The company is currently seeking U.S. stimulus funding for the U.S. facility.

[1] The center, to be located in both countries, will focus on energy-efficient buildings, clean coal use and clean-fueled vehicles. The initiative is the latest evidence of deepening collaboration on green issues between the U.S. and China, from the signing of a ten-year cooperation agreement on energy and the environment in June 2008, to the seven new "eco-partnerships" announced during last December's Strategic Economic Dialogue in Beijing, to on-going bilateral talks on global climate change. A copy of the memorandum of understanding can be found at **http://www.state.gov**.

[2] HSBC Global Research, "A Climate for Recovery" (February 2009)

Comparing green stimulus spending

	China	U.S.	Cross-border investors poised to benefit
Renewable energy	• US$31 billion for wind, hydropower, solar and clean coal technologies	• US$3.4 billion for clean coal and carbon sequestration • US$2 billion for electric car battery development	• Renewable energy equipment manufacturers
Energy efficiency	• Unspecified, but large investments in "green" buildings and other projects designed to boost energy efficiency anticipated	• US$14.5 billion for energy-efficiency programs • US$11 billion to promote energy efficiency in public buildings and fleets • US$3.5 billion for energy-efficiency improvements for Defense Dept.	• Industrial process suppliers • Equipment manufacturers
Clean water	• US$40 billion for waste water treatment	• US$6 billion for waste water and drinking infrastructure	• Clean water tech companies • Waste management companies • Equipment producers • Testing companies

Sources: U.S. and PRC governments

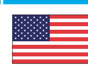
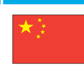
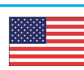
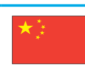
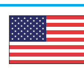
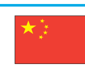
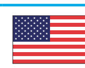
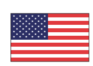
- A New York-based diversified manufacturer, already partnering with a California company to develop a pilot smart grid project in Florida, recently signed a business cooperation agreement with China's largest electricity transmission and distribution company. The Chinese company has been given a mandate to develop a national smart grid by 2020, which some industry experts say could entail spending in excess of US$10 billion annually.
- A joint venture between China's largest solar panel manufacturer and a local U.S. partner announced that it won a bid to build a solar power plant for a local utility in Texas. The project will power 5,000 Texan homes when it goes on line in 2010, and help the Chinese company further penetrate what it considers its largest future growth market. In May, the company announced that it was also scouting for locations to build a new solar panel assembly plant.

Given the wide range of potential synergies to be exploited — markets, product, supply chain, talent, technology, etc. — the specifics of each case matter less than the fact that in each instance, U.S. and Chinese companies are coming together to create a sum greater than its parts.

As demonstrated in the table below, in many segments of the renewable energy market, the U.S. and China are emerging as dominant players. In both countries, stimulus spending is expected to act as a powerful accelerant of this process, opening new areas for cross-border collaboration between the public and private sectors. The same phenomenon can be observed in other industries as diverse as automotive and healthcare.

This raises an interesting question for U.S. executives, regardless of industry – if the U.S. and China are the top two global markets in our sector, then shouldn't they be the top two markets for us as well? If the answer is no, then your strategic investment priorities may not be aligned with your greatest opportunities for future revenue generation, placing long-term global competitiveness at risk.

Top global markets for renewable energy

	Rank				
2008 Metric	**1**	**2**	**3**	**4**	**5**
Total 2008 investment in new renewable capacity*		Spain		Germany	Brazil
Wind power capacity added in 2008			India	Germany	Spain
– Total wind power capacity (end of 2008)		Germany	Spain		India
Solar PV (grid-connected) added in 2008	Spain	Germany		South Korea	Japan
– Total solar PV (grid connected) capacity (end of 2008)	Germany	Spain	Japan		South Korea
Solar hot water/heat added in 2008		Turkey	Germany	Brazil	France
– Solar hot water/heat capacity (end of 2008)		Turkey	Germany	Japan	Israel

Source: REN21, "Renewables Global Status Report " (2009 Update)

* Includes investment in wind, solar, geothermal, small –scale hydropower and biomass power generation

"Buy Chinese" — New policy or new context?

兼听则明

June 2009

Seven months after China launched its US$586 billion stimulus package, concern is mounting that China may finally be succumbing to the same protectionist pressures threatening the "green shoots" of a global recovery elsewhere. Reports of a new "Buy Chinese" policy, echoing the "Buy American" clause of the U.S. stimulus package, are stoking fears that China intends to curtail foreign participation in its unfolding stimulus plan. U.S. investors, however, may want to refrain from jumping to any conclusions just yet. A clear picture has yet to emerge and as with most policy developments in China, everything will eventually come down to implementation at the local level.

First, a quick review of what is known. The immediate cause for concern is a six-page document entitled *Opinions on the Implementation of Decisions on Expanding Domestic Demand and Promoting Economic Growth and Further Strengthening Supervision of Tendering and Bidding for Construction Projects* (Circular 1361) — issued on May 27 by the National Development and Reform Commission (NDRC), China's central planning agency, and eight other government agencies heavily involved in administering China stimulus package.[1] No official English translation is provided but the controversy revolves around a pair of sentences appearing near the top of page three, which can be translated as:

> *"Government investment projects should purchase domestic products, unless these domestic goods, construction engineering or services are not available in China or cannot be acquired on reasonable commercial terms. Projects requiring imported products will need prior approval from relevant government authorities."*

The document was posted on the NDRC's website on June 4, but went unnoticed until it was mentioned in a June 16 article in the official *China Daily*. Within days, global media outlets had picked up on the story, running alarming reports that China was rolling out a new policy designed to exclude foreign investors from stimulus projects. By month's end, Chinese officials were arguing that the circular was the subject of serious misinterpretation — their actual intention was to level the playing field for foreign and Chinese companies alike, especially in sectors like equipment manufacturing, where bidding practices had historically discriminated against local players — but by this time, the genie was already out of the bottle.[2]

Before exploring the potential impact of Circular 1361 on U.S. investors, a few observations:

- **An open preference for domestic products is not new in China (nor in many other WTO member countries)** — China's existing Government Procurement Law, which went into effect on January 1, 2003, includes nearly identical language on procurement of "domestic goods, construction engineering and services," although these provisions have not been strictly enforced. Prior approval for use of imports in government procurement was added in a notice released by the Ministry of Finance in December 2007 (**Measures for the Administration of Government Procurement of Imported Products**). In this context, Circular 1361 can be seen as a reminder to local Chinese officials of their existing obligations at a time of heavy public investment. Meanwhile, from the U.S. and German auto bail-outs to the questionable safety concerns about Chinese toys in India, there has been no shortage of local favoritism shown by other WTO members as the global recession began to bite.
- **Such preferences do not run contrary to China's WTO commitments** — Unlike the U.S., China is not among the 40 signatories of the WTO Agreement on Government Procurement (GPA), which guarantees mutual access to a collective US$400 billion annual procurement market.[3] The final "Buy American" provision of the U.S. stimulus package therefore included language to ensure that it was applied "in a manner consistent with U.S. obligations under international agreements," essentially exempting other GPA signatories. China, as a non-signatory, called the provision "protectionist poison" back in February but had no formal basis for complaint. The same lack of legal standing is now true for GPA signatories pursuing business in China. In fact, until more evidence emerges about how the policy will be implemented, assurances by officials of China's continued openness to foreign participation in the stimulus plan are about all we have to go on.

[1] The nine government agencies are the NDRC, Ministry of Industry and Information Technology, Ministry of Supervision, Ministry of Housing and Urban-Rural Construction, Ministry of Transportation, Ministry of Railway, Ministry of Water Resources, Ministry of Commerce and the Legislative Office of the State Council.

[2] **Ministry of Commerce statement** (Chinese-language only)

[3] As a condition of U.S. and EU approval of its application to join the WTO in 2001, China agreed to accede to the GPA "as soon as possible." To their consternation, however, China did not apply to start negotiations until December 2007. Talks are on-going, with the next session scheduled to resume in Geneva in mid-July.

- **It is not clear that U.S. and other foreign-invested enterprises (FIEs) in China are really being targeted** — Circular 1361 appears to distinguish between imported products and those that are domestically-produced, although "domestic" is not precisely defined (i.e. no reference to conference requirements). On multiple occasions this month, however, Chinese officials have emphasized that FIEs will be treated the same as other China-based enterprises. This likely reflects underlying pragmatism about the need to generate employment, regardless of the location of the employer's headquarters. Exporters to China, on the other hand, may press their governments to take action against China but given its status outside the GPA and global economic conditions, the odds for success are probably quite low.

As some observers are already suggesting, Circular 1361 may eventually be revealed to fit an emerging fact pattern of centrally-orchestrated economic nationalism in China. Evidence for this narrative can be found in China's stepped-up support for indigenous innovation, home-grown brands and "national champions" in the context of stimulus implementation. In one widely reported incident last month, not a single foreign bidder for a stimulus-related wind turbine project survived the first round of bidding. (The Europeans point to promotion of national champions — the Chinese say it was simply price). Yet one can also already point to many examples of large stimulus-related contracts going to U.S. and European companies, painting a mixed picture that suggests continued ambiguity as the most likely future scenario.

Given this uncertainty, U.S. investors may want to bear in mind that the actual treatment they receive in China is almost always in the hands of local decision-makers. The strength of local relationships may therefore emerge as a critical factor for success in such an environment. Unlike the U.S. "Buy American" clause, Circular 1361 is not law — it merely provides guidance to local officials regarding their purchasing decisions. As nearly three-quarters of China's stimulus package is being financed at the local level, where all projects are actually being implemented, there may be ample room for discretion.

In recent months, we have emphasized the importance of strengthening relationships with local stakeholders as a means of positioning U.S. investors for emerging opportunities in China. For some companies, the time to leverage strong ties to local authorities may indeed have arrived. Others may discover that strategic alliances with local partners now appear more attractive, opting to blunt any potential "Buy Chinese" sentiment by becoming more Chinese themselves. Fast-growing exporters to China may reach a similar conclusion, perhaps accelerating their decision to establish a local presence. In any event, U.S. executives will need to feel their own way forward, monitoring the situation closely and adjusting their strategies in light of new evidence emerging from the marketplace.

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The quest for coverage

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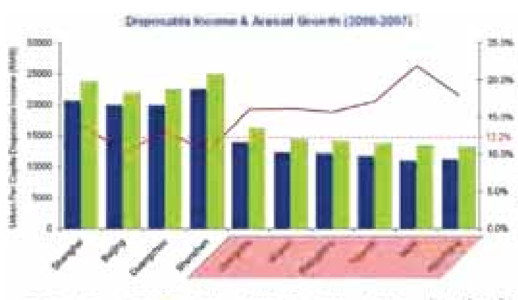
May 2009

In our discussions with clients these days, two questions regularly come up, regardless of industry or length of experience in China. The first is "How do we compete more effectively in markets where we already do business?" And secondly "Which emerging markets hold the greatest potential for us?" These questions get to the heart of two separate but closely related challenges — how to achieve scale in China while increasing coverage of growing markets. Of course, increased scale tends to lower costs, thus improving profitability, and coverage provides greater opportunity for top-line revenue growth. The quest for scale in China was the subject of our last two monthly commentaries. This month, we take up the other half of the sustainable success equation — the quest for coverage.

For many U.S. investors today, finding the right coverage in China often means beating a path beyond the well-trod markets of the coast. An excellent example is growing interest for Central China — the six provinces of Anhui, Guangxi, Henan, Hubei, Hunan and Shanxi. Last year, the six achieved a remarkable 12.4% average annual GDP growth rate, vs. 9.1% nationally, a trend many forecast to extend well into the future. What explains the region's exceptional rate of growth and in particular, confidence that it will continue? Two factors stand out:

- **Scope for catch-up —** Together, the six central provinces represent a very substantial market of roughly 370 million (22% larger than the U.S. and 28% of China's total). Yet in terms of GDP, the region accounted for just 19% of China's total last year, down from an average of 24% from 1980 to 2005. Per capita GDP is still half that of coastal China. Yet as illustrated in the graph below, urban per capita income in the region's six provincial capitals is growing much fast than China's major coastal cities.



Source: City Statistics Bureaus

- **Strong government focus —** To close the gap with coastal China, the central government launched a targeted development program for the region in late 2006, including measures to accelerate the migration of labor-intensive enterprises from the high-cost coast. The region is also emerging as a major focus of Chinese infrastructure spending. For example, while the region accounts for just 11% of China's land area and already boasts the country's densest rail network, it is slated to receive roughly 40% of all rail track to be added in China through 2020.

The potential for sustainably high growth rates in Central China is already attracting the attention of foreign investors seeking to increase their coverage in China. Indeed, the region experienced a 36% increase in foreign direct investment (FDI) last year, compared to a 24% increase nationwide (although, again, from a relatively low base). The region is also beginning to experience a subtle shift in what are perceived to be its competitive advantages. For example, in 2002, when Anglo-Dutch consumer giant Unilever announced its intention to shift its consumer products manufacturing base 400 kilometers west from Shanghai to Hefei, the capital of Central China's Anhui province, it was widely seen as a gutsy cost-cutting measure. Today, after several years in operation, the complex is as likely to be viewed as being ahead of its time in terms of positioning the company to optimally serve a rapidly growing base of local customers. Investors interested in exploring emerging opportunities in the region may be interested in the revised Catalogue of Advantaged Industries for Foreign Investment in the Central-Western Region, which went into effect on January 1st 2009.

Of course, Central China will not make sense for every foreign investor. In fact, the entire question of what constitutes sufficient coverage in China is highly subjective. It will vary from company to company and depend on the maturity of the operations, although benchmarking against competitors often offers a good objective barometer. Gaining coverage can also be an expensive undertaking, particularly early-on, when the new business is operating below the break-even point. This is especially true if entering a new market requires building a stand-alone cost structure. So how can investors create the space needed to explore growth opportunities in China without incurring start-up costs excessive enough to doom the expansion before revenue potential can be fully explored?

One approach commonly adopted is what might be called a "hub and spoke" strategy. Here, hub locations support expansion into promising nearby markets by lending infrastructure and sharing resources until a sufficient revenue stream is established. Deloitte itself adopted such a strategy in China to build its 11 office network in China today. Our Beijing office, for example, facilitated expansion to Tianjin, while Shanghai supported Nanjing, Suzhou and Hangzhou and Hong Kong backed expansion of coverage to Guangzhou and Shenzhen.

Coverage is important if your business is to keep pace in China in terms of revenue growth. Yet achieving profitable growth requires that your quest for coverage be balanced by a quest for scale.

The changing face of competition — China's plans for industry revitalization

April 2009

Last month, in our discussion of achieving and maintaining scale in China, we concluded that the ability to size up the competition is a critical success factor for determining whether sufficient resources are being allocated. After all, the fact that your China business may be growing faster than operations anywhere else is of little consequence if your competitors are growing faster. For U.S. executives with one eye cast over their shoulders, the industry revitalization packages recently announced by China's State Council offer important insight into how the competitive landscape may evolve for years to come, especially the development of local competitors.

First, what we know so far—In connection with its wider US$586 billion stimulus plan announced in November 2008, the government began approving revitalization packages for ten key industries in the run-up to last month's National People's Congress meeting, starting with the automotive and steel sectors in January. Many details have yet to emerge—only four of the plans have been officially released to the public—and much of what is known at this stage is via Chinese industry associations consulted during the planning process. With the exception of auto and steel, for example, the level of funds being committed is an open question, although the recent increase in allocation for innovation and industry revitalization in the main stimulus package to US$54 billion provides a clue. **Exhibit A**, below, summarizes the main policy measures thus far disclosed, either officially or according to press reports, and common across most of the ten individual revitalization packages:

Why single out these ten industries? The selection process is said to have been the subject of intense lobbying (logistics was reportedly chosen over real estate at the last moment, while cement and biotech were other reported "also-rans") but clearly, policymakers were looking to make the broadest impact. Together, the government estimates that the ten account for roughly 30% of China's GDP, 80% of its industrial value-added output and at least 40 million jobs in urban China alone. Textiles and light industry, already globally competitive sectors, are critical to employment, especially as the government develops plans for industrial migration to inland regions and rural areas. Most of these industries, especially steel and petrochemicals, also have important multiplier effects across wide swathes of China's economy. The inclusion of logistics is noteworthy in this regard, although it may also have been a nod to the growing role of services in generating jobs and complements China's massive stimulus spending on transport infrastructure.

Proceeding from left to right across **Exhibit A**, it is evident that Chinese policymakers have multiple objectives in mind, both short as well as long-term. To help China's distressed exporters survive the downturn, value-added tax rebates are being increased and access to trade and other financing is being expanded. By the time we reach the center of the table, however, it is clear that something much more ambitious is going on—namely, an effort to

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Exhibit A

	VAT rebate increases	Improved access to credit	Subsidies to spur domestic demand	Incentives for energy efficiency	Support for industry consolidation	Funding for technology upgrades	Promotion of domestic brands/products
Automotive	✓	✓	✓	✓	✓	✓	✓
IT/Electronics	✓	✓	✓			✓	✓
Light industry	✓	✓	✓	✓			✓
Logistics				✓		✓	
Machinery	✓	✓	✓	✓	✓	✓	✓
Non-ferrous metals	✓	✓			✓		
Petrochemical	✓	✓				✓	✓
Shipbuilding		✓	✓	✓			
Steel	✓	✓			✓		✓
Textiles	✓	✓		✓		✓	✓

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wean Chinese industry from excessive dependence on external demand, especially by unleashing the pent-up demand of China's 800 million rural residents through purchase subsidies. In February, a year-old pilot program offering subsidies to rural Chinese worth 13% off the purchase price of 197 basic home appliances and consumer goods was rolled out nationally and computers, motorcycles, solar water heaters and air conditioners added to the approved product list. In March, a similar subsidy worth RMB 5,000 (US$732) was introduced for rural buyers of subcompact cars and minivans, on top of the purchase tax reductions for cars with 1.6 liter engines or less already announced in January.

Over the longer-term, China is also seeking to leverage the crisis to accelerate industrial restructuring with measures to reduce outdated capacity, encourage industry consolidation and raise global competitiveness through technological innovation. Here, a central government objective is the transformation of merely large industries into ones strong enough to compete on a global basis.

For U.S. investors, the implications are many, short as well as long-term. Most immediately, many investors will have questions about the potential for local favoritism, always a concern during a downturn. While none of the industry plans make explicit reference to the role of foreign investors, the strengthening of domestic brands is mentioned as a favorable outcome in several. The concrete evidence thus far is mixed. On the one hand, several foreign brands—including Siemens (refrigerators), Sanyo (washing machines), Motorola and Nokia (cell phones)—were added to the list of 177 manufacturers eligible to participate in the rural subsidy program in February. On the other, some recent measures—especially the emphasis on boosting sales of smaller cars and minivans—seem calibrated to benefit product niches where Chinese producers dominate. When viewed alongside protectionist measures adopted in recent months at the sub-national level ("buy local" directives in Anhui and Hunan provinces, for example, or those covering autos and steel in the cities of Changchun and Wuhan, respectively) investors will want to keep an eye on this aspect of the competitive environment.

Over the long-term, China's industry revitalization plans should raise much broader questions among U.S. investors about their competitive positioning in China. Even at this stage, with many details outstanding, the following questions may well be worth asking:

- If the market for our goods and services substantially expands in China, either geographically or in terms of emerging consumer segments, do we have the capacity to rapidly assess the potential, develop a viable strategy and commit the resources necessary to develop any new markets we choose to enter? Demand among China's rural residents, for example, is still immature but the starting gates are opening and market share and brand loyalties among the world's largest remaining reservoir of latent consumer spending are being established now.
- If industry restructuring accelerates, how prepared are we to participate in a way that would ensure our competitive position when the economy turns around? If we choose to participate, what options are available to us—M&A, joint ventures or other strategic alliances? And if our competitors are faster to the draw, what are the implications for our plans to achieve scale in China?

Having announced its stimulus package earlier than any other major economy, there are already signs that the worst may already be behind China. While growth slowed to just 6.1% in the first quarter, other key indicators, including industrial production, fixed asset investment and retail sales, were stronger than anticipated. China's industry revitalization plans, like its wider stimulus package, suggest that the government would like to see a different China emerge on the other side. Competing in this new landscape will likely present new challenges, but if China does take a leading role in the global recovery, staying one step ahead of the competition will likely yield very substantial rewards.

The quest for scale

March 2009

Given the mixed signals emanating from China's Ministry of Commerce (MOFCOM) this month, U.S. executives likely found the complex task of reading the investment environment more difficult than usual. Consider the following announcements:

- March 6 — After four straight months of declining foreign direct investment (FDI), MOFCOM unveils new measures designed to accelerate approval of foreign-invested projects by delegating greater authority to provincial-level officials.
- March 16 — MOFCOM reports that FDI in China fell for the fifth straight month in February. Government officials say they remain confident that China can maintain the momentum set by last year's record-breaking US$92 billion FDI intake.
- March 18 – In a closely watched test of China's new Anti-Monopoly Law, MOFCOM rejects the US$2.4 billion bid by Coca-Cola Inc. for Huiyuan Juice Group, citing its concerns about competition in China's beverage market.

While individual investors will see different implications in each announcement, it is difficult to see how the sum could sway an investment decision one way or another. Some argue in favor of slowing down investment, others for accelerating it. Keep in mind, however, that China's investment environment is constantly evolving and that any single month's developments are an imprecise indicator of what the future may hold. Given the uncertainty, the best companies will focus on the many ways they can leverage China today to enhance global competitiveness over the long-term.

For many U.S. investors in China today, the quest to achieve scale in the country's huge and rapidly-growing markets has emerged as a central challenge with strong implications for global competitiveness. As domestic sales take over from exports as the primary investment motive for U.S. investors, China's relative importance in generating revenue has climbed along with its traditional role as a cost-cutter. But how do investors know they have achieved and can maintain the appropriate scale in markets that are likely larger, less known and faster-moving than anywhere else they do business?

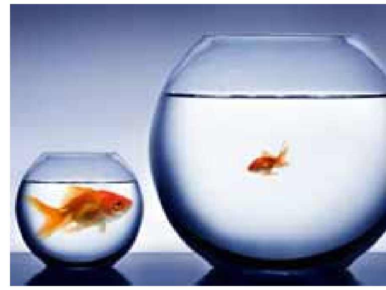
Foreign participation in China's US$1.59 trillion retail market illustrates the challenge. After 21% growth in 2008, the retail market has roughly doubled since 2004, although it is still 1/3 the size of the U.S. market. Beginning in the early 1990s, Wal-Mart and France's Carrefour Group SA, the world's top retailers by revenue, began shifting from an almost exclusive focus on sourcing to expanding retail operations, a process greatly accelerated by China's WTO accession. Nonetheless, after nearly twenty years in China, Wal-Mart cracked the top ten list of China's 100 largest retailers only in 2008, placing 9th, while Carrefour has held steady in the 6th spot for a second year in a row. Despite thoroughly dominating their respective home markets, the combined market share of both companies is not yet 1% of China's retail market and neither derives more than 5% of global revenue from China. If two companies not normally associated with difficulties achieving scale have their work cut out for them, the enormity of the China challenge for foreign investors in general comes sharply into view.

When considering the issue of scale in China, it may be helpful to answer the following two questions:

- Are you putting sufficient resources into China, probably the fastest growing market for your company?
- Are you growing fast enough in China to maintain and grow your market share?

The first question looks at scale in terms of your own global footprint — between your China business and your global operations. Here the central aim is to ensure that you are allocating the appropriate level of resources to develop the China market. Taking retail as an example, Carrefour's sales in France, which accounted for 44% of global revenue in 2008, rose just 1.0% year-on-year in 2008. China sales, which accounted for 3.5% of global revenue in 2008, grew 14.5% year-on-year in 2008 at constant exchange rates, vs. 6.3% globally. Despite the global slowdown, Carrefour expects "better than 15%" growth for China sales in 2009. All and all, a very compelling argument for dedicating greater resources to China and indeed, Carrefour reportedly plans to invest in 28 new hypermarkets in China this year, up from 22 in 2008 and 19 in 2007. By comparison, Carrefour ended 2008 with just ten more hypermarkets in France than a year earlier but twenty fewer supermarkets.[1] (Carrefour's overall expansion plans for 2009 have not yet been made public.)

The second question considers scale relative to your competition in China. It is very possible that your China operations may be growing faster than your operations anywhere else, but if your growth is still lagging behind your competitors, then you are losing market share and do not have the right scale in China. For example, global automakers have been investing heavily in China's fast-



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[1] Carrefour Group, 2007 Annual Report and 2008 Full-Year Sales Report

growing automotive market and have enjoyed higher growth in China than most other geographies. Over the past decade, however, they have been losing collective market share in terms of units sold to Chinese-branded cars, sales of which have risen from less than 10% in 2001 to roughly 30% in 2007.

The issue of scale is really about allocating sufficient resources to the fastest growing markets and growing faster than the competition. By almost every account, China will be one of those higher growth markets for the foreseeable future so pursuing the right scale in China will be of critical importance to most global companies. As we have explored in recent commentaries, we believe there are many ways to achieve scale in China through various forms of strategic alliance beyond M&A and greenfield investment. When everyone is short of capital and wary of risk, whoever can develop an innovative approach to improving scale in China becomes a more formidable global competitor.

Partnering with provincial governments

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February 2009

In last month's commentary, we considered the dilemma facing U.S. executives struggling to keep pace with growth in China at a time of capital scarcity and diminished tolerance for risk. As an alternative to traditional greenfield projects and M&A, we suggested that the time might be right to explore new forms of innovative collaboration with a broad range of stakeholders in China. Forging a network of alliances can generate long-term value at reasonable cost by exploiting synergies and cementing relationships within industries. This month we look at one group of prospective strategic partners in China just emerging on the radar screens of foreign investors — China's provincial governments.

While overall industrial policy is set in Beijing, it is largely up to China's 31 provincial-level governments (22 provinces, five autonomous regions and four provincial-level municipalities) to interpret, implement, and enforce these policies in the marketplace. Provincial authorities have therefore emerged as key drivers of economic development in China, overseeing complex regional economies with broad discretion over industry restructuring and the role of foreign investors in local markets. From a U.S. executive's perspective, the business case for a strategic partnership with provincial authorities emanates from the three key roles they play vis-à-vis local industry:

- **Owner/Manager** — State ownership is largely a local matter in China — while just 141 state-owned enterprises were managed by central authorities at the end of 2008, 1,043 were managed by provincial authorities, with many thousands more controlled by municipal-level governments.
- **Regulator** — In recent years, approval authority for an expanding range of investment projects has passed from central to provincial and even municipal-level authorities. This authority adds to the already considerable power exercised by sub-national officials over how regulations are interpreted and enforced in China.
- **Investor** — Like their counterparts in U.S. state capitals, provincial officials often serve as the key enablers of local industry, steering resources, developing human capital and putting the necessary infrastructure in place to ensure competitiveness (and thus, jobs and an expanding tax base).

Given the prominent role of provincial governments in shaping the future of Chinese industry, it is not surprising that foreign investors have begun to take note. In recent months, we can point to several announcements of new strategic alliances forged between foreign investors and Chinese provincial authorities:

- **Alcoa and Henan Province (February 2009)** — U.S. aluminum giant Alcoa enters into a strategic cooperation agreement with Henan Province to jointly identify projects with the objective of establishing "a globally competitive base for aluminum production in China." Alcoa says it will bring its strengths in technology and market leadership to the table while Henan provides "the necessary support for resource allocation, energy supply, development plans and policies" to make the plan work.
- **Rockwell Automation and Hebei Province (October 2008)** — Rockwell Automation, a Wisconsin-based provider of industrial automation solutions, signs a strategic partnership agreement with the Hebei Province Development and Reform Commission, the province's lead planning agency, to cooperate on projects that "help give the province a leading position in sustainable industrial development," with an initial focus on achieving greater energy efficiency.
- **The Carlyle Group and Shandong Province (May 2008)** — U.S.-based private equity Carlyle Group signs a mutual cooperation agreement with the Department of Foreign Trade & Economic Cooperation of Shandong Province. By the terms of the agreement, Carlyle will designate Shandong as its preferred investment destination in China and "dedicate resources, capital and expertise" to assisting Carlyle-invested Shandong companies with their overseas expansion plans. In return, Carlyle will receive recommendations from authorities for opportunities for strategic co-operation, essentially a first look at new deals.
- **Lafarge Group and Yunnan Province (December 2007)** — France's Lafarge Group, Europe's largest cement manufacturer, enters into a strategic cooperation

agreement with Yunnan provinces designed to assist the province with the modernization and restructuring of its building materials industry. (It is worth noting that the Lafarge announcement is the only one to make any mention of capital outlays).

While it is too early to issue a verdict, the choice of provincial partners is telling. They all have high growth rates, solid industrial bases and infrastructure. Over the past five years, all four provinces have experienced growth rates higher than the national average and two of the four (Yunnan and Henan) are inland provinces already singled out by Beijing for accelerated development under existing regional initiatives. Hebei and Shandong, as well as less-developed Henan, are more industrialized than the average Chinese province and all three enjoy some of the strongest transportation links in China. Even in Yunnan, in China's distant southwest, industrial growth was higher than the national (and Western China) averages over the past five years and central authorities are keen to promote the province as China's gateway to India and the ASEAN states.

Each of these provinces also represents an area of clear strategic opportunity to the foreign investor in question. In Alcoa's case, Henan is China's leading producer of non-ferrous metals and contains China's second-largest reserves of bauxite, a primary source of aluminum. Rockwell's selection of heavily industrialized Hebei makes sense given the province's position as China's second-largest energy consumer and the price the province has paid in terms of pollution and environmental degradation. Shandong, one of China's most economically diverse provinces and second only to Guangdong in output, is a natural choice for a financial investor like Carlyle given its wide cross-sectoral approach to opportunity. Finally, Yunnan was already the focus of many high-profile infrastructure projects under China's 11th Five-Year Plan (2006-2011), including the massive US$2.9 billion expansion of Kunming airport. Not long after the announcement of China's national stimulus package last November, Chinese state television reported that Yunnan planned to invest RMB 3 trillion (US$438 billion) in infrastructure over the coming five years — the largest provincial-level stimulus plan put forward by any Chinese province so far. If even a fraction of this investment is made, Lafarge will be well-positioned for the future.

Never static, China's economic geography can be bewilderingly complex. A good way to reduce this complexity is to focus limited resources on provinces that have made your industry a strategic priority. Every provincial government draws up lists of strategic industries for fast-track development and more often than not, authorities are also explicit about how they plan to achieve their objectives, whether through consolidation, technological advances, green initiatives etc. With a short-list in hand, it is time to demonstrate to provincial officials that collaboration with your firm can help move the goal posts closer.

Creating China value beyond greenfield and M&A

强强联手

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During the global financial crisis, the volume of cross-border M&A and greenfield investment in China has been falling. Comparing November 2008 to November 2007, M&A deal flow has dropped by 35%, falling from US$1.6 billion in disclosed deal value in 2007 to US$1 billion a year later. Greenfield investment has also slowed. In November 2008, there were only 98 announced cross-border projects in China with an estimated value of US$7.5 billion, a 12.4% reduction from 138 projects in November 2007 valued at US$8.5 billion.*

This shift in investment patterns is understandable. Without question, the global business community is facing the most difficult economic climate in a generation. In the midst of this crisis, global companies are pausing to undertake a comprehensive assessment of how they should respond. Even those who are ready to resume investing may face two additional hurdles:

- Lack of access to capital: Companies are witnessing a huge reduction of available credit and many cannot find the financing necessary to make overseas investments.
- Pressure to lower risk profiles: Boards that may have been looking to emerging markets as a source of growth are having second thoughts about the acceptable levels of risk in these economies.

U.S. executives understand the importance of expanding their China presence commensurate with the growth in the market. If they do not expand, they will not only lose market share in China, but they put their global competitiveness at risk. After all, China is still one of the world's fastest growing major economies, despite the slowdown. How can these companies keep pace while minimizing capital outlays and managing risk? Is there a viable alternative to M&A and greenfield investment?

For some investors, the time may be right to seek new forms of innovative collaboration with Chinese companies. Such collaboration can serve many purposes, from product development to joint marketing to production pooling, and assume many forms, whether contractual or equity-based. Alliances can be as straight-forward as product-bundling, for example…

- China Security and Surveillance Technology (CSST), a Shenzhen-based provider of security technologies, signed a joint marketing agreement in December 2008 with Israel-based Alvarion Ltd., a provider of "WiMAX" wireless broadband network systems. By bundling Alvarion's technology into CSST's "Safe Cities" networked security system, the two companies are hoping to enhance their sales offerings in a sizeable market in China — city-level governments.

…or they can be as complex as a three-way, multi-purpose alliance.

- Intel entered into a strategic alliance in March 2007 with Chinese appliance maker Haier and second-largest electronics retailer Suning Appliances to target the personal computer (PC) market in China. Intel provides brand resources and its computer chips at a discount, Haier installs the Intel chips in its PCs, and Suning helps to market the final product in its stores. Many observers believe that Intel entered into this alliance to protect its brand position against lower-cost rivals. Haier is looking to boost its competitive position against larger and more established Chinese PC makers, while Suning is hoping to propel growth and compete more effectively against its principal rival.

Regardless of their purpose or form, all innovative collaboration should yield an outcome that is greater than the sum of its parts. When capital is scare and tolerance for risk is low, strategic alliances may be a preferable alternative to M&A or greenfield investment. Their effective use can not only enhance a company's odds of survival, but also position it for long-term success.

**Citing data from Thomson M&A and fdiMarkets.com*

A balanced approach — China's economic stimulus plan

November 2008

Since China's State Council announced plans for a two-year US$586 billion economic stimulus package on November 9, much attention has focused on the plan's short-term measures, including higher public spending and measures to support the export sector. Less attention is being paid, however, to how the stimulus is in line with China's long-standing efforts to rebalance the economy and place China on a more sustainable development path.

The comprehensive ten-part plan is unquestionably massive, representing 14% of China's projected GDP in 2008. It is nearly four times the size of the US$152 billion stimulus approved by the U.S. Congress in January 2008. If the U.S. government were to pass a stimulus on this scale, it would be valued at approximately US$1.7 trillion. While many details are still forthcoming and there is some question as to how much of this spending was already planned, it is clear that the stimulus is a significant and rapid response to China's moderating growth.

The ten focus areas of the plan are as follows:

1. Building more affordable **housing,** especially in rural areas
2. Accelerating **rural infrastructure** construction, including roads, power grids, and water conservation projects
3. Expanding **transportation** networks, including railways and airports in western provinces
4. Improving **health and education** services
5. Enhancing **environmental protection** efforts
6. Supporting **innovation and industrial restructuring**
7. Speeding **disaster rebuilding** in areas affected by the May 12, 2008 earthquake
8. Raising average **incomes,** especially in rural areas
9. Adjustments to the value-added **tax** system
10. Making increased **financing** available to domestic companies

Rather than economic, the most immediate short-term effect of the stimulus plan seems to be political, directed at instilling confidence in both domestic and foreign audiences. The plan is a public demonstration to the average Chinese citizen of how seriously China is taking the potential threats to their livelihood. Internationally, China's leaders are backing up their stated view that the best thing China can do to help with the global financial crisis is to ensure "relatively fast, but stable economic growth," in the words of Premier Wen Jiabao. At the same time, China's leadership is taking advantage of the need for the stimulus to build consensus among various factions of the Chinese Communist Party (CCP) about where to take China's economy next.

In fact, over the long-term, the plan serves to accelerate implementation of the CCP's headline development policy, the Scientific Concept of Development (SCD), by promoting more sustainable economic growth. Sustainability is defined in terms of achieving the "Five Balances" — between urban and rural development, development among China's regions, economic growth and social welfare, man and nature, and domestic development versus opening up to the world. In the matrix below, we show how each of the ten areas of the economic stimulus package will help China arrive at one or more of the Five Balances.

To demonstrate the linkages, let's take a deeper dive into how the plan will affect one industry and help drive long-term development. China's 11th Five Year Plan called for US$179 billion in investment in China's railways from 2006 through 2010. According to officials at the Ministry of Transport, China will now spend US$500 billion on new and improved railways over the next three years. This investment is expected to generate up to six million new jobs – the equivalent of almost half of the total U.S. manufacturing labor force of 13.3 million. Furthermore, much of this railway construction will take place in underdeveloped interior provinces to help better connect these regions to China's coastal areas. This will help open China's interior to increased investment in manufacturing, as railroads are the most efficient method for moving goods and people in a country the size of China.

As long as the Chinese government continues to put policies in place that work to achieve the Five Balances, foreign investors can be confident that China will remain a stable, open place to invest. By helping ensure sustainability, the economic stimulus will help keep the door open to companies looking to create value.

One specific thing foreign investors can do is to practice greater corporate diplomacy and collaborate more closely with Chinese companies that are emerging onto the global stage. By creating stronger connections between companies on both sides of the Pacific, foreign investors can help ensure valuable commercial relationships between the U.S. and China.

高瞻远瞩

The Five Balances (SCD)

The ten parts of the stimulus plan	Urban and rural development	Development among China's regions	Economic growth and social welfare	Man and nature	Domestic development vs. opening up
Housing	✓	✓	✓		
Rural infrastructure	✓	✓	✓		
Transportation	✓	✓			✓
Health and education	✓		✓		
Environment			✓	✓	
Innovation and industrial restructuring		✓		✓	✓
Disaster rebuilding		✓			
Incomes	✓	✓	✓		
Taxes			✓		✓
Finance	✓	✓			✓

China's economic slowdown — How to respond?

瞬息万变

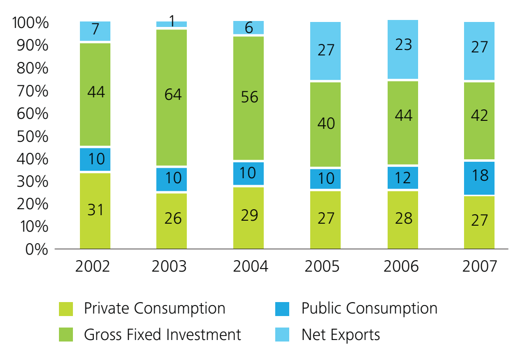
October 2008

Imagine a China country manager for a major U.S. corporation flying in this month for a meeting with his CEO to discuss the firm's China strategy. For more than a year, both have been closely tracking the global economic slowdown and looking to China as a back-stop to maintain top-line revenue growth. Then news breaks that China's economy is slowing as well. The CEO kicks off the meeting by asking — given recent events, do we need to adjust our China strategy?

A quick review of the facts. On October 20, China's National Bureau of Statistics (NBS) released its economic report for the first three quarters of 2008. Year-on-year GDP growth was 9.0% in the third quarter, down from 10.1% in the second quarter and 10.7% in the first quarter. Other recent indicators across the main drivers of China's growth show a mixed picture:

- **Fixed-asset investment:** Overall investment growth for the first three quarters of 2008 was up 1.3% over the same period in 2007.
- **Exports:** China's export growth through September 2008 slowed 4.8% from same period in 2007.
- **Consumption:** While retail sales growth accelerated 6.1% to 22% in the first three quarters, auto sales declined for a second straight month in September.

Contributions to China's GDP growth during the WTO era (GDP component by percentage)



Source: National Bureau of Statistics, Asian Development Outlook 2008 (ADB)
Note: Figures for each year may not add up to 100% due to subtraction of imports from total

Looked at in isolation, news of a slowdown could be seen as aligned with the Chinese government's long-standing goal of lowering GDP growth to a more sustainable level. But the speed of the downturn, coupled with the deepening global credit crisis, has clearly heightened concern that China's GDP growth rate could drop below the 8% level widely considered necessary to generate employment and maintain social stability.

The response by the Chinese government has been swift. Two days before the NBS announcement, the State Council, China's executive cabinet, presented the broad outlines of an economic stimulus package. Over the next several days, individual ministries announced specific implementation measures. The stimulus plan addresses each of China's growth drivers:

- **Fixed-asset investment:**
  - The plan includes pledges to accelerate key projects in agriculture, water conservation, energy, transportation and urban infrastructure, especially in China's less-developed interior. In fact, this is one of the few occasions in the past five years where the central government is urging local governments to step-up, rather than slow down, project approvals.
- **Exports:**
  - The Ministry of Finance announced that effective November 1, VAT rebate rates on 3,486 export items, representing 25.8% of China's exports in 2007, would be raised.
- **Consumption:**
  - The State Council said that it may slash taxes on housing transactions, and there are also indications that it may make long-promised income tax reductions as well.
  - The stimulus includes increased agricultural subsidies and higher floor prices for grains, including a 15.3% increase in the minimum price for wheat, starting next year.
  - The plan also calls for higher lending to China's small and medium-sized enterprises, which are responsible for much of China's job growth in recent years.

Returning to our meeting between the CEO and the country manager, the question remains — does the company need to change its China strategy because of the downturn? Given that China might not be able to compensate for a slowdown in top-line growth, should the firm scale back its China ambitions and take a "wait and see" approach to investing in the market?

The answers to these questions depend on the company. But one thing is sure — a smart company will be looking not just to weather the potential downturn, but to better position themselves to seize opportunities when the economy inevitably turns around. Its executives would start by reassessing China's relative role in the firm's long-term global strategy, and closely monitor what competitors are doing. Just as China is seeking growth from all drivers of its economy, the firm would also reexamine its own plans within each of these areas, among others:

- Fixed-asset investment: Can the company provide any products or services in connection with new infrastructure investments? Once new infrastructure is in place, how will that change the market potential in each of China's regions?
- Exports: Given the new measures to boost exports, should the company continue to reduce its dependency on China for its sourcing needs? Does it need to take a fresh look at its global sourcing strategy?
- Consumption: Can the firm find new opportunities arising from government efforts to stimulate demand, especially through SMEs or the agricultural sector?

Contact information

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