Business Trends & Corporate Strategies

CHINA FOCUS

FIDUCIA 德信
Management Consultants

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Is China's Door Closing?

In this issue:

This year marks the 40th anniversary since Deng Xiaoping's "Open Door Policy" kickstarted China's opening up to the world. President Xi Jinping has promised that the country's doors will continue to open "wider and wider" to foreign trade and investment. But against the backdrop of rising trade tensions on the global stage, and grand industrial ambitions at home, will China keep its word?

Many of our clients are optimistic. They welcome recent tax reductions and the lifting of foreign-ownership caps in the automotive and financial sectors (see p. 2). They appreciate China's anti-pollution drive – despite its short-term costliness – for its effective and fair enforcement across foreign-invested and domestic entities. And they see fields of opportunity in the country's wealthy and experimental consumer market (see p. 4).

But new roadblocks have also emerged. In sectors where China is pursuing dominance, such as high-tech manufacturing and materials, some feel that government funding, unfair licensing processes, and "buy local" policies are skewing competition in favour of domestic players.

Across industries, international firms are also burdened by China's ever more impenetrable "Great Firewall". And when it comes to the US-China trade dispute, it's either already causing cost hikes (see p. 3) or threatening to seriously disrupt supply chains if it keeps escalating – a scenario which, unfortunately, looks increasingly likely.

So which way is China's door swinging? For executives who are drawing business plans and making investment decisions, it might seem necessary to side either with the optimists or pessimists. But our recommendation is not to. The future of China's business environment is too complex and industry-specific to make simplistic projections. Some doors will close but others will open. Accepting this is the starting point to ensuring that your business is ready to avert risks as well as seize opportunities.

For four decades, China's gradual reforms and export-led growth model have benefited the Chinese economy and foreign companies simultaneously. Now that China has established itself as an economic power, it is pursuing a second wave of tech-driven development with larger global ambitions. This time around, it's harder to say whether the results will be "win-win".

In a climate of geopolitical uncertainty, it's more important than ever to have open, informed discussions about China's business environment. This issue of China Focus is our attempt to spark a nuanced conversation. We invite you to join our upcoming events, where we will keep exploring the open doors and firewalls that matter for your China business.

Stefan Kracht

German-speaking event
October 9, 2018 | BMW World, Munich

FIDUCIA MITTELSTANDSTAG 2018

"OPEN DOORS & FIREWALLS"

Join our 5th annual "Mittelstandstag" for thought-provoking, practice-oriented discussions about new opportunities and emerging risks in the Chinese market.

Register online
www.fiducia-china.com

China's grand mission to shift gears towards high-tech and consumption-led growth has coincided with a rise in global tensions. The result is an eventful year full of frequent and sometimes confusing regulatory moves. In an attempt to make sense of it all, we have put together a table highlighting some of the reforms and barriers that have impacted our clients the most over the past year.

OPEN DOORS | FIREWALLS

TRADE

Chinese Tariff Cuts

- Dec 2017 - Jul 2018: Tariff cuts on **1,700 types of consumer goods** including food, garments, and sport gear took effect.
- Jul 2018: Tariffs on **cars and car parts** were reduced. Only 4% of cars sold in China are imported, so the impact has been small.

US-China Trade Dispute

- Jul 2018: US imposed **25% tariffs on $34b** worth of Chinese goods, e.g. medical equipment, machinery, and cars. China raised equal tariffs on US food and e-vehicles.
- Aug 2018: US threatened China with further tariffs on $200b worth of goods. **China vowed to retaliate.**

MARKET ACCESS

Liberalisation in Key Sectors

- China vowed to phase out the rule forcing **foreign carmakers** to form local joint ventures. Tesla signed an agreement to open a wholly-owned plant in Shanghai.
- Foreign ownership caps for **financial services** and life insurance firms will be raised from 49% to 51%.

"Made in China 2025"

- 43% of EU firms surveyed by the EUCCC in 2018 reported **"increased discrimination"** under MIC2025 (China's plan to dominate high-tech industries).
- MIC2025 barriers include **"buy local"** policies. E.g. Since 2017, Sichuan hospitals can only buy China-made PET/CT scanners.

"Negative List" Updates

- China's "Negative List" outlines all sectors where FDI is prohibited/restricted. In 2018, **the list was cut for the 7th consecutive year.**
- However, many reformed sectors are still blocked by strict licensing requirements, SOE dominance or unofficial barriers.

Stricter Merger Reviews

- Jul 2018: China warned it will broaden its merger review process – following similar moves by the US and Germany.
- **Trade war weapon?** Chinese regulators failed to approve Qualcomm's takeover of NXP (the biggest semiconductor deal ever) shortly after the US went ahead with tariffs.

EASE OF DOING BUSINESS

Simplified Business Setups

- **"One Window, One Form":** A reform to simplify foreign business registrations was rolled out nationwide on June 30. The real extent of the reform is yet to be seen.
- **"Internet Plus":** >70% of government services for foreign investors are planned to be accessible online by the end of 2019.

The "Great Firewall"

- US and EU chamber surveys rank China's web restrictions as a **top operational burden.** Banned websites/apps hamper communication and data exchange.
- The 2017 **Cybersecurity Law** requires foreign entities to store data locally, which implies costly and complex IT solutions.

Tax Cuts

- May 2018: First round of VAT cuts (part of a US$64b tax cut plan for 2018) take effect:
  - Manufacturing: **17% → 16%**
  - Transportation, construction, agricultural, and telecom enterprises: **11% → 10%**

Anti-Pollution Crackdown

- Since early 2017, China has ramped up factory inspections and introduced an **Environmental Protection Tax.** The result: higher compliance and production costs, factory closures, and tougher approvals for construction sites.

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"IP enforcement has gotten stronger and the mindset of suppliers has shifted.

Einhell Germany AG was part of the wave of foreign companies that entered China before the country became "the world's factory". Fiducia has helped set up and run its growing China operations since 1993. Today, as "cheap China" fades and automation grows, the stock-listed provider of power and garden tools continues to see China as its most important purchasing market. **Andreas Weichselgartner, Managing Director of Einhell China for nearly 16 years,** spoke to us about how changes in Chinese regulations, factories, and mindsets have kept opening doors for them.

Has the ease of doing business in China improved?

Regulations: Yes and no. Law and order are more transparent and "Westernised" now, but this implies stricter rules and compliance. For foreign enterprises the change is mostly positive. Increasingly, the same rules apply to domestic and foreign companies. "Guanxi", good relationships, especially with authorities, are nowadays less crucial to solve problems or enjoy subsidies, so foreigners with fewer local contacts enjoy more equal respect.

Industry: Chinese factories have really upgraded their efficiency. Automation is improving quality and compensating for rising labour costs, while stricter government checks – especially environmental ones – are pushing out those who don't play by the rules.

Are IP risks still a problem?

In our business scope we have seen an improvement. IP enforcement has gotten stronger, contracts are better, and the mindset of suppliers has shifted. The young Chinese generation running factories nowadays grew up with fewer needs and better education. They understand that loyalty to customers ensures long term success, whereas previous generations were more opportunistic.

And yet, within our large supplier base of over 170 factories, we still find some "black sheep" - cases where we develop a new product and find out that the supplier is commercialising it on other channels.

How do you manage China-specific risks?

Supplier relations: Apart from ensuring good contracts and relationships, we try to generate dependency. If a supplier makes \$100m turnover and \$90m of that turnover comes from your business, he will be willing to listen and to honour your agreements.

Market monitoring: We don't sell our products in China, but we're always checking the domestic market to see if anyone is selling them without authorisation.

Specialists: In China you need trustworthy partners in fields that are crucial to your business scope, which is why we have cooperated with Fiducia for decades. As an export-oriented company, tax and customs specialists are key for us because tax refunds amount to 17% of our turnover. Since China is so "black and white", a simple typing mistake could take you 3-5 months to solve.

Are US-China trade tensions affecting your company?

We have seen rises in the price of raw materials and imported electronic components, but the impact has been limited until now. The US will be one of our end markets in the near future, so if tariffs are imposed on our product range it could affect us. But whether this will happen is uncertain. Even the largest power tools player in the US has a factory with over 11,000 employees in China.

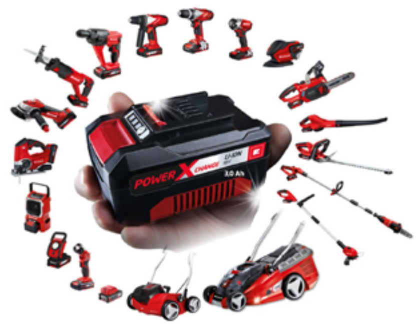
Is Einhell planning to deepen its investment in China?

Over the next five years, Einhell plans to double its turnover globally and enter new end markets. It's very likely that we will invest more in China to drive this growth. I'm confident that the centre of power and garden tools will still be here. Eventually, China will go through a similar shift than Germany did when labour intensive production moved out to Eastern Europe, but automation and component manufacturing remained in Germany.

As a sourcing, tech, and quality office, we in China will have to keep working heavily on efficiency and process performance to remain competitive.

What would you recommend to companies considering to enter China today?

China has changed more drastically and quickly than any other market in the past 15 to 20 years, and continues to do so. Any foreign company entering China has to be ready to change rapidly as well, at a pace that is very different from what traditional German companies are used to.



Power X-Change is Einhell's new rechargeable battery system. The same battery can be used to power different tools, offering consumers a more cost-efficient and environmentally friendly option.

FIDUCIA ADVICE | Managing new China risks

For companies sourcing or producing in China, many current challenges don't require brand new solutions, but rather a diligent execution of common best practices. Here are some ways in which our Trade & Technology Team helps clients manage old and new risks:

ENVIRONMENTAL COMPLIANCE

- **Supplier due diligence:** Evaluate environmental compliance more strictly than before.
- **Supply chain transparency:** Improve visibility beyond your Tier 1 suppliers to detect potential disruptions on time.

TRADE TENSIONS

- **Second sourcing:** Diversify your supplier base beyond China to mitigate tariff risks.
- **Export Control Officer:** Set up a dedicated unit to ensure compliance with international trade laws and sanctions.

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Digitisation: China's Door Opener

> *"In today's China, digitisation is the key door-opener.*

Like many B2C players attracted to China's booming consumer market, Swiss outdoor brand **Mammut** is betting big on China as a growth horizon for its premium products - and winning at it. Fiducia has supported the company's setup and operations as it expands its regional footprint. **APAC Managing Director Dr. Oliver Arndt,** who leads Mammut's subsidiaries in China, Japan, Korea, and Hong Kong, shared his take on why the Chinese market is as promising as ever, despite new challenges.

Do you think China's doors have opened wider to foreign businesses?

We've always experienced China as a highly competitive yet welcoming and open society. Its digitised retail landscape is opening up tremendous possibilities for businesses to connect with end-consumers. In terms of regulations, many developments have been positive for us: VAT reductions, lower import duties, and especially central government directives to develop outdoor sports. For our business, market opportunities have definitely expanded.

What makes you optimistic about the future of China as a growth market?

Chinese consumers are evolving beyond labels as status symbols, focusing instead on brand heritage, product requirements, and sustainability. All of this matches our offering and core brand message: Mammut, Swiss, founded in 1862.

China is the world's frontrunner in digital applications, so it also offers space to innovate. As a globally active brand, we constantly ask ourselves – how can we leverage China's digital advantages and apply them worldwide?

What are the biggest barriers that foreign brands still face?

A fast-changing market is both an opportunity and a challenge. In Japan and Korea the focus is still on traditional distribution channels, for instance, whereas China is now the biggest omnichannel market. We're adapting by investing heavily into online retail – Tmall, JD.com, Amazon, and soon WeChat – while also growing our overall presence through selected partners and our own physical stores.

Compared to more established and saturated markets like Japan, China's untapped potential is still huge – but this also makes it more difficult to know from the outset whether a project will succeed or not. This is why we encourage our teams to make mistakes, but to make them early and learn from them.

How can foreign brands unlock opportunities in China's consumer market?

Digital-first: In today's China, digitisation is the key door-opener. "Mammut Connect" is one of our latest initiatives. We're inserting near-field communication (NFC) chips into certain products. Consumers can then access various functions through their smartphone NFC readers, e.g. reading product details pre-purchase or receiving hiking routes once they're on the go.

Customer-first: Modern Chinese consumers seek innovative experiences. Last year we launched the Mammut Alpine School to take customers on expeditions with professional tour guides in Switzerland.

Local team: China requires unique business approaches and solutions, which a lot of foreign brands entering the market have difficulties adapting to. In addition to our local team in Beijing, we therefore set up a regional office in Hong Kong to deepen our commitment to the Asian market.

With the new DELTA-X collection, Mammut takes its mountaineering experience to the city for "urbaneering" through a range of high-performance products designed for the urban outdoors.

FIDUCIA ADVICE | *Seizing opportunities in the new China*

Succeeding in China's sophisticated retail landscape requires specialised know-how and speed to market. Establishing a local presence is, therefore, increasingly crucial. Here a few ways in which our Executive Search and China Consulting Teams are helping clients achieve this:

OPTIMISING YOUR SET-UP

- **Location analysis:** Shanghai, HK, a Tier 2 city? A pre-investment evaluation of office and store locations is key in a regionally diverse China.
- **Localised decision-making:** Solid on-site leadership ensures agility in a market where speed is king.

DIGITAL COMPETITIVENESS

- **Local partnerships:** Identify strategic distributors & "TP partners" (certified e-commerce partners) to drive online sales.
- **Digital talents:** Recruit China-experienced "digital natives" to manage your online marketing strategy.

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