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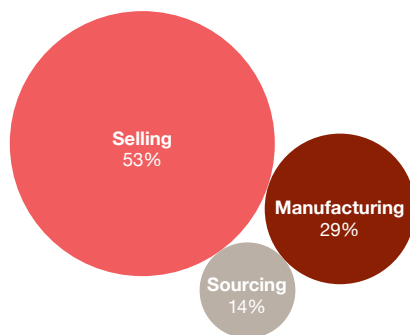
China strategy
Refining yours could open new doors

China strategy: Refining yours could open new doors

Private companies' entrepreneurial agility may give them a key advantage in today's China, where business success increasingly depends on flexibility and finding common ground.

Best business opportunities in China, as cited by private companies

Source: *Building a Presence in Today's Growth Markets: The Experience of Privately Held Companies*, PwC, 2011



Looking to regain growth momentum lost during the recession, many private companies are setting their sights on China.¹ And for good reason: China is the world's fastest-growing major economy, providing ample business opportunities for companies headquartered in slower-growing Western markets.² But what Western businesses want from China—and the best way to go about it—is changing in many cases. What China wants in return is changing as well.

For their part, Western private companies are less interested in making goods in China these days than they are in selling them there. This reflects how rising wages are not only turning Chinese workers into consumers, but also making those individuals more expensive to employ. So while low-cost manufacturing continues to draw private companies to China, for many of them it's no longer the primary lure. Nor is China, for its part, relying wholly on exports to drive its growth, as it once did.

Rather, China's 12th Five-Year Plan (unveiled in March 2011) is focused on boosting domestic consumption, as well as shifting growth and investment inland. That shift may open up new opportunities for businesses that are willing to venture away from China's coastal cities, where competitors are saturating the market and skilled workers are at a premium. At the same time, higher wages and better employee benefits (additional goals of China's Five-Year Plan) should encourage more household spending across the country, leading to potential windfalls for appropriately positioned foreign businesses—while also presenting challenges for companies relying on China as a manufacturing hub.

Challenges are by no means restricted to manufacturing companies. Western businesses in general—whether they be big or small, public or private, manufacturers or sellers—are grappling with China's highly localized, relationship-driven culture, lack of protection for intellectual property rights, perceived growing protectionism, and struggles with an evolving regulatory environment, among other conditions.

¹ *Building a Presence in Today's Growth Markets: The Experience of Privately Held Companies*, PwC, 2011: A whitepaper based on a survey of 158 private-company executives primarily headquartered in North America and Western Europe.

² In a 2010 survey by the American Chamber of Commerce in Shanghai, 87% of respondents reported revenue growth; 79% reported being either very profitable or profitable; 61% reported gaining market share for their China products/services; and 71% expect a revenue increase in China of more than 10% in 2011. All indicators were up significantly from the corresponding figures in the 2008 and 2009 surveys.



69% of Western private companies say they are either doing or planning to do business in China.

Source: Building a Presence in Today's Growth Markets: The Experience of Privately Held Companies, PwC, 2011

“One way that some Western companies are dealing with these challenges is by paying closer attention to the interests of Chinese stakeholders and seeing where alignment can be achieved,” says Martin Foley, a PwC partner who’s worked with a variety of US private companies operating in China. “Those businesses have begun to seek common ground and mutually beneficial value propositions with China’s stakeholders—including the government, customers, suppliers, employees, and even competitors—making this a key part of their China strategy.”

Some would say this approach accords with the direction of US-China relations overall: As Eswar Prasad, a senior fellow at the Washington-based Brookings Institution, recently noted, “The two countries are becoming increasingly evenly matched in terms of economic clout.... The *quid pro quo* approach may be the only productive avenue.”³

The traditional strategy

Whether a *quid pro quo* approach and stakeholder alignment become standard practice for Western companies operating in China remains to be seen. To date, such companies have tended to rely on a handful of well-rehearsed methods for market entry and expansion in China: set up a sales representative office, enter a joint venture with a Chinese partner (often required for investment in certain industries), or establish a wholly foreign-owned enterprise (WFOE)—with Hong Kong and China’s seaboard being the favored locations. Foreign businesses with deep pockets have also made outright acquisitions of Chinese companies.

Common to all of these methods—acquisitions, WFOEs, majority-ownership joint ventures, and sales-rep office setups—has been the foreign company’s ability to maintain control (over operations and quality) and efficiently export profits.

Often such approaches have been a logical extension of a company’s larger global strategy, with a team of experienced expatriate executives brought in to adapt the company’s global business practices to local operations. Chinese staff have been expected to adapt as well—to the business culture of their Western employer. Many are English-speaking graduates from China’s top universities, which tends to hasten the assimilation process, as do employee-development programs that some companies offer.

That many foreign investors—large multinational corporations (MNCs) and small businesses alike—continue to apply this overall strategy for doing business in China speaks to its ability to achieve positive results.

3 US-China Strategic and Economic Dialogue; two-day high-level policy talks held in Washington, D.C. on May 9 and 10, 2011

4 *ibid*

5 http://www.uschina.org/statistics/fdi_cumulative.htm

6 National Bureau of Statistics of China

7 Jeffrey Immelt speech to AmCham Shanghai at the 2010 Shanghai World Expo, June 2, 2010
<http://www.amcham-shanghai.org/AmChamPortal/Event/EventDetail.aspx?EventId=4486>

8 *Financial Times*, “Foreign Groups Told to Make Chinese Cars,” March 20, 2011

New considerations

As China continues to evolve, and at an accelerated pace, some Western companies have begun to consider refining their business strategy in that country. They see a China that, strengthened by its economic success over the past 30 years—as well as emboldened by its quick recovery from the global economic crisis—is changing the way it views both itself and its trading partners, with implications for how foreign businesses will operate in China going forward.

Some of those implications appear favorable to Western businesses, such as those likely to result from China's continued effort to align its policies and business practices with mature markets—e.g., via participation in the World Trade Organization and the country's recent commitment to delink its government procurement policies from its indigenous innovation policies.

Nevertheless, many Western businesses are skeptical. Not all of them are convinced that China's government will heed Treasury Secretary Timothy Geithner's call for the two countries to "share in the fortunes and bear the hardships together."⁴ Rather, they see a China that's seeking its own path of development, one that won't necessarily converge with the intended path of Western MNCs.

Why, such skeptics might ask, would China want to change policies and institutions that ushered in \$641 billion in foreign direct investment from 2000 to 2009,⁵ produced 9.91% average GDP growth from 1979 to 2010,⁶ helped to create globally competitive Chinese companies such as technology giant Lenovo and home-appliance producer Haier, and allowed China's economy to emerge from the global recession relatively unscathed?

Their skepticism notwithstanding, MNCs are unlikely to drop China from their business strategy. What they may do instead is seek a clearer understanding of where the ground is shifting—the better to position themselves for success in China's evolving business landscape.

Where the ground is shifting: Challenges and opportunities

There is no crystal ball that can show US companies precisely where and how China's business landscape will change over the next several years. But there is a blueprint: China's latest Five-Year Plan, which presents the central government's agenda for China's economic growth through 2015.

"What I love about China is that it's transparent," remarked GE Chairman and CEO Jeffrey Immelt in a speech last year. "You don't have to guess. You just say, 'What's the next Five-Year Plan?' Okay, here's our company strategy...here's where we're going."⁷ Admittedly, the average private company might not find it so easy as all that. Still, an understanding of China's Five-Year Plan, and its socioeconomic backdrop, provides an indispensable compass for any Western business attempting to navigate the Chinese market. Here are some chief considerations for private companies to keep in mind as they chart their course forward:

China's desire to move up the value chain

As China focuses less on low-cost manufacturing and more on moving up the value chain, various sectors have begun to question whether continued cooperation with foreign companies is the best way to achieve that goal. Some Chinese stakeholders argue that decades of foreign investment and growth have resulted mostly in massive profit exportation while doing little to build Chinese brands and develop local intellectual property.

"During 10 years of trying, China has become a big factory for foreign companies, and their Chinese partners didn't get advanced technology," says Lang Xuehong, automotive analyst with Sinotrust. "Through [its new industrial policy, the central government] would like Chinese carmakers to get IP in order to own this market."⁸



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The industrial policy Lang references has led to a number of significant changes in China's regulatory environment vis-à-vis foreign companies. Gone, for instance, are the nationwide tax incentives for foreign-invested enterprises, which had once helped to defray initial investment costs.⁹ Instead the government is now targeting specific industries (e.g., the high-tech sector) and regions (Western/inland provinces) for development incentives, with the aim of bringing in intellectual property (IP) while downplaying low-cost, export-oriented industries.

These actions have inevitably heightened Western concern about Chinese protectionism, regulatory discrimination, and continued infringement of IP rights. In 2010, surveys by both the American Chamber of Commerce (AmCham) in Shanghai and the US-China Business Council (USCBC) pointed to perceived protectionism, lack of protection for IP rights, and struggles with the evolving regulatory environment.

But not all Western companies are equally worried. With respect to IP protection, CEO Bill Kozyra says that after 25 years of operating in China, his Detroit-headquartered company TI Automotive — a privately held global supplier of automotive fluid systems — is comfortable that the company is not at risk when it puts its most valuable technology in China.¹⁰

Indeed, the more experienced a private company is in emerging and fast-growth markets generally, the less risky China appears — this according to a recent joint study by the Economist Intelligence Unit and PwC. The study found that 75% of private companies investing in just one or two emerging and fast-growing markets consider China “high risk,” compared with just 41% of companies investing in five or more such markets. It also found that 93% of private companies investing (or planning to invest) in China characterize return on that investment as either high (55% of participants) or medium (38%).¹¹

For companies such as these — which see as much (or more) promise in China's evolving business landscape as they do difficulty — a willingness to explore new types of cooperation with Chinese partners could help gradually ease the latter's mistrust, leading to mutually beneficial opportunities as China makes its way up the value chain. Private companies, which tend to have greater flexibility and swiftness than their larger public counterparts when it comes to adopting and executing new strategies, may be particularly well positioned to enter such relationships.

Focus on economic development inland

Another chief objective of China's 12th Five-Year Plan is greater economic development in its inland regions. This supports the central government's larger goal of reducing wealth disparity between the country's interior and the coastal cities.

Western companies willing to venture into China's interior may be able to take advantage of new tax incentives and other preferential policies. These are being rolled out by China's inland provinces to encourage foreign investment in certain industries (e.g., high tech and new energy). They include exemptions from or reductions in corporate income tax, value-added taxes, import taxes, and urban land taxes.

The provincial governments in China's interior are offering other, nontax incentives as well, such as subsidies, guarantees, and cost reductions for land, rentals, utilities, and the like. “Some of the incentives are quite substantial,” says Wendy Guo, a PwC tax partner in Beijing. “And they are available to companies in general, not just those in encouraged industries.”

Guo adds, however, that “foreign private companies are often unaware of these incentives. Consequently, many of them don't shop around to see what's available through the various local governments before deciding where to set up operations.”

Western companies willing to venture into China's interior may be able to take advantage of new tax incentives and other preferential policies.

9 The favored tax treatment once given to foreign-invested enterprises was phased out with the 2008 implementation of the Enterprise Income Tax Law.

10 *Building a Presence in Today's Growth Markets: The Experience of Privately Held Companies*, PwC, 2011

11 *ibid*

Despite government incentives, an inland strategy in China could be a hard sell for many private companies just now and might not be appropriate in all instances. A key obstacle is that the business and physical infrastructure in China's western provinces currently lags behind that in coastal regions, often requiring foreign companies to establish their own.

For companies that aren't in a position to implement such solutions, a move inland may have to wait—although perhaps not for long: Roughly a dozen “supercities” are being rapidly developed throughout inland China and are scheduled to be linked by high-speed rail come 2015. With the interconnection of these once relatively isolated areas, large new markets should open up to Western businesses that look beyond China's seaboard.

Tighter Chinese labor market in saturated coastal cities

Much as Western companies may prefer to operate in China's coastal cities, those markets are becoming saturated with competition from MNCs and domestic businesses (both state-owned and private). The competition for talent, in particular, has intensified. Chinese companies can offer attractive pay these days and are—for the first time—actually becoming employers of choice.¹² Indications suggest that they're also providing work for a broader group (e.g., non-English-speaking Chinese employees), offering better opportunities for advancement, and enabling greater work/life balance.

Foreign companies in China are feeling the effect of these shifting expectations among Chinese workers. The AmCham and USCBC surveys both show that finding and retaining qualified staff in China is the number one issue for their survey respondents—a problem that has in turn contributed to increased wage costs (another key concern among the USCBC respondents) and higher turnover. Western companies may therefore want to consider exploring indigenous talent development and other creative HR solutions as they refine their China strategy (see sidebar on leveraging China's local talent).

Greater bargaining power among Chinese competitors

A tighter labor market is just one challenge posed by increasingly formidable Chinese competitors. Well financed and commanding high valuations, Chinese companies are also becoming more difficult for foreign MNCs to acquire. And they're growing less receptive to arrangements involving foreign majority ownership and control, choosing instead to set new conditions for joint business relationships, such as the contribution of intellectual property, technical know-how, and access to foreign markets. Western businesses that are open to these more-equitable arrangements may find new business opportunities available to them in China.

12 http://www.chinadaily.com.cn/business/2010-08/23/content_11188800.htm

Where policymaking = growth opportunity

Understanding Chinese government policies and then aligning a company's business strategy with them can be a winning approach, if done right. Take Caterpillar, for example:

When the Chinese government announced its \$586 billion stimulus package in 2008, Caterpillar identified opportunities in infrastructure spending and was ready to capitalize on them. Caterpillar's group president, Rich Lavin, who's responsible for the company's China operations, credits the company's strong growth to effective cooperation with the Chinese government on its stimulus package.

"With increasing domestic demand, the requirement for infrastructure will simply increase," says Lavin.* The company continues to ramp up capacity in China, where this year it expects to produce 60% more excavators than in 2010.**

* http://news.xinhuanet.com/english/2009-11/11/content_12428998.htm

** <http://www.ft.com/cms/s/0/3d32d17c-2a18-11e0-997c-00144feab49a.html>

Leveraging China's local talent

As it continues to modernize, China wishes to transition from being a labor-rich country to one that's talent-intensive. To this end, the government aims to increase China's pool of highly skilled workers from 114 million to 180 million by 2020* — primarily through greater investment in higher education and human resources.

In the meantime, a number of Western companies have already been using local talent, placing them in management-level positions traditionally filled by expatriates. Not only does this help companies address the talent-shortage challenges they're starting to face in China, but it also helps them lower their costs and leverage the cultural intelligence of local workers. Such intelligence is particularly useful in an environment where complex social dynamics underlie all business interactions.

Indeed, for some private businesses, relying on local talent is nothing new. Take the privately held business TI Automotive, which has been operating in China for 25 years: The company employs only local staff. "Our president [of operations in China] is a Chinese national," says the company's CEO Bill Kozyra. "His whole management team is Chinese nationals. We don't have any Westerners running our business for us."**

Local Chinese hires tend to be assimilated to Western business practices and possess leadership skills. Some foreign companies, however, have also begun hiring Chinese workers who don't fit the traditional mold. That's because while traditional hires generally make a good match for MNCs operating in coastal cities, they may be less well suited to a company looking to access markets outside China's top-tier cities. There, local culture and institutions can be markedly different from what many Western businesses are accustomed to in China, creating barriers to market penetration if the right local talent isn't on hand to help negotiate the cultural differences.

Negotiating cultural differences invariably helps foreign businesses better align themselves with Chinese stakeholders, such as customers, suppliers, and local officials. Admittedly, indigenous talent development might not suit every Western company, but for those willing to explore that avenue, it may present a distinct opportunity to build a sustainable competitive advantage over other foreign companies in China.

* http://news.xinhuanet.com/english/2010-06/07/c_13336664.htm

** *Building a Presence in Today's Growth Markets: The Experience of Privately Held Companies*, PwC, 2011

Tax considerations

Chinese tax law has become more detailed in recent years. Here are a few issues that China-bound US businesses may want to keep in mind:

Interpretation / implementation

While Chinese tax policy is clearer since enactment of sweeping changes in 2008, the interpretation, implementation, and enforcement of the tax code remain uneven across China. A business may find, for instance, that it can deduct certain expenses in one city but not in another. Likewise, the central government may indicate that particular entities qualify for certain tax incentives, whereas the local government may interpret the tax code as suggesting something else.

“To limit uncertainty about how to apply Chinese tax laws, it’s important for a company to know the priorities of the local government,” says Eugenia Rao, a partner in PwC’s Private Company Services practice, with a special focus on tax. “Enlisting advisors with knowledge of local tax-policy implementation can help you in negotiations with the local tax authority, as well as reduce the need for such negotiations.”

Transfer pricing / management fees

Companies operating in China should exercise caution when it comes to transfer pricing. “This is an area of focus for the Chinese tax authority,” says Rao. “It is conducting audits and taking a close look at mandatory transfer-pricing documentation. Businesses should therefore make sure their methodology is correct and robust.”

The allocation of management fees in particular may draw the Chinese tax authority’s attention. “Chinese law does not allow such fees to be charged at the Chinese-company level,” explains Rao. “If such charges are attempted, the tax bureau won’t issue a tax-clearance certificate, and so remittance on such charges will be impossible.”

If there is a US parent company, allocated management fees can be charged through to it, but the parent must be ready to withstand a high degree of scrutiny and supply adequate substantiation. The Chinese tax authority will require detailed information, such as the kind of management services the US company provided and hourly rates paid to the individuals providing those services.

The Chinese tax authority is looking at service fees generally, not just management fees. “It’s important that the service fee of a US partner or parent be structured properly,” emphasizes PwC tax partner Wendy Guo, “so that it’s comparable to the benefits the Chinese company receives. Recognizing that some foreign companies may use service fees to export money out of China, Chinese tax authorities are increasingly viewing inter-company service payments closely—not only with regard to tax deductions for the Chinese payees but also with respect to levying Chinese business tax and potential corporate income tax for the foreign recipients.”

Smaller and midsize companies that haven’t built up political goodwill in China or have limited international tax expertise may be particularly vulnerable to the Chinese tax authority’s scrutiny. Pursuing more-collaborative approaches to doing business in China, whereby a fair amount of the profit is used to grow the business rather than being expatriated to the United States, could help alleviate the tax authority’s concern.

VAT / accounting discrepancies

China’s value-added tax (VAT) is imposed on the transfer of tangible property. Generally, a business in China prefers to issue a VAT invoice and pay the tax after the goods have been physically received and paid for. That way, the recipient of the VAT cannot take a tax deduction until rendering payment, and the issuer of the VAT avoids being out of pocket for potential non-payment, as well as avoids the process of obtaining a VAT refund from the government.

Under these circumstances, a Chinese accountant usually will not record a sale until payment is received. In the case of a joint venture or other partnership between a US business and Chinese company, the US partner’s accountant would most likely follow accrual-basis accounting. Therefore, a variety of adjustments would have to be made to reconcile the US and Chinese approaches to accounting for the sale of tangible property.

To avoid the need for reconciliation (which can be onerous), management should devise a set of assimilated procedures and train their accountants in them. (For larger private companies, using a shared-services center is another option.) As both the United States and China continue to converge their accounting systems with International Financial Reporting Standards (IFRS), accounting discrepancies should become less frequent.

Private companies' entrepreneurial agility may actually put them in a better position than their public counterparts when it comes to taking advantage of collaborative opportunities with Chinese partners.

***Reimagining collaboration:
Seeking greater common ground***

So what do these new business opportunities and arrangements look like? Currently, a number of deals in the pipeline involve Western MNCs taking a minority ownership stake in joint ventures with Chinese companies—a departure from the traditional approach. We've also begun to see MNCs explore creative minority cross-ownership structures, such as those in which the Chinese party has a majority ownership interest and management control in the Chinese joint venture while holding a minority interest in the MNC. In many of these instances, Western MNCs are offering technology, expertise, and global distribution support for Chinese products and services in exchange for distribution support for the MNCs in China and capital from the Chinese party.

While such arrangements might not be a natural fit for some US private companies—or, for that matter, Chinese businesses (which tend to be run by tightly knit management teams, with much of the decision-making often residing with the business owner)—these more equitable relationships are not the exclusive domain of public MNCs. Indeed, private companies' entrepreneurial agility—their ability to swiftly decide on a strategy, obtain the necessary approvals, commit capital, and then execute—may actually put them in a better position than their public counterparts when it comes to taking advantage of collaborative opportunities with Chinese partners.

Take, for instance, Thayer Lodging Group, a privately held real estate investment company that's based in Maryland. Last year it entered into a joint venture with Shanghai's Jin Jiang International Hotels to purchase Interstate Hotels & Resorts, a large independent hotel management company. Whereas in the past a US joint venture partner might have been the one supplying most of the capital in exchange for access to China's market, we've begun to see interests on both sides of the table converge, with the Chinese partner contributing substantial capital and proving equally intent on widening its market access. In the case of the Interstate deal, says Jin Jiang Group chairman Yu Minliang, "This acquisition significantly accelerates our ability to expand internationally, giving us immediate access to a worldwide platform."¹³

Approaches like these may require a psychological shift by companies that are accustomed to following a more traditional business model in China. Yet while larger MNCs tend to lead the way in embracing new market-entry and expansion strategies, smaller private companies have the advantage of generally being more nimble, with fewer corporate silos and more-centralized decision-making. Because these attributes are shared by many private-sector Chinese businesses as well, that common ground may make it easier for Western private companies to understand and appreciate the perspective of their Chinese counterparts—a distinct benefit in China's business culture, where relationships are critical.

Of course, before entering into a relationship with a Chinese company, a business will want to adequately assess the needs, interests, and capabilities of potential partners to determine whether there is indeed enough common surface. Proper due diligence is therefore essential. Once an appropriate partner has been vetted and taken on, a robust integration strategy should be put in place to ensure a smooth bridging of people and processes.

¹³ <http://www.hospitalityworldnetwork.com/trends/developing-story-thayer-jin-jiang-hotels-purchase-interstate>

Conclusion

While the traditional model of doing business in China will remain preferable and best suited to many private companies, it may be worth refining if China is a key component of their growth strategy. “Even if you choose not to explore more-innovative approaches to operating in China, it is important that you take the interests of Chinese stakeholders into consideration when reviewing your China agenda, seeking ways to align and reconcile those interests when they diverge, and doing so in ways that are mutually beneficial,” emphasizes Alan Chu, PwC partner and leader of US-China Business Services. “This allows you to essentially co-opt China’s long-term goal of economic stability and prosperity, making it integral to your China strategy—an approach that should benefit stakeholders on all sides.”

More information

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