KPMG
cutting through complexity

The Future for MNCs in China

A KPMG Study

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In partnership with SILK ROAD ASSOCIATES

Contents

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China continues to attract the world's top multinationals seeking to establish a presence and expand their footprint in the world's second largest economy.

Multinationals will continue to play an important role but China has evolved quickly, as have Chinese homegrown businesses. Opportunities abound however, as the CEOs we spoke to point out, it is increasingly important to be flexible in this market and prepared to adapt.

It is a competitive environment and Chinese domestic players are now raising the stakes, with global aspirations for their own brands.

In terms of the changes that we see taking place, as multinationals move further inland to the tier 3 and tier 4 cities, they face new challenges and may need to consider their investment options, including the joint venture route.

We also see a new generation of savvy entrepreneurial business executives in China and as the economy rebalances to emphasise domestic consumption, there will be increasing focus on innovation and on sectors such as clean energy, high tech and services.

KPMG has mostly grown organically in China and our business focus has also adapted to help both multinationals looking inbound and Chinese domestic companies seeking outbound opportunities.

In response to these changes, we launched our Global China Practice (GCP) in September 2010 and we now have China practice teams in over 40 countries around the world. These teams combine China cross-border investment experience, Mandarin language capability and local knowledge to help Chinese firms expand outside China, and assist multinational clients address opportunities in China.

Our China business is set to continue to grow and we see Chinese firms' expansion overseas as a key factor in that growth. Within five years, China's mainland will be among the top ten markets for KPMG International globally. We also plan to double the size of our Chinese workforce to 18,000 employees in the next four years.

In terms of our business strategy, we will focus on building our auditing, tax and advisory services. And as a further demonstration of our commitment to this region, KPMG International last year relocated its Global Chairman office to Hong Kong, the only Big Four accounting firm to do so.

Our report highlights the strategic importance of the China market for multinationals and longer-term opportunities for them to establish fully-fledged operations focusing on the domestic market.

I would like to thank all of our contributors for their insights and input.

Ben Simpfendorfer
Managing Director
Silk Road Associates

China's economy has made remarkable gains over the past three decades. The ongoing global crisis represents yet another challenge, but one that China has so far dealt with successfully.

Nonetheless, there is a growing recognition that only fundamental economic reform in all countries will successfully bring an end to today's global challenges.

Chinese policymakers have a long history of carrying out such reforms. Yet, the challenge is greater today given China's economy is now larger than the combined economies of the three other BRICs members--Brazil, Russia and India--and to decide the appropriate reform for such a large economy is not always straightforward.

The world's multinationals can help in this respect. Not only do they provide insights into economic developments that are not always apparent in the economic data itself. They can also contrast their experience with that in both the developed and developing world, providing an important source of best practice for China.

The case studies in this report are taken from a variety of industries. The CEOs and senior executives also typically have twenty years of experience, having watched China's economy evolve from the early 1990s until today. That is crucial, as understanding where China has come from helps to understand where it needs to get to.

For the most part, the world's multinationals remain optimistic towards the country's outlook. There is recognition that China still offers plenty of untapped opportunities and an entrepreneurial spirit. Few markets also change as fast: the rapid emergence of the autos and housing sectors is a case in point.

However, there is also a general recognition that the next five years will be more difficult than the last ten, and robust changes are needed if the country can fully tap those opportunities and maintain its strong rate of growth.

The fact that both foreign multinationals and Chinese firms are again eager to set up joint-ventures is perhaps the most positive trend highlighted of the report. On the one hand, foreign multinationals are looking for help to enter China's interior markets and third- and fourth-tier cities. On the other, Chinese firms are looking for assistance to expand abroad.

It is a development that needs to be encouraged by all parties, especially at a time when the global crisis is producing new national divisions. If multinationals and Chinese firms can find new grounds to cooperate and grow, then we should rightly feel more optimistic about the global outlook and the chances we will find a path through the current global economic crisis.

The big picture What next for China and the world's multinationals?

The fate of China and the world's multinationals is bound tightly together. In the past two decades, both benefited from the spectacular growth in global trade and investment: China's share of the global economy rose from four percent in 1990 to fourteen percent today, even as the world's multinationals saw their combined share of the global economy reach 25 percent and sales by foreign affiliates grow to USD32 trillion[1].

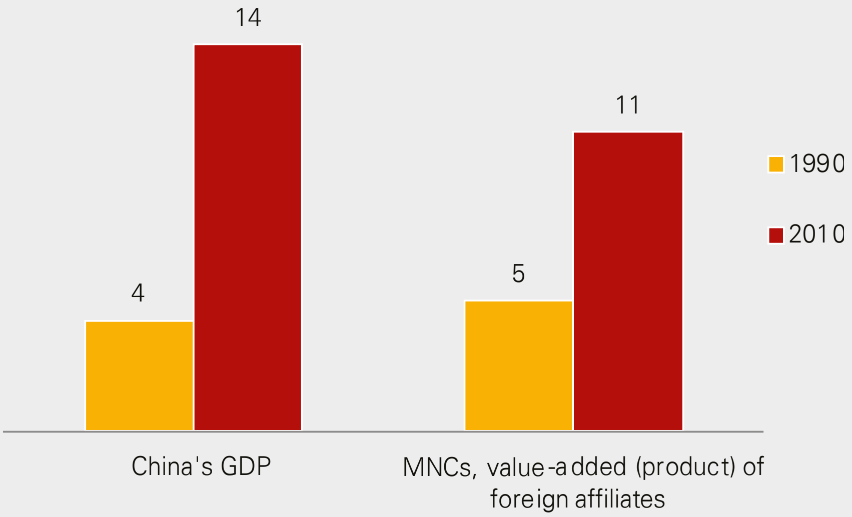
It is perhaps no surprise that the recent global crisis has seen some subsequent changes to this relationship: China is rethinking its open-door policy to foreign firms, whether by introducing new requirements for licensing or technology transfer; some multinationals are less convinced that China is their only answer to growth, as other emerging economies, though smaller in size, enjoy similarly robust economic expansion.

With the global crisis continuing and the benefits of globalisation being reconsidered, the relationship between China and multinationals is set to continue to evolve.

1 UNCTAD, World Investment Report 2011

To better understand the changes, we have interviewed senior executives working for a range of multinationals, both large and small, across a variety of sectors, all with responsibility for China. Our interviews included questions on China's economic outlook; where multinationals saw the greatest challenges to their business and, equally the greatest opportunities for growth, and what policy changes they would most like to see in the coming years.

China and MNCs account for a rising share of the world's GDP

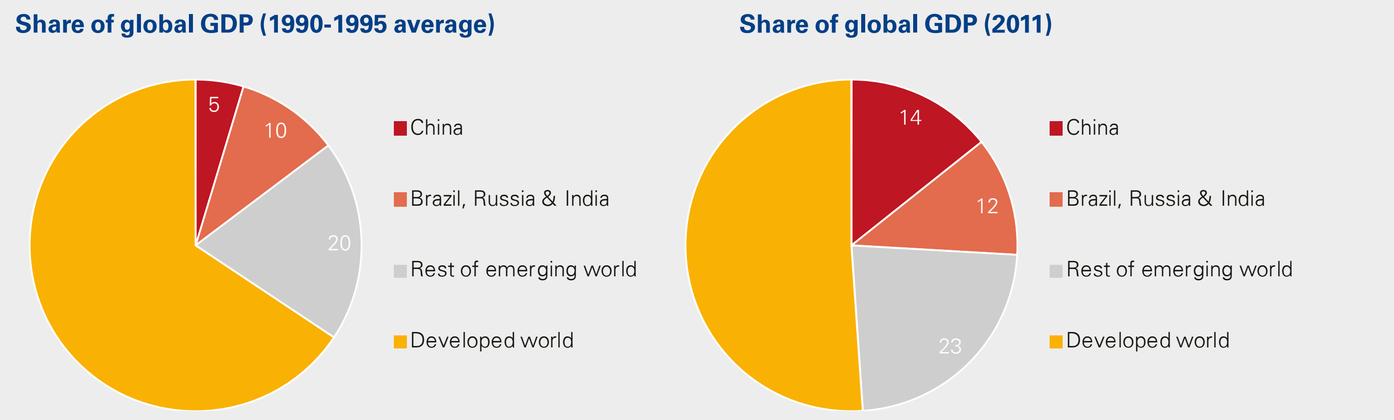


Source: International Monetary Fund, World Economic Outlook Database, April 2012; UNCTAD, World Investment Report 2011

Note: China's GDP share is shown on purchasing parity basis

China's inland economy naturally ranks high on any multinational's wish-list, both as a place to source product or build retail stores. It is no wonder, given that the inland regions have a combined GDP of USD3,150 billion and population of 720 million, competitive in size to Africa, Latin America, or the Middle East. There is a belief that China's success (or not) in developing its inland economy will be one of the biggest drivers of global growth over the coming decades.

Some hold the view however, that only the largest multinationals will succeed. Tim Smith, CEO of North Asia for Maersk sums up the challenges when he says: "We want to be aware of the changes taking place in the inland provinces, but we also don't want to over commit", as doing business in the coastal regions is still "lower-cost, higher-yield, and less-fragmented". It is not clear whether smaller multinationals can sustain the same effort.



Source: International Monetary Fund, World Economic Outlook Database, April 2012

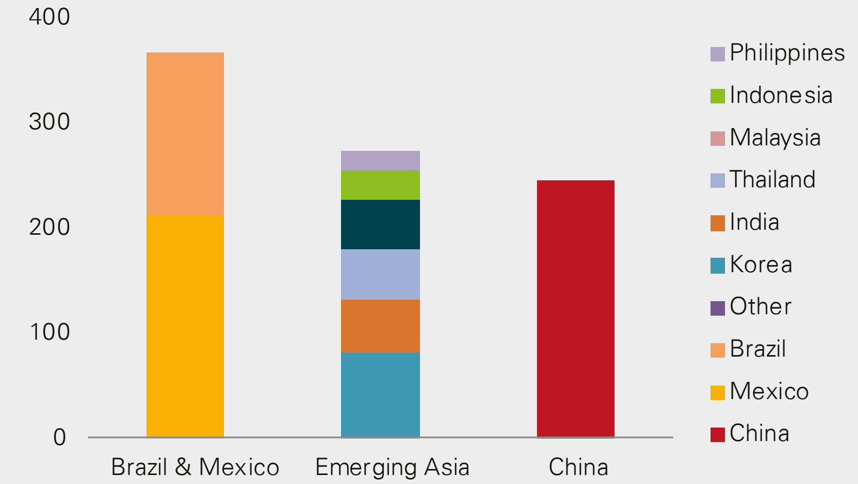
Note: Russia's figures for 1990 and 1991 are estimates

Multinationals certainly have alternatives to China's inland regions (or even China itself). UNCTAD's latest World Investment Prospects survey, for example, shows China as the top priority for multinationals in 2011-13, India and Brazil rank third and fourth, while Russia, Indonesia, and Mexico all make the top ten (with Vietnam and Thailand close behind). Together, those countries account for 16 percent of the global economy, or a similar share to China.

Indeed, some multinationals are becoming increasingly aware of their dependence on China. The country's huge fiscal stimulus was a source of growth in the early stages of the global crisis. But growth is now slowing and even those manufacturing in China are looking to diversify whether because of worries about rising costs or concerns over potential trade disagreements. As a result, it is common for multinationals to talk of a China + 1 (and often more) strategy or 'near-sourcing'.

So why are multinationals still so interested in China? Size is of course important. But so is the pace of change. New markets can emerge seemingly overnight. Ashley Micklewright, CEO of Bluebell Far East, for instance, notes how the market for women's high-end fashion was challenging in the late 1990s (a shortage of drycleaners was one of many problems), but has grown exponentially since and rewarded those fashion houses that were ready for change.

US MNCs and sales by all foreign affiliates (by country)



Source: US Bureau of Economic Analysis, U.S. Direct Investment Abroad: Financial and Operating Data for U.S. Multinational Companies; Note: Latest available data is 2009.

Even if China's economic growth was to slow in the coming years, to around 8 percent, the country would still account for thirty percent of the world's growth through to 2017, based on latest global forecasts from the International Monetary Fund. That is a compelling outlook and the product marketing firms we have spoken to, say that enquiries from American and European producers looking to sell in China have surged in the past two years.

The upshot is that the relationship between China and the world's multinationals is set to not only grow, but also grow in complexity. In this, it reflects the change in the global economy, as the established order between the developed and developing world is overthrown. This makes predicting where we will be in the next ten years harder than during the past twenty years. The multinationals featured in this report offer some important lessons for the future.

FedEx on track in China

Eddy Chan, Head of China for FedEx

Eddy Chan is Head of China for FedEx, one of the world's largest logistics companies headquartered in the United States and with operations in over 220 countries and territories. FedEx's global presence and sensitivity to the global manufacturing chain leaves it well positioned to observe both China's role in the global economy, the fallout from the global crisis, and changes in China's own domestic economy.

Chan has worked in logistics for over 27 years, running FedEx's China business since 1998. From his office in Shanghai, he has watched FedEx's business grow steadily.

FedEx is optimistic about China's economic outlook in the long-term. "China remains a dynamic market and will continue to fuel the development of global industry," Chan says. "China is benefiting, in particular, from its Go West policies and the increasing migration of manufacturing to second- and third-tier cities. The government has done a very good job of improving infrastructure in these cities over the past ten years."

However Chan has some concerns. "Our main worry is China's willingness and ability to reform going forward. There is increasing resistance to the continued reform that is necessary in order to keep the country's growth momentum. We have seen that reforms slowed down during the previous three to five years, especially after the global crisis and especially towards foreign investment."

In terms of the biggest challenges his firm faces, he explains: "The country's software."

"Efficient logistics relies on two factors. First is the hardware, or infrastructure, such as airports and highways. Second is the software, or the government regulation that affects the performance of the industry. It is the second that worries us most, as the licensing regime is unclear and the implementation of policies is changing constantly. That's where more clarity is needed."

"E-commerce offers us huge opportunities. China currently has more than 500 million internet users. With the expanding middle-class we are seeing the trend of growing demand for domestic delivery with the rapid development of e-commerce in China."

What policy changes would Chan like to see? "We are seeing a growing number of agencies regulating our industry—the state postal bureau, the civil aviation administration, customs, etc. In our opinion, to make the industry more efficient we need more streamlined regulation and more consistent interpretation of those regulations. We believe fair competition between all market participants is the best way to ensure China's business continues to grow continuously and have access to the best possible service."

Chan would also add to his wish-list the more challenging "liberalization of the aviation market and increase in the Chinese airspace available for civilian use."

While FedEx's bigger challenges relate to China's software, there are also issues with the hardware, or infrastructure. "The country's rapid growth has created a massive challenge for our business. In China, there are many airports in remote areas that are underutilized. Yet, in the busy airports, we can only fly at night. So, while the country's investment spending has been overall a good thing. There has been some misalignment of infrastructure resources."

Where does Chan see the greatest opportunities in the next five years? "E-commerce offers us huge opportunities. China currently has more than 500 million internet users. With the expanding middle-class we are seeing the trend of growing demand for domestic delivery with the rapid development of e-commerce in China," he says.

Chan is also optimistic about domestic demand for luxury foreign goods. "We have seen the rapid development of high-end products entering the China market. But when the value of your goods is higher, you are also more selective in terms of a reliable transportation provider. It is all about reliability, security and flexibility," Chan says.

Chan also sees China's major regional hubs starting to specialize, not only in services, but also geographies: "Guangzhou, or the Pearl River Delta, is a perfect location for us as an Asia-Pacific hub. Shanghai is a little bit further north and is a window for China to the world, such as Europe and the U.S. The Bohai Rim (including Beijing and Tianjin) is a hub for North Asia, Korea and Japan," he adds.

Sourcing for China's consumers

Christophe Roussel, CEO of global non-food sourcing and logistics, Tesco

Christophe Roussel is CEO of global non-food sourcing and logistics for Tesco, the UK-headquartered retailer with over USD110 billion of annual sales. The UK accounts for over sixty percent of Tesco's revenues. The company has over 1,719 stores in five Asian countries, including over 100 in China, and so is well placed to understand China's outlook, as both a major source of supply and demand. Having spent the past twenty years in Asia working in the sourcing and logistics industry, and with a particular focus on China, Roussel is equally well positioned to watch the industry's rapid evolution.

What are the biggest challenges for Tesco? "Labour costs remain our biggest challenge. More and more factories are running below capacity", Roussel says, echoing a concern felt by many manufacturers and buyers. "The good news, however, is that factories are responding and finding other ways to cut costs, such as by investing in capital equipment, introducing lean manufacturing techniques, or reconfiguring production lines."

Is this common for the average factory? "Our suppliers are relying heavily on Tesco's production engineers for advice. But factories are also investing money and time themselves. Labour costs have finally risen to the level where they have to respond. A few years ago, even if wages were rising, they were still low enough to discourage factories from investing in capital equipment or production techniques."

"It makes me hopeful that for these factories, by moving inland or finding other ways to save costs, they will in a few years be able to keep their prices stable or even cut prices," he explains.

That said, China is less important for certain categories than it was five years ago, according to Roussel. "Garments are a good example. We have increased our buying from the Indian subcontinent and Mediterranean Rim. Stocks are a major reason, as sourcing closer to Europe means we can respond more rapidly to demand."

"The government could also assist manufacturers moving inland. That's where our sourcing focus is. We find the right equation in the inland—better quality and better price."

In terms of other challenges, he adds: "From a sourcing perspective, we are concerned about moves to cut export subsidies as part of the government's policies to develop the domestic economy. Generally, certainty is important for us in order to make long-term plans."

What reforms are needed to help Tesco grow its business in China? "We welcome the government's focus on education, especially teaching innovation to its engineering graduates so that China can start to innovate new products more," Roussel says.

"The government could also assist manufacturers moving inland. That's where our sourcing focus is. We find the right equation in the inland—better quality and better price." Roussel makes an important point, as often only the largest export factories have the capacity to relocate or open new factories inland, especially at a time when rising production costs have left many factories struggling to generate sufficient cash to fund investments.

In terms of the most significant opportunities, Roussel concludes: "Definitely the domestic market where people are consuming more, but also want to feel reassured about the quality of the product and where it was sourced from. This is especially true for food and baby products. We are focused on the coastal cities for the moment, as that's where the demand is, but there is also massive opportunity in the interior cities, especially the second and third tier cities."

And what about the importance of the Chinese yuan's liberalization? "It was exciting six months ago, as we could have saved a few points on the price of each good where most of the raw materials and accessories were sourced in China. But today it is no longer at the top of our list, as there are bigger things to worry about," Roussel concludes, referring in particular to the challenges in Europe and the impact of rising inflation, especially gasoline price inflation, on consumer demand globally.

Business challenges The end of 'cheap China'?

Multinationals are finding the operating environment tougher than ever and it is a popularly held view that China is no longer a cheap destination to manufacture goods and outsource services.

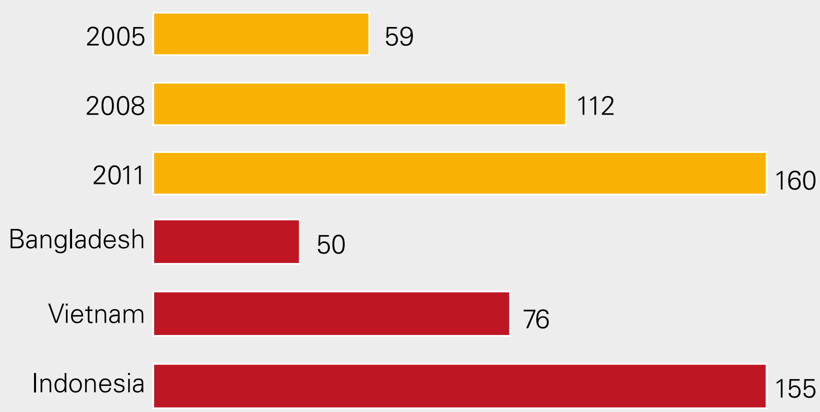
We may therefore see a shift in the world's production chain. It used to be that multinationals viewed China as a low-cost export platform, manufacturing goods in Dongguan or Wenzhou for export to the United States and Europe, and so helping to grow market share and even margins. Not any more: costs are soaring across China making the country an increasingly expensive place for business.

In this changing landscape, what are the biggest challenges for multinationals? Almost all the multinationals surveyed in this report spoke of labour shortages and wage inflation as their single greatest issue. That is especially true for the consumer goods sector where China's once cheap-labour offered a major cost advantage. But the country's ageing population has changed the cost equation abruptly.

To put China's demographics into perspective, the country's median age is thirty-five years, around ten years older than either Korea or Japan at the same stage in their development.

China's minimum wages have risen steadily since 2005, and are now higher than minimum wages in many Asian countries

USD per month, figures for Bangladesh, Vietnam, and Indonesia are from 2011



Source: China's National Bureau of Statistics; Indonesia's Government Statistical Service; American Chamber of Commerce Vietnam; JETRO

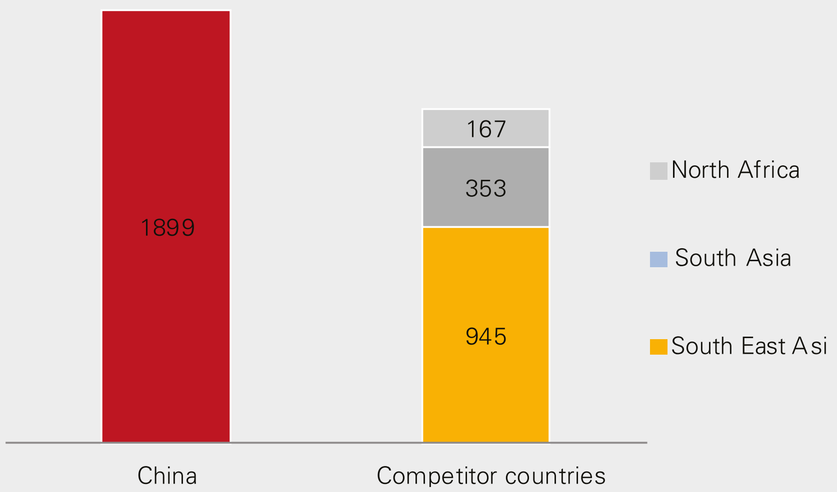
Note: China's 2005 and 2008 figures are calculated using 2011 exchange rates.

One implication, as mentioned earlier, is the growing phenomenon of 'near-sourcing', whereby multinationals are looking to manufacture closer to their home markets and shorten their delivery times and, thus, costs. For example, North Africa is a commonly cited location: not only is the region close to Europe, but labour costs are cheap and most countries have free trade agreements with Europe.

That does not mean the end of China as the world's manufacturer. For a start, there is no simple alternative to China: the country exports almost as much as the rest of emerging Asia combined (USD1,900 billion versus USD2,000 billion annually) and twelve times that of North Africa. Further underscoring the point, some of China's largest container ports also have vastly more capacity than entire countries, such as India or Vietnam.

China's exports versus the world

USDbn, 2011



Source: National Statistical Sources; UN Comtrade; Silk Road Associates

Note: North Africa figures are for 2010

There is also optimism that Chinese manufacturers are responding to the challenges by investing in capital equipment (as a substitute for capital) or learning new production techniques (such as lean manufacturing) to save costs. Some multinationals even expect that within two to three years, Chinese manufacturers can hold prices steady, or even start cutting prices again. If so, China will hold on to much of its manufacturing capacity.

For China to succeed however, more government support is needed. Helping smaller manufacturers relocate further inland or spending more on education to foster innovation, are just some of the possible responses proposed by multinationals. The government might also encourage multinationals to assist their Chinese partners in importing best practice from abroad, whether by providing advice on energy conservation or the configuration of factory lines.

Targeting China's rapidly growing middle class

Helmuth Hennig, Group Managing Director, Jebsen & Co Ltd

Helmuth Hennig is Group Managing Director of Jebsen & Co Ltd, a trading house established in Hong Kong over 100 years ago and today marketing and distributing high-end products in China and other parts of Asia. From Robert Mondavi wines to Raymond Weil watches, the firm is benefiting from the rapid growth in China's super wealthy and, increasingly, it's middle-class.

Hennig himself has lived in Hong Kong for nearly thirty years, almost all of that time spent working for Jebsen, and observing the region's rising consumption first-hand.

He is, not surprisingly, a fan of China's middle-class: "We have seen explosive growth in both desire and purchasing power. To me, the wine business sums up China's middle-class. We have been in the wine business for twenty years, but only used to serve five star hotels. Yet, we now also sell commercial wines geared to the middle-class. We wouldn't have sold those wines five years ago, but we've since found a considerable market", he says.

Why are people buying? "It is largely driven by consumers' experience on the internet, especially blogs, observing what other people are doing, and, of course, travelling abroad," he explains.

In terms of how to stay ahead of the curve, and be able to predict those changes, Hennig explains: "We prefer to be at the sharp end of development. That risks over-investing in a sector. For instance, we opened up a wine store in Shanghai five years ago, but it was too early, so we had to close it down. Our benefit is that we are a private-company and our major shareholder shares our vision of building up the business for the long-term."

Where are the greatest opportunities in the next ten years? "We sell mainly to the super wealthy. But we see lots of potential in the middle-class. For instance, we are now working with Dyson vacuums. They believe, and we agree, that everything the firm stands for—design, sophistication, technology—are increasingly desired by the Chinese middle-class."

> "In the past, foreign clients weren't always ready to commit either the time or resources to China. Now they are interested and wanting to talk. And they are using Jebsen as a way to test the water without have to over commit."

"The complexity and consistency of regulations is a problem. A good example is when the government changed the rules on the import of autos. Beijing promulgates the rules, but the local governments might not agree. And it is impossible to gather all the relevant authorities into the same room to streamline the process. The situation is not worsening, but it certainly is not improving," he maintains.

In terms of challenges, he says: "At the end of day, successfully selling to the middle-class depends on whether the government gives a nod to a specific industry. The autos industry is a good example. It used to be that private owners preferred safe cars like Audis and Mercedes. But then the regulatory environment changed, and all of a sudden they were experimenting with Ferraris and Porsches", he says.

Staff turnover is an additional challenge. Hennig notes: "The education and foreign language skills of our staff are constantly improving. But our biggest problem is retaining staff. Our turnover is 15 percent, about average for the industry, but that means we are mainly recruiting in order to replace lost staff, rather than to grow our business. And there is a huge loss in productivity as a result."

On the outlook for China's economy, Hennig says, "The first half of this year was relatively stagnant. But we aren't seeing a contraction in growth, just a slowing in growth from already high numbers. And last year was a record year. Therefore, even a flat performance this year would be good although we are expecting five to six percent growth on a stronger second-half."

The global crisis is, however, creating new opportunities for Jebsen as American and European firms look to China for the first time. "In the past, foreign clients weren't always ready to commit either the time or resources to China. Now they are interested and wanting to talk. And they are using Jebsen as a way to test the water without having to over commit," Hennig concludes.

Maersk anchors its global strategy in China

Tim Smith, CEO of North Asia, Maersk

Tim Smith is CEO of North Asia for Maersk, a global shipping giant with a fleet of 600 ships sailing between 125 countries. Maersk has benefited significantly from China's rise as a manufacturing hub: not only does China account for around a quarter of the firm's total shipping business, but Maersk does more business with China's inland provinces along the Yangtze River than it does with some European countries.

From his regional headquarters in Hong Kong, Smith has watched China's ascent over the past decade as the country's exports have grown from USD300 billion to nearly USD1,900 billion.

"We expect that China will remain the engine of trade over the coming five years," he notes. "That said, we also expect to see some variation within that trade. Exports to the emerging markets—Africa and Latin America—will offer the greatest opportunities. Sure, those markets aren't as large as Europe or the United States. But they will continue to grow more strongly."

However, the biggest changes, and indeed challenges, are found in China itself as the country grapples with rising production costs.

"What is China's role as a manufacturing base for the world? That's the biggest issue that drives our business," he says. "Our global strategy is our China strategy, and China's role as a manufacturer is clearly changing, so we need to adjust to that. We need to be more cautious about market growth. We need to build fewer ships. And we need to consider where to deploy them."

Smith is already observing changes between China's coastal provinces, not just between the coastal and inland regions. "The southern China market is starting to look like a typical developed market. We are now seeing 1.5 percent to 3.5 percent market growth in southern China, whereas we still see double-digit growth in the northern and the inland provinces."

"Our global strategy is our China strategy, and China's role as a manufacturer is clearly changing, so we need to adjust to that. We need to be more cautious about market growth. We need to build fewer ships. And we need to consider where to deploy them."

How optimistic is Smith about the inland provinces? "We are paying attention to the inland trade, but the international business is still lower cost, less fragmented, and higher yield. We want to be aware of the changes taking place in the inland provinces, but we also don't want to over commit and we don't want to assume that consumption patterns in the rising second- and third-tier cities will be the same as those in Europe or the United States."

China currently prevents foreign shipping lines from participating in the domestic shipping business. As a result, Maersk and others must sub-contract to a local shipper in order to bring a good from, say Qingdao to Shanghai, or Fujian to Guangzhou, before shipping the same good onwards to Europe. It is a market restriction that applies also to businesses that operate in the express air-freight business.

"That is the biggest policy change we would like to see in the coming five years—being able to participate in the international relay business," Smith says.

One implication of these changes in China, especially rising production costs, is that 'near-sourcing' is increasingly popular as buyers look to source their goods nearer to their home markets. For instance, rather than source from China, European buyers might increasingly look to low-cost North Africa, even in spite of the recent unrest. "It is a common trend among our European customers," Smith notes.

"Of course, they will continue to use China as there isn't an obvious alternative. On the other hand, they will want to diversify and lower their risk. And we are going to have to be a bit more agile in dealing with the fragmentation of production patterns."

Looking to the long-term, it is China's growing domestic demand, whether for luxury goods or foodstuffs, that will be another future driver of Smith's business. "There is an upside to China's changing economy," Smith notes. "Today, most inbound goods are bulk and low-quality goods. But if China wants to start to import more wines, for instance, they will need a higher quality service."

Rising consumption China's middle-class. Myth or reality?

The rise of China's middle-class has had a number of false starts and some multinationals looking to sell to wealthy Chinese consumers in the 1990s, were disappointed. However, this has changed over the past ten years and there is a flood of anecdotal evidence pointing to rising consumption.

The idea of over hundreds of millions of people buying more cars or redecorating homes is captivating. However, there is no single definition of the middle-class. Estimates range from between USD5,000 to USD20,000 annual income per year.

Using China's urban income data it is possible to produce several estimates: at USD5,000 annual income per person (on a USD purchasing power parity basis), China's urban middle-class numbers 275 million people, and at USD10,000 the figure falls to 'just' 100 million people.

Still, selling to China's middle-class isn't always easy. For instance, consumption patterns can change overnight to create new markets and that requires either investing in new sectors speculatively or responding late to market changes.

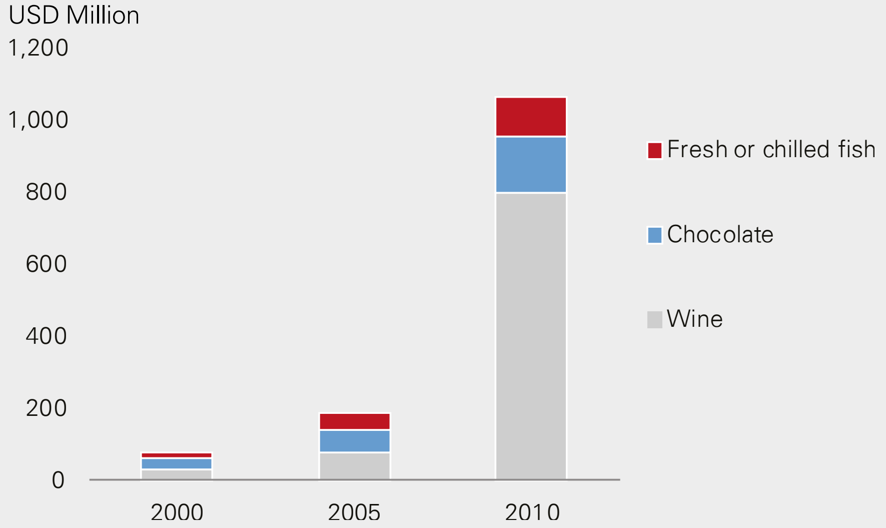
All the multinationals we spoke with are bullish about China's middle-class. So far, at least, income growth is outpacing inflation, leaving consumers with more discretionary income to spend. The explosive change in consumption patterns also makes it critical to anticipate tomorrow's market. It was difficult to sell commercial wines in China just five years ago, for instance. However, the market has since grown exponentially, with China's wine imports more than doubling every two years.

China's urban middle-class

Million people, per capita annual income, purchasing power parity basis

Source: China's National Statistical Bureau; Silk Road Associates

China's imports of luxury products: Wine imports have, in particular, surged



Source: UN Comtrade

The problem with such sudden market changes is that the statistics won't initially indicate if you are succeeding, notes Helmuth Hennig, Group Managing Director of Jebsen & Co Ltd, a large product marketing company with a long history in China. As a result, "We prefer to be at the sharp end of development. That risks overinvesting in a sector", he continues. But it helps that "we are a private company" and "building up the business for the long-term."

Importantly, it is the end of 'cheap China' that has partly triggered the rise of 'consuming China'. China's government is rightly trying to boost incomes and, ultimately, consumption. Tougher labour laws and higher minimum wages are a part of this effort. So long as reform is sustained, the result should be a better balanced economy more reliant on consumption, not investment. In turn, multinationals are viewing China as a place to sell to, not just to buy from.

And yet, we would also maintain the need for some caution: it is possible for a middle-class to fall, not only rise, as a result of rising inflation or slowing growth. Consider the events of the 1997 Asian crisis, when collapsing job markets and property values pushed many households back below the poverty line. For multinationals selling to the lower-middle class, the ability of China to manage both inflation and growth will be crucial going forward.

Helping brands to get ahead in China

Ashley Micklewright, CEO, Bluebell Far East

Ashley Micklewright is the CEO of Bluebell Far East, a Hong Kong-headquartered promoter with over fifty-five years experience representing some of Europe's best-known luxury brands in Asia Pacific. Today, Bluebell markets over fifty brands in eight Asian countries, and the company has an in-depth understanding of the particular challenges MNCs may face when selling to China's emerging middle-class.

Micklewright is a twenty-year veteran of Hong Kong, having grown up in the city in the 1960s before returning again in the early 1990s after some time in the UK. He has observed Hong Kong's middle-class emerge during the past decades as a major buyer of global brands. In terms of the rise of China's middle-class, Micklewright says he thinks it is "currently just a fraction of what it will be in another five to ten years."

It's not the response you might expect from a luxury goods seller. After all, China's emerging middle-class already accounts for a large share of revenues for some of the world's mega-brands. And Bluebell understands this better than most, having brought some of the world's largest brands to the region during the past decades.

"Bluebell introduced Louis Vuitton to much of the region when it was still a family business. We also started to work with Jimmy Choo when it only had a handful of stores in Europe. That's what we do," Micklewright notes.

So why is it tough selling to China's middle-class?

"China's luxury market is currently dominated by a small number of mega-brands. The landlords are clearly comfortable with these larger players, and the stores are getting bigger and bigger. So it is much tougher for a lesser known luxury brand to enter the market. That's not true in Hong Kong or Taipei where you can more easily introduce new brands and let consumers make their choice. You would be amazed at the fashionistas in these cities that know these small European brands. With some careful planning in terms of marketing and finding the right location for the boutiques, then word of mouth does the rest."

"The resulting price differential between China and Hong Kong means a lot to shoppers, and many will just buy in Hong Kong rather than in China. These taxes make China an even more challenging business model compared to the rest of the region, so I would like to see these cut."

The larger players also have another advantage: "One of the biggest problems for small or emerging luxury brands entering China is finding good prime retail locations. They are in short supply and the rents can be as high as those in Hong Kong. And yet if you don't take the best locations, then traffic in the secondary locations can be dead and you just don't make the sales. It is a dilemma that has put off many lesser known brands from entering China."

But Micklewright does not expect that will always remain the case. "Sooner or later people are not going to go into these big shops. They are going to get bored because so many people are buying the same products. And eventually, there is going to be demand for these small brands."

Micklewright is also optimistic about opportunities in the second-and third-tier cities for lesser known brands. "That is where the business model starts to make more sense. The trade-off between rent and demand is better in the second- and third-tier cities."

Yet, whether a luxury goods company decides to open in Beijing, Shanghai, or a second-tier city, there is still a risk that Chinese shoppers will simply buy from overseas.

"Import duties and VAT are a major headache," concludes Micklewright. "The resulting price differential between China and Hong Kong means a lot to shoppers, and many will just buy in Hong Kong rather than in China. These taxes make China an even more challenging business model compared to the rest of the region, so I would like to see these cut."

For Micklewright it is the combination of high-rents, high-taxes, and risks that the bigger brands get bigger still, that make China "an incredibly tough market" for smaller luxury brands.

A long presence in China

Jason Lo, Head of China Strategy, Honeywell

Jason Lo is Head of China Strategy for US multinational firm Honeywell, which sells everything from automation, to aerospace systems in over 100 countries. The firm also has a long history in China, employing 12,000 staff in the country.

Jason, a Hong Kong native, but based in China for the past ten years, is responsible for the firm's strategy and business development.

He foresees a promising outlook for China's economy: "In the short term, everyone is concerned about the Eurozone collapse that could trickle down to the local economy, causing exports to slow and investments to delay. Over the longer term, the middle class is growing rapidly in size and wealth. Tier two and three cities are quickly maturing, and catching up to tier one cities in terms of investments. All are signals for a growing market with strong demand."

In terms of China's importance to the BRICs markets, he says: "China is right now the best place to do business, but we see the global economy changing fundamentally over the next ten to twenty years. We now have one President & CEO for High Growth Regions (HGR), including China, India, Brazil, Russia, and other high-growth markets. These markets are all going to be hugely important to us as they contribute to the lion's share of the future GDP growth."

What are Honeywell's major challenges? "We are proceeding diligently on protecting our technologies and intellectual properties. We know that Chinese companies can learn quickly. And with the staff turnover, there is going to be an outflow of skills from the company, even if there is no outright IPR infringement. Some companies are willing to transfer technologies in exchange for market access. We have to weigh it carefully, particularly when it comes to technologies where we have years of lead time," he says.

> "Over the longer term, the middle class is growing rapidly in size and wealth. Tier two and three cities are quickly maturing, and catching up to tier one cities in terms of investments. All are signals for a growing market with strong demand."

That said, Lo notes that IPR issues have not prevented Honeywell from employing 1,400 Chinese engineers to work in local research centres.

He notes some regional differences across China, in terms of the speed of development. "We see the Pearl River Delta becoming saturated. The fast growing tier two cities, such as Chengdu and Chongqing, are going to surpass Guangzhou and Shenzhen fast. We are also seeing much faster growth in the Bohai Rim, especially Tianjin with its rapidly developing commercial district and its goal to be the next financial hub."

Lo says the inland provinces are critical for the next phase of economic development, and can be equally profitable. However, the competition is also more intense. "The business model will also take a different structure. We will have to rely more on local product development and different sales channels. In fact, most of our 1,400 engineers and researchers in China are working to develop local products that are competitive and suited to local needs," Lo explains.

He also highlights crossovers of these products to other BRICs economies. "There is great similarity between the needs of China, Brazil, Russia, and other emerging regions. We have a head start in developing East-for East (E4E) products in China, and are now embarking on an East-to-West (E2W) strategy using China as a platform."

What about additional opportunities? "China got rich by attracting inbound investments. And we expect outbound investments to even surpass inbound investment in a few years. So we are excited about the prospects of working alongside Chinese firms as they invest abroad. These firms are likely to choose partners with a China presence and a global footprint. And we are well prepared to do so," he concludes.

Regulatory challenges A harder place to do business?

China might be one of the global economy's last bright spots, but some multinationals are finding it harder than ever to compete in the country. Some foreign CEOs cite 'Buy China' or 'indigenous innovation' policies, among a list of concerns, as preventing foreign firms from fully tapping into China's robust growth and providing an advantage to local competitors.

However, economic nationalism is on the rise in most countries and governments across the world are raising regulatory barriers to foreign firms as a response to the global crisis.

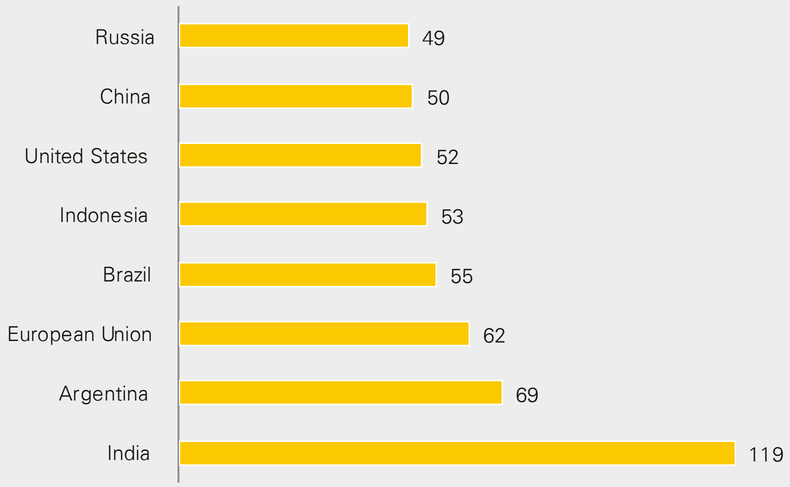
A recent study by the World Bank measured the rise of trade protectionism since 2008[2]: the results show the European Union and the United States were among the highest initiators of trade restrictive measures, alongside India, Argentina, Brazil, Indonesia, China and Russia. The fact the other BRIC countries are equally heavy users of trade measures is not encouraging for multinationals looking to expand into those emerging markets.

2 Taking Stock of Trade Protectionism Since 2008, 'Economic Premise, World Bank, December 2011: No. 72...

Yet, while China might not be alone, it still matters what multinationals think. The country is managing economic transition and multinationals bring with them new technologies and management practices, helping local firms to move up the value chain or move into new industries entirely.

Number of newly initiated trade restrictive measures

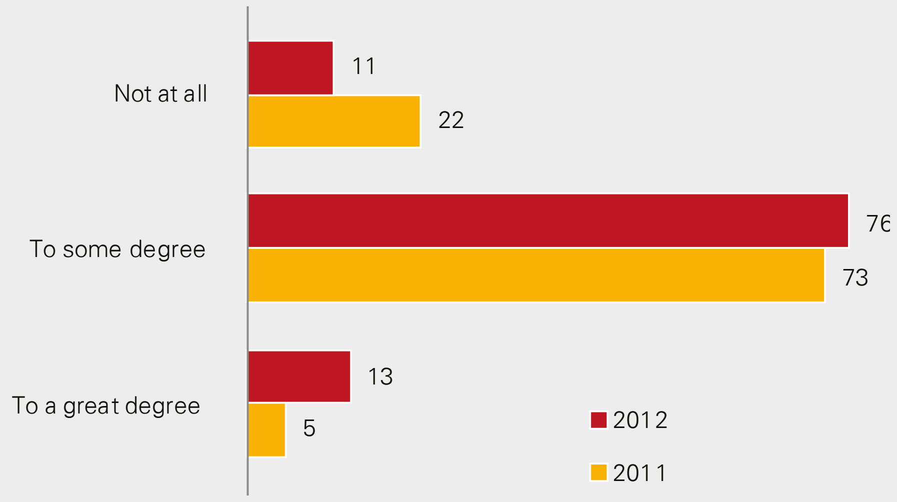
September 2008 to July 2011



Source: Mohini, D, Hoekman, B, & Malouche, M, "Taking Stock of Trade Protectionism Since 2008", *Economic Premise, World Bank, December 2011*

The challenge therefore, is striking a balance between nurturing local industry and encouraging foreign investment.

Is China losing competitive advantage due to rising costs?

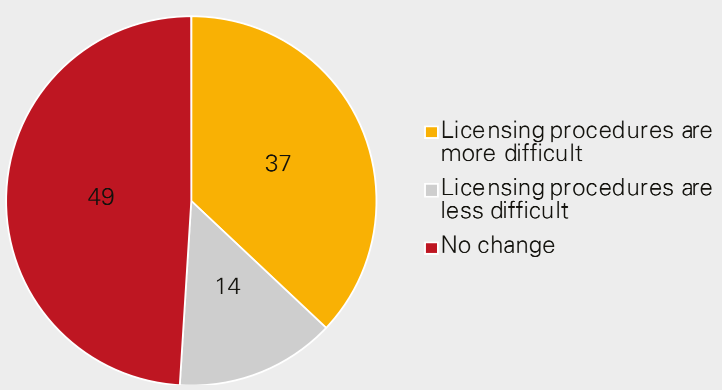


Source: AmCham China 2012 China Business Climate Survey Report

We see that licensing requirements and technology transfers are on the rise. How serious are the risks? In our conversations with senior executives, such concerns ranked below those on the growth outlook, labour costs, and policy implementation, but they are nonetheless growing.

What next? On the one hand, Chinese firms will enjoy breathing space to develop their own technologies. On the other, multinationals do have alternatives to China. It is therefore equally in China's interests to support a liberal global trade and investment climate, otherwise Chinese firms may face similar restrictions abroad, not just in Europe and the United States, but also other BRICs countries.

Has the awarding of licenses changed in your industry in the past couple of years?



Source: AmCham China 2012 China Business Climate Survey Report

Advising MNCS on their bricks and mortar strategy

Anthony Couse, MD of Shanghai and Eastern China, Jones Lang LaSalle

Anthony Couse is Managing Director of Shanghai and Eastern China for Jones Lang LaSalle, the global real estate services firm. In Greater China, the firm has offices in twelve cities, with over 1,600 corporate staff and 10,000 site staff. Its clients include some of the world's largest multinationals.

Anthony has been working in China since the mid-1990s, watching the emergence of China's property sector from its early years.

Couse remains optimistic on China's outlook. "Despite government austerity measures imposed on the residential sector, which have had the desired effect to slow the market, we remain very positive on the medium to long term. Current global economic conditions and uncertainty in China has led to a slowing growth in some industry sectors, in particular the finance sector. However, we continue to see growth in many areas including healthcare, pharmaceutical, manufacturing, luxury brands, fast fashion, and sports apparel," he says.

What are the firm's biggest challenges: "For the last seven years, I would have said that HR was our greatest challenge, but more recently rising business costs have emerged as an area of concern, including income tax, business tax, and staff benefits," Couse says.

"From an HR perspective, we have managed to reduce staff turnover from 30 percent to 15 percent through training and other human resources initiatives, and although this is relatively high by western standards, I believe this figure is respectable for the service sector in China."

Couse notes that Jones Lang LaSalle has recently outsourced some of its regional back-office operations to Dalian: "We chose Dalian because of its abundant language skills giving us the potential to service Mainland China, Taiwan, Korea, Japan, Hong Kong and many of the English speaking countries in the Asia Pacific region."

"All our clients are looking at ways to save costs these days, as the recovery from the economic slump remains modest and we believe the outsourcing trend will become more apparent in China."

"Southern China is maturing, as factories either move inland or out of China. The nature of the tenant is also changing, especially in Guangzhou as the city's economy matures, we are now seeing the growth of the service sector."

"Southern China is maturing, as factories either move inland or out of China. The nature of the tenant is also changing, especially in Guangzhou as the city's economy matures, we are now seeing the growth of the service sector," he explains. "We are receiving a significant number of new enquires from multinationals to help them set-up branches in Chengdu, Chongqing and more recently, in Wuhan," he adds.

The second-tier cities also provide opportunities, according to Couse. "Until the last 18 months, we had been quite conservative in opening in the second-tier cities with a total of six offices; primarily because of the lack of talent to lead our businesses. We see the massive potential for these markets but the cities are essentially still in their infancy and our view is that we have not missed the market and have certainly not overpromised clients in these cities," Couse says.

"There is a huge wave of retail and office construction underway in the second-tier cities. But in many respects this is urgently needed as many markets lack quality retail and office space," he adds.

"We are also seeing change in the primary cities. The multinationals have always occupied and dominated the Grade A office space. But the domestic companies are starting to move very aggressively into Grade A, partly as a result of the war for talent. They realize that offering staff a quality and well located office environment is essential to attract and retain talent."

Couse says this will fundamentally change the whole demand dynamic for the Grade A market. "Domestic companies will compete for quality office space in primary cities with the potential for low vacancy and rising rents over the medium to long term. As markets such as Shanghai mature, the already emerging decentralised markets, will offer tenants cost effective solutions located in areas only a few metro stops away from the traditional CBD. We have already seen some major MNC companies take advantage of these cost savings. Infrastructure is key to this development, as the Shanghai subway system now extends well out to the suburbs," he concludes.

Helping MNCS expand their footprint

Peter Kung, Senior Partner in Southern China for KPMG China

Peter Kung is the Senior Partner located in Southern China for KPMG China, one of the world's Big Four auditors with thirteen offices across China and around 9,000 professionals. The firm provides auditing, consulting, and transactional services for many of the world's largest multinationals—as well as China's largest financial firms—and so is a close observer of many of the opportunities, and challenges, faced by multinationals in China today.

Kung is a Hong Kong national, and a former President of the Taxation Institute of Hong Kong, and also a member of the Chinese People's Political Consultative Conference in Shenzhen.

Kung recognizes that the economy is slowing, but is still confident in the outlook. "This year's economic environment is tough. But China has plenty of ammunition to prevent a hard landing. First, the reserve ratio is very high and it is on a downward trend now. Second, there is scope to reduce the lending rate further. The banks are also now allowed to cut their interest spread further so, if banks follow this guidance, the lending rate can fall further," he says.

"The issue is not that China is short in money supply. The general public has a higher saving rate when compared with the Western world. However, the money is not going to the right channels. A lot has gone to the property sector, but not enough is reaching the private companies in order to help them grow. If more money was directed to the country's high-growth sectors, then the outlook would be far stronger," he adds.

"To facilitate this process, we need a larger group of trustworthy professionals. Not just accountants, but also lawyers, valuers, credit rating companies. They must perform their job with high ethics in order to protect the confidence of the public who invest their savings into private companies in the form of shares or corporate bonds. Sure, ethics are taught at university and as part of professional exams, but the teaching of ethics has to be strengthened. This would help facilitate stronger and healthier development of the Chinese economy," he says.

> "This year's economic environment is tough. But China has plenty of ammunition to prevent a hard landing."

He continues: "I would also encourage the Shenzhen authorities to use the Qianhai special services zone [developed in cooperation with Hong Kong] as a place to enlarge the pool of offshore renminbi funds, and then permit good quality private companies to raise money in Qianhai at lower rates. Companies in Hong Kong have successfully issued dim sum bonds at interest rates of around 2 percent, which is much lower than interest rates in the mainland."

"Qianhai would also provide a forum for high-quality professionals to gather to facilitate the process. It can potentially provide great opportunities for Hong Kong and mainland professionals," he adds.

In terms of the outlook for middle-class, Kung explains: "China understands the importance of the middle-class. The tax reform of 2011 was a great benefit to the middle-class as the new individual tax rates for the middle class are less punitive. For example, those who earn RMB 10,000 a month will be subject to tax at around 7.5 percent, reduced from 12.3 percent. However the government needs to do more to tighten tax-enforcement, especially with respect to the super-rich whose tax burdens can be significantly reduced once they hold a foreign passport. This is something the government could address in order to balance the situation a bit," Kung says.

Kung also highlights high staff costs as another common challenge faced by multinationals. "One of the biggest problems is that staff costs are rising faster than revenue. This problem is faced by all industries. Staff costs are rising not only because of wages. Increasing social fund and housing fund contributions are biting too," Kung says.

Kung adds: "Chinese enterprises are ambitious and are looking to boost their core competitiveness, not just focusing on high returns and high growth. They are also seeking a sustainable mode of development by transforming their growth model. Many major Chinese enterprises are pursuing strategic transformation by inbound and outbound investments to absorb advanced overseas technologies and management expertise, and by consolidating their supply chains as well as market and brand resources."

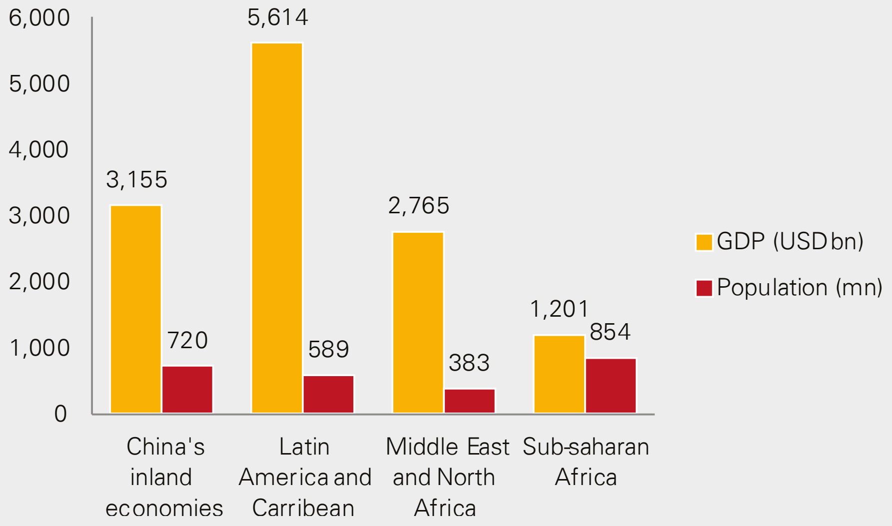
Regional differences There's more than one China

It is used to be that boardrooms spoke of a single 'China strategy'. Today, that approach no longer works, and it is common for the world's largest multinationals to operate multiple strategies, distinguishing between the coastal and inland regions; the first, second, and third-tier cities; and, the large regional clusters in the southern Pearl River Delta, the central Yangtze River Delta, and the northern Bohai Rim.

This makes sense, given that China's economy is similar in size to that of the Eurozone, on a USD purchasing power parity basis, but with four times the population. It is only natural that multinationals will start distinguishing between markets in Gaungdong and Henan, just as they do between France and Germany or California and Ohio.

Multinationals will certainly start treating single Chinese provinces with the same importance they treat entire emerging economies. After all, China's inland provinces are alone are similar in size, either on a GDP or population basis, as other emerging regions, such as sub-saharan Africa, the Middle East or Latin America.

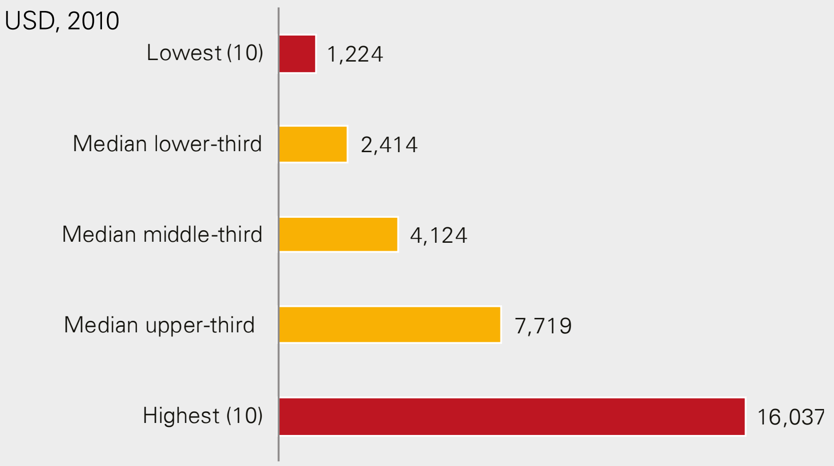
China's inland economies versus major regional economic blocs



Source: International Monetary Fund, World Economic Outlook Database, April 2012; China's National Statistical Bureau; World Bank

Note: China's inland provinces include: Anhui,Hebei,Henan,Hubei,Hunan,Jiangxi,Shanxi,Chongqing,Gansu,Guangxi,Guizhou,I nner Mongolia,Ningxia,Qinghai,Shaanxi,Sichuan,Tibet,Xinjiang,Yunan

Per capita GDP in around 290 prefecture level Chinese cities



Source: China's National Statistical Bureau; Silk Road Associates

Spending on transport infrastructure is also creating new regional markets. The Pearl River Delta's construction of a light-rail network has linked up 40 million consumers within a short train trip (around one hour) of each other. The northern Shandong Peninsula is less populated and more spread out, but construction of a high-speed rail network may create a heavy industrial corridor much like that stretching between Tokyo and Osaka in Japan.

The differences between the regions will also widen should China's economy slow. Historically, local government and industries have initiated economic reform, the central government later approving the change. Questions that MNCs are therefore asking include: what types of industries is the local government keen to attract? How tied is the local economy to the global economy? How reliant is it on government money? How wealthy is its population?

For multinationals looking to set up headquarters or branch offices in China, how might they view the relative differences? Beijing remains the country's political capital, but also a hub for North Asia, including, Korea and Japan. Shanghai is the financial capital, but also a window through which China deals with the rest of the world. And Guangzhou, alongside Hong Kong, is meanwhile re-establishing itself as a hub for South East Asia.

A quality approach to business in China

Masayuki Kamiya, Senior Executive Officer, Asahi Glass Co.

Masayuki Kamiya is Senior Executive Officer of Asahi Glass Co. ('AGC') and Chief Representative of AGC Group for China.

AGC Group is one of the world's largest flat glass producers for building, automotives, solar and display sectors. The firm has fifteen affiliated companies in China with a turnover of about 5 billion RMB (USD800 million) and 5,400 employees.

Kamiya worked in Europe for five years before relocating to China. He has since been impressed by the speed of change taking place in China: "I speak regularly with government officials, heads of state-owned firms, and private businessmen. Their style and attitudes have been changing significantly. They have clear visions and are making quick decisions. The speed of implementation is also marvelous. This is something that Japanese and other foreign multinationals find difficult to compete with," he says.

The ability to adapt ourselves to change is important, says Kamiya, as moving up the value-chain will be crucial to any firm's survival: "We have a variety of businesses in China. But for the commodity-type of business, we cannot compete with local producers unless we are the lowest cost producer. Taking architectural glass business for instance, we need to go into more value-added products. We need to differentiate ourselves with new innovative products and new technologies," he says.

While impressed with the operational excellence of Chinese firms, Kamiya notes that they struggle with innovation: "This is a part of their weakness. Many local firms are good in their current business. But they are not so good in the high-tech business yet," he says.

Nevertheless, he sees some Chinese companies are smart enough to deal with the problem: "I am a bit surprised to see a lot of Korean and Japanese staff working for Chinese companies. In Japan, there are many Chinese recruitment companies to employ Japanese engineers and researchers. "Another approach is to acquire foreign companies through M&A, whether in Japan or Europe, in order to get their technologies and engineers," he adds.

> "I speak regularly with government officials, heads of state-owned firms, and private businessmen. Their style and attitudes have been changing significantly. They have clear visions and are making quick decisions. The speed of implementation is also marvelous."

Kamiya also notes that labour costs are rising fast in China, echoing a common concern among multinationals. "We have many factories, where labour costs are increasingly sharply. We expect local salaries will also rise at nearly fifteen percent per year over the next five years, so the salary level will likely double in five years, and the compensation of an average manager will be close to the level of Japanese managers," he says.

Human resource is the most challenging issue. "It is really important for us to have good local people. So how to recruit, develop, and retain talented local people is certainly key for success. Especially, how to attract and retain those talented people is most important. It is not only the matter of compensation. For very talented and ambitious people, we need to communicate well and show them respective future prospects. I am always saying that we need to look after and inspire our most talented people," he says.

Kamiya maintains that there is no single ideal strategy to succeed in China: "China is a very huge and diversified market. You can find a big market for both low-end and high-end products like mobile phone. The same is true for automotives. Sure, there are a lot of low-end cars that are sold, but there are also many high class BMWs and Mercedes. So we need to have diversified view points on our markets. We also need to have a good marketing ability in China in order to watch what is going on in each of those markets," he says.

Kamiya concludes: "China is a huge attractive market, but it is also a fierce battlefield. If you go to the battlefield without any weapons, you will be killed immediately. You need to ask yourself what is your weapon?"

Navigating China's legal framework

Qiang Li, Managing Partner of O'Melveny & Myers, Shanghai

Qiang Li is Managing Partner of O'Melveny & Myers' Shanghai office. The firm has one of the largest China practices of any US-based law firm and was one of the first to open in the country. With around 800 professionals working in the U.S., Asia, and Europe, the firm serves many of the world's largest multinationals with respect to their China business.

Qiang Li has practiced in China for around fifteen years advising multinationals and Chinese clients on their cross-border M&A and direct investment projects.

What are your main concerns with respect to China's outlook? "First and foremost, China needs serious financial reform because its capital market is not appropriately functioning as an engine of growth. It is not market-oriented, which is why China's capital allocation has been inefficient. The CSRC appears quite serious about reform, but it remains to be seen whether there is the political will to make sustained efforts," he explains.

How serious are the risks of technology transfer? "Worries about technology transfers may be somewhat overblown. I don't see why multinationals can't buy market access in exchange for their current technology. After all, multinational companies still hold the key to the future, as they have a huge advantage with regards their innovative culture. And I think depending on the specific market opportunity being presented, it may well be a good trade for them if they are only contributing their current generation of technologies," he says.

In terms of the biggest challenges faced by multinationals, Qiang says: "Intellectual property rights are the most important issue for my clients. The legal system could also do with a deeper reform with a more developed and better articulated jurisprudence. Generally speaking, the present law only sets out big principles and leaves much to government agencies to interpret and enforce the law. On the other hand, I believe the multinationals can do more to help themselves, by creating and nurturing a more favourable ecosystem in which they operate."

"I think we are at a historic tipping point where the Chinese and multinationals have just realised they genuinely need each other, yet they don't know how to work with each other."

"But my general view is the environment will at least in the short run steadily improve for multinationals. It is just about reaching a point of recognizing the true value of multinationals."

Are worries about economic nationalism exaggerated? "Economic nationalism was on the rise. But that is yesterday's story. The Chinese government and local companies are realizing the value of multinationals. Joint-ventures are popular again, but unlike fifteen years ago, they are more likely to be undertaken voluntarily, not simply because of legal requirements. Multinationals are starting to understand the worth of the local players, and vice-versa," he explains.

"I think we are at a historic tipping point where the Chinese and multinationals have just realised they genuinely need each other, yet they don't know how to work with each other."

In terms of labour costs and shortages, he says: "Labour costs are not the issue. The biggest issue is giving future local leaders a true stake in the game. A decade ago everyone wanted to work for a multinational. Today, multinationals are not sufficiently leveraging their advanced corporate culture. There's definitely a money element to it. But at the same time, you need to have a program to identify your future leaders early and to groom them. Interestingly, the Chinese government does a good job at that."

How has the global crisis affected the China strategy of multinationals? "The US capital market is more or less closed to Chinese companies for now. The pre-IPO financing market is also cooling. So that presents a huge opportunity for multinationals looking to buy local firms. The fiction of high price-earnings ratios for locally-listed firms is also starting to fade away as a result of financial reforms. And we are starting to see companies—earlier planning to list on the A-share market—now being sold to multinational companies," Qiang concludes.

Part of China's fabric

Frank Liao, General Manager of China, Avery Dennison RBIS

Frank Liao is General Manager of China for Avery Dennison RBIS, an integrated global apparel and footwear industry solutions provider. The company is the USD1.5 billion division of Avery Dennison, based in Framingham, Massachusetts.

Avery Dennison RBIS employs 20,000 staff in 115 offices, across fifty countries. The firm also has a strong presence in China's textiles sector.

Liao develops and executes strategies and programs aimed at promoting the firm's growth and profitability across Northern China. Specific regions covered include Suzhou, Kunshan, Fuzhou and Qingdao. Prior to joining Avery Dennison, Liao held various leadership roles at well-known multinational manufacturers, including GE and 3M, in China.

What challenges do multinationals face in the coming years? "The multinationals started in the big cities and only then tried to go to the villages. That's different from the local firms that started in the villages. It's probably easier going from a fourth-tier city to a third-tier. Therefore, I think it will be very challenging for multinationals to do the reverse," Liao said.

"Twenty years ago, if multinationals risked coming to China, chances were high that they were going to be successful. But that's going to be more challenging as they look for growth in the rural areas. I expect their success rate will drop significantly due to the tough business environment. I just don't think we will see another KFC-style success story," he continued, pointing to KFC's success with more than 3,200 stores in 650 Chinese cities.

On China's innovation efforts, Liao says: "There has been an improvement in engineering skills, but the general climate doesn't yet encourage big innovation. The country is very good at adopting technologies rather than inventing technologies. Indeed, technology transfer and the availability of local talent are equally important nowadays."

"Twenty years ago, if multinationals risked coming to China, chances were high that they were going to be successful. But that's going to be more challenging as they look for growth in the rural areas. I expect their success rate will drop significantly due to the tough business environment."

Labour costs and shortages are another topic of concern for Liao. "In general, even with wage rises, there is a shortage of labor. The newly employed staff of a multinational tends to be very young. Their wage level is important, but even more important is their development path, and so creating a well structured career trajectory is vital to retain staff," he noted.

However, this is more difficult for the textiles sector, Liao pointed out. As a result, the textile industry will gradually move away from China to other low labor cost countries, such as Vietnam and Cambodia, he explains.

In terms of infrastructure differentials across Asia, "The textile industry came to China twenty-five years ago, before the country's infrastructure was developed, and so it will similarly move to other countries. For instance, I was recently talking to a major client that had set-up factories in Anhui province and Cambodia, and their Cambodian factory is now growing rapidly," he adds.

Liao also noted opportunities for factories to move inland, especially given the state of the global economy and the rapid growth of the domestic market.

"The global economic crisis has certainly made China's domestic market more important to us. But it may also entirely change our business—the typical commodity might sell for USD10 in the U.S., but only USD2 to USD3 in China; profit margins are also lower and the local competition more intense; the local consumer also behaves differently from consumers in our traditional markets," Liao mentioned.

What policy changes would Liao like to see? "The textiles industry is booming in China and we witness strong support from the government," he says. "Of course, we are paying attention to the policy about minimum wages. But there is little the government can do here, as wages would be rising anyway. Perhaps there is something the government could do on the VAT export rebate. From our point of view, a hike in rebates would be a beneficial."

The company considers China to be one of the top emerging markets and an area of focus along with its established markets in America and Europe. "We will continue to invest in China and help retailers and brand owners to elevate brands and accelerate performance throughout the global retail supply chain," he concludes.

The future Looking forward to the next decade

There is little doubt that China will remain a large and growing source of revenue for the world's multinationals. However, the shift from "cheap China" to "consuming China" means firms will be looking to produce less in the country's factories, and instead sell more to its consumers—ultimately a more challenging business model, but one that offers significant rewards.

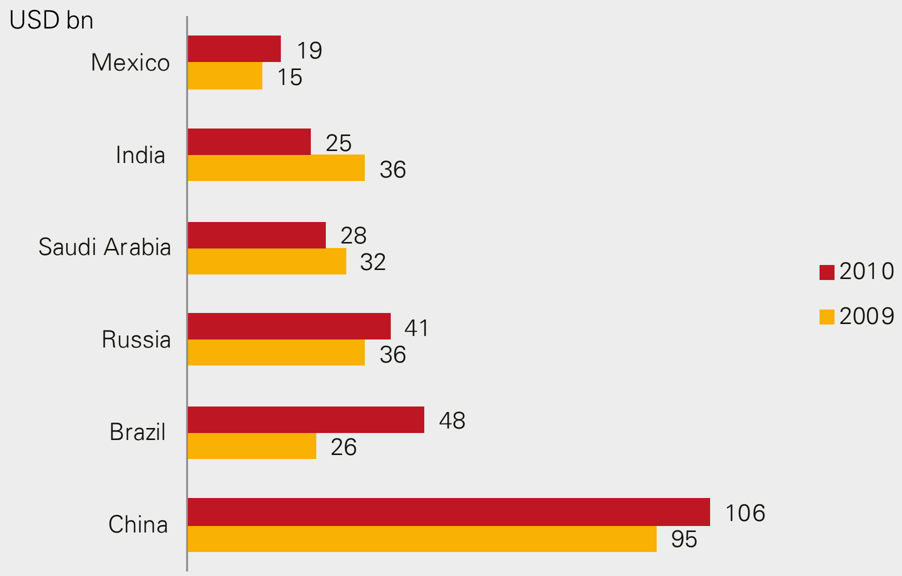
One major change to look out for is a return to joint-ventures. Such arrangements were popular in the 1990s, largely because legal alternatives were limited. However, that approach changed soon after China's entry to the World Trade Organization in 2001, and many foreign firms took advantage of more liberal investment laws to set up wholly-owned enterprises, believing that such structures gave firms a greater control over their own destiny and allowed for organic growth.

However, the popularity of joint-ventures is rising again, especially as a result of greater local competition and a push into the more challenging third and fourth-tier cities. It has accordingly made more sense for multinationals to team up with local partners as a way to expand their market, rather than through acquisitions or organic growth. Local firms are also increasingly maturing, valuing joint-ventures not just as a source of income, but as a source of strategic strength.

Another change will be the extent to which multinationals invest more in the services sector, as opposed to the manufacturing sector, a development that would be consistent with China's own move up the value-chain. So far, such investments have been largely limited to the logistics and financial sectors. But were China to open up a wider range of service industries to foreign participation, multinationals would be sure to respond.

Key however, will be ensuring that both China and the world's multinationals continue to jointly lobby for further growth in global trade and investment flows amid a period of global difficulties and uncertainties. Both parties have benefited so far from globalization, and should expect to continue to do so.

Global FDI inflows, 2009 and 2010



Source: UNCTAD, World Investment Report 2011

The right fit in China

Paul Salnikow, Chairman and CEO of The Executive Centre

Paul Salnikow is Chairman and CEO of The Executive Centre, one of Asia's largest serviced office providers with seventeen locations in six Chinese cities, including Beijing, Shanghai, Guangzhou, Shenzhen, Tianjin and, shortly, Chengdu. Established in 1994, the firm's customers include many of the world's largest multinationals, from Apple to Morgan Stanley.

Based in Hong Kong, Salnikow is also a twenty-two year veteran, running The Executive Centre from its inception, and later buying out the company alongside a private equity group.

"We don't see any slowdown. Our business is in core-CDB, strong economic locations, and we fit out to the highest standards. There is still fundamental growth in the economy and so clients such as Aston Martin and Bentley, for example, are starting to put management in China, rather than simply running their business from Europe," he says.

"But we are also seeing new arrivals because of uncertainty about the economic outlook, as clients want to hedge their bets, even in China," Salnikow adds.

How important are the inland provinces? "We are focused on premium service industries and so a city has to have basic parameters. It can't just be a manufacturing centre or ports hub. It needs to have legitimacy as a regional services centre. With that in mind, we are opening up an office in Chengdu. It's a market we've been tracking for five years. Other centres opened up three years ago, but we held back."

"We are also tracking Wuhan, Shenyang, Chongqing, and Hangzhou," he adds.

> "There is still fundamental growth in the economy and so clients such as Aston Martin and Bentley, for example, are starting to put management in China, rather than simply running their business from Europe."

In terms of the biggest challenges, he explains: "The cost of employment is constantly being rewritten. Management and secretarial wages are almost the same as wages in Hong Kong, often higher when including performance pay. Our problem is that we are a service business, and so our secret ingredient is people, not a manufacturing technology. So we have to find ways to retain staff, such as offering warrants as a form of payment, even though we are a privately-owned company."

"High tax rates make it an even bigger problem. You run into issues where staff don't actually want their performance pay, as it pushes them into a higher tax bracket and actually lowers their take-home pay. The tax system was set-up for mega-rich, but it is increasingly penalizing regular high-earners."

The licensing system is also a challenge, Salnikow explains. "It has both its advantages and disadvantages. You don't receive a national license, but rather a local license. There is even competition among districts of the same city for your business. When we opened in Chengdu, for instance, we were offered all sorts of advantages to open a new wholly-owned foreign enterprise in the city. But it made more sense to open up as a branch of our Tianjin main office. Why? In China, a bank only looks at your consolidated results. So breaking the firm up into many small parts means you only end up getting many small loans. But I need the efficiencies of a national structure."

There are some regional differences across China. "In spite of the noise about Western China and the secondary cities, most of our expansion has been in southern cities. As manufacturing moves out, services moves in, including back-office and even, in some cases, front-office. That's especially true for the financial services—the further inland one moves, the smaller the financial services business is and that affects demand for our product," he says.

That said, Salnikow adds: "We still see the greatest opportunities in Shanghai and Beijing. Foreign firms used to have only representative offices in these cities, but are now turning them into full branches. We expect to add one to two centres a year in Beijing and Shanghai, though it's a struggle as there is a lot of competition for limited space. A huge amount of property is being built, but also consumed." he concludes.

Seeking talent in China

Charles Hunting, CEO of Genpact Asia Pacific

Charles Hunting is CEO of Genpact Asia Pacific, one of the world's largest providers of Business Process and Technology Management and Smart Decision Services. The company began as a business unit within GE in 1997, providing outsourced services, such as finance and accounting.

In 2005, Genpact became an independent company and now serves over 600 clients from eighteen countries, including China where the firm employees nearly 5,000 people.

Hunting sees a transition on the horizon in China's economy: "In the short-term, it used to be that multinationals did business largely on their terms in China, and local governments spent a lot of effort and provided significant incentives to attract them. But with the shift towards a domestic economy this has resulted in a subtle change in attitude towards multinationals and how they are expected to do business in China." In the medium-term though, Hunting worries more about rising costs: "It's not much beyond five years before China's cost advantage is substantially reduced and its position in the global market challenged – especially as a destination for outsourcing services," he says.

Can China compete with India's BPO business? "In ten or fifteen years, we can expect to see a couple of things. First, India will remain a destination for outsourced services and will continue to be seen as more important for the U.S. and Europe, where it is strongly aligned. By contrast, China will become much more domestic-focused. And ultimately, China will have a larger overall business, because of the potential size of its domestic market," Hunting says.

He adds, "China will become a leader in innovation, partly as a result of its need to compete globally, but more as a result of the specific challenges in the local market stemming from its size, speed of change and overall complexity."

> "India will remain a destination for outsourced services and will continue to be seen as more important for the U.S. and Europe, where it is strongly aligned. By contrast, China's BPO business will become much more domestic-focused. And ultimately, China will have a larger business, because of the size of its domestic market."

Hunting maintains that China's domestic market still has its challenges, especially in the inland provinces where it's especially hard to find staff. But he argues that similar challenges occurred when Indian cities came on-line after the initial strong holds of Bangalore, Mumbai and New Delhi/Gurgaon – for example Chennai in the early 2000's.

When asked about the biggest challenges in China, Hunting replies: "People, people and people. And it's not just a China problem. We are struggling in all the major economies to find the right people. Sure there is a lot of supply coming out of the universities. But the innovation and management skills are missing."

Hunting continues: "I think the appetite for innovation is as high in China as it is in the U.S. The thing that is missing is the platform, and that's an environment issue. If you put a lot of smart people in Silicon Valley, a lot of exciting things will happen. China does not have this environment yet. But once it does, then you will start to see more things coming out of this country than the rest of the world."

Hunting also sees regional changes in the outsourcing business. "There are a lot of the jobs leaving Japan and going to China. The same is for Korea, and more generally North Asia," he says. He also expects newer outsourcing engineering services to follow factories that are setting up in neighboring low-cost South East Asian countries. "I know of one auto company who already has 1,000 people doing engineering data services in Vietnam since diversifying from China to Vietnam," he says.

While not an advocate of major policy reform, Hunting does see room for improvement. "Good progress has already been made on policy reform and I think it's more about continuing and extending the policies already implemented. Most important though is how the government uses other measures to stimulate our industry. For instance, state-firms continue to operate very much on a 'command and control' model, and so are reluctant to outsource their business services," he says. "A shift in this will have a tremendous effect on our industry."

Adapting strategies for the China market

KPMG Partners share their views on current opportunities and challenges for multinationals in China

China remains a strategically important market for multinationals (MNCs), however they also face a number of challenges as they expand their footprint in the world's second largest economy. These include rising inland provinces, strengthening local competition, and an economy not immune to the current global economic malaise.

MNCs therefore see an increasing need to adapt their strategies in China, in order to succeed. **Honson To, Partner in Charge, M&A and Transactions Services, KPMG China**, explains: "Unlike ten years ago, MNCs are trying to expand, rather than simply enter the market. They are also finding it increasingly challenging as local competitors have become more competitive."

"Chinese companies used to rely on foreign capital and so were willing to go to the negotiation table. Today, they don't need money. They either have their own or are well backed. It's instead the foreign multinationals that are keen to enter a promising market, and so they find it far more difficult at the negotiation table. And unless they have an attractive brand, such as Mercedes Benz or GM, it is difficult to convince a local partner why they should agree to a joint-venture."

A lot more domestic consolidation and M&A is expected across many industries as a result. **Babak Nikzad, Partner in Charge, Consulting Services, KPMG China**, says: "Multinationals will be part of the consolidation and M&A story, and the smaller multinationals may struggle to exist profitably as a result. We already see that directly in the consulting business. The marginal players with thirty to fifty staff can no longer sustain their business and are already pulling the plug through disposals or leaving China."

Rupert Chamberlain, Partner, Head of Transaction Services, agrees: "The challenge is now to make China a profitable story. Multinationals previously preferred to go wholly-owned as that was the best way to drive their own destiny. There are also more local players that see a joint-venture as a key part of their own global expansion as they seek to leverage multinationals more widely, not just a way to earn income and leverage the expertise that multinationals have to offer."

Some of the larger multinationals also face challenges: "The local firms are becoming much smarter. Many Chinese nationals are going overseas to be educated, while local firms are also paying good money to poach talented professionals from multinationals. It's also cheaper to buy software today, unlike before when you had to spend years developing and implementing systems. As a result, many local firms have become very credible and competitive by properly packaging the people and technology infrastructure aspects of their business," Babak adds.

Before China joined the World Trade Organization in 2001, joint-ventures were a key priority for MNCs in terms of their China entry strategy. However, shortly afterwards, some MNCs felt it would be better to establish their own enterprises and grow either through M&A or organic growth. Honson points out: "Today, they are finding it difficult to compete and are slipping back into joint-ventures. There is an element of, if you can't beat them, joint them, not only in the inland areas, but also the coastal areas. Joint-ventures are also crucial in any area that requires licensing."

Honson To
Partner in Charge, M&A and Transactions Services, KPMG China

"Unlike ten years ago, MNCs are trying to expand, rather than simply enter the market. They are also finding it increasingly challenging as local competitors have become more competitive."

Babak Nikzad
Partner in Charge, Consulting Services, KPMG China

"Many local firms have become very credible and competitive by properly packaging the people and technology infrastructure aspects of their business."

MNCs have historically tended to set up contract manufacturing structures in China, with a view to targeting overseas customers. However, this is set to change.

Khoonming Ho, Partner-in-charge, Tax, KPMG China, says: "In the long run, we see greater opportunities for foreign companies to establish full-fledged manufacturing operations in China with a primary focus on the Chinese market. Intangible assets can be moved into the Chinese operations to increase their market competitiveness. The Chinese tax authorities have implemented several regimes to grant favorable tax treatment to foreign invested companies that develop and own technologies in China, conduct local R&D activities to maintain such intangible assets, and interface with the Chinese customers directly to tailor goods or services for the domestic markets."

"For instance, if a Chinese subsidiary of a MNC with IP ownership in China qualifies as an advanced and new technology enterprise, the corporate income tax rate is reduced from the headline rate of 25 percent to 15 percent. Furthermore, qualified R&D expenses incurred by the Chinese subsidiary are eligible for a 50 percent bonus deduction, which can further reduce the effective corporate income tax rate in China," he explains.

Shared-services is another important area that offers new opportunities for China MNCs. Babak notes: "China's MOFCOM is expected to announce its plans for the industry next year, including how China will position itself with respect to other major shared services centres in the world such as India and the Philippines. The industry won't service only the needs of MNCs, but also domestic companies. This is part of the government's plan to shift the economy from manufacturing to services."

This is also likely to impact MNCs. "First, they are likely to relocate some of their overseas back-office operations into China, much as they did with India. And second, they will organize their domestic operations with more being done out of shared services centres to create efficiency and to manage risk better."

In addition, while the costs of MNCs operating in the coastal cities of China have increased significantly, some areas, such as the western region encompassing less developed inland provinces, are still quite competitive in term of local labour and infrastructure costs.

Khoonming explains: "The Chinese government attaches great importance to the modernization of the western region and encourages MNCs to increase their investment into these areas to balance the overall economic development. The tax authorities have indicated that if certain conditions are satisfied, enterprises in western China can be eligible for a reduced 15 percent corporate income tax rate during the period from 1 January 2011 to 31 December 2020. This provides another mechanism for MNCs to reduce business and tax costs in China."

VAT reforms in China are also set to offer additional opportunities for MNCS. A pilot scheme introduced in 2012 in Shanghai has replaced Business Tax (BT) with a Value Added Tax (VAT) for the transportation, asset leasing and modern services sectors. This program is the first step, in an overall plan to replace BT with VAT across the whole services sector in mainland China.

Rupert Chamberlain
Partner, Head of Transaction Services, KPMG China

"The attractiveness of the market is still very much driven by the consumer story. Multinationals are seeking to benefit from anything to do with the growing affluence of the Chinese, whether it's acquiring existing business or licensing Chinese franchises."

Khoonming Ho
Partner-in-charge, Tax, KPMG China

"In the long run, we see greater opportunities for foreign companies to establish full-fledged manufacturing operations in China with a primary focus on the Chinese market."

Khoonming adds: "A major benefit for multinational companies is that the pilot program contains more favourable rules for cross border transactions, as compared with the old BT regime. This potentially helps MNCs seeking to provide services to, or from, their overseas head office. The pilot program has been an early success and represents a giant step forward in the modernization and development of indirect taxes in China. However, there remains much work to do, with the challenges of applying VAT to financial services, real estate and construction, entertainment, and telecommunications still to occur over the next few years."

MNCs are also set to reap the benefits of a presence in China, as the country shifts towards a greater focus on domestic consumption. The technology sector is a good example, as MNCS look for opportunities to target tech savvy Chinese consumers. An increasing number of Chinese consumers now engage in online shopping, more so than compared to the rest of the world. This is across a wide range of items, from household to luxury products.

Egidio Zarrella, Clients and Innovation Partner, KPMG China, says: "The Chinese Government is encouraging significant investment in three key areas - shared services and outsourcing, payments and cloud computing. The 12th Five-Year Plan is also driving innovation in these critical areas, in order to virtualize the nation. This spells huge opportunities for MNCs, particularly those that realize and adapt their strategies to target a growing and very sophisticated tech savvy Chinese consumer market."

Egidio Zarrella
Clients and Innovation Partner, KPMG China

"The Chinese Government is encouraging significant investment in three key areas - shared services and outsourcing, payments and cloud computing. The 12th Five-Year Plan is also driving innovation in these critical areas, in order to virtualize the nation."

In fact, more transactions are processed in China and Asia than all mobile payments in the western world.

Zarrella adds: "The Chinese government has introduced some new and smart initiatives around cloud computing, which will allow greater access to technology and to more people across China. As a result, some of the major MNCS, such as Microsoft and Hewlett Packard are now setting up world class cloud centres in China. The Chinese government has identified five cities to start with - Beijing, Shanghai, Hangzhou, Shenzhen and Wuxi. Chinese consumers and MNCs located in those cities therefore are all set to benefit from this initiative."

There are similar opportunities in other sectors, such as the luxury segment. Many international brands are establishing a footprint in this market, pursuing different strategies according to the scale of their operations and the ambitions.

Rupert Chamberlain concludes: "The attractiveness of the market is still very much driven by the consumer story. Multinationals are seeking to benefit from anything to do with the growing affluence of the Chinese, whether it's acquiring existing business or licensing Chinese franchises."

About KPMG

KPMG International is a global network of professional firms providing audit, tax and advisory services, with an industry focus. With more than 138,000 people worldwide, the aim of KPMG member firms is to turn knowledge into value for the benefit of clients, people, and the capital markets.

In 1992, KPMG was the first international accounting firm to be granted a joint venture licence in China and the Hong Kong operations have been established for 60 years. Today, KPMG China has approximately 9,000 professionals working in 13 offices; Beijing, Shanghai, Shenyang, Nanjing, Hangzhou, Fuzhou, Xiamen, Qingdao, Guangzhou, Shenzhen, Chengdu, Hong Kong SAR and Macau SAR.

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KPMG Global China Practice

About KPMG's Global China Practice (GCP)

KPMG's Global China Practice (GCP) was established in September 2010, to assist Chinese businesses that plan to go global, and multinational companies that aim to enter or expand into the China market. The GCP team in Beijing comprises senior management and staff members responsible for business development, market services, and research and insights on foreign investment issues.

There are currently over forty China Practices in key investment locations around the world, from Canada to Cambodia and from Poland to Peru. These China Practices comprise locally based Chinese-speakers and other professionals with strong cross-border China investment experience. They are familiar with Chinese and local culture and business practices, allowing them to effectively communicate between the firms' Chinese clients and local businesses and government agencies.

The China Practices also assist investors with China entry and expansion plans, and on both inbound and outbound China investments provide assistance on matters across the investment life cycle, including market entry strategy, location studies, investment holding structuring, tax planning and compliance, supply chain management, M&A advisory and post-deal integration.

kpmg.com/GlobalChina

About Silk Road Associates

Silk Road Associates is a Hong Kong-based consultancy focused on cross-border business and investment. The firm helps clients makes sense of an increasingly complex global economy, whether they are designing market strategies, making strategic acquisitions, or performing due-diligence.

The firm's strength is in combining views from multiple sectors and countries to produce a single strategy and its clients are spread across a variety of sectors - industrial firms, investment banks, private equity, and multinationals. The firm also works across a number of countries, including China, Vietnam, India, Saudi Arabia, and Egypt.

Its philosophy is to combine high-level and ground-level research. The team comprises former economists and strategists for some of the world's largest banks. They speak the local languages - Arabic, Cantonese, Mandarin, Russian, and Thai - and regularly visit factories, interview CEOs, and survey consumers to validate their views.

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