FIDUCIA 德信
Management Consultants

Business Trends & Corporate Strategies

CHINA FOCUS

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ADVERSITY: A TIME FOR TRANSFORMATION

INTRODUCTION

> *"We see adversity as an opportunity to "get the house in order" and create lasting transformation.*

The global economy is losing steam. As Germany and Hong Kong edge closer to recession and China's slowdown deepens, many of our clients have added "downturn readiness" to their 2020 agendas.

There's no consensus over whether, when, or how hard the storm will hit - especially in China. Its GDP, industrial output, and retail spending are indeed cooling, but this seems less alarming when taken in context: its economy is more than twice the size it was when it last recorded double digit growth, the quality of industrial expansion has improved, and - by global standards - retail here is still booming (see infographics below).

A survey we carried out with China-based business leaders revealed that less than half of them are actively preparing for a downturn (see page 3). As a trusted advisor we see it as our responsibility to help businesses prepare for the worst, even when they're planning for the best. Which is why we came up with a **transformation-focused approach towards downturn readiness** (see page 4). Regardless of what happens, we see adversity as an opportunity to "get the house in order", create lasting transformation, and rethink your Greater China growth strategy. Rather than focusing squarely on costs, our approach addresses three main goals:

1. **Gearing up:** protecting your business against risks and disruptions.
2. **Getting fit:** optimising costs by transforming your setup and processes.
3. **Growing selectively:** refocusing your strategy on future growth engines.

In our four decades of advising businesses in Greater China, we have helped clients sail through adversity before. We have learnt that tough times spark new ideas and accelerate overdue changes within companies. We're excited to see how organisations like yours will evolve this time around and hope to be part of that change.

Stefan Kracht
Managing Director

DOWNTURN FACTS

Google

"Recession"

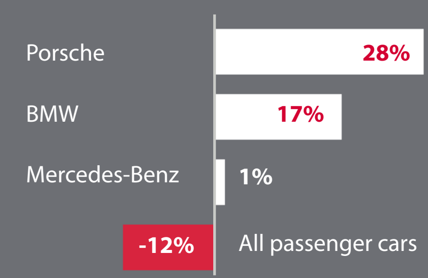
Monthly global searches for "recession" this August were the highest since 2009.

Consumer downgrading...

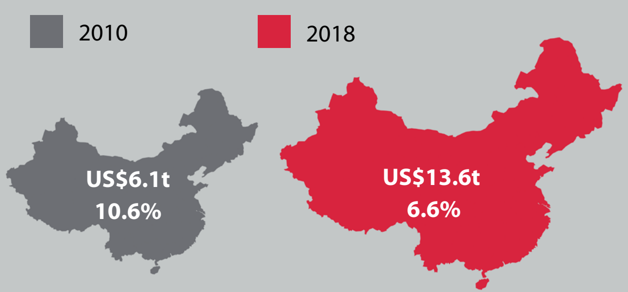
Instant noodles sales are rising in China for the first time since 2014.

...or upgrading? High-end cars are outperforming cheaper brands as overall sales sink:

Cars Sold in China
(Jan-Jun 2019, yoy % change)

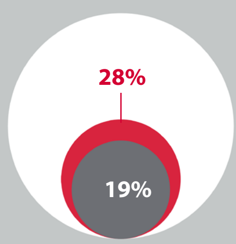


PRC GDP: Size and Annual Growth Rate



GDP growth has been slowing since 2010, but China's economy then was half the size it is now...

China's Share of World GDP Growth



...and today, it accounts for a larger share of gobal growth.

Growth in Retail Sales
(Jan-Aug 2019, yoy % change)

Hong Kong's protest-triggered retail troubles are worrying but temporary, while China's retail growth beats that of most developed countries.

READY FOR 2020?

How China-based leaders are preparing for upcoming headwinds

The possibility of a global economic slowdown is not the only issue keeping Greater China-based executives awake at night. Hong Kong's ongoing social unrest and China's Corporate Social Credit System - CSCS, a new framework to track and rate the behaviour of businesses in a unified database - are also high up on their list of headwinds to consider while doing their budgets for 2020.

But gauging overall business sentiment based on casual conversations with clients is tough. For every Managing Director we speak to who tracks tariff developments closely, there is another one who claims the impact of the trade war is overstated.

We decided to ask business leaders in our Greater China network how they expect these challenges to impact their business, and what they're doing to prepare. Our Executive Survey gathered an overwhelming number of responses (100) - most of them from MDs, GMs and C-levels of international mid-sized companies. Take a look at some of our findings.

EXTERNAL FACTORS

Is your company actively **preparing for a downturn**?

Yes 40% | *No* 60%

Have you expanded your sales/sourcing/ production beyond China to minimise your exposure to the **trade war**?

Yes 35% | *Not yet* 20% | *No* 45%

Only **1/10** understand how their company's **CSCS score** will be calculated.

How will the **Hong Kong protests** impact your business?

No impact 60% | *Not sure* 25% | *Negatively* 15%

INTERNAL ACTIONS

Top actions taken to **ensure liquidity**
(% of respondents)

- **50%** Reviewing payment terms in accounts receivable/payable
- **40%** Postponing/reducing non-essential expenses
- **35%** Renegotiating fixed costs (e.g. rental)
- **25%** Strengthening internal controls

Top actions taken to **optimise costs**
(% of respondents)

- **50%** Streamlining processes
- **40%** Accelerating digitisation
- **15%** Consolidating physical footprint
- **15%** Outsourcing administrative functions

How will you avoid losing **valuable talent** despite cost-down initiatives?
(% of respondents)

- **60%** Continue hiring for strategic positions
- **35%** Recruiting candidates who can adapt to change
- **15%** Exploring alternative work arrangements

GEARING UP FOR ADVERSITY

Fears of a downturn can pressure firms into survival mode. But once the dust settles, those who continue to give growth a chance will come out winning. While defensive strategies to curb risks and costs are vital, it's equally important to seize the opportunities that adversity presents. For businesses in China who are already grappling with a "new normal" of slower growth, rising costs, and dizzying market trends, the prospect of a downturn offers one key opportunity: the chance to hit "reset" and drive changes that may well be long overdue. This is why at Fiducia, we believe that getting "downturn ready" is just another way of getting "future ready". We're helping clients achieve this by gearing up, getting fit, and growing selectively.

> *The prospect of a downturn offers the chance to hit "reset" and drive changes that may well be overdue.*

1 GEAR UP

Mitigate risks.

Downturns disrupt "business as usual". Late payments on the customer side, capacity problems on the supplier side, tighter access to credit - risks start to emerge from all sides, making it hard to keep the wheels of your business turning if you're caught off guard. Below are some of the actions you can take to avoid this. They must be taken early, before you or those around you face financial distress.

Cash Flow

Smart cash flow management is particularly vital in China, where you must file and pay VAT on the *fapiaos* (invoices) you issue monthly, regardless of when clients pay. Start by:

- Reviewing payment terms in accounts receivable/payable
- Renegotiating fixed costs (e.g. rental)
- Reducing non-essential expenses
- Taking up/increasing bank loans

Compliance

Difficult times tend to increase fraud and other integrity risks within organisations, as employees come under heightened pressure, e.g. to meet their sales targets. It's also common for tax and other authorities to increase their oversight. So stepping up internal and external compliance - already a top concern for China-based leaders - becomes even more urgent in the current context. Key actions include:

- Reviewing and strengthening internal controls (e.g. establishing a Whistleblower System)
- Reviewing tax and regulatory compliance

Supply Chain

The last global crisis shook Chinese supply chains. In 2008, half of China's toy exporters went out of business. Since then, China's manufacturing base has indeed matured. Our clients have built solid relationships with reliable suppliers. And yet when we carry out supplier assessments, we continue to find established Chinese manufacturers who, for instance, lack a proper MRP or accounting system. How well can they weather the next downturn? Avoid shocks down the road by addressing underlying volatility in your supplier base early:

- Identify supply chain risks (e.g. assess/monitor existing suppliers)
- Draw contingency plans
- Diversify your vendor network (within and outside of China)

> *In 2008, half of China's toy exporters went out of business.*

Case Study 1 | Finding and Preventing Fraud

Challenge - Our client suspected that non-compliant behaviour in the sales team was causing losses in their Shanghai WFOE. We performed a Corporate Health Check that involved analysing the clients' financials and internal processes and speaking to relevant stakeholders within and outside the organisation.

Solution - We found proof that the former sales director and other team members had sold discounted products to shell trading companies that they set up themselves and created fake business licenses to cover up the relationship. We helped the client fix internal control loopholes to avoid a similar situation in the future.

Case Study 2 | Complying with New Transfer Pricing Rules

Challenge - A multinational group with sales and distribution entities in Hong Kong and China requested a Corporate Health Check of their Greater China companies as part of their downturn-readiness programme.

Solution - One of our findings was that the Hong Kong subsidiary's intra-group transactions in 2019 met the recently introduced threshold that requires them to provide special transfer pricing (TP) documentation to tax authorities. We helped the client prepare the necessary reports to avoid a potential non-compliance penalty and challenge. We are now reviewing their cross-border pricing strategy to optimise tax savings.

2 GET FIT

Optimise costs.

Cost initiatives are the first thing that come to mind when discussing downturn readiness. And while they're certainly necessary when margins tighten and revenues shrink, the focus is too often on cost *reduction* rather than *optimisation*. The former can hamper your company's growth prospects: while trying to cut fat you can end up cutting muscle. The latter is about refocusing resources to where they matter most, delivering savings while still boosting profitable capabilities. Below are some areas where you can free up resources without losing competitiveness.

Organisational Setup

The prospect of a downturn is not the only reason why foreign companies in China are reviewing their setup. But it's making the task all the more urgent. Many of our clients established their China operations under an entirely different market reality. Companies who started sourcing/buying here 15 years ago, for instance, are increasingly looking to sell into the local market. Their original setups have been adapted on-the-go, but not always in the most cost-effective ways. Many of our clients have been able to optimise costs by:

- Adapting their investment structure to match current needs
- Consolidating their physical footprint
- Outsourcing business/administrative functions

Processes

As with their setups, companies should regularly adapt their processes to China's changing market and regulatory conditions to avoid prolonging obsolete operations. For example, tax authorities regularly update filing requirements - often eliminating certain time-consuming steps. This, combined with adopting the right digital tools, can free up significant resources from low-value operations. We recommend clients to:

- Review processes regularly and eliminate unnecessary steps
- Accelerate digitisation by leveraging "plug-and-play" tools (e.g. virtual team platforms to reduce travel expenses)

Tax Optimisation

China's tax burden on corporations is the 12th highest in the world according to the World Bank (2018). And anyone who has seen a Chinese company from the inside has probably gotten lost in its maze-like system of tax rules and incentives. So it's no wonder that a closer look at your taxes in China often reveals vast room for improvement. Common solutions include:

- Restructuring cross-border operations
- Careful tax planning, e.g. ensuring all available deductions are claimed
- Tax-efficient employee compensation strategies under the updated Individual Income Tax (IIT) guidelines

> "Cost optimisation is about refocusing resources to where they matter most.

Case Study 3 | Selling to China: A Low-Investment Setup

Challenge - Our client, a German furniture manufacturer exporting to China, was at risk of losing its top Chinese customer to a competitor. Unlike our client, this competitor had a WFOE in China and could therefore issue *fapiaos* (official VAT invoices) that allow customers to offset their own payable tax.

Outcome - Fearing a downturn, our client decided against the option of opening a WFOE now. Our trade services team provided an agency solution for them, managing their sales and issuing *fapiaos* in China on their behalf. Our client was able to salvage its key account and improve its competitiveness in China with a low-risk solution.

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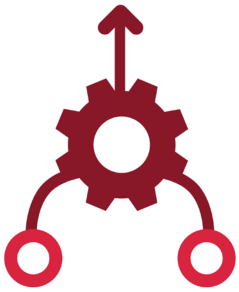


Case Study 4 | Optimising Your China Footprint to Fit New Needs

Challenges - Our client, a European industrial equipment supplier, set roots in China 20 years ago with one trading company in Shanghai and one in Nanjing, planning to turn the latter into a "China for China" plant. Over time their import business boomed, so they scrapped their plan to produce locally. The Nanjing office became less useful and profitable, so the client requested our help to consolidate its operations in Shanghai.

Solution - We created a step-by-step consolidation plan and helped the client implement it. This included gradually moving all Nanjing operations to Shanghai, changing the Shanghai WFOE's business scope accordingly, untangling inter-company billing, and getting the Nanjing entity ready for de-registration. The new setup generated significant cost savings and, more importantly, clearer and more efficient processes.

3 GROW SELECTIVELY

Focus on future growth engines.

After years of fast top line growth, many foreign invested companies in China are under pressure from their headquarters to up the pace. These expectations are getting harder to meet - especially for businesses who are simply doing more of what they've always done. To succeed in an increasingly competitive China, companies need to identify their future growth engines and invest disproportionately in them. The problem with this is that it entails disruptive transformation, but the prospect of a downturn might give China-based executives the buy-in they need to drive a bold change of strategy.

Growth Strategy

It's hard to overstate just how quickly market opportunities shift in China. Environmental regulations can make or break the demand for a certain industrial material overnight, online channels can gather or shed millions of users in a month, and entire sectors that were previously off-limits for foreign investors suddenly open up. Many foreign players fail to review their growth strategy often enough to enable a swift reaction to such changes. The possibility of a downturn raises the need to do so in order to avoid wasting potentially scarce resources in segments or strategies that will not be relevant tomorrow. Key actions include:

- Analysing market potential to identify growth-driving business segments
- Reviewing your sales and distribution channel strategy
- Reallocating resources accordingly
- Identifying potential M&A targets/routes

People Strategy

A downturn can hurt your long-term competitiveness if slashing costs becomes the main task of your HR department. Unwise redundancies can demoralise employees and a culture that rewards austerity can push managers towards bad decisions. Instead, the focus of HR professionals should be on building resilience while keeping the organisation focused on the future. For instance, by continuing to invest in attracting, retaining, and developing R&D and innovation talents that will help the company unlock new growth and "bounce back". Forward-looking HR professionals should:

- Improve work flexibility to attract/ retain talent and save costs (e.g. telecommuting to optimise space)
- Recruit candidates who can adapt to change, especially for key positions
- Drive organisational and cultural change to improve performance

> " A downturn might give China-based executives the buy-in they need to drive bold change.

Case Study 5 | Targeting high-growth application segments

Challenge - Our client, a European manufacturer of high-performance materials, was facing lower downstream demand from the automotive and smartphone industries. They requested our support in identifying specific application segments that could help them unlock new growth in the Chinese market.

Solution - Our China Consulting Team carried out a benchmarking analysis of 10 major competitors, including an in-depth cost analysis, to identify high-potential and high-profitability application segments. Based on our findings, the client developed a new plan to target solar energy and medical applications.

Case Study 6 | Weathering the slowdown with the right sales leader

Challenge - As a manufacturer of premium machinery for the packaging industry, our client had been losing business to mid-market Chinese competitors. Fearing that this trend would accelerate now that slowing exports and rising uncertainty are making customers put off capital investments, our client partnered with Fiducia's Executive Search Team to look for a Sales Director who could help them reverse the sales slump.

Solution - After analysing the sales team's pain points, we advised the client to search for a candidate with a proven understanding of Total Cost of Ownership (TCO). We helped them find and hire a Sales Director who is now incorporating TCO calculations into the company's sales proposals and pricing strategy, making it easier for buyers to gauge the long-term benefit of choosing a high-end machine over a cheaper one.

HOW WE CAN HELP YOU

GEAR UP Mitigate risks.	GET FIT Optimise costs.	GROW SELECTIVELY Focus on future growth engines.

- ✓ The Fiducia Corporate Health Check (a tailored compliance and/or efficiency audit)
- ✓ Tax advisory (corporate & individual)
- ✓ Supply chain digitisation (ERP plus integrated QC/QA & other tools)
- ✓ Corporate Social Credit System Check
- ✓ Whistleblower system
- ✓ Supplier search & evaluation
- ✓ Optimising your investment structure
- ✓ Company relocation/consolidation
- ✓ Outsourced administrative functions
- ✓ Cost structure analysis & optimisation to reallocate resources to high-potential areas
- ✓ Trading agency solution to manage your sales in China
- ✓ Market analysis & strategy planning
- ✓ On/offline channel analysis
- ✓ Partner search & matchmaking
- ✓ Organisational transformation
- ✓ Recruiting new talent
- ✓ M&A support

Snapshot from Europe:

AN ECONOMIC STORM IS COMING - ARE YOU READY?

By our partner h&z Management Consulting

h&z Die Beratung mit Hirn, Herz & Hand

Business leaders in Europe are getting nervous: the threat of a severe crisis now looks possible after years of economic upswing. The good news is that at least we can see this coming, unlike the devastating crash of 2008. Are businesses prepared for an economic downturn after years of healthy growth?

To find out, we interviewed representatives from more than 30 companies and gained some valuable insights, some of them disturbing (see infographics below). We found that two thirds of all companies still feel safe in the current economic environment, despite the clouds on the horizon. We feel that this is a false sense of security due to full order books and good utilisation of capacity.

Life insurance for companies: Early warning systems and stress tests

We are convinced that more can and should be done to mitigate the threat posed by a potential downturn. At the very least, a good early warning system is needed, including relevant industry-specific indices, intense communication with your customers and structured feedback loops. Additionally, a stress test will help you to identify the effects of a downturn on your company's EBIT margins, working capital and financial reserves. Armed with this data, you would be in a far better position to put preventative measures in place.

Preparation is the name of the game

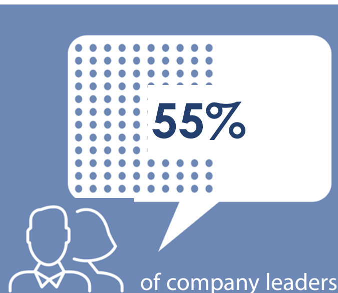
The recommendations stemming from our survey can be summed up in two words: be prepared! Below is our 10-point preparation plan:

1. Install early warning systems that aggregate market indices and customer feedback.
2. Examine simulations and different scenario calculations.
3. Develop contingency plans for sales and earnings slumps, liquidity and existential crises.
4. Review the value chain and where possible streamline operations, processes and organisational setup.
5. Consolidate your company's footprint and search for best-cost alternatives.
6. Re-define your business model, leverage service businesses when feasible and look for new growth opportunities.
7. Define procurement commitments, volumes, prices, and exit clauses with existing suppliers.
8. Unleash your company's financial reserves that may currently be tied up in working capital and assets.
9. Terminate and re-allocate financial investments and raise new capital as a financial reserve.
10. Negotiate employee agreements with the joint aims of becoming more flexible and reducing overtime.

Are you flexible (enough)?

Irrespective of the threat or not of a downturn, it is generally wise to make your company more flexible. When asked about measures to secure their future viability, 70 percent of the companies we spoke to mentioned digitisation and the development of new business models. Only 40 percent recognised the inevitable increase in agility as a pre-condition to secure their future. Where do you stand?

2/3 of all companies still feel safe in the current economic environment, despite the clouds on the horizon.



of company leaders openly discuss the potential of a downturn among their top management.

Less than **1/3** of the companies use indices or scenario simulations to anticipate the impacts of a downturn.

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