The Third Plenum's Impact on Industries and Business Opportunities

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The Decisions by the Central Committee of the Communist Party of China on Some Major Issues Related to Comprehensively Deepening Reform (hereafter referred to as *'the Decision*') released on November 15, 2013 brings forward a series of policy initiatives that could have a profound impact on various industries, and provide a variety of business opportunities.

A unified and open, orderly and competitive market

The pledge by *the Decision* that a "unified and open, orderly and competitive" market will be established is probably the most significant impact that the Third Plenum will bring to market participants. We must underline, however, that the path toward implementation of the far-reaching reforms outlined in the Third Plenum is fraught with difficulties that must be overcome. These include entrenched political, bureaucratic, and commercial interests. Alignment of these interests to achieve the policy and economic visions represented in *the Decision* is a monumental task that China's top leaders must now embark upon. Progressive realization of this vision will require the exercise of concerted political will and political capital over the course of many months and years. Through *the Decision*, China embarks upon a bold and visionary path, but this path will almost certainly be characterized by forward steps and backward lurches. An ability to operate in an ongoing environment of uncertainty will be a distinguishing factor for successful businesses going forward in China in the coming months and years.

That being said, several important changes will take place if this policy initiative is effectively put into practice. First, we foresee a potential significant reduction in local protectionism and the resultant entry barriers that have fragmented the market and increased operating costs for businesses. *The Decision* promises that the leadership will clear and abolish existing practices and rules that have hindered the function of a unified national market and fair competition. In a policy memorandum issued by the Paulson Institute in January 2014, Andrew Batson from GaveKal Dragonomics highlighted that after a period of rising efficiency of

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capital use from 1997-2003, SOE efficiency has declined since 2003[1]. It is expected that companies, particularly larger corporations, are likely to see additional pressures in the competitive environment and a need for increased operating efficiency after a unified market is established. It is timely for these companies to consider adjusting their operating model and organizational structure to benefit from this change.

Secondly, the government has made it clear that it will further open a large number of sectors to both foreign companies and domestic privately-owned players. The specific measure is a "ban list" (also known as "negative list") management system. Except for the specific sectors in the list, foreign companies and privately-owned business are free to enter without seeking special approvals.

Additionally, under its declared principle of "fair, open and transparent market rules," the government has shown its determination to rely on the market mechanism, rather than the planning mechanism, in resource allocation, and to let competition, rather than government preferences, decide the outcome. *The Decision* states that "the market will play a decisive role in resource allocation", and China will strive to "establish a market-oriented pricing mechanism. For prices that can be determined by the market, the government will not intervene. The prices of water, petrol, gas, electricity, transportation, and telecommunications will be gradually determined by the market." This change expects to further correct market distortions and create a level playing field for every market participant.

> **"A unified market entry system based on the creation of a 'ban list' will be implemented. Various market players can by law have equal access to sectors not appearing in the list. A model of pre-entry national treatment plus a "ban list" approach will be explored regarding foreign investors."**
>
> ***The Decision***

Opportunities embedded in urbanization

The policies on urbanization will have profound impacts on a number of industries. Below we outline a number of such impacts.

1. More public investments in infrastructure projects. It is expected that investments in areas such as environmental protection, urban road networks, sewage disposal systems, recreational facilities, and other public facilities

[1] "Fixing China's State Sector," Andrew Batson, January 2014, Paulson Policy Memorandum, http://www.paulsoninstitute.org/media/117965/fixingchina_sstatesector_english.pdf

will be greatly increased. While hard infrastructure investment will continue in strategic areas, services riding on top of the infrastructure such as logistics, or hospital administration within health care facilities, are also expected to grow. During the process of urbanization, there will be new consumer groups arising among second and third tier cities, and new urbanized areas. Manufacturers and retail enterprises focused on such consumer segments will greatly benefit from this process.

2 As the urbanization ratio increases, the need for medical services will increase commensurately. It is expected that Chinese government will step up investments in county-level public hospitals. Medical equipment manufacturers and relevant service providers will benefit.

3 There will be extra demand for residential and commercial real estate as the urbanization progresses moves along. Developers, construction companies and related service providers including but not limited to urban planners, eco-city planners, sustainability advisors, hospital planners, and aged-care facility planners would be potential beneficiaries of this trend.

4 There will be a shift from agribusiness activities oriented around the family unit towards industrialized agribusiness enterprises, as arable lands are allowed to be traded at the markets. Companies with technology and knowhow driving mechanization/automation for farm efficiency, seed/hybrid development, and anything contributing to food security will benefit. In addition, the highly symbolic "Policy Document #1" for 2014 was just released, and is focused on agribusiness for the 11th year in a row.

In addition, as *the Decision* stated, rural collectively-owned non-arable construction land will be gradually allowed to be traded at the market. The ultimate goal is to establish a unified market system spanning both urban and rural areas. At the same time, a land-related taxation system will be established accordingly. The business tax, deed tax, and land value-added tax will be levied during the transaction process. These taxes will be added to local government fiscal accounts, and help finance the infrastructure projects invested by local governments: this may be a partial answer to local government debt issues, among other measures. At present, the local governments rely on land sales as their primary revenue source. If the rural lands are listed and then traded on the market, the fiscal and financing issues of local governments will become more sustainable. The purpose of this reform is to transform the land-sales-reliance model to a market-oriented management system.

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A reviving capital market

"The financial industry should be further opened up to foreign and domestic investors. On condition that adequate regulation exists, qualified private capital will be allowed to set up small- and medium-sized banks. The reforms of policy financial institutions should continue to proceed. A multi-layer capital market system should be built, and the reform toward a registration system for stock issuance should be pushed forward. Equity financing needs to be expanded through multiple channels, and the bond market must be developed and regulated. The proportion of direct financing will be increased."

The Decision

IPO

The Decision also addressed reforms in capital markets. For example, the Initial Public Offerings (IPOs) system will change from an application-and-approval system to a registration system, which is the practice in the US, Japan and other major economies. The regulatory authorities are also required to be especially protective of small investors' interests.

Following the spirit of the Third Plenum, the Chinese Securities Regulatory Commission issued the "*Opinions on Further Promoting the IPO Reform* (hereafter referred to as *The Opinion*)" on November 30, 2013. It states that within roughly one month, some companies will be scheduled to complete the required pre-IPO procedures. On Dec 30, 2013, five companies obtained relevant documents for an IPO. It is estimated that dozens of companies will complete the procedures and start the IPO process in January 2014.

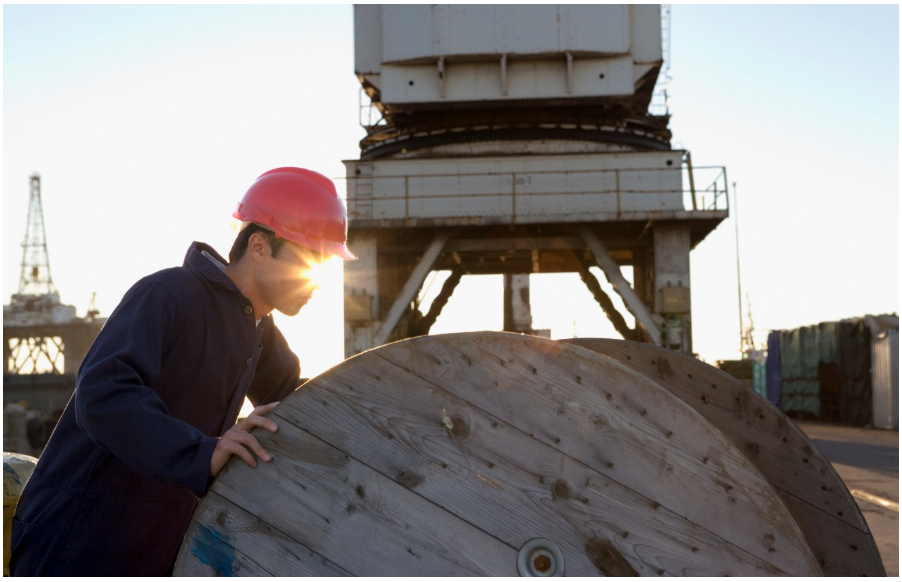
The Opinion also indicates a major shift to the issuance registration system of share public offering. An issuance registration system mainly means that when a firm applies for a public listing, this issuer must accurately disclose a variety of information to the security regulatory authorities. The responsibilities of the regulatory authorities are to review the comprehensiveness, accuracy, authenticity and timeliness of the filings, rather than reviewing and judging the issuer's qualifications. Whether the shares are worth investing in or not will be left to the market to decide.

The key point of an issuance registration system is that the regulatory authorities have no right to intervene if the materials submitted by the issuer is not false or misleading, and does not omit important information. Even if the security has no value for investment, it is still the investors' own right to make their decisions. This share issuance system is highly market driven.

Considering that a large number of firms are qualified to publicly issue their shares, and historically only a small fraction of these was allowed to do so, it is expected that there will be more public companies than ever if the issuance registration system is implemented. Accordingly, there will be more opportunities than ever for the professional service providers.

The arrangement has pros and cons as well. The pros include: the market will play the decisive role in share issuance, which then helps improve the efficiency of resource allocation; regulatory authorities will focus on combating fraud; and information disclosure will be more transparent. The cons include: small investors who are not equipped with much investment knowledge may suffer more losses; it is expected that many enterprises will issue shares in a short period, and the market may initially become more volatile. In addition, the intention to build a more market-driven IPO system is not guaranteed to bear fruit right away, and may be hampered by the current underdeveloped nature of the Chinese stock market, inadequate infrastructure and the historical lack of investor protection. Since December 31, 2013, 36 companies have gone through the IPO process, which has had an impact on the market, and the Shanghai Stock Index has dropped below 2,000 points: too many IPOs in too short a time period has generated some problems. Other related issues include pricing, inaccurate disclosure, and trading practices of brokerage firms. Mr. Xiao Gang, Chairman of CSRC, recognised these various challenges, and stressed that the market has to be relied on for solutions[2]. These developments suggest that the reform policies need solid implementation to create opportunities for all market participants.

The key element of a successful issuance registration system is that the pre-IPO companies and advisors are well prepared. These



[2] "Xiao Gang on IPO," Hexun.com, http://stock.hexun.com/2014-01-28/161838133.html

advisors include brokerage firms, law firms, and auditors that help review these pre-IPO companies. These advisors play a critical role in reducing the likelihood of misleading statements from those pre-IPO companies during the listing process.

Furthermore, it is expected that the regulatory authorities will introduce more measures to protect the interests of small investors. The pre-IPO companies are required to improve their governance and internal control levels, which may create significant opportunities for consultants.

Bond Issuance

In 2010, local governments had debt of around RMB 10 trillion, according to data released by the National Audit Office of China (NAO). It is reported that this figure has increased to RMB 17.9 trillion as of the first half of 2013[3]. At the same time, the local governments have been largely restricted from issuing bonds. *The Decision* states that "local governments will be allowed to expand financial channels for urban development through various ways such as bond issuance". Brokerages (and other financial services companies such as rating agencies) will benefit from this change of policy. "This represents a natural and necessary step in the evolution of local government finance options for China's municipalities, and will require careful planning and implementation to minimize risks inherent in the process", states Richard Dawson, KPMG China's Head of Debt Advisory.

Private Equity

The Decision states that China will improve innovation, and increase access to capital by Small and Medium Enterprises (SME), and create a more favorable environment for venture capital. This suggests that technology SMEs may benefit from this policy.

Furthermore, Chinese capital markets will be more open to foreign investors through introducing more Qualified Foreign Institutional Investors (QFII) and RMB QFIIs. Overseas RMB/USD funds will be able to more easily invest in the Mainland China market. Private equity funds in China will be more internationalized and diversified.

Moreover, the IPO process has restarted in January 2014. Private equity funds including venture capital funds will greatly benefit from this in terms of investment appreciation and exit.

[3] "Announcement No. 32, 2013," National Audit Office of the People's Republic of China, http://www.audit.gov.cn/n1992130/n1992150/n1992500/n3432077.files/n3432112.pdf

SOE Reform and Transactions/Restructuring Services

> **"More SOEs will be allowed to merge with non-state entities to become mixed ownership structures. Projects invested by SOEs will allow the participation from private investors. Employees stock ownership plan will be allowed in enterprises with mixed ownership structure to form a common interest between labor and capital."**
>
> ***The Decision***

The Decision states that "a mixed economy will be greatly encouraged", thus it is believed that private capital will be encouraged to invest in SOEs. Shortly after the end of the Third Plenum, on November 25, 2013, one senior officer from the powerful National Development and Reform Commission declared that not only Chinese private investors but also foreign investors are allowed to hold controlling stakes in SOEs.

The Decision states that a mixed ownership structure is to be encouraged. The state will manage capital, not the operation of individual SOEs. This applies to all types of SOEs, which will eventually become commercial. Historically, the Chinese government has been concerned about losing control of certain industries/enterprises which can play key roles in economic development, social stability or national security. This new policy initiative indicates a shift in the government's position. In transition, the state will still be concerned with some SOEs in sensitive industries. However, even with mixed shareholders, the state can have some measure to ensure things will be under control. We believe that both goals of opening up to Chinese investors and keeping control of key enterprises/industries are still achievable. Even if the government is not the controlling shareholder of a certain company, it can still exert control. For example, the government ownership can be designated as preferred stock with veto power, which can be exercised by the government to maintain control. The government can also hold a golden share, which is designed to be able to outvote all other shares in certain specified circumstances.

Based on the data released by the National Bureau of Statistics, there are in total RMB 110,631 billion SOE assets as of the end of 2011. This amount of assets is supposed to be open to other investors including Chinese private investors and foreign investors. This will be one of the largest (partial) privatization waves in history. The scale of SOEs means massive opportunities for many industry players.

Impact on specific industries

The Decision lists many specific industries for which the government will either lower the entry barrier or give high priority and more resources for development. This shift will undoubtedly create new business opportunities for companies in both manufacturing and service sectors. Specially, market players will benefit in the financial service sector as well as education/healthcare, resources/new energy, infrastructure, real estate, trading, shipping and ports, defence, agribusiness, border trade and logistics, leisure and consumer markets will benefit.

The document states that "The financial sector should be further opened to internal and external investors. Under adequate regulation, qualified private investors will be allowed to establish small- and medium-sized banks and other financial institutions". The deregulation of the banking industry also brings more competition and, as a result, investment opportunities for private and foreign investors. At the same time, the insurance industry will benefit from the introduction of a deposit insurance system. Brokerages are likely to benefit from the establishment of multi-level capital markets (the expansion of the OTC market launched by the Chinese Securities Regulation Commission on December 14, 2013 is providing a clear and positive boost to the brokerage industry).

Furthermore, *the Decision* also states that "private capital can invest directly in medical areas which are highly demanding, and participate in restructuring public hospitals. Private-invested medical institutions will be covered by the medical insurance". As most of the hospitals in China are public hospitals and China's medical insurance currently only covers public hospitals, the prospect that medical expenses incurred at private hospitals will also be covered does send a very encouraging signal to private investors. Together with other preferential policies, the barriers to entry in healthcare are expected to be reduced.

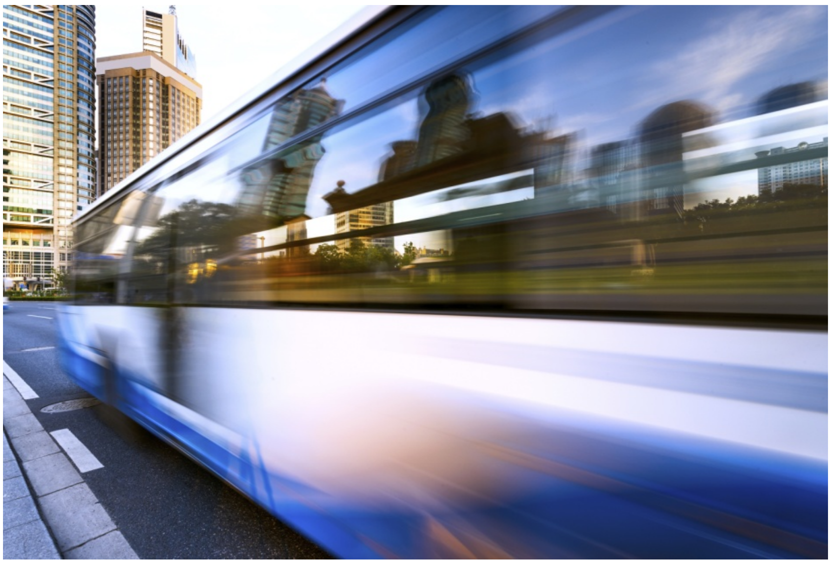
The resources sector may also benefit. First, deregulation will bring more competition, and create more investment opportunities. Second, environmental protection was identified as one of the sixteen tasks in *the Decision*. It is expected that the government will implement a series of strong measures to prevent and control pollution, and heavily invest in environmental protection. For example, energy saving technologies will very likely be one of the focuses of government investments and/or subsidies. However, the benefit may not be felt by all sectors or players. One could argue that the effect will be to a) impose additional compliance costs on the sector, and b) reduce consumption. Both of which would be negative for the resources sector, or at least for some (e.g. wind companies may gain, coal companies not so much).

There are also a number of trends that may boost the infrastructure sector. First, a reform of the taxation and fiscal system, and the ability to trade rural land will facilitate more sustainable urbanization.

Second, the reform of the Hukou system will create a large number of permanent urban residents and bring more demands on infrastructure facilities. Last but perhaps most important, private investors will be allowed to invest in and operate urban infrastructure projects. "While Premier Li Keqiang's "new urbanization" focuses on layering in urban support services such as improved medical care and education on top of China' existing 'hard infrastructure', the opening up of infrastructure projects to outside investors represents a hugely significant step in China's continued process of economic modernization" states David Frey, KPMG China's Head of Strategy and Operations Consulting.

The Decision states that China would "explore the establishment of intellectual property rights courts." In China, there have been discussions about the possibility of setting up a specialized intellectual property court for quite some years. A significant redistribution of power among a number of administrative organs is needed, and this process is not likely to be easy: however, the reference to setting up such a court in *the Decision* does signal a major step. Large multinational companies with historical or planned research and development investments in China would benefit from progress in this area, as well as the cultural sector such as film makers and music publishers.

In terms of the real estate industry, developers have experienced a shortage of capital as the regulatory authorities have adopted a series of measures to restrict financing activities to curb (or prevent) property bubbles. Considering that the IPO process has restarted and the market is also now slated in time to play a decisive role in resource allocation, it is expected that current restrictions on developers' financing will be loosened. Furthermore, in the context of SOE reform, private developers can potentially restructure/take over state-owned developers. Third, urbanization will help create new demand for properties. Last, as residential land and agricultural land are to be tradable, real estate agencies

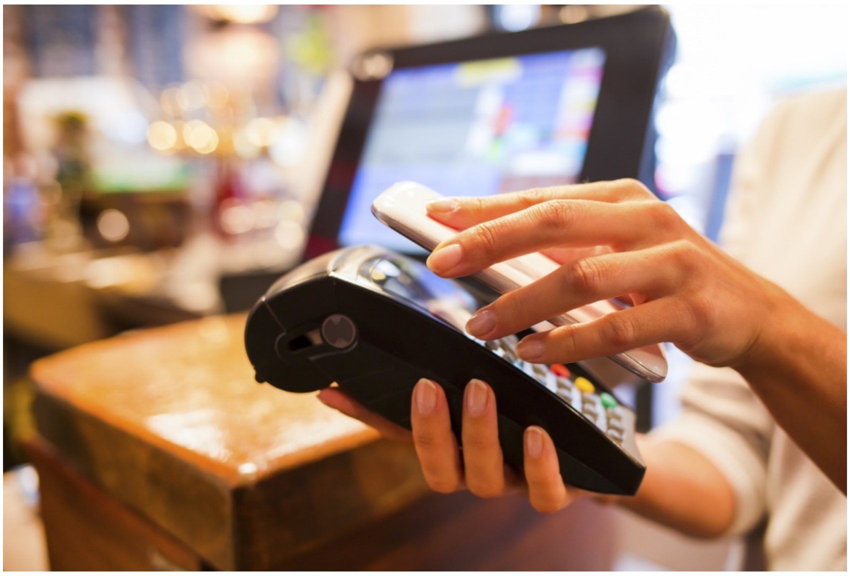


will benefit in this process.

The defense industry will especially benefit from two factors. First, the high level National Security Council (NSC) has been established, and President Xi Jinping is the head. There have been discussions about setting up an NSC for quite a number of years, dating back to the (former President) Jiang Zemin era. The decision to establish the NSC signals decisive steps forward in integrating issues of national security across ministries and departments National security will be raised to an even higher level and require more resources. The trend of increasing military spending in recent years will probably continue as NSC provides better coordination or efficiency on defence, which will benefit military equipment manufacturers and relevant service and technology providers. Second, in the context of SOE reform, private investors can also enter this area which has been largely controlled by SOEs to date.

To some extent, the agribusiness industry of China has been overlooked by investors. There are reasons for this. The agribusiness industry contributes less than 10% of China's economic output (only around 6% in 2012), a share that has been declining over time. The return on equities in this sector is the lowest among all industries. One reason is that China's agribusiness is mainly family-oriented. Most farms are very small and inefficient. *The Decision* states that the contracting rights of rural lands will be encouraged to be transferred to professional and large farms, farmers' cooperatives, and agribusiness enterprises. This policy will in time bring significant and positive impacts to China's agribusiness sector in terms of productivity, profitability and sustainability.

The Decision also states that China will increase the income at the bottom end of the population, and expand the proportion of the middle class. The consumer market will benefit. Also, the relaxation of the one-child policy will boost demand for baby goods. Manufacturers and service providers that target the aging



population will also benefit as preferential policies will be implemented by the government.

Lastly, more free trade zones are to be introduced. Though free trade zones contain comprehensive reform measure in opening up the service sector, liberalizing the financial sector, improving investment and trade management, it will also directly boost trade activities. The import-export business will be stimulated. Shipping and ports businesses will also benefit. It is reported that fourteen provinces/cities have planned free trade zones including the much-anticipated Guangdong-Hong Kong-Macau free trade zone.

Table 1 summarizes our analyses conducted above.

Table 1, Industries that could be impacted by the Third Plenum

Industries	Major measures/policies that could possibly exert influence
Financial service	Banks • Growth potential from China's next golden decade • Local governments allowed to issue bonds • Securitization of debts introduced • Deregulation/opening up to private investors Insurance • Deposit insurance system introduced • Interest rate liberalization to be implemented • Introduction of catastrophic insurance system • Improve the agriculture insurance system Brokerages • Securitization of debts • Establishment of multi-level capital market SOE reform enhances M&A among brokerages Asset management • More QDIIs [this was not mentioned in the article]
Education/Healthcare	• Deregulation/loosening access restriction
Resources sector/new energy	• Deregulation (oil, coal, electricity etc) • Anti-pollution/clean technology • Subsidies
Infrastructure	• A more sustainable urbanization • To unify the infrastructure development between urban and rural areas • Private capital allowed to invest in urban infrastructure projects • Hukou system reform

Industries	Major measures/policies that could possibly exert influence
Real estate	Developers • Financing restrictions loosened • M&A opportunities between SOE and POE developers • Urbanization Real estate agency • Residential land and agricultural land allowed to trade
Import & Export, Shipping/ports	• More free trade zones to be introduced
Defense industry	• The establishment of National Security Council • Private capital allowed to invest in defence industry • Reform on innovation and procurement in defence sector
Agribusiness	• Contracting rights of rural lands encouraged to shift to professional and large farms, family farms, farmers' cooperatives, and agribusiness enterprises • Capital encouraged to invest in modern farming and breeding business
Border trade and logistics	• Accelerating the pace of opening the border for trade, allowing the implementation of special policies on logistics and tourism in border cities and economic cooperation zones[4] • Establishment of development financial institutions to accelerate the cross-border interconnection of infrastructure construction
Cultural industry	• Stronger implementation of intellectual property protection • Market allowed to play a decisive role in innovation • Private capital encouraged to invest in cultural industry
Consumer markets	• To increase incomes of the low-income class • To expand the proportion of the middle class • Baby goods: Relaxation of one-child policy • Encouragement of services to the aging population

Sources: *The Decision, released on November 15, 2013*, and KPMG analysis

Conclusions

Almost all sectors of the economy in China have experienced tremendous growth in the last three decades. According to a research released lately by the Korean International Trade Research

[4] Border cities are the cities that border foreign countries. For example, the City of Manzhouli (满洲里) of China's Inner Mongolia Autonomous Region borders Russia, and the City of Baise (百色) of China's Guangxi Zhuang Autonomous Region borders Viet Nam etc.

Institute, China has 1,485 products that rank number one in the global export market, followed by Germany with 703 and the US with 603 products[5]. During China's continued "reform and opening up" process, fast-growing industries have continued to emerge due to deregulation and an ongoing process of innovation. Further reform and opening up initiatives are likely to remove the barriers to entry into many previously restricted or monopolized industries, which will bring competition, efficiency and even rapid growth.

In this way, the 2013 Third Plenum is poised to have a profound impact on a wide variety of industries, though many challenges exist, and entrenched interests must be overcome through continued political will. A unified, open, orderly and competitive market will be beneficial to market players. Specifically, the new urbanization wave means more public investments in the infrastructure sector. The capital market will benefit from liberalization and deregulation, including the reform on the IPO process, permission of bond issuance by local governments, and more opportunities for private equity. SOEs will be more open to private investors. The service sector will see a broad landscape of untapped and unmet demand open in front of them.

With the implementation of the large number of reform measures in 2014 and beyond, we will see changes in the industry landscape and opportunities in the horizon. Adaptation and far-sighted planning are keys for companies to take advantage of the newly emerging landscape in China.

[5] BWCHINESE.com, http://www.bwchinese.com/article/1052400.html

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 50 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 member 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.

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