

CHINA FOCUS

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Unlocking Third Tier Cities

Most China observers know of the opportunities the largest hubs (Beijing, Guangzhou, Shanghai and Shenzhen) offer, as well as those found in second tier cities, such as Chongqing, Hangzhou and Tianjin. In this issue of China Focus, we bring you one step closer to unlocking the third tier cities, often less well-known gems by firstly, explaining to you via

an interview what makes these cities so unique, secondly, introducing three of our favourite third tier cities, and lastly, putting all the statistics into perspective for you by creating a comparison to Berlin, Germany's largest city.



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Are You Ready for China's Third Tier Cities?

An interview with Jens Richter, Managing Director of Multivac Packaging Equipment Ltd.

Which third tier cities do you prefer for your business?

Since our business requires us to work with food producers, we spend more time in second, third, and fourth tier cities because this is where the food plants are located – in the remote areas of China. There are several strategically important cities near Wuhan, which is surrounded by the strong agricultural provinces Hunan, Hubei and Henan. Zhengzhou in Henan, for example, is a third tier city that is developing rapidly and has strong strategic advantages.

Another high potential area is Sichuan Province, especially the cities around Chengdu. We recently participated in our first regional exhibition in this area and sold a high value, fully automated packaging line just at our booth! We were expecting to take the machine back to Shanghai so it was a pleasant surprise and shows what high potential these remoter areas offer.

What trends do you see shaping the way business is conducted in these cities?

A positive aspect of doing business in third tier cities in China is that as a foreign company, we still enjoy a special reception, especially as foreigners who speak Chinese. Since we take the trouble to go that far, we usually receive

a warm welcome from local customers and authorities. In Beijing or Shanghai this doesn't happen anymore, while in third tier cities it helps you open doors and is a definite advantage.

Nevertheless, politics are often complicated in these smaller cities. When you go to these cities you immediately feel the influence of the political system on companies that operate there. As a result, the speed of working is very different.

You have been in China for a long time – what changes have you observed in the last 5 years?

That's a big question, as you can see changes everywhere! From the infrastructure point of view, the central government of China has invested in this unbelievably fast high speed train network, making it so much easier to gain access to a variety of cities. Moreover,

due to the advancements in how information travels these days, there is much more exchange in general, facilitating how we do business in more remote areas in China. Cities are developing much faster as a result.

The business culture is changing too: while it is still strongly relationship-driven, we have found that people are looking for good quality products and will consider all their options instead of just going for the nearest local competitor. In addition to this, a very positive change we have observed is that the young people are better educated now and often even speak English. Five years ago you may not have come across this as much, especially in third tier cities.

What are the cultural difference between first tier cities and third tier cities?

In Shanghai and Beijing you immediately get down to business: customers know you,



Jens Richter of Multivac Packaging Equipment Ltd.

“When you go to the third tier cities, you are often new and one of the first regular foreign visitors. You have to pick your targets carefully.”

they can visit your offices and get to know your staff. In third tier cities, you must create trust especially if you don't have offices in these locations. People often worry about the necessary support and access to spare parts, showing more insecurity when dealing with foreign companies. As a result, business owners and high-level decision makers are more hands-on than in Shanghai, for example, and are more involved when purchasing new machinery.

How do you bring the necessary level of service to remoter areas?

We have invested heavily in service in China, which I believe is the key to the local market. In the food machinery industry, there is very little automation compared to automotive or electronics, making it very labour intensive. Customers are interested in purchasing high-value equipment, but often worry about what to do if there are difficulties. We have built up a strong service team run by an Australian expert with 30 years of experience and his local counterpart to make sure that our customers everywhere in China are taken care of. Due to the country's good infrastructure, we can guarantee a fast response time, as our engineer will be on site in 24 to 48 hours in most areas of China.

In terms of spare parts, we are now in the process of setting up a warehouse in the Shanghai Free Trade Zone. There, we will have more stock because we don't have to pay customs tax on arrival, allowing us to be more flexible in sharing spare parts with other locations like Mongolia or Taiwan and even South East Asia. Without the customs procedure problem, we can extend our range of spare parts and shorten delivery times.

What is your selling strategy to third tier cities?

In the first tier cities, companies tend to build up repeat business. When you go to the third tier cities, you are often new and one of the first regular foreign visitors to a local company. You have to pick your targets carefully. Our strategy is to catch the top 10 of a province in the relevant businesses for us (e.g. beef, pork, and poultry) and we try to establish business with these market leaders. Third tier city companies can often be described as 'copying models': if we are successful with one company, the next company is likely to ask for the same machine. In Hubei, we sold a very nice packaging line and immediately we got other requests for a quotation from companies in the same industry. This is very important: people talk to each other and are

more open to learn from another player. In Shanghai or Beijing, the customers already know exactly what they want.

What are the challenges or pitfalls of operating in a third tier city?

Business is generally done a little differently in third tier cities. Contracts are signed and down payments are made but the significance of this is sometimes reduced in these areas. You have to be more careful when you do business there: as much as the customer does not know you, you also do not know the customer, who might purchase your machine to hand it to a local competitor for example.

We also face a number of HR issues in third tier cities. Recruitment, for one, can be very challenging as it is difficult to find the right talents with relevant experience. There is often a language barrier or our customers face people's unwillingness to work in a food plant. Retention of employees is also a big problem and risk. The training and supervision of these employees is not easy and since it's a huge country you don't get to see your staff as often as you would like to.

Most importantly, depending on the company and the customer, you have to be aware of the political system. We often have to deal with the local government even if according to our western understanding and mindset, the project has nothing to do with them. Some customers want to use our advanced German technology to gain investment or support, for example. In Shanghai or Beijing, this does not tend to happen and business is done without any political impact.

Do you have any tips for people who want to expand into third tier cities?

That depends on the company. As a German SME, I'd say take it step by step. Set up your customer base remotely from Beijing or Shanghai first so you are able to sustain your business in the area. Once you are there you are very welcome, especially as a foreign company, but there are also special risks, like paying a little extra on rent, though it is still cheap compared to Shanghai or Beijing.

There are really many opportunities in these cities since there are still very few international players in these places. Focus on sales and service first, establish yourself with a solid base of customers and be open to new ways of doing business and adjusting to local customs and culture. With the right amount of persistence and flexibility, you will be able to take advantage of the many opportunities that third tier cities have to offer. ☺

What is a third tier city?



Fiducia has taken a simplified approach to defining the various city tiers, based on population and common understanding:

- **First tier:** Beijing, Shanghai, Shenzhen, Guangzhou
- **Second tier:** all provincial capitals, sub-provincial cities, and cities with a population greater than 8 million
- **Third tier:** all cities with a population less than 8 million but greater than 1.5 million
- **Fourth tier:** all cities with a population below 1.5 million

Langfang, Hebei Province

Population: 4.3 million

GDP: 179 billion

GDP growth: 9.7%

GDP per capita: RMB 41,600

State-level development zones: 1

Number of German companies: 11

Pillar industries: auto parts, agricultural products processing, timber processing, furniture manufacturing, printing and packaging, electronics and information technology

Fiducia Analysis: With its perfect strategic location between Beijing and Tianjin, Langfang's main draw-card is its easy accessibility. Intersected by a major highway and the future site for a Beijing-Shanghai High Speed Rail stop, the city is ideally situated for companies looking to access Northern China. With only 70km to Beijing International Airport and 110km from the port in Tianjin, foreign companies can benefit from the optimal infrastructure the city has to offer. Langfang is a printing hub, having absorbed most of the printing business from the surrounding areas. As part of the latest 5 year plan, the IT industry in Langfang is growing rapidly, attracting major Chinese players, such as BOE, Huawei, and ZTE.

Fiducia Project: WFOE incorporation for a major German automotive component company.

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Lángfáng

How Fiducia can help

If you are interested in setting up in China's third tier cities but are unsure where to start, here is how Fiducia can help you:

- ▶ Assess which city is ideal for your business model and industry
- ▶ Research competitors and current market
- ▶ Devise an optimal structure from a business, legal and tax perspective
- ▶ Set up all operations and legal entities
- ▶ Recruit key staff for your growth strategy
- ▶ Outsource accounting and payroll to keep your organisation lean

Email us at contact@fiducia-china.com for more information.

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Wúxī

Wuxi, Jiangsu Province

Population: 6.5 million

GDP: 757 billion

GDP growth: 10.1%

GDP per capita: RMB 116,500

State-level development zones: 3

Number of German companies: 56

Pillar industries: machinery, metallurgy, petrochemical industries, electronics and textiles

Fiducia Analysis: Wuxi is a booming third tier city in the densely populated region of the Yangtze River Delta. With a year-on-year GDP growth of over 10% in 2012, the city is a popular site for private investment in China. Over 80% of Wuxi's added value comes from heavy industries, such as machinery. With its own regional airport and well-connected highway system, Wuxi is an ideal access point to several important cities in the region, including Shanghai, Nanjing, Suzhou and more. A large amount of foreign direct investment contributes to the rapid growth of the city, best exemplified by the 87 Fortune 500 enterprises that set up 157 projects here. 17% of the Jiangsu's total tourism revenue comes from Wuxi, a city with substantial cultural and natural attractions.

Fiducia Project: Business plan and growth strategy development for a global rubber and plastic machinery manufacturer resulting in local product development.

Huizhou, Guangdong Province

Population: 4.6 million

GDP: 237 billion

GDP growth: 12.6%

GDP per capita: RMB 51,200

State-level development zones: 3

Number of German companies: 5

Pillar industries: electronics, petrochemicals

Fiducia Analysis: Comprising one fourth of the land area of the Pearl River Delta, Huizhou offers a substantial advantage not only due to its proximity to Hong Kong, but also the first tier cities of Shenzhen and Guangzhou. With 3 universities and 39 vocational schools, Huizhou is a major source of talent in the region. As a primary sea port, the city is an export hub, with goods being shipped to Hong Kong, Japan, the US, the EU, South Korea and South East Asian countries every day. Huizhou is connected to China and Asia via high speed rail, major highways, and its port, with additional close proximity to several airports in the region. The Hong Kong investment giant Hutchison Whampoa established operations in this city.

Fiducia Project: Customer survey and analysis for a global market leader in the supply of plants, equipment, and services for various industries resulting in a revamp of the customer service structure.

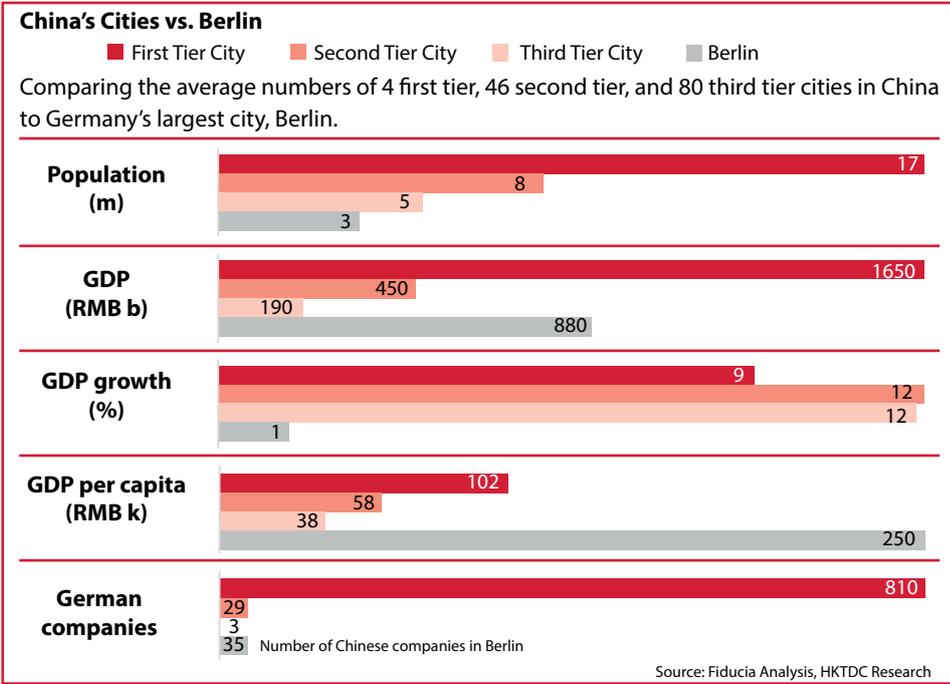
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Location Map



Source: Fiducia Analysis, HKTDC Research

Putting the Numbers in Perspective



How large are China's cities really? In the above bar charts, we create some perspective for you to really understand the opportunities available, especially in China's third tier cities. We look at 5 categories, taking the averages for China's first, second, and third tier cities and comparing them to Berlin, one of Europe's most prosperous cities, to shed light on the differences in scale and development.

Population

Third tier cities may seem small and unknown, but they are still larger than almost all of Europe's capital cities. Berlin is Germany's largest and the EU's second largest city with 3.5 million inhabitants. Yet compared to some of China's cities, it is just a blip on the map! Even China's third tier cities exceed Berlin's population on average by more than 1.5 million people.

GDP

In terms of GDP, there is still a vast growth potential for second and third tier cities in China with populations vastly exceeding Berlin's. The German city's GDP is generally far ahead, though no where near its Chinese first tier counterparts. In terms of second tier cities, only a few, namely Suzhou and Chongqing, rival the GDP of Berlin.

GDP growth

This figure is a clear indication of the opportunities in China's second and third tier cities. Although growth in the first tier cities has been cooling down in the last few years, growth rates are still in the double-digits in almost all 2nd and 3rd tier cities. With a growth rate of just over 1%, Berlin is lagging behind severely.

GDP per Capita

Berlin, being a fully evolved Western city, far outranks all Chinese cities in the GDP per capita category. China's third tier cities have an average GDP per capita that is at not even one fifth of Berlin's. Shenzhen's GDP per capita is still not even half as high as Berlin's even though it is the leader of China's cities.

Number of German Companies

The average number of German companies operating in these cities is a good indication of the level of internationalization and foreign business activity. Of course first tier cities are and will remain the entry point to the Chinese market. With an increase in the quality of infrastructure, personnel and generally established business networks, third tier cities hold great promise for foreign companies wanting to expand in the region. ☺

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