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China 360 Volumes

Selected issues of KPMG's "China 360" newsletter

Content

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China 360 is a monthly newsletter designed to keep readers up-to-date with topical issues in China. Each issue focuses on a separate topic, which may include current economic analysis, analysis of government and policy developments, and tips and practical advice on doing business in China or with Chinese companies.

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China 360

E-commerce in China: Driving a new consumer culture

January 2014

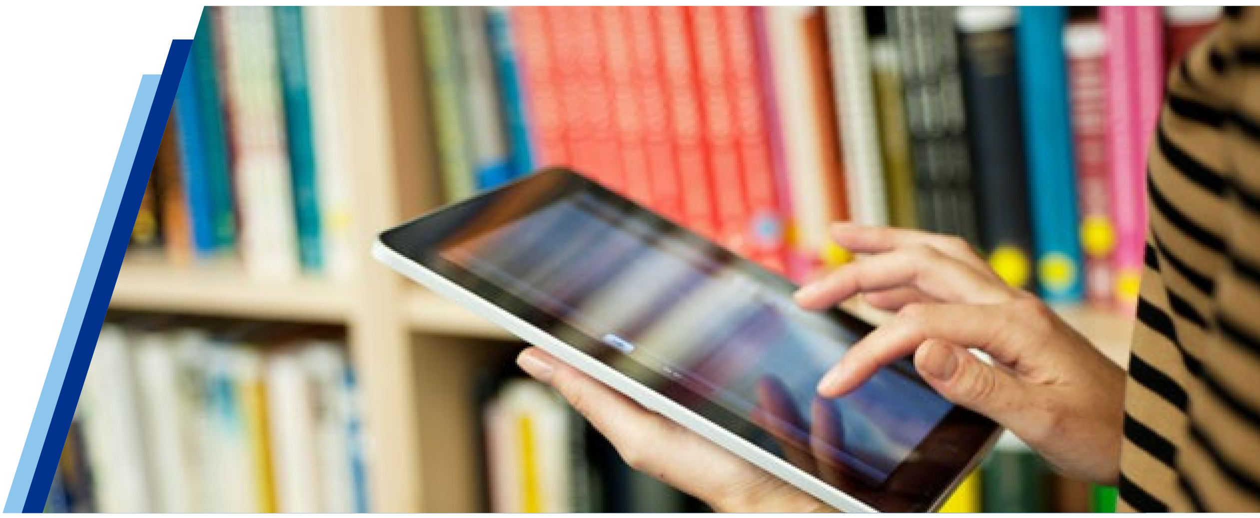
In China's e-commerce 12th Five-Year Plan (2011-2015), the Chinese government's Ministry of Industry and Information Technology unveiled policies to make China a global e-commerce leader, in line with China's transition from an investment-heavy growth model, towards a more consumption-driven model.

Nonetheless, the speed at which the Chinese e-commerce industry has grown, and the way in which it is affecting businesses and consumers has come as a surprise to many: by the end of 2013, China will lead all other countries in B2C and C2C purchases.[1] Jack Ma, founder of Alibaba, was recently quoted as saying: "in other countries, e-commerce is a way to shop, in China it is a lifestyle".[2] No matter how you slice the numbers, trends or forecasts, it's clear that e-commerce is booming in China.

This month's *China 360* breaks down China's explosive e-commerce growth within the business-to-consumer (B2C) and consumer-to-consumer (C2C) arenas. Of particular interest are the home-grown platforms underpinning the rise of on-line transactions, as well as the increasingly important roles of social media and mobile devices. These trends and others are fundamentally re-shaping the ways Chinese consumers purchase goods and services.

This article also highlights the importance of knowing exactly who your consumers are, how they make their purchases online, and highlights some foreign and domestic success stories in the market.

1. He Wei. 'China set to overtake US in e-commerce'. *China Daily.* August 28, 2013 http://usa.chinadaily.com.cn/business/2013-08/28/content_16927926.htm
2. 'E-commerce in China: Gain entrance into a completely different world'. Group of Companies, June 16, 2013 http://www.ptl-group.com/blogs/e-commerce-in-china-gain-entrance-into-a-completely-different-world



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The e-commerce explosion in China

A little over a decade ago, China's path to e-commerce leadership would have been difficult to foresee, even as the tech boom in the US and other markets saw the development of e-commerce as an important B2C and C2C channel.

In 2000, China had yet to develop any[2] e-commerce applications, and had only 2.1 million total internet users.[3] Payment systems and physical delivery mechanisms to facilitate the development of e-commerce transactions were well-developed in other markets, but were simply lacking in China.

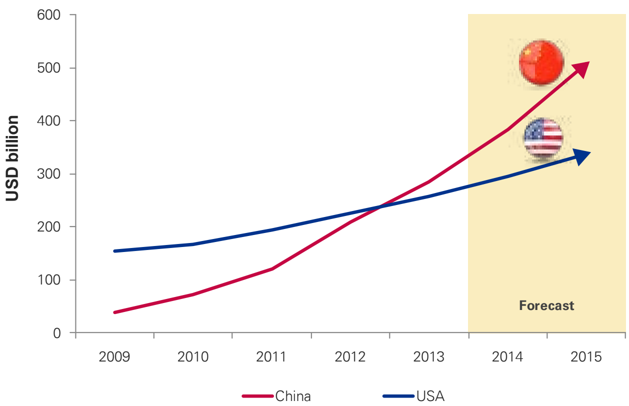
Fast forward to the end of 2013: with Chinese internet users quickly approaching 600 million[4], and e-commerce revenue growth (from 2009-2012) topping 70 percent compounded annually[5], China is on pace to pass the US and become the largest e-commerce market in the world.

11/11

China's **'Singles Day'** occurs on November 11 each year. The month and day are represented by 'ones' (11/11).

In 2013, **'11/11' online sales rose by 80 percent** from the previous year, **to over USD5.7 billion** – more than tripling the amount of 'Cyber Monday' revenues in the US.[6]

Value of e-commerce transactions in the US and China, 2009-2015



Sources: KPMG analysis of US and Chinese e-commerce data from Statista, Bain & Company

By 2015, e-commerce transactions in China are projected to hit USD 540 billion, or approximately 10 percent of total retail transactions, and by 2020, China's e-commerce market is forecasted to be larger than those of the US, Britain, Japan, Germany, and France combined.[7]

Essentially, China's large and growing middle-class have become accustomed to making frequent e-commerce purchases. Furthermore, as in many longer-standing e-commerce markets, they are also developing brand awareness, an increasing proclivity to purchase high quality and/or individually satisfying products, and showing a commitment to brand loyalty and repeat business: VANCL, a Chinese online clothing and apparel company, reported that 80 percent of its consumers had made repeat purchases in 2012.[8]

The future development of China's e-commerce channel is closely linked to technology developments and also the behaviors of Chinese consumers, including the way they research and order products online, and their preference for speed and convenience.

According to Mary Chong, KPMG Partner and Head of E-commerce and Payments for China, there are four drivers of e-commerce growth in China: e-commerce platforms, social media platforms, digital payments platforms and mobile devices.

2. David Wei. 'E-commerce bigger in China than United States'. *CNN*. September 19, 2013 http://edition.cnn.com/2013/09/19/business/on-china-alibaba-e-commerce/index.html
3. David Wei. 'E-commerce bigger in China than United States'. *CNN*. September 19, 2013 http://edition.cnn.com/2013/09/19/business/on-china-alibaba-e-commerce/index.html
4. 'CNNIC released the 32nd Statistical Report on Internet Development'. *CNNIC*. July 22, 2013 http://www1.cnnic.cn/AU/MediaC/rdxw/hotnews/201307/t20130722_40723.htm
5. Bain Brief. 'China's e-commerce prize'. Bain & Company. August 28, 2013 www.bain.com/publications/articles/chinas-e-commerce-prize.aspx
6. J.T. Quigley. 'Singles Day in China Decimates Online Shopping Records'. *The Diplomat*. November 12, 2013 http://thediplomat.com/2013/11/singles-day-in-china-decimates-online-shopping-records/
7. Amanda. 'China E-Commerce Market to Reach 30 Trillion Yuan in 2020'. *China Internet Watch*. March 13, 2013 http://www.chinainternetwatch.com/2007/china-e-commerce-market-2020/
8. Chiang. 'China Ecommerce Roundup: IPOs, Downsizing, and Gaopeng'. *Business Insider*. February, 2012 http://www.businessinsider.com/china-ecommerce-roundup-ipos-downsizing-and-gaopeng-2012-2

Two purchase platforms dominate the e-commerce landscape

Similar to China's specialized social media platforms, China has its share of home-grown e-commerce players. Some of these competitors not only occupy a sizable share of the Chinese e-commerce market, but actually handle a greater number of transactions than their more well-known global competitors.

Alibaba is one of those home-grown companies. Perhaps not yet as well-known outside China as Ebay or Amazon, Alibaba is China's undisputed market share leader of B2C and C2C e-commerce. Alibaba recently reported that the total value of merchandise sold in 2012 was greater than that of Ebay and Amazon combined.[9] By 2016, Alibaba expects to pass Wal-Mart as the number one retail network in the world.[10]

Alibaba operates two distinct platforms:

- Alibaba's Taobao (淘宝网) – Taobao is a C2C site analogous to Ebay, and was created by Alibaba in 2003. Sellers are able to post new and used goods for sale or resale on the Taobao Marketplace, either at a fixed price or by auction. Taobao claims over 500 million registered consumer accounts, 800 million product listings, and holds a staggering 80 percent share of China's C2C market.[11] Like Ebay, Taobao's market is a place where many merchants sell their products directly to customers; however Taobao doesn't charge any commission fees on transactions: its main revenue stream is from advertising on the site.

- Alibaba's Tmall (天猫) – In 2008, Tmall was created as a B2C site (similar segment as Amazon), to compliment Taobao's C2C marketplace. Tmall is able to provide a unique 'mall experience' for brands to set up their own mall website. Sellers pay a deposit to list on the site, and Tmall earns a commission on each transaction.[12] Popular domestic and foreign brands occupy 'mall space'. Each brand can have its own virtual store in the mall, and for foreign sellers, a Tmall store avoids the requirement of obtaining an ICP license needed to sell on-line in China. The Tmall model has proven tremendously successful: in 2012, Tmall accounted for around 51 percent of China's B2C online sales, up from 35 percent in 2010. Comparably, Amazon's share of the market in the US is closer to 20 percent.[13]

Together, these two giants dominate China's market, selling everything from Lamborghinis to shoe laces.

However, despite Alibaba's market position, the e-commerce market in China is large enough for other competitors and niche players to thrive, including some regional platforms, such as Daminwang (大闽网) in Fuzhou, and Jingdong (京东) 360buy.com. Jingdong holds roughly 15 percent of the B2C market.[14] It is primarily focused on electronic items, and is currently the '3C' e-commerce sales leader in China (computer, communications, and consumer electronics).

9. Kenneth Rapoza. 'Alibaba Says Sales Better Than Amazon And eBay...Combined'. *Forbes*. September 9, 2012
http://www.forbes.com/sites/kenrapoza/2012/09/09/alibaba-exec-brags-sales-better-than-amazon-ebay-combined/
Juro Osawa. 'Alibaba Isn't the Amazon of China'. *The Wall Street Journal*. October 16, 2013
http://blogs.wsj.com/digits/2013/10/16/alibaba-isnt-the-amazon-of-china/
10. 'E-commerce giant will not list on Hong Kong exchange'. *South China Morning Post*. October 11, 2013
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11. Adam Jourdan. 'Surviving Chairman Ma: Life in the shadow of China's Alibaba'. *Reuters*. November 26, 2013
http://www.reuters.com/article/2013/11/26/us-china-ecommerce-idUSBRE9AP17H20131126
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http://www.techinasia.com/taobao-launches-hong-kong-official-site/
12. Juro Osawa. 'Alibaba Isn't the Amazon of China'. *The Wall Street Journal*. October 16, 2013
http://blogs.wsj.com/digits/2013/10/16/alibaba-isnt-the-amazon-of-china/
13. Adam Jourdan. 'Surviving Chairman Ma: Life in the shadow of China's Alibaba'. *Reuters*. November 26, 2013
http://www.reuters.com/article/2013/11/26/us-china-ecommerce-idUSBRE9AP17H20131126
14. Steven Millward. 'A guide to China's top 10 e-commerce sites'. *CNET*.
www.asia.cnet.com/blogs/a-guide-to-chinas-top-10-e-commerce-sites-62215025.htm

Social media influencing consumer behavior

China's social media platforms have become an important additional driver or facilitator of e-commerce activity. These platforms, such as Tencent's We Chat or Sina Weibo (China's leading Twitter-style microblogging platoform) have been growing rapidly: Tencent's We Chat reported over 600 million subscribers, up from 300 million in January 2013.[15]

With almost instantaneous feedback and easy-to-use interfaces, social media platforms have become a staple in the life of Chinese e-consumers. Consumers in China use these platforms for immediate 'buy/don't buy' advice from friends, to post product reviews, and to seek product knowledge/advice from key opinion leaders. According to recent e-commerce statistics in China, 40 percent of China's online shoppers read and post reviews about products – more than double the number in the US.[16]

These social media platforms are stepping up their integration into the e-commerce chain. Retailers are developing a more sophisticated social media presence, and some social media platforms – We Chat is a recent example – have added payment functionality, so users can make purchases directly from the application. These trends are fostering an environment whereby mobile devices are an increasingly crucial element in China's e-commerce arena.

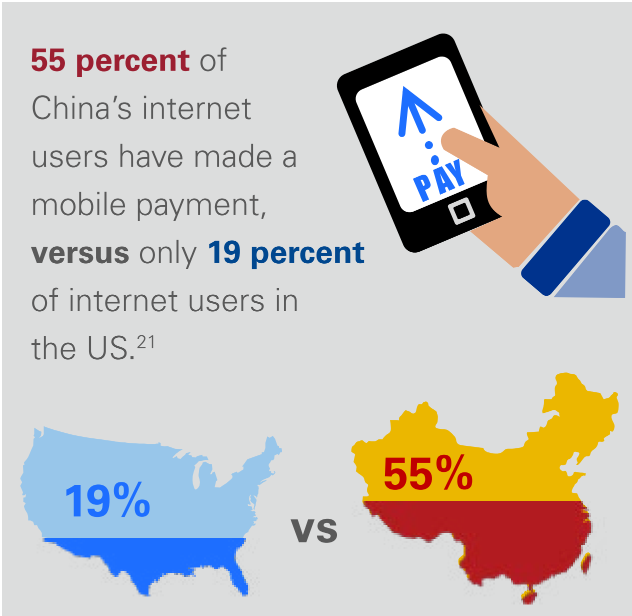
For more on social media in China, see Issue [8] of *China 360*.[17]

15. Tracey Xiang. 'WeChat Reportedly Surpassed 600 million Users'. TechNode. October 24, 2013 http://technode.com/2013/10/24/wechat-reportedly-surpassed-600-million-users/
16. 'E-commerce In China – Statistics and Trends'. GO Global.com. February 08, 2013 www.go-globe.com/blog/ecommerce-in-china/
17. KPMG. 'Social media in China: Local innovation connecting the country'. April 1, 2013 http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Pages/China-360-Issue8-201304-Social-media-in-China.aspx

E-commerce going mobile

Accompanying the rise of e-commerce in China is a clear trend towards mobile devices. In the space of a few years, China has emerged as the country with the largest number of mobile-based e-commerce transactions.[18]

In 2012, mobile transactions totaled USD7.8 billion,[19] representing 3.7 percent of all e-commerce transactions in China. However, by 2015 mobile commerce in China is forecasted to more than quintuple, to USD41.4 billion,[20] representing 8 percent of all e-commerce transactions.



Mobile purchasing aligns with the Chinese consumer's desire for speed, and the convenience of 'any time' shopping. According to data presented by Taobao, the busiest time of the day for mobile shopping is 10pm, and purchases made by mobile devices are 67 seconds faster than purchases made on personal computers.[22]

The trend towards 'smarter' and more functional phones and tablets, coupled with the rising use of social media platforms to inform and connect consumers, is likely to fuel the continued rise in the number and proportion of so-called 'm-commerce' transactions in the Chinese e-commerce market.

18. 'China, South Korea Lead World in Mobile Commerce Adoption'. *eMarketer*. March 20, 2013 http://www.emarketer.com/Article/China-South-Korea-Lead-World-Mobile-Commerce-Adoption/1009742
19. Steven Millward. 'China's M-Commerce Shopping Spree to Hit $27.1 Billion in 2014, Surpassing US Mobile Shoppers'. *TECHINASIA*. March 18, 2013 http://www.techinasia.com/china-mobile-shopping-hits-27-billion-dollars-in-2014/
20. Steven Millward, 'Mobile Commerce Worth $4.29 Billion in Q1 in China, But One Company Dominates'. *TECHINASIA*. May 21, 2013 http://www.techinasia.com/china-q1-2013-mobile-commerce-worth-over-4-billion-dollars/
21. China, South Korea Lead World in Mobile Commerce Adoption'. eMarketer. March 20, 2013 http://www.emarketer.com/Article/China-South-Korea-Lead-World-Mobile-Commerce-Adoption/1009742
22. Vaughn Highfield, 'Infographic: China's M-Commerce Set to hit $27.1 Billion in 2014'. TotalPayments. March 18, 2013 http://blogs.terrapinn.com/total-payments/2013/03/18/infographic-chinas-commerce-set-hit-27-1-billion-2014/

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Know your customer and market

As the e-commerce market in China matures, businesses must develop more sophisticated strategies to influence and reach target customers: a 'one-size-fits-all' e-commerce strategy is no longer sufficient. China's on-line population is not only incredibly large, it is also highly diverse, in terms of consumer behavior. Businesses should not assume that the China's consumer market is homogeneous.

Exactly the opposite in fact: sales vary widely by the different tiered cities China. In tier-1 cities such as Shanghai, many consumers are e-purchasing vacations, cars, or high-end personal care accessories, including cosmetics, handbags, and high-end fashion with greater transactional frequency than their counterparts in tier-2, tier-3, and tier-4 cities.[23]

Brand loyalty is also materializing at a markedly higher rate in tier-1 cities than anywhere else in China. In contrast, in smaller markets such as Dalian, Xi'an, or Fuzhou, one may find greater variability amongst what products and brands are favored – for example 'last season' items may sell poorly in Shanghai, but still sell well in other markets. Consumers from lower tier cities are still more focused more on basic value propositions when making purchase decisions.[24]

The methods of influence also differ between different markets: tier-4 cities tend to rely more on 'key opinion leaders' and less on word-of-mouth, or user reviews and blogs. Contrary to expectation, tier-4 city residents have relatively less discretionary income, yet they appear to be spending similar amounts on-line as consumers from tier-3 or even tier-2 cities.[25]

Overall, China's e-commerce market does tend to be skewed heavily towards fashion and accessory purchases such as handbags, shoes, and cosmetics. Roughly 40 percent of all e-commerce transactions are fashion and accessories, purchased by younger, white-collar, urban female shoppers.[27]

The road to e-commerce success

Despite China's e-commerce growth, success is certainly not a given; businesses need to do their homework to understand the target market, and how best to influence and direct their on-line purchases. A common model is to sell through established e-commerce platforms.

Uniqlo, a Japanese 'brick and mortar' retailer, chose to operate on Alibaba's Tmall. Upon entry in 2009, Uniqlo set up two sites: a company-specific site that shows detailed information about the company as well as brand clothing offerings and price info, and another that is hosted on Tmall. The two sites use the same layout, categories, assortment, and pricing schemes, and because Uniqlo's site executes purchases through Taobao, both of Uniqlo's sites centralize ordering and payment with Alibaba.

There are many routes to success however, and many companies have had success without listing on an established platform.

Suning is one such example. Suning is a national 'big box' electronics retailer in China who entered the e-commerce arena relatively early, in 2009, and does not occupy space on Tmall. Their strategy called for the development of a user-friendly website, heavy in content and products. Suning also invested in technology to ensure seamless cross-channel fulfillment between their online store and their physical store. During the last four years, it expanded product categories online, as well as through mobile applications, to integrate its digital channel with its brick and mortar stores. From 2010-2012 online sales grew by a compounded annual rate of 190 percent,[28] and Suning is now rated amongst the top three B2C e-tailers in China, by market share.[29]

23. Bain Brief. 'China e-commerce: Heading toward RMB 1.5 trillion'. *Bain & Company*. February 27, 2012 http://www.bain.com/offices/china/en_us/publications/articles/china-ecommerce.aspx
24. McKinsey & Company '2012 Annual Chinese Consumer Report. From Mass to Mainstream: Keeping Pace with China's Rapidly Changing Consumers'. September, 2012 http://www.mckinseychina.com/wp-content/uploads/2012/09/McKinsey-2012-Annual-Chinese-Consumer-Report1.pdf
25. KPMG. 'The rapidly Changing Face of D-commerce'.pdf. November, 2013
26. 'Average value of U.S. online shopping orders in 2nd quarter 2013, by device (in U.S. dollars)'. *Statista*. September 2013 http://www.statista.com/statistics/239247/us-online-shopping-order-values-by-device/; KPMG. 'The rapidly Changing Face of D-commerce'.pdf. November, 2013
27. 'With E-Commerce Surging In China, Who Needs Brick-And-Mortar?'. Jing Daily. June 13, 2012 http://www.jingdaily.com/with-e-commerce-surging-in-china-who-needs-brick-and-mortar/18894/
28. Bain Brief. 'China's e-commerce prize'. Bain & Company. August 28, 2013 www.bain.com/publications/articles/chinas-e-commerce-prize.aspx
29. Steven Millward. 'A guide to China's top 10 e-commerce sites'. CNET. www.asia.cnet.com/blogs/a-guide-to-chinas-top-10-e-commerce-sites-62215025.htm

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Conclusion

China's e-commerce landscape is still experiencing rapid growth. For any businesses seeking entry into China's competitive e-commerce market, it would be advisable to develop a strategy that encompasses a thorough understanding of the target market, how consumers evaluate and purchase products, and how they prefer to utilize technology in the local market.

It is also important to devise strategies that not only cater to the needs of tier-1 consumers, but also those in other locations: these are important and growing markets for many businesses, but their purchasing behaviors are not uniform.

Finally, the approach toward and integration of social media should be a crucial element of any e-commerce strategy today, as consumers are increasingly integrating these applications into their every day lives.

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The emergence of Chinese multinational corporations (MNCs): Local and global implications

(This article is based on KPMG commentary *Dancing with the Dragon: The emergence of Chinese multinational corporations and what this means for the rest of the globe*).*

As China's national economy continues to globalize, it is important to see how this is playing out at the corporate level. A number of Chinese companies, both State-owned and private, are successfully internationalizing operations, in many cases in a matter of a few years.

Some firms have pursued overseas listings, some have entered into joint ventures or cooperation agreements with foreign companies, and others have expanded overseas through M&A, Greenfield investment, or other forms of outbound direct investment (ODI). As a result, the global business community is now seeing a new phenomenon: the Chinese MNC.

* http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Pages/Dancing-with-the-dragon-O-201309.aspx

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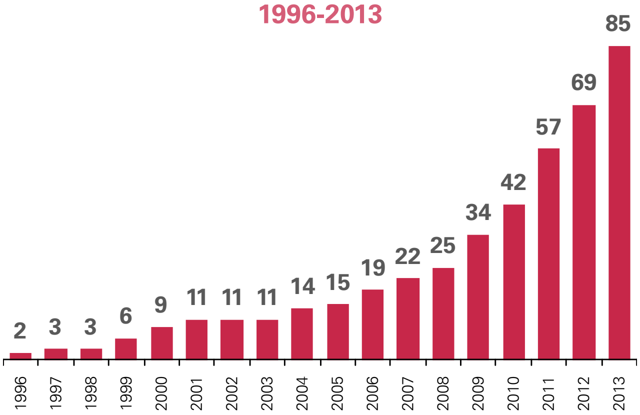
The rise of Chinese multinational companies

Over the last 30 years, as China has pursued policies of economic reform and re-balancing, China's corporations have evolved as well. Large private enterprises have hurtled into being, and even the largest State-owned enterprises (SOEs) have undergone massive change. Many of China's large companies, however, have developed in an environment characterized by strong domestic demand, comparatively low labor and variable costs, and the ability to set market prices due to limited or restricted competition.

These domestic market conditions, and the scale of the Chinese market itself, have helped to propel corporate growth for Chinese companies, with the result that some Chinese companies have quickly risen up the global league tables, to rank among the largest and most successful corporate players in the world.

As can be seen from the chart below, in the past three years alone, the number of Chinese companies in the 'Global Fortune 500' has more than doubled to 85 companies in 2013, versus 42 in 2010. By this measure, China recently overtook Japan, which has 62 companies on the Fortune list, and trails only the US, which still holds the top spot with132 companies.

Chinese Global Fortune 500 Companies, 1996-2013



Source: Fortune China. http://www.fortunechina.com/fortune500/c/2013-07/08/2013G500.htm

Chinese MNCs take advantage of market dynamics

China has long benefited from the flow of foreign direct investment (FDI) demand into the country. In recent years, however, it has been China's outbound direct investment that has garnered attention: ODI represents the willingness and ability of Chinese companies to invest directly in equity and/or assets of foreign companies located outside of China. China, long known as a top investment destination for MNCs, has recently grown its ODI to almost equal the amount it receives in FDI.

This trend started to gain momentum as the global crisis took shape in 2007 and 2008. It was during the global financial crisis, as well as the subsequent European debt crisis, that market prices (both equity and real assets) were pushed downward. Inside China, to mitigate the global financial crisis' impact on China's economy, the government helped lift domestic demand through a variety of stimulus packages, while adjusting policy measures and structural reforms. This helped enable Chinese companies to make purchases at suppressed market prices.

At the same time, the Chinese government has been allowing China's currency, the Renminbi (RMB), to marginally appreciate. Although a stronger RMB has had a clear impact on China's exporters and therefore its net export trade balance, it has also benefited Chinese companies looking to invest outward, by enhancing their purchasing power versus other local currency.

Over the past five years, a combination of factors has provided a tailwind to Chinese companies looking to invest outside of China: they have not only been making investment decisions to buy foreign assets at a time of lower global market prices, but have been doing so with a marginally stronger local currency.

The proof is in the numbers, and the numbers show a clear and sustained trend. China's ODI in the late 1970s was next to nothing, and as recently as 2002, China's ODI was only USD2.7 billion.[1] In just a decade, this figure had grown by leaps and bounds to hit a record USD87.8 billion in 2012,[2] which represents an 18 percent year-on-year increase.

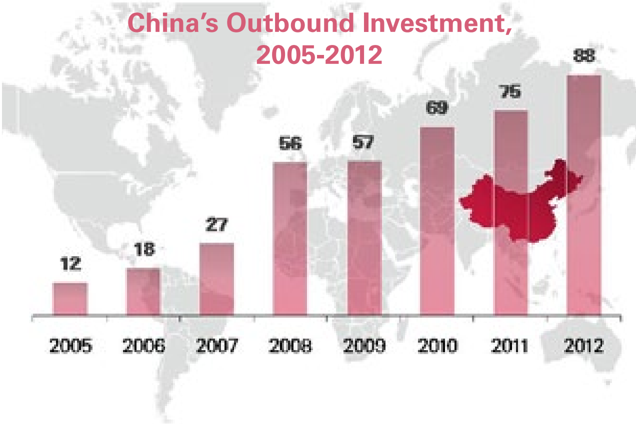
For the first time since its reform, China has become a top 3 outbound investor in global markets.[3] Thus, it is not a matter of 'if' China's ODI will exceed the FDI figure (USD111.7 billion in 2012[4]), but 'when'.

[1] Perkowski, Jack. 'Get ready for more China overseas investment'. *Forbes*, March 10, 2012. http://www.forbes.com/sites/jackperkowski/2012/10/03/get-ready-for-more-china-overseas-investment/

[2] 'China 2012 ODI hits record high'. *Xinhuanet*, September 9, 2013. http://news.xinhuanet.com/english/china/2013-09/09/c_132704494.htm

[3] Wang, Yanlin. 'China among top-3 global investors'. *ShanghaiDaily*, September 10, 2013. http://www.shanghaidaily.com/Business/finance/China-among-top3-global-investors/

[4] 'FDI inflow to China dropped by 3.7% in 2012 to USD111.7 billion, first time since 2009'. *Current Affairs Business News*, January 17, 2013. http://currentaffairs-businessnews.com/2013/01/17/fdi-inflow-to-china-dropped-by-3-7-in-2012-to-usd-111-7-billion-first-time-since-2009/



Sources: *2011 Statistical Bulletin of China's Outward Foreign Direct Investment.* China Statistics Press; 2012 data from the China Ministry of Commerce (*2012 Statistical Bulletin of China's Outward Foreign Direct Investment* remains unreleased at the time of publication)

MNCs with Chinese characteristics

Like earlier waves of fast-growing Asian MNCs from Japan, South Korea and Taiwan, and their contemporaries from India, Brazil and Russia, Chinese MNCs are bound to create an impact on the competitive landscape of the global business world. Competition for talent, capital, resources, consumers, and innovation will become more intense.

When looking at the implication for the rest of the globe, from the ongoing emergence of Chinese MNCs, it is important to remember that most Chinese MNCs have travelled on a different path to get to where they are today. By and large, the top companies in China have had the backing of the State, which means abundant resources, controlled competition, and low variable costs. The same companies that no one outside of China had heard of two years ago, are now making daily headlines on international newswires and even becoming market leaders in their respective fields.

Chinese companies are also choosing diverse industries and sectors to outwardly invest. In the recent past, Chinese companies were known for investing in narrow industries overseas such as engineering and contract projects, energy and power, metals and mining, automotive, and financial services. However, recently Chinese MNCs have been diversifying their reach. Substantial outbound deals have been made in progressive industries such as: consumer goods and services, real estate, or agribusiness industries. For example, Chinese privately-owned enterprise Dalian Wanda Group recently acquired AMC entertainment company in a deal worth around USD2.6 billion, creating the largest theater chain in the world.[5]

Issues and responses for Chinese multinationals

Despite international success stories, some Chinese MNCs have run into international resistance during their M&A transactions. Some of these setbacks can be attributable to local market political resistance, due to lack of corporate transparency. In China's domestic market, these companies may enjoy competitive advantages in terms of access to capital, scale, and de facto monopoly position in certain industries. However, when the focus turns to outbound investment, the ballgame shifts to the firm they are acquiring and the country's rules, restrictions, and transparency arrangements they must abide by.

In addition to the different management style and control characteristics of multinational SOEs, there are some other factors that may hinder the progress of these companies. For example, despite the stellar growth of China's mega companies inside China, they are rarely seen as influential or having strong brands in their respective industries. According to Interbrand's 'Top 100 Brands' list, a Chinese brand has yet to make the list. In contrast, many companies from smaller or emerging economies made the list in 2012, such as Spain's Santander Bank, and Mexico's Corona.[6]

Not only have Chinese companies failed to produce any global leading brands, but Chinese companies were also perceived to lack innovation and creativity. In *Forbes* 'The World's Most Innovative Companies' list, the magazine included only four Chinese companies out of 100 (namely Tencent, China Oilfield Services, Sany, and Zoomlion).[7] In addition, of the 50 companies ranked by *Fortune* as 'The World's Most Admired Companies 2013', none were from China.

[5] Voigt, Kevin. 'China firm buys AMC to form world's largest cinema chain'. *CNN*, May 21, 2012. http://edition.cnn.com/2012/05/21/business/china-amc-wanda-theater/

[6] 'Best Global Brands 2012'. *Interbrand.* http://www.interbrand.com/en/best-global-brands/2012/Best-Global-Brands-2012.aspx

[7] 'The World's Most Innovative Companies'. *Forbes.* http://www.forbes.com/innovative-companies/list/

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Although the world has yet to see a truly global 'brand name' from China, Chinese companies are making progress: Gree Electric Appliances is selling its air conditioning products in over 70 countries, while automaker Chery is exporting automobiles to over 50 countries. It is only a matter of time before the world starts recognizing innovative products from China.[8]

Chinese MNCs also lack experience managing a global business. Although Chinese companies may be quite effective at managing their sizable domestic operations, the challenge of running a multinational or global operation requires a different managerial skill set. Some companies simply are not yet 'mentally' ready to be global players; they tend to operate their global business in the same way they manage their domestic business. Managing daily operations overseas, including issues such as working with labor unions in other countries, has proven challenging to Chinese management in the past. In addition, Chinese MNCs have had difficulty bridging gaps in culture, deailing with unfamiliar legal environments, and different compliance landscapes from that of China.

It is likely that Chinese MNCs will make internal adjustments to their operating model, and also explore external-facing strategies, in order to be more effective in running a multinational business. Internal adjustments could include policies to hire or retain local talent to deal with local issues, training that is specific to local country processes, implementing an international rotation program, or setting up an internal government or community relations capability. External-facing strategies may include a systematic process to learn and manage local government expectations of compliance, teaming up with local organizations, such as non-governmental organizations or local community agencies, and bridging culture gaps or mitigating other operating challenges in the local context.

The future of POEs and SOEs on the global stage

Within the next 10 years, the outflow of Chinese overseas investment will touch a wide range of companies, industries, and geographies. Investors will comprise: privately-owned enterprises (POEs) and SOEs. Although SOEs have been behind many of the past 'headline-making' overseas investments, POEs will certainly play a more active role going forward. Compared to SOE companies, POEs are more market driven, flexible, efficient and nimble in decision making, and have clear ownership and incentive structures.

Deal industries will also become more diversified. Despite the continuing wave of large ODI deals in natural resources – oil & gas, coal, iron ore and minerals – future Chinese MNCs are not likely to be from these industries alone. Companies in the energy and resources fields are mainly State-owned, enjoy a monopolistic position in the domestic market, and are tasked with implementing the national strategy of securing resources. By comparison, companies in manufacturing, technology, and services have operated in a competitive environment in the domestic market, and maintain fewer government ties or obligations. They have also developed core capabilities in operations, and accumulated knowledge of the global market by associating with overseas business partners.

Xing Yujing, Secretary-General of China's Central Bank's monetary policy committee notes that "the Central Bank supports the ever-stronger RMB to purchase assets or equity in cross-border transactions", as the currency will offer SOEs and POEs greater global opportunity. In addition, Li Jinzao, Vice-Minister of Commerce, predicted "outbound investment from China will reach USD500 billion in five years"[9]

[8] Flannery, Russell. 'China Mobile tops best Chinese brands list'. *Forbes*, July 6, 2010. http://www.forbes.com/2010/07/06/china-top-brands-markets-emerging-markets-omnicom-group.html#

[9] 'Economy, ODI and currency bring opportunities'. *Xinhuanet*, September 26, 2013. http://news.xinhuanet.com/english/china/2013-09/26/c_132751252.htm

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The trend is clear that Chinese MNCs are emerging and making their presence felt all over the world. Whether they will follow the trajectory of MNCs from other countries remains to be seen – it is perhaps more likely that they will build upon their own successes and setbacks, rather than replicate the experience of MNCs from other regions.

Acquiring an understanding of their motivation and behavior will help the global business community better work with them, and create an overall benefit for the global economy. Developing effective strategies to interact and work with these new market participants is critical for the advancement of the world economy; global companies need to rethink their strategy in response to the changes that Chinese MNCs will bring to the competitive landscape.

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China 360

The rise of the urban ‘post-90s’ generation in China

September 2013

In 2012, a new generation of young people began to enter China’s workforce. This generation has been dubbed ‘the post-90s’ generation in China (90 后), and the traits and characteristics of this group has been extensively analyzed in Chinese society, just as the ‘Gen X’ and ‘Gen Y’ phenomena were in the West.

In China, the ‘post-90s’ generation is approximately 135 million[1] strong. They are a product of China’s economic reform policies, and over the next 10 years, will have an increasing impact on China’s economy and society. It would therefore be relevant to understand their expectations and motivations, what distinguishes them from their parents’ generation, and how they plan to add value to an economy that seeks to further develop its future GDP growth around consumer spending.

The allocation of resources in a post-1990s China

Growing up in the 1990s and 2000s, the post-90s generation have enjoyed the fruits of China’s economic rise: an economy growing at a double-digit pace, less government control over daily life, a proliferation of communication and information technology, greater access to local and foreign goods and services, and remarkable increases in family discretionary income.

The post-90s generation has also been raised in a stronger and more global China, with milestone events such as the 2008 Olympics, the 2010 Shanghai Expo, the successful Chinese space program and China’s emergence as the second largest economy all looming large for this generation.

For this issue of *China 360*, four KPMG post-90s professionals were interviewed, to capture views and opinions representative of urban post-90’s, about topics ranging from the economy and technology to consumer habits. What may come as a surprise is the stark differences in outlook, expectations, and consumer behavior between this group and their parents’ generation – the last generation of parents from China’s pre-one-child policy era.

[1] ‘Population of China: Statistics, trends, patterns and consequences’. Jeffrey Hays, http://factsanddetails.com/china.php?itemid=129

In contrast, the parents of the post-90s generation were raised in an entirely different China, which has potentially increased pressure and expectations of the post-90s to take advantage of the new opportunities available to them.

Some examples of China's 30 years of economic progress that have contributed to the post-90s' improved living standards are listed below:

- In 2012, China's per capita GDP was approximately RMB38,000 – versus RMB527 in 1982.[2]
- In 2012, there were nearly 7 million university graduates in China – versus 450,000 in 1982.[3]
- In 2012, there were nearly 340,000 Chinese students studying abroad – versus approximately 10,000 from 1980-1985.[4]

"It is important for our parents to provide for us, because our parents do not want us to struggle like they had to. At times, they were unsure if they had enough food or water to share with rest of the family."

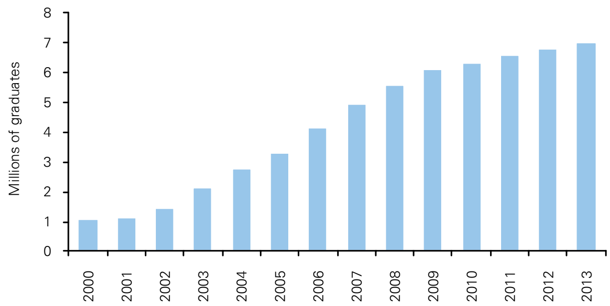
– **Rani Guo,** Transactions & Restructuring, KPMG China. Birth year: 1990

Generation driven by higher expectations, more alternatives

China's growth and prosperity over the past few decades has provided the post-90s with tangible economic benefits, but has also clearly bolstered the confidence and the expectation of future success for this generation. More than ever before, this generation is open to choosing jobs that will satisfy their personal passion, rather than focus only on a traditional 'successful career path' as defined by their parents.

As this cohort enters the workforce in record numbers, however, China's economy is shifting toward a new stage of development – marked by substantially slower economic growth rates. The double digit growth rates of the 1990s and 2000s are likely to continue to moderate between 6 and 8 percent, with implications for the career prospects for the post-90s.

College graduates in China



In 2000, there were just over 1 million new college graduates in China. As of 2013, this number has skyrocketed to nearly 7 million.[5] In the current economic cycle in China, a considerable number of new post-90s graduates have been unable to secure a specific job or position they desire, and many are electing to delay the start of their career. Newly minted graduates are opting to pursue higher education options, at home or overseas: recent reports suggest that nearly 20 percent of graduates[6] from Beijing universities prefer to further their education with post-graduate degrees.

[2] National Bureau of Statistics of China, http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20130221_402874525.htm; 'National data'. National Bureau of Statistics of China, http://data.stats.gov.cn/search/keywordlist2?keyword=GDP%201982

[3] Liu, Qiang. '6.99 mln grads hit market'. *China.org.cn*, May 20, 2013. http://www.china.org.cn/china/2013-05/20/content_28875009.htm; National Bureau of Statistics of China, http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20020331_15376.htm

[4] China Market Report Center, http://www.chinairn.com/news/20120918/639306.html; *China Inspection and Quarantine Times*, http://cngm.cqn.com.cn/cngm201002/html/2009-09/09/content_38334.htm

[5] Liu, Qiang. '6.99 mln grads hit market'. *China.org.cn*, May 20, 2013. http://www.china.org.cn/china/2013-05/20/content_28875009.htm

[6] Liu, Qiang. '6.99 mln grads hit market'. *China.org.cn*, May 20, 2013. http://www.china.org.cn/china/2013-05/20/content_28875009.htm

> **"Our parents' generations were programmed to focus on their initial job. They did not have many choices like we have. If they were textile producers in the 1970s or 1980s, their primary career goal would be to focus on knowing everything about how to manufacture textiles and become experts in that area, irrespective of liking or disliking the job."**
>
> – **Emily Qu,** Transactions & Restructuring intern, KPMG China. Birth year: 1990

Consumer awareness

The consumer behavior and awareness of the post-90s is markedly different from previous generations. Although they are the youngest and newest generation of independent consumers and may still have relatively limited consumer purchasing power, the post-90s generation is both more willing and able to access more specific product information and feedback than past generations.

They are able to effectively take advantage of the information explosion represented by social media sites, micro-blog feedback services, direct product websites, and peer-to-peer instantaneous feedback via China's now-ubiquitous messaging platforms. This heightens their ability to make informed and researched decisions about products and services, creating both opportunities (to build a loyal customer base) and risks for companies (those unable to respond nimbly to issues, trends, and consumer demands).

The technological savviness of the post-90s generation makes them de facto 'experts' in the eyes of elder generations, and this means that they wield influence (and even decision-making power) beyond their own personal spending capacity, by impacting the purchase decisions of their family or elder acquaintances. One study[7] suggests that urban youth consume, or directly influence, 50 percent or more of their family's expenditures. Nearly one-third said they made decisions about major purchases, including houses and cars, and over 60 percent of urban post-90s youngsters have their own credit card. In terms of corporate advertising and marketing, the post-90s are an important target for companies to build up their brand equity.

> **"People look to us for information, we have the greatest ability to seek out and obtain information about products' functions and uses. Thus, our elders (especially our family members) trust us to know what products are most reliable, have the widest uses, or are worth the steep price tag."**
>
> – **Marc Zhao,** Transactions & Restructuring, KPMG China. Birth year: 1990

[7] Kisselmann, Olga. 'China's post-90 generation is making its mark'. Digital Development Debates, http://www.digital-development-debates.org/issues/11-youth/lifestyle/chinas-post-90-generation-is-making-its-mark/

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The target market

Companies that have started aggressively marketing to post-90s are finding that they are a challenging group to target. This demographic often chooses to forego brand name purchases, in favor of choosing a product that retains the greatest long-term value. In a recent survey, only 13.3 percent of responders reported that a brand was the first factor they considered when shopping, while 65.2 percent took both brand and practicality into account when making a purchase. Before making a purchase decision, 70 percent said they considered both quality and price in shopping decisions, while 47.3 percent viewed the product's style and design as 'important decision-making factors'.[8]

Leading consumer product companies, such as China-based sporting goods and apparel giant LiNing Corporation, are finding it difficult to connect with this young group. According to LiNing, "this generation is not lured by the star power as past generations were. They are young and hard to interpret, but will become the pillar of China in the next 10 to 15 years. They are better educated than consumers from past generations."[9]

"Everyone knows staple products such as Apple, everyone trusts these products. But for foreign or domestic products that are lesser known, more diligent research is necessary for me to make a purchase."

– **Li Nan,** Global China Practice intern, KPMG. Birth year: 1991

Chinese consumer electronics manufacturer Xiaomi, on the other hand, is a local company that is having tremendous recent success with young Chinese consumers. The company has not only developed a reputation for quality products at an affordable price point, but also allows users an open-ended platform to contribute feedback, allows other users to view the feedback, and even encourages them to make suggestions for forthcoming software releases.[10] This embrace of consumer engagement taps into the very fabric that motivates the post-1990s generation to make purchases and stay loyal to a brand.

It is also important to remember that the post-90s, growing up entirely in the internet age, are avid users of e-commerce channels to purchase products. China's 2012 e-commerce purchases amounted to USD212 billion versus USD228 billion in the US, representing average 71 percent average year-on-year growth of China e-commerce since 2009, versus 13 percent from the US.[11] Forecasts have China outpacing the US to become the largest e-commerce market in the world by the end of this year.[12] This extraordinary growth is driven in large part by the technologically savvy consumers of the post-1990s generation.

"Technology has taken over our lives. I don't think I could ever live without it. I don't remember a time where I haven't been using it, or adjusting to it."

– **Marc Zhao,** Transactions & Restructuring, KPMG China. Birth year: 1990

[8] Kisselmann, Olga. 'China's post-90 generation is making its mark'. Digital Development Debates, http://www.digital-development-debates.org/issues/11-youth/lifestyle/chinas-post-90-generation-is-making-its-mark/

[9] 'Brands struggle to connect with China's "Post-90s" generation'. *Jing Daily*, http://www.jingdaily.com/brands-struggle-to-connect-with-chinas-post-90s-generation/19296/

[10] Perez, Bien. 'Xiaomi eyes global expansion as it hires Google's Hugo Barra'. *South China Morning Post*, August 30, 2013. http://www.scmp.com/business/china-business/article/1300477/xiaomi-eyes-global-expansion-new-hire-google; Hong, Kaylene. 'Here's why you should care about rising Chinese smartphone firm Xiaomi'. *The Next Web*, September 6, 2013. http://thenextweb.com/asia/2013/09/06/heres-why-you-should-care-about-rising-chinese-smartphone-firm-xiaomi/

[11] Carsten, Paul. 'Chinese shoppers set to become world leaders online'. *Reuters*, August 28, 2013. http://www.reuters.com/article/2013/08/28/net-us-china-ecommerce-idUSBRE97R0GT20130828

[12] Ding, Yining. 'China's online sales may overtake US'. *Shanghai Daily*, August 29, 2013. http://www.shanghaidaily.com/Business/consumer/Chinas-online-sales-may-overtake-US-/shdaily.shtml

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China 360

Innovated in China: New frontier for global R&D

August 2013

For much of the past 30 years, manufacturing investment has been the driving force behind the foreign direct investment (FDI) landscape in China, and China has developed a global reputation as the factory of the world. During this time, Chinese companies were typically not viewed as true innovators; foreign companies, for the most part, kept their advanced designs and products off-shore.

However, the focus of China's government, domestic companies, and global corporations alike, is now clearly shifting toward research and development (R&D) – especially R&D in China, for China, and for the rest of the world. With strong support from the 12th Five-Year Plan, and underpinned by corporations' need to innovate their way to success in a competitive market, R&D activities in China are entering a new era.

Multinational companies (MNCs) and foreign-invested enterprises (FIEs) are increasingly locating key R&D activities in China, not only because of tangible business advantages (and incentives), but also to be closer to the ever-expanding Chinese market. While it is commonly known that China has surpassed the US to become the world's largest manufacturing nation, it will come as a surprise to many that China may soon become the world's global R&D investment leader as well.

This month's *China 360* examines the new R&D landscape in China, including some emerging R&D hot spots and available incentives. The article will also explain some of the advantages and challenges of setting up R&D centers in China, as well as the current and historical trends that support growth of China-based R&D activities.

The China R&D attraction

China is quickly rising up the global ranks in a number of intellectual property-heavy sectors, from healthcare and biotech, to high-tech manufacturing, information technology, and alternative energy. In the last ten years, R&D investment in these sectors has been significant, and the number of MNCs setting up R&D centers in China continues to rise. Since 2000, the number of foreign-invested R&D centers has increased from under 200 to over 1,300.[1]

R&D spending in China is rising as a result. In 2011, China passed Japan to place second in the world for total R&D spending,[2] and in 2013, China is expected to spend approximately USD220 billion. While this still places China a distant second behind the US (the 2013 forecast is USD424 billion), based on current R&D growth trends, China is on track to overtake the US in about 10 years;[3] according to a United Nations report, China had already surpassed the US to become the world's 'most attractive' destination for R&D investment.[4]

1 'World to gain from an innovative China'. *The Business Times*, July 11, 2011. http://www.businesschina.org.sg/en.php/resources/news/317/1

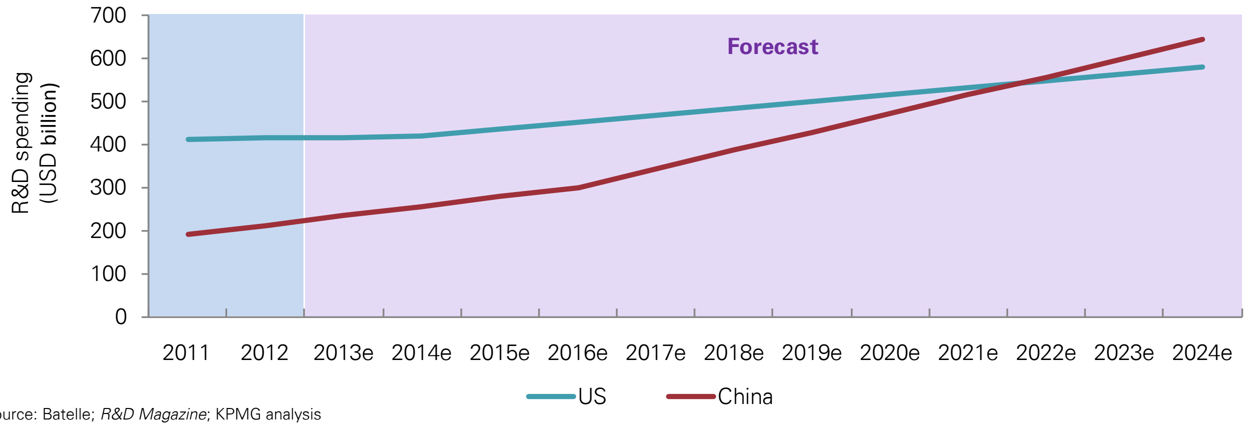
2 Naik, Gautam. 'China surpasses Japan in R&D as powers shift'. *The Wall Street Journal*, December 13, 2010. http://online.wsj.com/article/SB10001424052748703734204576019713917682354.html

3 Thibodeau, Patrick. 'China set to surpass U.S. in R&D spending in 10 years' *Computerworld*, December 24, 2012. http://www.computerworld.com/s/article/9234976/China_set_to_surpass_U.S._in_R_D_spending_in_10_years_

4 'Building successful research and development centers in China'. Russell Reynolds Associates http://www.russellreynolds.com/zh-hans/content/building-successful-research-and-development-centers-china

Although R&D and innovation has arguably not been a significant driver of China's development in recent decades, a number of factors are underpinning increased R&D activity. Increasingly sophisticated local tastes and technology standards in China, and the need for Chinese companies to compete in the global market are among the drivers for Chinese R&D. The government has not only made massive investments in technology and industrial parks to support and facilitate the move toward indigenous innovation, they have introduced policies to create an environment that will attract and sustain R&D investment in the future.

Annual and projected R&D spending, US and China



Source: Batelle; *R&D Magazine*; KPMG analysis

Ongoing policy reform favors R&D in China

Around 10 years ago, China began to reform its legal environment and offer attractive benefits for R&D investments. In 2006, China's government released the 'National Medium- and Long-term Program for Science and Technology Development' (2006-2020). Some of the goals of this Program were to:

- increase R&D expenditure as a percentage of GDP to 2.5 percent by 2020
- derive more than 60 percent of China's economic growth from technical progress by 2020
- position China as fifth in the world for patents and citations of publications worldwide.[5]

Subsequently, in the last decade employment in the R&D sector in China increased from about one million to 2.8 million, while R&D as a share of GDP doubled, from 0.8 percent to 1.75 percent.[5] This compares favorably to many other developing nations, such as Brazil, Russia, and India, whose R&D contribution as a percentage of GDP were 1.2 percent, 1.2 percent, and 0.8 percent respectively.[6]

Policies and guidance to support intellectual property rights (IPR) have also been significantly upgraded in the last decade. Since the implementation of a national IPR strategy in 2008, China's leading companies have focused on strengthening their capabilities in IPR creation, utilization, protection, and management. In addition, the implementation of national plans to protect IPR, such as the 12th Five-Year Plan on National Intellectual Property Development (2011-2015) and the 12th Five-Year Plan for Patent Examination (2011-2015), have increased the confidence of foreign-invested enterprises conducting R&D in China.[7]

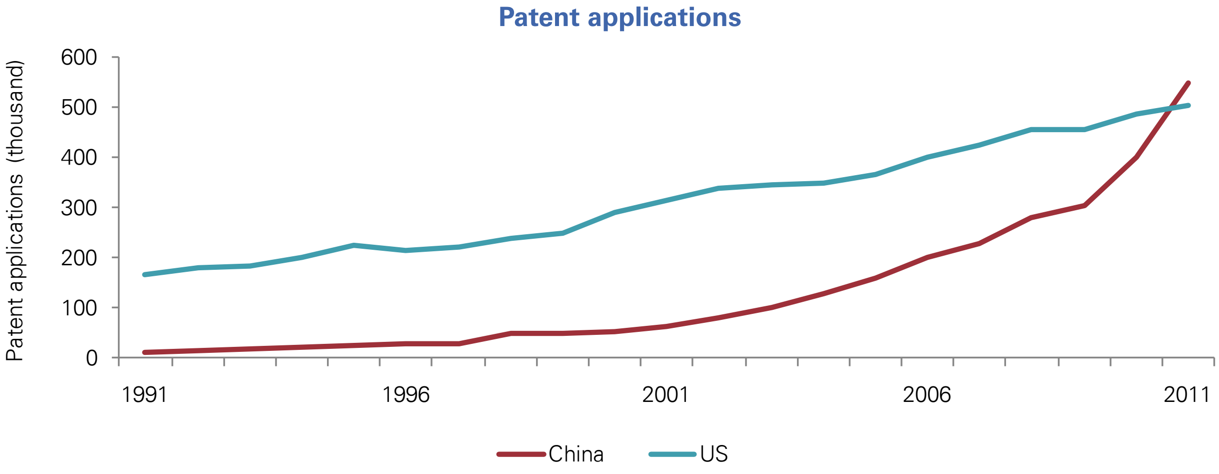
More favorable policies and IP protection measures have contributed to an increase in the number of applications for patents and inventions in China. In 2011, China reported 525,000 patent filings, compared to just over 500,000 for the US. Only a year earlier, China ranked a distant second to the US, with approximately 400,000 patent applications versus 490,000 in the US.[8] While some have challenged the numbers as potentially reflecting quantity rather than quality of innovation, the trend shown in the graph below is clear.

[5] Fabre, Guilhem and Stéphane Grumbach. 'The world upside down, China's R&D and innovation strategy'. Fondation Maison des sciences de l'homme, April 7, 2012. http://hal.inria.fr/docs/00/68/63/89/PDF/FMSH-WP-2012-07_Fabre-Grumbach.pdf

[6] Garcia Herrero, Alicia, and Fielding Chen. 'Innovation: Where does China stand?' *Economic Watch*, June 8, 2012. BBVA http://www.bbvaresearch.com/KETD/fbin/mult/120608_ChinaWatch_Innovation_EN_tcm346-332809.pdf?ts=2082013

[7] Bin, Yang. 'It pays to know where you stand on R&D'. *China Daily*, November 23, 2012. http://usa.chinadaily.com.cn/weekly/2012-11/23/content_15952428.htm

[8] Garcia Herrero, Alicia, and Fielding Chen. 'Innovation: Where does China stand?' *Economic Watch*, June 8, 2012. BBVA http://www.bbvaresearch.com/KETD/fbin/mult/120608_ChinaWatch_Innovation_EN_tcm346-332809.pdf?ts=2082013



Source: Garcia Herrero, Alicia, and Fielding Chen. 'Innovation: Where does China stand?' *Economic Watch*, June 8, 2012. BBVA http://www.bbvaresearch.com/KETD/fbin/mult/120608_ChinaWatch_Innovation_EN_tcm346-332809.pdf?ts=2082013; KPMG analysis

Incentivizing foreign-invested entities

Governments from different countries can choose among various tools to attract and expand R&D business activities. They can offer direct support via government grants and procurement, or they can use a more indirect approach by offering fiscal incentives, such as tax holidays and credits. China is pursuing a multi-pronged approach that includes government policy measures to support R&D efforts, as well as a number of attractive tax measures to incentivize R&D investment.

These incentives may include:[9]

- reduced corporate income tax rates (15 percent versus 25 percent) for 'high and new technology enterprises'
- a super deduction of eligible R&D expenditures (expense deduction of 150 percent versus 100 percent)
- tax concessions for advanced technology service enterprises
- customs duty and value-added tax exemption/refund for purchases of R&D equipment, and
- concessions for technology transfers.

There may also be additional local or municipal subsidies available when investing in specific cities in China. The following are two examples:

- In 2009, Shanghai's municipal government introduced subsidies for corporations engaged in pharmaceutical research and development. Shanghai approved a 10 percent government subsidy for additional investment in biomedical or biopharmaceutical research, development, and production. The subsidy can be increased to 30 percent of an investment in new technologies that represent a major breakthrough, or in the construction of a public research platform.[10]
- In Chongqing, as well as other western areas of China, local and municipal subsidies may be granted to companies supporting government-backed industries. For example, a 15 percent income tax rate is available for enterprises established in the western regions of China engaged in industries supported by national policy, which includes research and development. In addition, Chongqing's local government may grant financial subsidies for 'new products' developed in Chongqing.[11]

[9] 'Securing R&D tax incentives in China'. KPMG, October 2012. http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Pages/Securing-Research-Development-Tax-Incentives-in-China-201210.aspx

[10] 'Development of Shanghai's pharmaceutical industry'. Information Office of Shanghai Municipality, May 28, 2013. http://en.shio.gov.cn/presscon/2013/05/28/1152304.html

[11] 'Chongqing new northern zone: China's inland open economy demonstration zone'. Chongqing Municipal Government, December 29, 2010. http://en.cq.gov.cn/Investors/PriorityDevelopmentRegion/2983.htm

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The rise of R&D localization

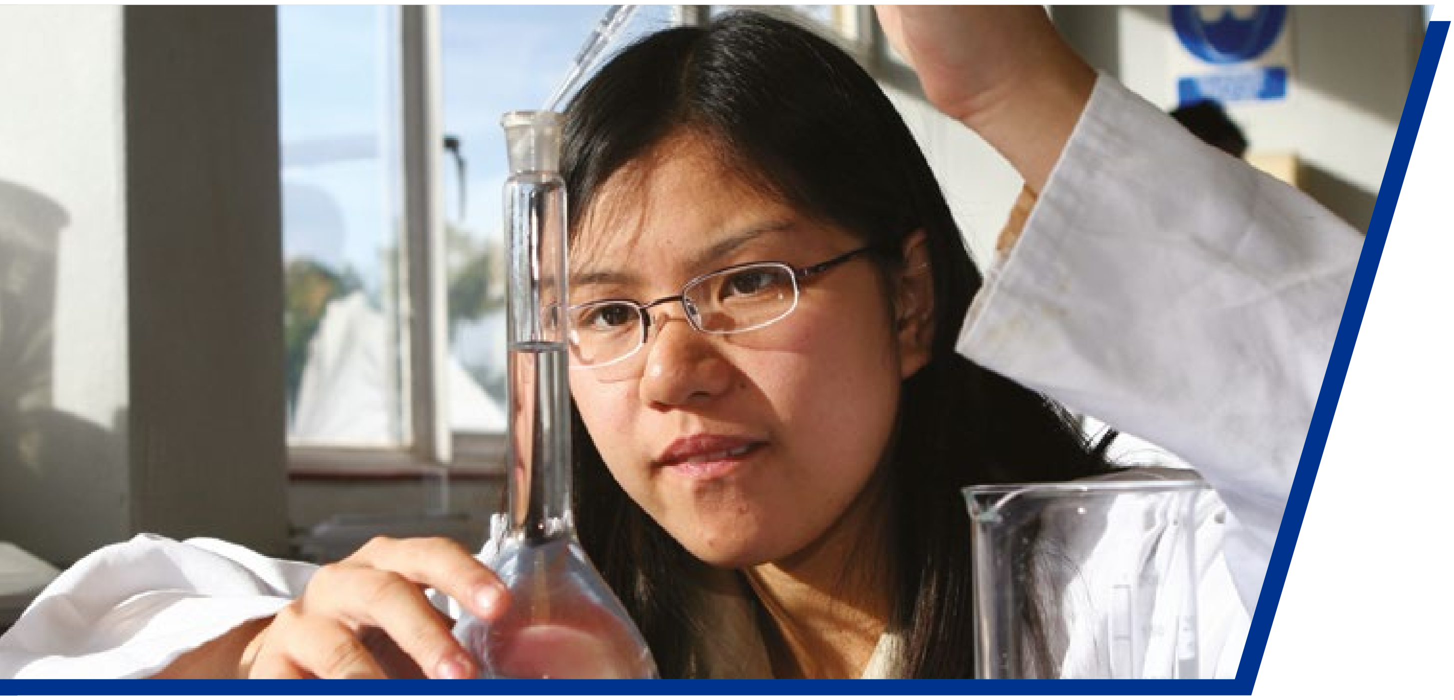
Currently, there are over 1,600 R&D centers in China,[12] with at least 1,300 belonging to multinational corporations – up from just 120 in the year 2000.[13] This number continues to rise rapidly thanks to the ongoing investment interest by MNCs: of all major multinational companies investing in R&D, 61 percent now have at least one research and development center already set up in China.[14]

A key reason behind this explosive growth is the ongoing desire for MNCs to localize products in China. For decades, the sheer size of China's market tempted many of the world's largest companies, which previously served China with products created elsewhere and adapted them for mainland sale. Today, multinationals have been moving R&D closer to their target market, not only to get closer to customers, but to better enhance their products toward local market preferences.

Some recent examples are listed below:

In 2012, PepsiCo (owner of Frito-Lay and Quaker Brands) opened its largest R&D center outside of the US, in Shanghai. Their new USD45 million facility includes kitchens where PepsiCo chefs develop new flavors suitable for the Chinese marketplace; laboratories where they taste-test the product with consumers; and plants where test batches are produced. The resulting products can hit China's shelves in as little as two weeks – and cater to Chinese customer tastes: purple sweet potato oatmeal and hot and sour fish soup-flavored potato chips.[15]

BASF is a leading chemical company servicing several diversified industries. In early 2004, BASF established the BASF Asia Technical Center in Shanghai; nine years later, they have a total of 10 R&D centers in Shanghai, and recently opened a USD75 million innovation center, also in Shanghai, which is their greater China headquarters. According to the Vice-Chairman of the BASF Board of Directors, "BASF continues to increase investment in China because the BASF product lines need to be adjusted to China requirements and tastes, and their proximity needs a more efficient location to better service customer requests."[15]



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Top spots for R&D

Shanghai and Beijing are undeniably the leading cities for R&D activity by MNCs in China. Beijing has over 550 such R&D centers,[16] while Shanghai has over 350.[17] One location in Beijing – the Zhongguancun Science Park – is the largest science and technology park in China. It houses nearly half of all R&D centers in Beijing, and is often referred to as 'China's Silicon Valley'.[18] Top MNCs include: Hewlett-Packard, Samsung, IBM, Motorola, Sony, Microsoft and Sun Microsystems.

Although Beijing and Shanghai remain the two largest cities for research and development, local governments from tier-two and tier-three cities are actively offering incentives to locate new or transferred R&D operations to their cities. Xi'an, Chengdu, and Chongqing, all in the interior of China, are attracting greater foreign R&D interest and investment. Recent moves by MNCs toward these tier-two cities can be seen below:

IBM – In 2010, IBM announced the opening of their rational software analyzer lab and regional software growth center in Xi'an. It opened with 200 employees but plans to continue its expansion for the next 10 years. Currently IBM operates seven regional software growth centers in China, comprising: Xi'an, Nanjing, Jinan, Wuhan, Hangzhou, Shijiazhuang and Shenyang.[19]

Applied Materials – In 2009, Applied Materials opened a 400,000 square foot solar technology center in Xi'an. Applied Materials is the world's largest supplier of equipment to the photovoltaic industry, and believes that this facility will help improve industrialization of its solar modules and scale production to lower cost.

EMC – In 2011, EMC announced that it had established its third R&D center in China, located within the country's largest professional software park in Chengdu. The new facility aims to better service Southwest and Northwest China, promote business development in the region, and attract international talent due to its highly livable environment. According to EMC management, the local talent pool from universities and research institutions was "better than corporate expectations",[20] and they expect to benefit from local talent – which is often cheaper than talent in Beijing or Shanghai.

R&D in China – Challenges and upsides

In the past, due to a lack of qualified technical personnel, MNCs might have had doubts about setting up R&D centers in China. This situation has drastically changed, as China is the biggest 'producer' of science graduates in the world. Currently, there are more than seven million[21] new university graduates per year (and rising) in China. Approximately 900,000 of these are engineering majors, compared to only 80,000 in the US.[22]

However, expectations that a Chinese R&D facility will come with a small price tag may be a bit dated. Although construction, plant, and property costs are still quite low in China, particularly away from the coastal regions, salary costs for skilled R&D staff may not be as minimal as some may expect. While junior staff may be 25 to 30 percent cheaper than in the US or Europe, costs for middle managers may be comparable, while packages for senior managers may actually be 20 to 25 percent higher.[23] This is due to a short supply of senior R&D managers in China, as well as relatively strong demand from both local and MNC rivals, who will bid up potential employee salaries to land highly skilled senior R&D management in their facility.

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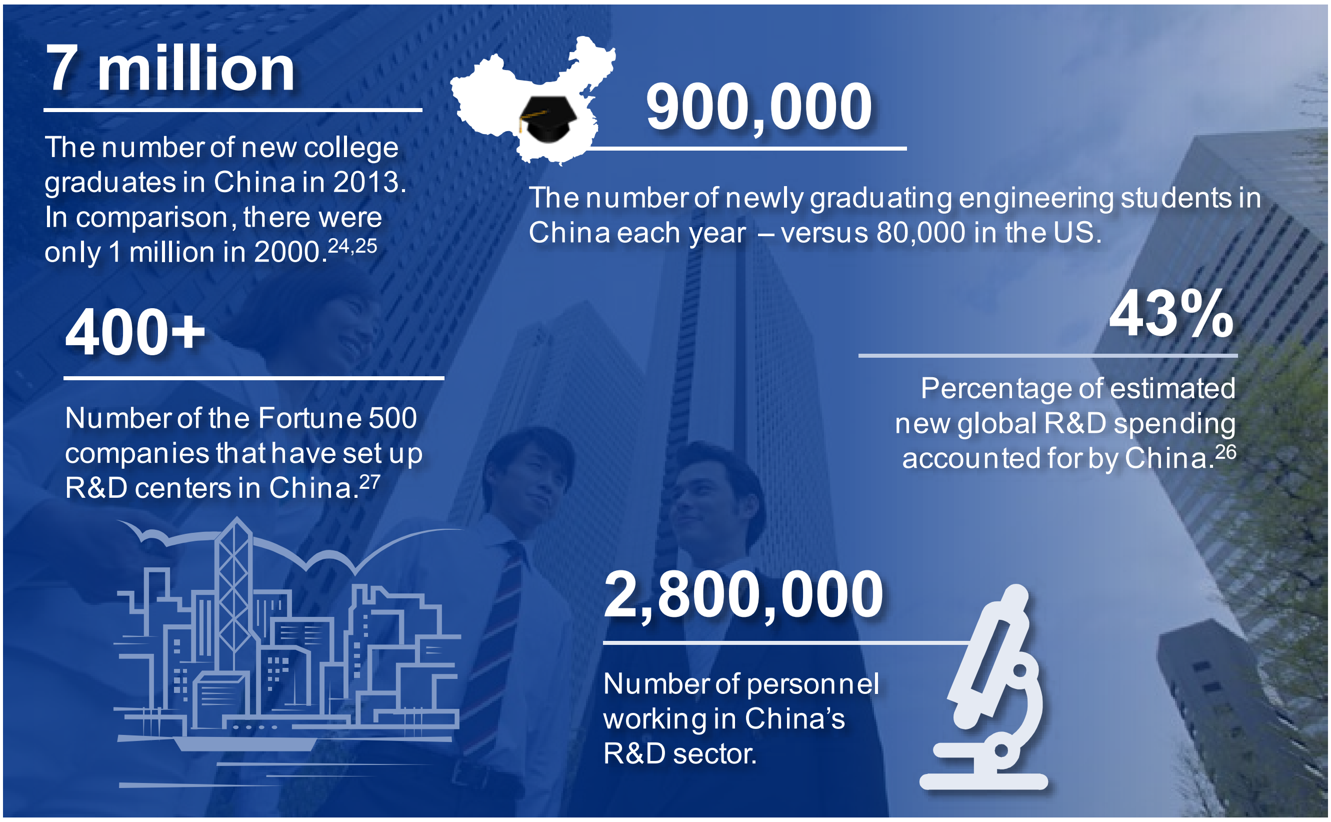

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China R&D outlook

Foreign direct investment into China continues to outpace the global economy, and R&D investment into China is playing an increasingly significant role.[28] In 2012, while many countries experienced significant FDI declines, China's FDI decreased only marginally, due in part to R&D investment into China. In 2013, global R&D spending is forecast to grow by USD53.7 billion, to USD1.5 trillion: China is expected to account for USD23 billion (or over 40 percent) of this projected growth.[29]

It is expected that the R&D investment boom in China still has many years of growth ahead. Given the diversity of sectors undertaking R&D, the continuous growth of R&D centers in China, and MNC expansion to second- and third-tier locations, it would seem that R&D as a percentage of total FDI will also continue to climb. Additionally, not only is the government (both nationally, and at the local levels) actively encouraging this form of clean, high-value added, knowledge-based investment, corporations are also finding that basing R&D activities in China provides a strong competitive boost to their ability to service a large and growing market.

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