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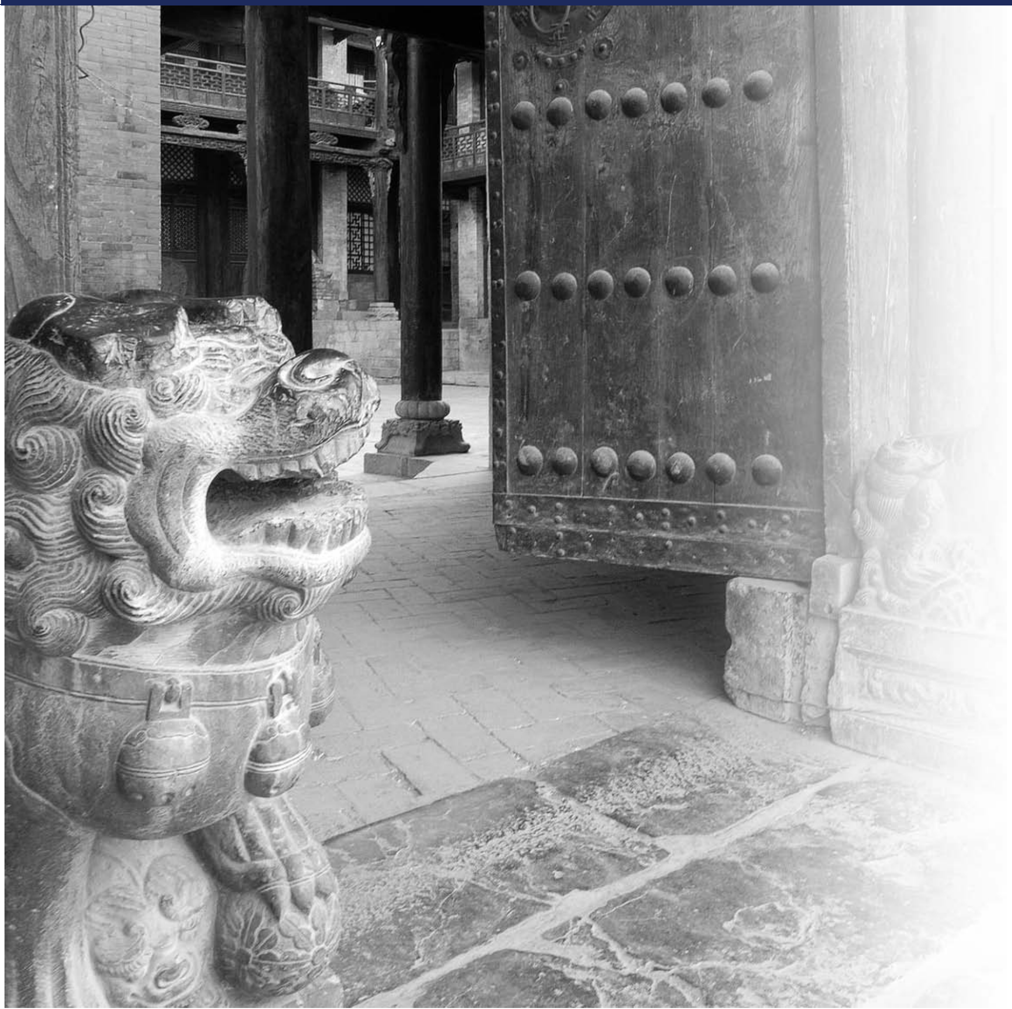
Sailing In Choppy Waters

Business Implications Of The Economic Reforms For The Decade Ahead

White Paper

By **Jan Borgonjon, Eduardo Morcillo, James Sinclair and Simon Zhang** | October 15 , 2013



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Overview

The first half of 2013 has been an unusually turbulent period for companies in China.

Amidst an apparent economic slowdown, the new leadership has pursued an anti-corruption drive, a government frugality campaign, and a strengthened Internet crackdown. More specifically, we have seen the trial of Bo Xilai and largest political scandal in decades, the purging of China's most profitable state owned enterprise PetroChina, pharma executives paraded on national television admitting commercial bribery, the collapse of the high-end restaurant sector, infant formula brands paying considerable fines for alleged price fixing and forced to drop their prices, liquidity in the banking sector dry up for two weeks, and the taming of the "Big V" micro-bloggers on the Internet.

The international press was full of negative reports on China's growth prospects in July until the news suddenly turned positive in August. Meanwhile, many sectors and businesses in China have continued to develop strongly. Automotive companies are having one of their best years ever with strong growth and good margins, many consumer industries such as packaged goods, e-retail and food service continue to witness double digit growth, and growth also remains robust in healthcare, automation and logistics among others.

No wonder there is some degree of confusion in corporate boardrooms and even among executives in China about the direction China's economy is heading and what this means for their companies; however, we'd better get used to this lack of clarity. InterChina considers that over the coming years, uncertainty and volatility will become the name of the game in China. Much of the turbulence to date has been a consequence of the leadership regime establishing its authority and improving public support, and this turbulence will continue as the regime now proceeds with its policy priorities and economic reforms for the coming decade.

For those ready to ride these choppy waters, the range of opportunities will broaden. Growth in consumption will remain robust, advanced offerings will find new markets as the economy upgrades, market access and fair competition will improve, and acquisition options will arise as consolidation accelerates.

However, international companies will need to handle the new environment of uncertainty and volatility in order to take advantage of these opportunities. Although there will be big differences across sectors in terms of what this means, there are some common denominators which we describe in more detail in this article.

Economic Reforms: Long-Term Benefits But Short-Term Volatility

Given its current weaknesses and long-term challenges, China has no choice but to restructure and upgrade its economic model. The main reform goals will be the improvement of investment efficiency and productivity, and the continuation of consumption growth and household income growth.

The range of reforms required to achieve these goals is very wide, starting with (a) bolstering the role of the market, addressing distortions to improve competition (b) decelerating and re-directing investment into productive capital stock (c) improving the quality and efficiency of the urbanization process (d) continuing to unlock consumption, developing wage-intensive industries and looking after peoples livelihoods (e) reducing debt levels, and introducing more appropriate financing sources.

We believe that the new government is committed to achieving these goals, set to be unveiled in November at the Third Plenum of the Communist Party's 18th National Congress. More importantly, we believe they are also building the political muscle to tackle the interest groups that will resist the reforms. Nevertheless, the vast array of specific reforms will take years to cascade through the government bureaucracy, facing many obstacles and complexities. We should expect a gradual and experimental approach, following Deng Xiaoping's "crossing the river by feeling the stones". So while the general direction may be clear, specific reforms will be assessed based on their effectiveness, and then either retracted, refined or deepened. Each step may be small, but meaningful in view of the bigger picture.

In addition, the new regime will be treading a fine line. While the economic model is under transition, to ensure that growth does not collapse or large-scale unemployment does not ensue, China will have to continue to rely to a large degree on state-led investment despite the problems of poor investment absorption and low investment efficiency. This is just one of many factors that could exacerbate the current disequilibria, including a further slowdown in the economy, the influence of the interest groups, insufficient tools and levers given the economy's increasing complexity, and miscoordination between the various actors responsible for the implementation of reforms.

This environment of uncertainty and volatility is bound to last for a considerable time, until finally the dust settles and the reforms take effect. We estimate that we could easily be looking at a period of 5 years or longer given the depth and range of reforms required.

So, What Does This Mean For Business?

This profound change of status quo will start to impact business faster and harder than many expect. Business in China will become more complicated and risky, but will also generate new opportunities not currently reflected in most corporate strategic plans. What this means for individual companies in specific sectors is not possible to predict in detail, but there will be a set of common themes.

Growth Will Slow

As a maturing economy, growth must slow compared to the previous decade. The size of China's labour force is now contracting, the investment boom has led to declining efficiency of investment, and productivity growth rates have also been falling off. China needs to grow at 7-8% this decade and 5-6% the next to become the world's largest economy and escape the "middle-income trap". This trajectory is possible if the new leadership proceeds with productivity boosting reforms, but a significant improvement in the global economy would be needed otherwise. And while the economy becomes more dependent on consumption, volatility will increase, as the spending behavior of fickle consumers is less controllable than the investment patterns of credit-fueled SOEs.

The Economy Will Upgrade

Despite the fast growth of the last decade, Chinese labour productivity is still only similar to that of South Korea in the late 1970s and below that of Japan in the 1960s. International experience shows that labour productivity growth is a prerequisite for sustainable growth. We expect China to pursue reforms that will raise productivity, meaning the movement of resources from low-productivity to

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high-productivity industries; more investment in machinery and automation; more innovation in new technologies, products and ways of working; and more education and training to upgrade workforce skills.

The Market Will Be Bolstered

SOE reform remains fraught with barriers, and thus ambitions to bolster the market will focus on addressing existing distortions and improving competitive conditions. This will include allowing the private sector to play a more prominent role, a recurring theme for decades. We expect deregulation to relax control over market access; financial reform to increase private sector access to capital; and the liberalization and streamlining of administrative procedures. Meanwhile, we also expect an increase in pressure on inefficient borrowers, including SOEs.

Consolidation Will Accelerate

One of the most severe problems facing the Chinese authorities is over-capacity, caused by the excessively fast growth in investment. And thus one of the major consequences of the shift in growth model will be faster consolidation. Inefficient and uncompetitive companies, increasingly starved of cheap financing, will be pressured to sell out or die slowly. This is already evident in sectors with less government interference, such as consumer goods or automotive components, where we are seeing a marked increase in M&A activity. The direction is harder to predict in sectors with strong government involvement, as this will depend on the degree to which private capital is allowed to participate in restructuring. As the government will not be able to rely on SOEs alone to achieve its new growth model, we are moderately optimistic that private capital, including foreign capital, will have a role to play.

Consumers Will Pose New Challenges

Despite the common wisdom that the Chinese consume too little and save too much, consumption has been growing at a healthy rate of 9% per annum for the past two decades. In addition, the consumption rate as a share of GDP is likely underestimated, and is in reality comparable with the East Asian tiger economies at a similar stage of development. Over the next few years, we do expect consumption-driven industries to out-pace GDP growth, and investment-driven industries and infrastructure to grow slower. And with the consuming class increasing by several hundred million over the coming decade, consumer-facing companies will need to meet a more heterogeneous and discerning set of needs, with demand dispersed across hundreds of cities and towns.

Government Will Intervene On Behalf Of Consumers

Consumers will become increasingly vocal, especially on the Internet, and the government will increasingly listen and respond. In other words, what is important to the consumer will be important to the government: the cost of living, quality of medical care, safety of food, impact of pollution, access to education etc. It is significant that many price fixing and commercial bribery investigations have been launched in response to media reports. While this may lead to stronger supervision and more order over the long-term, it will mean more arbitrary intervention in the short-term.

Costs Will Increase Further

The upgrading of the economy is inevitably resulting in higher operating costs. We have seen this over the last 3 years, and the trend will to continue over the next 5 years. This will put pressure on exporting companies, but also on domestically oriented companies. In the face of revenue growth pressure and rising cost structures, a re-focus on operational efficiency and productivity will be required to maintain profit levels. This will not be easy for companies which for decades have been focusing on top-line growth.

Outbound Investment Will Grow Slowly But Steadily

We expect a shift to a more natural flow of outbound investment, away from the politically mandated investments by large SOEs, and towards investments by smaller SOEs and private companies. These acquisitions may be smaller and less eye-catching, but more sustainable given their business rather than political foundations. The implication for international companies is a more rational basis to enter into business partnerships with Chinese companies at a global level.

How Should Business Get Ready?

The new status quo does not mean that the traditional success factors for China have expired: headquarter commitment to China, a capable local team, local decision-making autonomy, a business model and offering adapted to local needs, and alignment with government priorities. All remain critical to success in China, and perhaps even more so under the changing conditions we described above. However, given the uncertain and volatile environment ahead, international companies need to consider a further set of initiatives.

Managing The Headquarters View

Headquarter executives will, as usual, react to specific China issues raised in the foreign press without a good understanding of their significance in the broader context. Given the choppy waters ahead, this risks over-reaction to singular issues, and the gradual mounting of concerns and weakening of confidence. Now more than ever it will be important to manage headquarter expectations. China country management will need to forewarn their headquarter colleagues about the volatility to be expected ahead, explain events as and when they happen, and keep describing how their strategy fits with the changing business environment.

More Frequent & Practical Strategic Reviews

The continuous state of uncertainty and change will require an increase in the frequency of strategic reviews, possibly every 2 years or even less. In particular, sales and profit goals will have to be continually assessed against the market reality; customer sectors will have to be monitored to remain focused on those that are most attractive; product and service portfolios will have to be evolved to meet changing market needs, including investment in new product development specifically for the Chinese market; and new sources of growth will need to be identified and pursued as they emerge.

Optimize Sales & Distribution

The potential of greater consumption in China also poses the challenge of getting the sales & distribution economics to work. Companies will need to accurately pace the expansion of their sales & distribution platforms, select the most efficient geographies and models, and share good practices between regions while allowing sufficient autonomy to meet local needs. Companies should also consider new route-to-market approaches, fully embracing e-retail as it starts to account for 10%, 20% or 30% of category sales, and looking at partnerships between those with strong product portfolios and others with mature sales & distribution platforms.

Go For Consolidation

Given the pending consolidation in many sectors, inorganic growth will become obligatory for either establishing a significant presence or staying competitive, both for Chinese and international companies alike. Few international companies are prepared for this new reality. They will need a reliable view of the consolidation dynamics of their sector, both at the macro (i.e. sector structure) and micro (i.e. available targets) levels. The preferred targets might not be available at present, and therefore they will need to establish and cultivate relationships well in advance of acquisition discussions. And they will need to be implementing strategies to defend against intensifying competition and bigger competitors. This will not be easy, and will require leadership attention and strong execution capabilities.

Re-Aligning With Government Interests

International companies should pay attention to the Party’s Third Plenum in November and the subsequent policy announcements and implementation plans. They should be looking for changes relevant to their own businesses, identifying new ways to align with government interests, and helping the government make good on its policy goals and reform agendas. This will not be a one-off activity, but ongoing, as the details gradually become clearer. And as in the past, the most tangible opportunities will occur at the local level with local governments.

New Challenges, New Opportunities

While China has always been considered a complex and dynamic market, the restructuring and upgrading of its economic model will lead to greater uncertainty and volatility over the next 5 years. In the build up to the Party’s Third Plenum in November, there will be much speculation over the policy priorities and reform initiatives. Sweeping reforms are unlikely, and many commentators will express disappointment. However, we expect the general direction to be a positive and lasting one, and meaningful steps to follow quickly. With a greater emphasis on consumption, efficiency and productivity, there will be new opportunities for international companies. And while the choppy waters will be navigable, international companies will need to make sure they are ready for them. What worked in the past will no longer be enough. There will be a shake-out in many sectors, and only the better prepared companies will flourish.

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