

**Andrew Leung International Consultants Ltd**

## **Understanding China Businesses – Critical Insights**

*A presentation to the McCombs School of Business  
The University of Texas at Austin*

*China Study Tour*

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# Strengths

- World's 4th **largest economy**, > US by 2017, and > US by 70% by 2050 (Goldman Sachs graph)
- **Private sector** 70% economy (*Hu Angang*), 40m entrepreneurs, 4 m private enterprises (90% family-owned), with 50 m employees (25% urban workforce)
- **Trade** = 75% GDP (v Japan, India, Brazil 25 – 35%)
- AmCham Survey 2005 – 68% **profitable**; 70% = or > margin v world (*Business Week*, 22.08.05)
- **World's Factory** – not just cheap land and labour costs but concentration of super-efficient global production chains (within 3 hour radius) – e.g. 70% of world's microwave ovens, DVD players and digital watches, 50% of world's shoes, garments, mobile phones, many in just one town
- **Technological development** (a) telecom (e.g. Huawei, ZTE, Datang) (b) consumer electronics – HD TV, 3Cs (c) software (123m becoming largest internet population) (e.g. Sina, Alibaba, Shanda)
- **Home Dragons** e.g.
  - Galanz (world's largest microwave oven producer (1/3))
  - Changhong, Konka and TCL (best-selling TVs brands in China)
  - CIMC (40% of world's refrigerated containers)
  - BYD (50% of world's mobile phone batteries)
- **National Champions** e.g.
  - SAIC, Chery, Geely, Sina, Li Ning, Master Kong, Wahaha, Mengniu, Gome
- Emerging **Global Champions**
  - ICBC, PetroChina, China Mobile, Sinopec, Lenovo, Haier, Huawei
- High **literacy rate** 96% for age 12 -40; 6 m **university enrolments** p.a. (5 x 1999), Goal to push **high school** enrolment from 40% to 70% (2010) and 85% (2020); **university** from 13% to 20% (2010) and 40% (2020) (v US 93% and 60%)
- 32 m **scientists and technologies**, 5th highest in published scientific papers; by 2010 more science and engineering PhDs > US; growing share of high-tech (electronics) production (28% exports 2005)
- Excellent transport and communications **infrastructure**
- **Pro-business bureaucracy and people mindset**
- **PEW 2006** – Satisfaction Index 48% (2002), 72% (2005), 81% (2006) v 29% (US), 35% (UK)

# Weaknesses

- GDP = 27% US, **GDP@** 1/16 of US, below 100; even by 2050 = middle-income@ LDC
- Economy heavily reliant on investment (45% GDP)- rising **inequalities** (900M rural dwellers average income only US\$380 p.a.); **regional** imbalance, **economic imbalance**, **environmental degradation**, rampant **corruption**, developing **rule of law**, **IPR** violations, inadequate village **social protection**, healthcare and pension provision, looming **ageing profile**, economic **overheating**, food and commodity price **inflation**, social **unrests**, **human rights**, **separatist risks** (Tibet, Xijiang, Taiwan)
- Inadequate **agricultural resources** - 20% of world population but 7% of arable land, fresh water availability 1/3 world average, eschewed distribution 20%/64% v 80%/36%, highly polluted. No longer agricultural self-sufficiency. Considering overseas agricultural investments e.g. Brazil
- **Unstable, Unbalanced, Uncoordinated, and Unsustainable** – 17<sup>TH</sup> Party Congress, Premier Wen, 15.03.07.
- The **State's Long Apron Strings** (*Business Week*, 22.08.05)
- Low **overall capital efficiency** - \$5 -7 investment to generate one dollar worth of GDP (\$1-2 in advanced countries)- China infrastructure still to reach saturation
- **Big 4** (ICBC, CCB, BoC, ABC) – 80% (> RMB 1.8 T) deposits, 57% of all lending
- Immature and ill-regulated **stock markets**, IPO pricing decided by bureaucrats, 2/3 shares non-tradable
- Weak **innovation** - Rare > 5% revenue on R & D (Huawei 10%); IPR challenge
- Weak **international management knowhow** - China <5,000 out of 75,000 executives with international experience needed in the next five years (*Competition from China*, Two McKinsey Surveys, May 2008)

# Threats (1)

- Still largely *energy-intensive, energy-inefficient,, labour-intensive, polluting, low-margin* economy – uphill battle for global proprietary technologies, innovations, brands and standards
- ***Oil geopolitical risks*** - by 2025, China expected to import 75% her *oil* (2x now) and consumes 10.6% of world total (US Energy Dept estimate)
- ***Emerging shortages of cheap labour*** as young migrant workers becoming less abundant (over 200m already + improved rural income = @+ 12.5% in H1,2005, e.g. migrant wage in Xiamen reach RMB 1200 -1500 pm.)
- ***Marginalized migrant community*** without adequate social provision and care of left-behind children
- ***Growth constrained*** by continuing RMB appreciation, squeezed margins, rising input costs (inc Labour Law, rising environmental standards), increasing resource scarcity, and growing protectionism (PMI (Purchasing Managers' Index) down from 59.2 (2007) to 53.3; export orders down from 58.9 to 53.4, May, 2008)
- ***Overcapacity and Inflation risks*** (Energy + Food) Food = 40% of household expenditure for 60% population, now +20% p.a. yoy (Lehman Brothers, June 2008), Energy pricing conundrum
- ***Global imbalance*** (China excessive savings financing US excessive debt))
- ***Aging population profile*** from 2015 - 4-2-1; in 3 decades 300M > 60s, 1/6 with pensions and 5% with healthcare

## Threats - Environment (2)

- ‘China achieves in 20 yrs what has taken the West 100 yrs , but now faces the environment problems of **100 yrs**’ – Pan Yue, Vice Minister, SEPA
- World’s largest emitter of **SO<sub>2</sub> and CO<sub>2</sub>**
- Pollution costs 8 billion yuan a year in healthcare (*Fudan*), Air pollution kills 400,000 p.a. (*Jamestown Review*, 2005); **Environmental loss** = 12-13% of GDP
- 1/10 **energy** @US, 1/5 @Japanese but 2 x @Indian
- **Energy @GDP** 7x Japan, 6x US and 3 x India
- 7% of world’s **arable land** for 20% world population
- **Desertification** – 25% of land already desert
- **@freshwater** = 1/3 world average, very unevenly distributed – 64% land with 20% water
- 7 main rivers and 25 of 27 main lakes already polluted; 1/5 cities face water shortages, 90% have pollution problems; 500 m without access to **safe drinking water** (*China’s Water Crisis*, Ma Jun, *one of world’s 100 most influential persons*, *Time Magazine* May 2006)
- **Yellow River** running dry due to increased irrigation, urbanisation, silting, and climate change; its floods threaten 78m (*When the Rivers Run Dry*, Fred Pearce, 2006).
- First-ever **National Assessment Report on Climate Chaos** (26.12.2006):
  - Av temp in China to rise 1.3 -2.1 degrees C by 2020
  - Glaciers on Qinghai Tibet Plateau shrinking by 131.4 sq km p.a.
  - Those in Western China melting down by 27.2% by 2050
  - Extreme weather conditions – floods, draughts, diseases, water and food scarcity
  - Calls for dramatic transformation of China’s development model

# Guess What?

- (a) Most of the beautiful scenic (lake) was hopelessly polluted by the so-called red-tides of polluted waters from the factories on its shores. Smog warning became regular and asthma sufferers began trekking to the hospitals. Regional complaints and petitions about pollution, about 20,000 five years (earlier), had risen to 76,000 as this decade began. In the south, hundreds of people fell ill from eating the local fish. Many died. Similar problems occurred in the north, with mercury-filled drainage from one factory and where a painful bone disease was caused by cadmium .....
- (b) For two decades, the government treated environmental protection as a distraction from economic growth.....Breakneck industrialization produced some of the worst air and water pollution in the world. According to environmental officials, acid rain is falling on one-third of the country., half of the water its seven largest rivers is 'completely useless'.....one-third of the urban population is breathing polluted air. More than 70% of the rivers and lakes are polluted., and ground water in 90% of the cities is tainted.

## Answer to Guess What?

- (a) Frank Gibney, *Japan: The Fragile Superpower*, W.W. Norton, 1975
  
- (b) Susan L. Shirk, *China: Fragile Superpower*, Oxford University Press, 2007

(Source: Chapter 6, A Planet Pressured, Bill Emmott, *Rivals – How The Power Struggle Between China, India, and Japan Will Shape Our Next Decade*, Penguin Books, 2008)

# Opportunities (1)

- **Environment e.g**
  - ~ \$20b industry +20% p.a. (*China Association of Environment Protection Industry*)
  - Clean cars
  - Thames Water \$70 m 49% in China Water (treats drinking and waste water in 7 cities)
  - Shell technology for Coal to Gas; Veolia (French) \$800 m 10 water treatment projects driven by methane from solid waste
- **Technology and Innovation e.g.**
  - Soon largest internet population – new generation Internet Protocol Version 6
  - Consuming > 20% global chip supplies, largest IT market by 2010
  - Beijing Genomics Institute 1st to decode Rice genome (*Science*)
  - 100 PhDs on cancer treatment at new \$60M facility at Zhangjiang High Tech Park
- **Heavy industries**
  - **Car industry** – 8.7 m capacity 2008, Middle Class + urbanization + infrastructural face-lift - Private cars 11@1000 v 500@1000 US, 500M cars by 2050 (*Goldman Sachs*); Delphi Corp new tech centre Pudong - 1,500 engineers to design parts for GM. VW and Nissan; Honda, Nissan, Chrysler for export
  - **Aircraft industry** – ~3,000 more large aircraft needed by 2025, State Council decision to develop aircraft industry, Airbus A320 production in Tianjin in 2009, Embraer in talks, GE and Rockwell partners, Boeing expected equivalence to Boeing 737 & 12% of global deliveries by 2020, but now 2/3 components still imported and in need of improved maintenance and support facilities
  - **Others** – Coal, power, water, steel, petrochemicals, ship-building

# Opportunities (2)

- ***The China Dream*** (*Chinese Media and Marketing Survey*, Grey Global Group, 2005- Survey of 16 – 39 age group in 30 cities)
  - Advancers (34%) – self-image and money, mostly male, 69% married (cars etc)
  - Experimenters (17%) – chasing the latest products and fashions
  - Young and hip (11%) – iPod generation
  - Motivated (11.6%) – passion to get ahead in their careers
  - Achievers (5%) – already at the top
  - The Independents (8.6%) – Individualistic + better life and career, Liberated women, International but Chinese, Thirst for Knowledge, Enjoyment but money and career first, Socially conscious
- ***Second – 3rd tier cities***
  - Much lower land costs and wages (e.g. Sichuan ½ Guangdong), lower staff turnover, abundant energy, new power grids and highways, increasing income levels, National strategy
  - FDI in central and W China increasing gradually, down in eastern China
  - 50% AmCham members starting to invest
  - Suburban mega-stores (highways, cars, incomes and lifestyles)
- ***Rural areas*** (> 750 million population)
  - Micro-finance
  - Agrarian technology
  - Green and environmental industries e.g. biomass fuels
- ***Product diversity*** e.g.
  - Larger frigs in steamy Guangdong v North
  - Geely \$3,700 as 1st car for college grads
  - Lenovo PCs from > @\$2000 with home entertainment systems to @\$200 - 300 for villagers
  - Haier \$38 washing machines for rural areas
-

# China joins the Capitalist Club

- **3(4) of world's top 5(10) corporations** (market cap) - *PetroChina (US\$1T 2 x ExxonMobile), ICBC (World's largest bank), ChinaMobile, Sinopec*
- **Massive IPOs** - *BoC (US\$9.7 b), ICBC (US\$21.9b), Alibaba (US\$1.5 b, largest internet IPO since Google)*
- **Booming M & A - Mainland** - *US\$ 29.4b in first 3Q 2007* **Outbound** - *CNOOC for UNOCAL, Nanjing Motor Group for MG Rover, CIC 10% in Blackstone, CDB 3.1% in Barclays, CCB for B of A's HK & Macao operations, China Minsheng 9.9% of UCBH (US bank), ICBC 20% of South Africa's Standard Bank, ChemChina + Blackstone for Nufarm (Australian agro-business), CITIC 6% Bear Stearns, Chinalco in dawn raid acquired 9% of Rio Tinto for US\$14b; Ping An paid Euro 1.81b for 4.18% of Fortis (expandable to 4.99%) and Euro 2.15b for 50% of Fortis Investment to form Fortis Ping An Investment*
- **China to grow yuan private equity** – *Wu Xiaoling, Dep Gov, PBoC, 2007 China M & A Annual Conference, Tianjin*
- **Imminent launch of stock index futures** – *hotbed for hedge funds already on Mainland by stealth e.g. trade settlements, property and Chinese stocks, betting on RMB, Asian hedge funds= US\$ 20-50b*
- **4 of Big 5 SCBs** (60% of all loans and deposits) embrace **foreign equity**: *HSBC 19.9% of BoCom (2004); BoA 10% of CCB, RBS 10% of BoC; Goldman Sachs 10% ICBC (2005)*
- **Local incorporation of foreign banks** – *Citibank, HSBC, SCB, BEA*
- **Controlled outflow** *Estimated US\$10b (Deutsche Bank), 23.4b (Morgan Stanley), 690 b (+80%)(Lehman Brothers), (US\$4,800 b household and corporate savings)*
  - *Liberalised QDII - banks allowed 50% overseas investment quota for approved equity funds*
  - *US\$6.6 b raised in Beijing in one day (Sept, 2007) for an overseas equity fund*
  - *Chinese citizens with a/c at the BoC Tianjin to invest in HK stock market*
- **China's Sovereign Wealth Fund - China Investment Corporation (CIC)** *to manage initially US\$200b of FX*

# China Mega-trends (1)

- (a) **Explosive urbanization** (McKinsey Global Institute, March 2008), by 2025 + 350m = 1b; 221 cities@ 1m (EU 35); 15 super-cities@25m; 11 hub-&-spoke conurbations @60m; 50,000 skyscrapers = 10 NYCs; GDP x 4 by 2020; concentrated urbanization mode = savings in 2.5% GDP in public expenditure and in 35% emissions
- (b) **Largest and fastest-built national transport infrastructure** in human history – 2001-5 = West 50 yrs, 2<sup>nd</sup> only to US interstate *highway system* in 17yrs, biggest *railway expansion* since 19<sup>th</sup> C, 78,000 km (25% world traffic but 6% of total length) to 100,000 km by 2020, 6-lane 36km world's *longest sea-spanning bridge* (US\$ 1.64b) over Hangzhou Bay linking Shanghai to Ningbo conurbation + Zhejiang, Jiangsu = total population 72.4m
- (c) **Rise of the 'Middle Class' – Urban household income** US\$1,000 p.m.= PPP US\$3,200 p.m.= 9.4% (2005), 21.2% (2015), 59.4% (2025) (*McKinsey Quarterly 2006 Special Edition*); 12% world *luxury sales* to grow to 1/3 by 2015; *Private cars* 11@1000 v 120 (world) v 500@1000 US, 500M cars by 2050 (*Goldman Sachs*); *The Young and Restless* – ladies in UK, gentlemen in US?, *Post-80s* Little Emperors, avant-garde *Me-Generation*, *Post-Torch Relay* + *Sichuan Earthquake impact*; *young entrepreneurs*, 300,000 *USD millionaires* + 50,000 p.a.
- (d) **Green Revolution - 11<sup>th</sup> FYP**, @ CO2 emission 87% of world average but *largest polluter*, 2.6 m sq km *desertification* affecting 400m people; 1978 *Green Great Wall* 4,480 km afforestation (recent snowstorm damaged 10%); world's largest ecological project now absorbing 500m tons (8%) green-house gas emissions p.a., to increase to 20 % absorption, coverage to 18.21% *to reduce 1b tons CO2 p.a. by 2010* ; energy efficiency - small coal power plants closed (< 10m kW completed 2007, target 50m kW); \$200b to be invested in renewable energies next 15 yrs (IEA + Deutsche Bank) inc hydro, nuclear, coal-seam gas, biomass, wind, solar, terrestrial heat and wave energies; Dongtan *Eco-City*; *Electric Cars* manufactured in Tianjin (NY Mayor Bloomberg visited) –Miles XS500 capable of 120 miles at 80 mph to launch in 2009 (*Zoom: The Global Race to Fuel the Car of the Future*); praised for proactive role in post-Kyoto *Bali Roadmap*; *airtickets* only and ban on *plastic bags* 1.6.08

# China Mega-trends (2)

- (e)(1) Drive for **Science and Technology**: 4 m *graduates* pa, 40% of overseas post-doctorates in US, 32M *scientists/technologists*, 5th largest no. of published *scientific papers* (*Science Watch 1996-2006*), *leading strengths* in biotech, genomics, stem cell, gene therapy research, world's largest *agricultural science program*, *Shenzhou VI* (2005), *Chang'e* (2007), *Shenzhou VII* (space-walk 2008), *11th FYP* 60% GDP, 2.5% on R&D by 2010, *Aircraft industry* – regional jets roll-out
- (e)(2) Building a **Nation of Innovation**: biggest market for *IC*, 3 x India's 24 *PCs @1,000*, 750 *international R&D centres* (India 100), world proportion in China (35%) = France v UK (47%) US (59%), home-grown *IGRS (Intelligent Grouping and Resource Sharing) Standards* approved June, 2005 & *3rd G 3G network TD-SCDMA* for *3C* (Computers, Communications, Consumer Electronics) and *IPTV* (Internet Protocol TV); satellite launch on 14.04.07 for China *GPS* (v US's GPS, Russia's Glonass and EU's planned Galileo); *Technologies* in energy and water resources, environmental conservation, proprietary technologies, life sciences, aeronautics, ocean sciences; 11th FYP - *20 Fortune 500* by 2010 (Lenovo, Haier, Huawei etc)
- (f) **China going Global** – (a) *Resources* (b) Overseas *markets* – home overcapacity + higher margins (c) *technology* (e.g. in Japan, Shanghai Electric Group bought Akiyama (high tech printers), Midea bought Sanyo Electric's microwave oven division, Huawei JV with NEC + Matsushita for 3G mobile phone technology (d) China joins the *Capitalist Club* (Slide 7)
- (g) **Outsourcing and In-sourcing** – from science and technology parks to *BPO* parks + universities (India), Chinese MNCs to outsource overseas compliance to host countries?
- (h) **Central and Western expansion**: *Balanced* development, New Socialist *Countryside*, Rising *mass consumers* in Tier 2-3 cities (*Marketing to Hinterland*, McKinsey Quarterly, 2006 Special Edition)
- (i) Inbound and Outbound **Tourism** (Top Tourism Destination before 2020)
- (j) **Emerging civil society** (public consultation and public *hearings mandated by law*, *local elections* of all village and county chiefs and urban neighbourhood committees, *online community forums*, *media* role in monitoring consumer rights and environment, *36m blogs* (60m bloggers), officials read public *internet feedback*, 250,000 *NGOs*, 80-100M *Christians* (*Jesus in Beijing*, David Aikman, 2003); *Post 5.12*

**Thank you**

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