Business Trends & Corporate Strategies

CHINA FOCUS

FIDUCIA 德信 Management Consultants

Issue IV / 2018

Year in Review

In this issue:

2018 has been a challenging year for our international clients in China. A turn for the worse in US-China trade relations weighed down an already slowing Chinese economy, complicated the plans and operations of businesses, and dampened the confidence of consumers and investors.

Apart from hoping for regulatory or diplomatic breakthroughs, businesses in China should see these hard times as a wake-up call – a chance to drive improvements that, on sunnier days, seem less urgent. In our case, we saw the need for a profound HR and cultural transformation at Fiducia. In this China Focus (p. 4), we share our plan to evolve into a people-focused organisation, hoping that we'll inspire others to reflect on how they too can become better employers and corporate citizens.

2018 - Year in Review

In the first part of this publication, we zoom into specific industries to see how they performed against a tough backdrop (p. 1-2). A closer look reveals bright spots and resilient sub-segments even in poorly performing industries. For instance, while annual car sales are at risk of contracting for the first time in two decades, sales of e-vehicles are booming.

2019 - The Year Ahead

As we enter 2019, many of our clients in China are conservative in their forecasts. Aside from the trade conflict and its drag on the economy, they worry about a significant increase in local competition, rising costs, and remaining or even increasing regulatory hurdles.

But there's a silver lining to the current geopolitical situation. If the Chinese government wants to soften an impending slowdown, it will have to go beyond just promising reform, and instead take action through fiscal and monetary measures that actually help businesses buffer current setbacks.

Important tax reforms have already been announced, or are in the cards, for 2019 (p. 2-3). Most will have positive implications for foreign-invested companies, but the new Individual Income Tax (IIT) Law may not entirely be good news for expat employees.

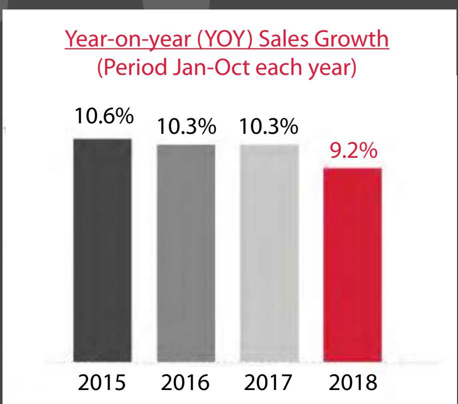
We look forward to helping you overcome headwinds, drive change, and unlock opportunities in these uncertain times. Until then, from the entire Fiducia Team, we wish you a smooth start into the new year!

Stefan Kracht

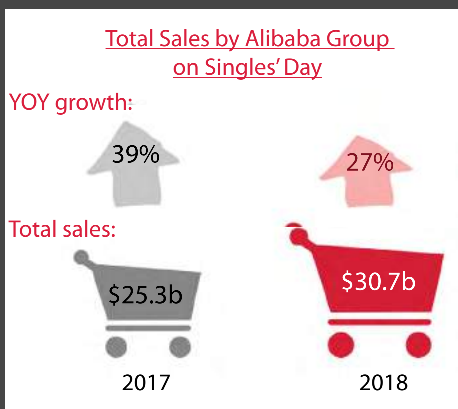
INDUSTRY HIGHLIGHTS 2018

RETAIL: Beating the Odds

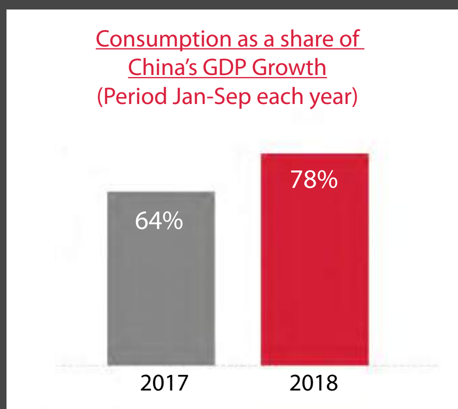
The escalating trade war has sparked fears of a slowdown in Chinese consumer spending. Retail sales have, indeed, grown at a slower pace this year:



But "Singles Day" – the annual online shopping frenzy that has become a barometer of Chinese consumerism – broke records. Sales growth slowed down but was still double-digit:



More importantly, China stayed on track in its transformation into a consumption-driven economy. Consumption has accounted for a larger chunk of GDP growth this year:



Sources: National Bureau of Statistics, Alibaba Group

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AUTOMOTIVE: Stalling

Car sales in the world's biggest automotive market were hit by several factors in 2018:

- the end of small-engine vehicle tax cuts introduced in 2015
- weaker consumer spending on big-ticket items amid economic uncertainty
- credit curbs
- a growing market for second-hand cars

If the trend seen in the January-October period continues, annual car sales could contract for the first time since the 1990s:

Annual Car Sales in China YOY Growth

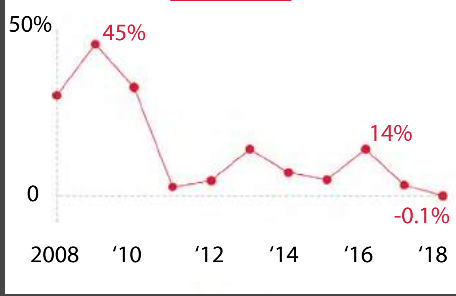
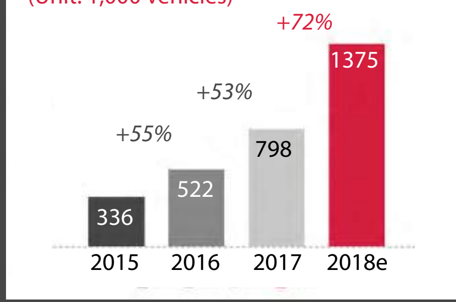


Figure for 2018 represents Jan-Oct YOY growth
Source: China Association of Automobile Manufacturers

But not all automotive segments are moving at the same speed. The new energy vehicles (NEVs) segment keeps accelerating:

NEV Sales & YOY Growth in China (Unit: 1,000 vehicles)



Source: EV-Volumes

INDUSTRIAL ROBOTS: On hold

In 2017, automation at Chinese smartphone and automotive factories accelerated, boosting demand for industrial robots.

This year, this momentum was lost. Many manufacturers paused their investments in automation because of trade war uncertainties. Some are waiting to see if tariffs reach a point where shifting their production away from China would make sense.

As a result, sales of industrial robots in China, the world's biggest robot market slowed down sharply this year.

Sales of Industrial Robots in China YOY Growth

Source: International Federation of Robotics

However, foreign robot makers – especially European and Japanese suppliers – still dominate the market. In 2017 they accounted for 75% of robot sales in China, including those produced locally, and their market share has not shifted significantly this year.

THE FIDUCIA "LEADERS' OUTLOOK BAROMETER" 2019

Our Leaders' Circle event brings together China-based high-level executives from international companies to discuss, in an intimate roundtable setting, how specific business trends are unfolding on the ground. Held in Beijing, Shanghai, and Hong Kong – three times a year at each location – it gives us and participants a unique opportunity to share experiences and gain insights.

This November, at the end-of-year Leaders' Circle series, we ran a survey to capture the attendees' outlooks for their Greater China business as we enter 2019. The survey is by no means representative of the country-wide reality. But it does help us gauge the business sentiment of China-based leaders of mid-sized international companies, especially European ones. Here are some interesting findings that came out of this year's "Leaders' Outlook Barometer".

** Respondents ranked eight challenges from most to least concerning.*

CHINA TAX OUTLOOK 2019

> *Among expat employees, the new individual income tax law has sparked numerous fears.*

In 2019, the Chinese economy is expected to see its slowest rate of expansion in 30 years. In October 2018, the International Monetary Fund (IMF) lowered its forecasted growth rate for China from 6.4% to 6.2%, citing the "negative effect of recent tariff actions".

Will the government be able to soften this slowdown? It's certainly trying. Beijing has started loosening its monetary and fiscal policy while allowing the yuan to weaken, and more stimulus is expected for 2019.

Here, we focus on tax-related measures set to impact international companies in 2018. There has been a lot of speculation recently around China's upcoming tax reforms, so throughout our analysis we differentiate between upcoming tax changes that are set in stone versus those that are either false or to-be-confirmed.

INDIVIDAL INCOME TAX (IIT) REFORM

China has approved cuts to personal income taxes in the hope of propping up consumption. They will take effect in January 2019 and will mostly benefit people with low and mid-range income levels. According to Deutsche Bank, the cuts could boost annual retail sales by about 1%. The table below shows how the tax burden of local employees on different salary levels will change.

As of January 2019, Chinese employees will be able to deduct certain expenses from their taxable income, an option that was previously only available to foreigners.

Among foreign employees, the new IIT law has sparked numerous fears: that their global incomes would start being taxed, that they would lose eligibility for many tax-deductible benefits, and that tax authorities will step-up their oversight of high-net-worth individuals.

The law has been ratified, but the final implementation guidelines that will ultimately clarify these fears are yet to be announced. Based on the draft guidelines released in October, this is what we expect:

▶ **Tax on global incomes:** Expats will continue to benefit from the "five year tax rule", which states that foreigners' global income becomes taxable only after spending five uninterrupted years in China. But there is one change. Expats reach the five-year period if they stay in China for over 183 days each year, down from one full year. To "break" the five year period, they must exit the country for 30 or more days in a single trip.

▶ **Tax-deductible expenses:** Foreign workers will continue to enjoy most of their tax-exempt benefits. For some items, such as housing and schooling, they will not be able to claim a tax exemption and a deduction at the same time. For others, such as meals and laundry, tax exemption is yet to be confirmed.

Monthly Salary (RMB)	Tax before Jan 2019 (RMB)	Tax as of Jan 2019 (RMB)	Tax Saving
10,000	745	290	61%
20,000	3,120	1,590	49%
30,000	5,620	3,590	36%
40,000	8,195	6,090	26%
50,000	11,195	9,090	19%
60,000	14,270	12,090	15%
70,000	17,770	15,590	12%
80,000	21,210	19,090	10%
90,000	25,420	22,590	9%
100,000	29,920	26,090	8%

▶ **Oversight of high income earners:** New anti-tax-avoidance rules have been introduced for high-net-worth individuals. Tax authorities are more empowered to investigate and punish IIT avoidance cases. Expats in this category who, for instance, have assets in China and cross-border business arrangements, should review their situation in light of the new rules to ensure compliance and manage their tax exposure.

EXPORT TAX REBATES

In September and November 2018, China increased the tax rebate rates enjoyed by exporters in an attempt to lower their cost burden. This table summarizes the changes:

Example of affected items	Previous rate	New rate
Machinery, LEDs	13-15%	16%
Lubricants	9%	10-13%
Stainless steel goods	5%	6-10%

** Some products, such as highly polluting goods, will remain at their current rates.*

The government has also promised to cut the average handling time for export tax rebate applications from 13 working days to 10. Based on similar promises to speed-up tax related paperwork, we don't expect a significantly shorter time frame.

TAXES ON CARS

In October 2018, Reuters, Bloomberg, and other media outlets reported that Chinese authorities were considering to cut purchase taxes on some smaller cars from 10% to 5% to help a troubled sector. Stocks of Volkswagen, BMW, and other carmakers rallied when the news came out.

But one month later, China's National Development and Reform Commission (NDRC) dispelled the rumours. They said the slowdown "could help stimulate the workings of the market, strengthen the industry's core competitiveness and eradicate outmoded capacity".

BECOMING A PEOPLE-FOCUSED ORGANISATION

We at Fiducia have embarked on a transformation based on what we perceive as the most significant generational and technological changes in our market – a new reality that we call "China 2.0". Managing Director Stefan Kracht explains why and how he is planning to turn our 36-year old business into a truly people-focused organisation.

Stefan Kracht (right) with Fiducia's fastest hikers at the 26km Charity Cross-Country Marathon organised by Sowers Action HK.

What prompted you to consider an HR transformation?

We're reacting to external and internal changes. Millennials want to work for organisations with ambitious propositions and meaningful work, so portraying ourselves as a family business committed to long-term careers isn't an effective way of attracting recruits anymore.

We realised that among new generations, our corporate social responsibility programme "Fidu-Share" has become a key reason why they choose us over other employers. But this alone is not enough to bring our turnover rates down. We need to strengthen our employer branding, talent acquisition, and onboarding processes to give candidates the best experience from their very first touchpoint with us.

What will a "people-focused" Fiducia look like?

We want to create an environment where everyone feels valuable and cared for, what we call a "people-focused" approach. This means establishing a feedback culture that encourages employees to voice their suggestions and frustrations comfortably.

We also seek to evolve our leadership style from task-oriented and financial-driven, to relationship and value-based, with managers putting a greater focus on motivating and empowering their team members.

How are you planning to get there?

We recognise this is not something we can change overnight, but we're happy to have kickstarted the process – which is often the trickiest part.

As a first step, I took the top 10 managers on an offsite meeting to discuss our HR pain points and suggestions. With the help of an external people-management expert, we dedicated our activities to building trust, transparency, and alignment. We finally drew up a transformation roadmap through tough conversations, fruitful workshops, and a "laughter yoga" session.

We then did a roadshow to explain our plans to all team members for their understanding and feedback. Everyone could feel that they're part of the change from the outset.

Can you share some of the changes you have in mind?

Recently, we launched our first company-wide employee engagement survey which will help us take a deep look inwards. Based on the feedback, we will prioritise areas of improvement and narrow down the actions, but broadly speaking we intend to offer more freedom and wellness initiatives, more defined career development paths, and better coaching and training opportunities.

What do you hope to achieve?

We believe that driving HR and cultural transformation will, in itself, send a positive signal to our team members and clients: we're a team that is willing to self-reflect, gather feedback, transform itself, and finally move from good to great. Becoming a people-focused organisation will not only make us a better employer, but also a better service provider and corporate citizen.

Fidu-Share Highlights: Supporting Our Communities

Fidu-Share volunteers from our Beijing team rolled up their sleeves to collect bags full of rubbish from the Chaoyang Park near our office.

Our Shanghai Fidu-Share team visited the Yodak Cardio-Thoracic Hospital with NGO partner "Heart to Heart".

With the German Chamber, we visited the Alba WEEE Park in Hong Kong, where discarded electronics are turned into re-usable materials.

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