CKGSB KNOWLEDGE

CHEUNG KONG GRADUATE SCHOOL OF BUSINESS

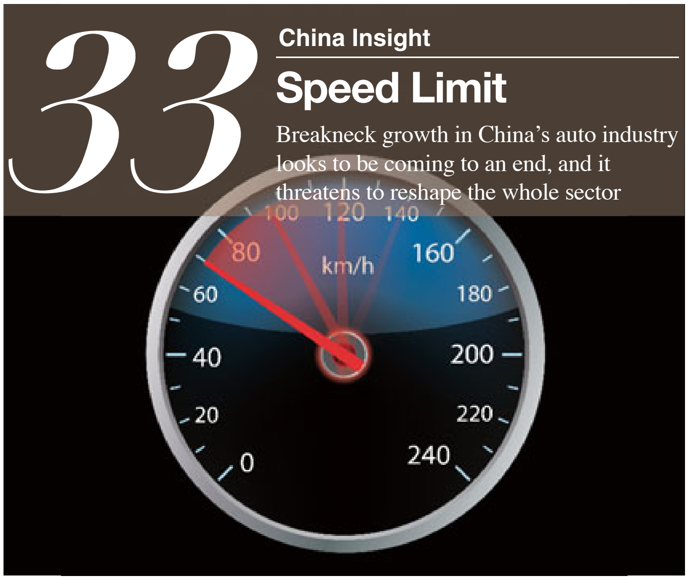
Volume No. 17
SPRING 2015
$12.00

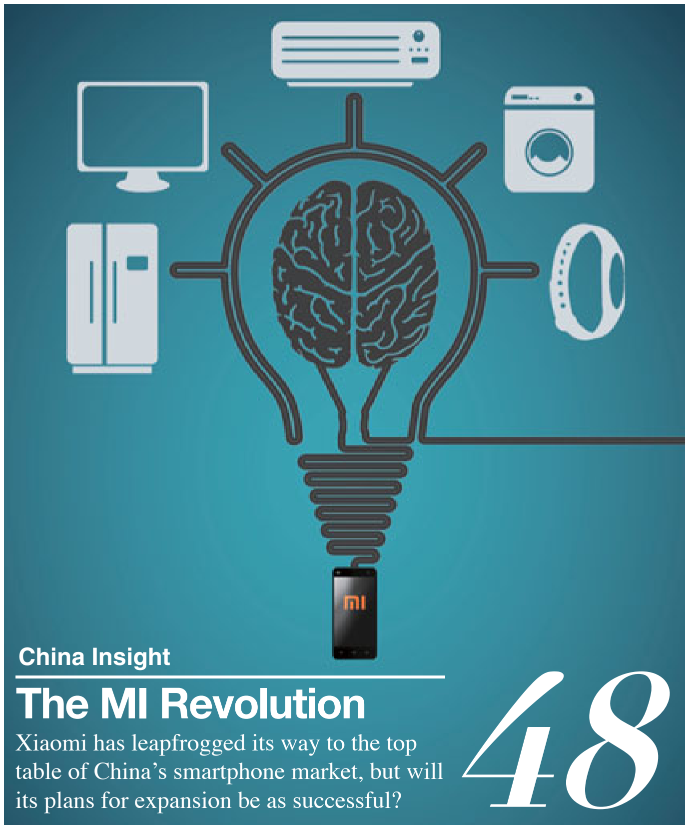
The New Silk Road

China's bold new trade and transport initiatives are reorienting the country's economy, and its place in the world

- China's tech giants on the hunt for investments abroad
- Leading business thinker Jim Collins on what makes companies great
- Xiaomi's mission to take over your living room, and everywhere else

Table of Contents





Issue: Spring 2015
Vol. No. 17

Editor-in-Chief
Zhou Li
Executive Editor
Neelima Mahajan

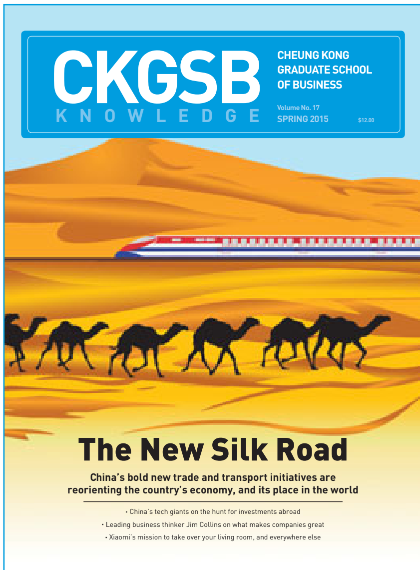
Produced By
SinoMedia
Managing Editor
Chris Russell
Design
Jason Wong, Max Lu

ISSN 2312-9905
Publisher
CKGSB GLOBAL LIMITED
Suite 3203, 32/F, Citibank Tower,
3 Garden Road,
Central, Hong Kong

For Letters to the Editor or reprint requests, please contact:
ckgsb.knowledge@ckgsb.edu.cn

Frontiers Old and New

Centuries ago, the legendary Silk Road that ran from China to Western Asia, Middle East and eventually Europe played a very important part in not just encouraging two-way trade ties, but also in enhancing political, religious and cultural exchanges across nations. For China, it was a connection to the world. It exposed the Chinese civilization to external influences and also took Chinese inventions like silk, gunpowder, papermaking and printing technology to the world.



Today the situation is starkly different from what it was during the Han dynasty, when the ancient Silk Road was developed after a tough peace mission led by Zhang Qian, a loyal Han diplomat, to Western Asia after travelling through a war zone. The world is much more integrated today, and information, technologies and people flow across much more freely. Yet in many ways, China's plan to establish a 'New Silk Road' sparks a sense of déjà vu.

The New Silk Road aims to go beyond improving trade and diplomatic ties across nations with China playing a linchpin role. It will connect China's inner regions with the world, thus spurring development in areas that have lagged so far. It may also help China to 'export' its industrial overcapacity to other nations and internationalize the renminbi.

Will the New Silk Road achieve the same significance as the ancient Silk Road? Will it achieve its lofty goals? These are early days still and it's hard to give a definitive answer, but the plan looks promising. I won't give away more here. Please read our cover story on page 22 to understand more about the plan, its goals and possible challenges.

Chinese technology companies have been making waves all over the world. In this issue we look at companies like Tencent, Alibaba, Baidu and Lenovo that have been leading the charge in Chinese outbound investment in technology. From making small investments these companies have gradually moved towards making big buys—such as Lenovo's acquisition of Motorola Mobility. We tell you what is fuelling this trend in our story titled 'The Technology Gold Rush' on page 10.

Elsewhere in this issue we turn our attention to the other darling of China's tech industry—the irrepressible smartphone company of Xiaomi whose valuation now is more than that of Uber. In just four years Xiaomi has acquired the kind of fan following and status that most companies only build after decades of hard work. Currently the world's fourth-largest smartphone manufacturer (by shipments), Xiaomi is now quickly expanding its reach beyond China. Our story looks at how the smartphone maker is now looking at conquering virgin territory—that of 'smart homes' through an ecosystem approach. Will it succeed? For answers turn to page 48.

In our interviews section, we bring you a very rare interview with management rockstar Jim Collins, author of books like *Built to Last* and *Good to Great*. Anyone who has done an MBA is familiar with his ideas of creating and sustaining greatness over time. In this interview Collins also touches upon how the structure of companies is changing from hierarchical organizations to networks with disparate entities, and the challenges of leading such companies. We also have Don Tapscott, the person who coined the term 'Digital Economy' 20 years ago. He tells us how we can deal with the seismic disruption that technology has brought into our lives. On page 64 Peter Cuneo, former CEO of Marvel Entertainment, talks about the trials and tribulations that come with turnarounds, and how CEOs can handle such situations.

I wish you all a very Happy Chinese New Year! I hope that the year of the Year of the Sheep will bring you much happiness, prosperity and good fortune!

I hope you enjoy reading this issue of *CKGSB Knowledge*!

Please email us at *ckgsb.knowledge@ckgsb.edu.cn.*

Yours Sincerely,

Zhou Li
Assistant Dean, CKGSB

For more insights on the Chinese economy and business, please visit the CKGSB Knowledge site: http://knowledge.ckgsb.edu.cn/

China Data

The stats you need to know

CROSSING THE BORDER

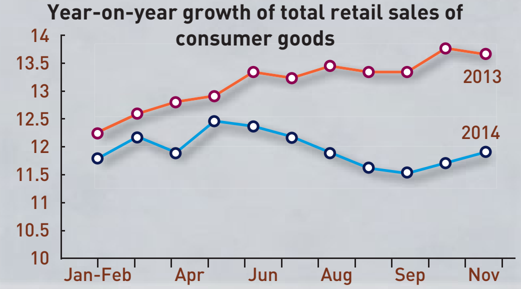
RMB 9.95 TRILLION

RMB 9.95 trillion was used for cross-border payments in 2014 (figures for 2013 not available). China's central bank says that the RMB is increasingly being used for such transactions. Chinese officials want to ensure a greater international role for the RMB. According to Swift, the international payments network, 50 countries now use the RMB for at least 10% of their trade with China.

Source: *People's Bank of China, The Wall Street Journal*

Curbed Consumption

Year-on-year growth of total retail sales of consumer goods



Chinese consumers are buying more, but in comparison to 2013, the growth is beginning to ease off.

Source: National Bureau of Statistics

Large Delivery

China's e-commerce market continues to scale new heights as more and more consumers and businesses head online.

Meanwhile specialist stores, supermarkets and malls saw year-on-year growth of 5.8%, 5.5% and 4.1%, respectively, slower than 2013.

* Includes B2B transactions, and sales from online retailers and e-commerce platforms.

Source: Tech in Asia

Dalian Wanda has bought a 20% stake in the Spanish football club Atletico Madrid, last season's league champions. The stake cost €45 million ($52 million). This is the third time a Chinese individual or company has invested in a top European football team.

Source: *The Wall Street Journal*

Losing its Luster

China's luxury market has been the savior of many top brands, but 2014 saw a contraction in the market.

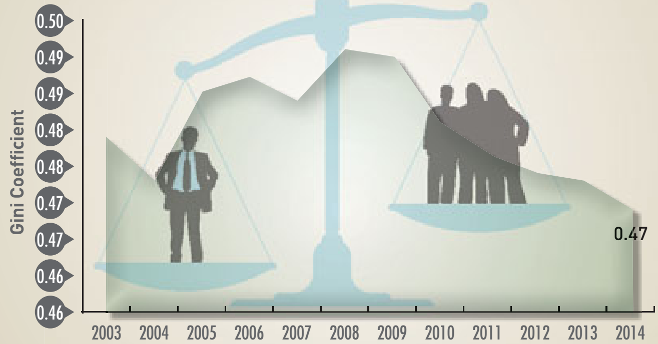
Growth of China's luxury market in 2014 (year on year)

Accessories	0%
Women's wear	11%
Shoes	8%
Jewelry	2%
Bags	0%
Cosmetics, perfume & personal care products	7%
Men's wear	-10%
Watches	-13%
Total consumption: RMB 115 billion	-1%

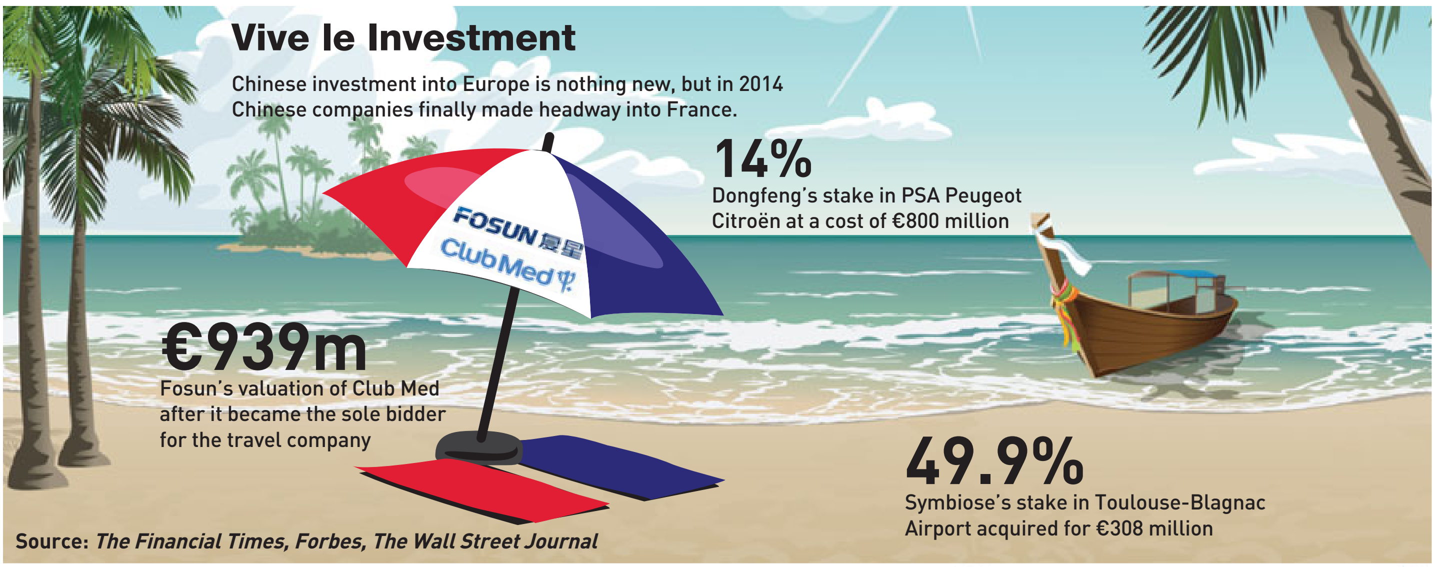
Source: Bain & Co

All Created Equal?

China remains a highly unequal society, but its gini coeficient, a measure of inequality, has been trending downwards in recent years.



Source: Peterson Institute for International Economics



Vive le Investment

Chinese investment into Europe is nothing new, but in 2014 Chinese companies finally made headway into France.

14%
Dongfeng's stake in PSA Peugeot Citroën at a cost of €800 million

€939m
Fosun's valuation of Club Med after it became the sole bidder for the travel company

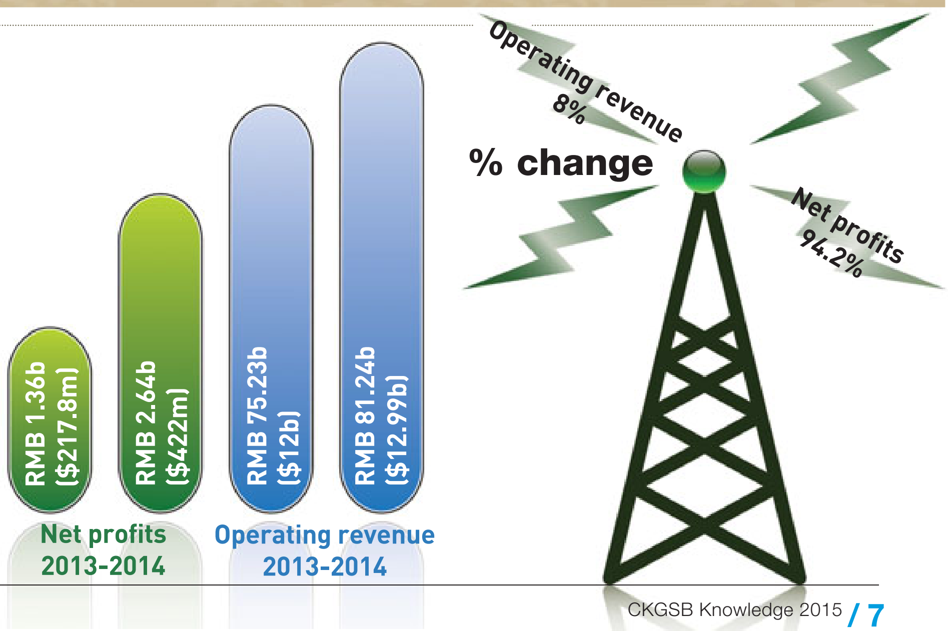
49.9%
Symbiose's stake in Toulouse-Blagnac Airport acquired for €308 million

Source: *The Financial Times, Forbes, The Wall Street Journal*

Strong Signal

Although only experiencing modest growth in its operating revenue, telecoms firm ZTE witnessed a surge in its net profits in 2014.

The company attributes this to optimization of its business operations. The company has also benefitted from the expansion of 4G in China.



Source: ZTE

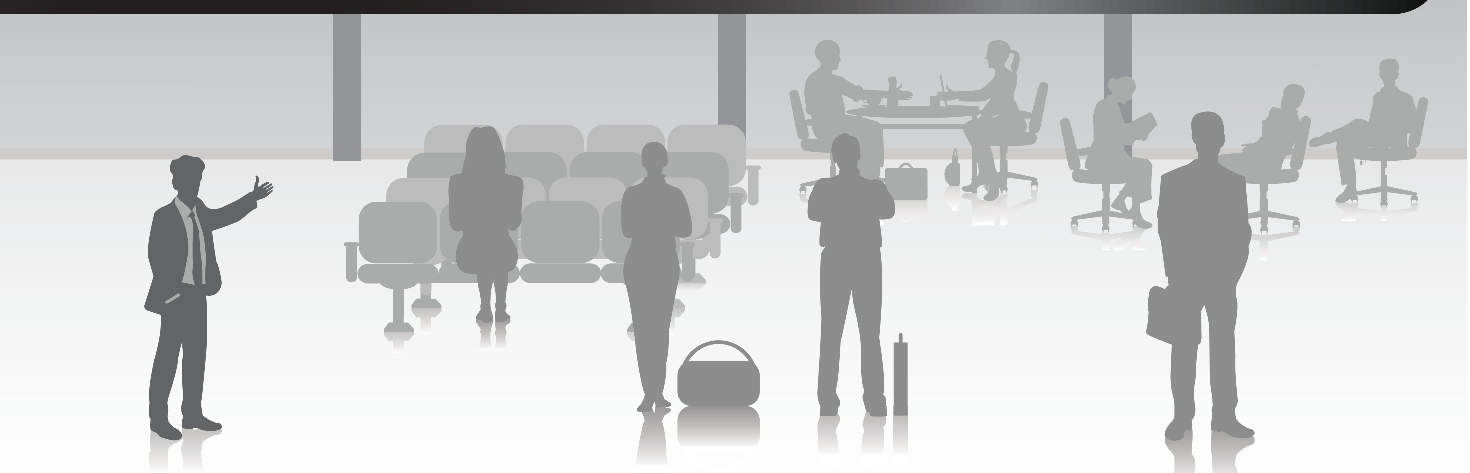
REACHING FOR THE SKIES?

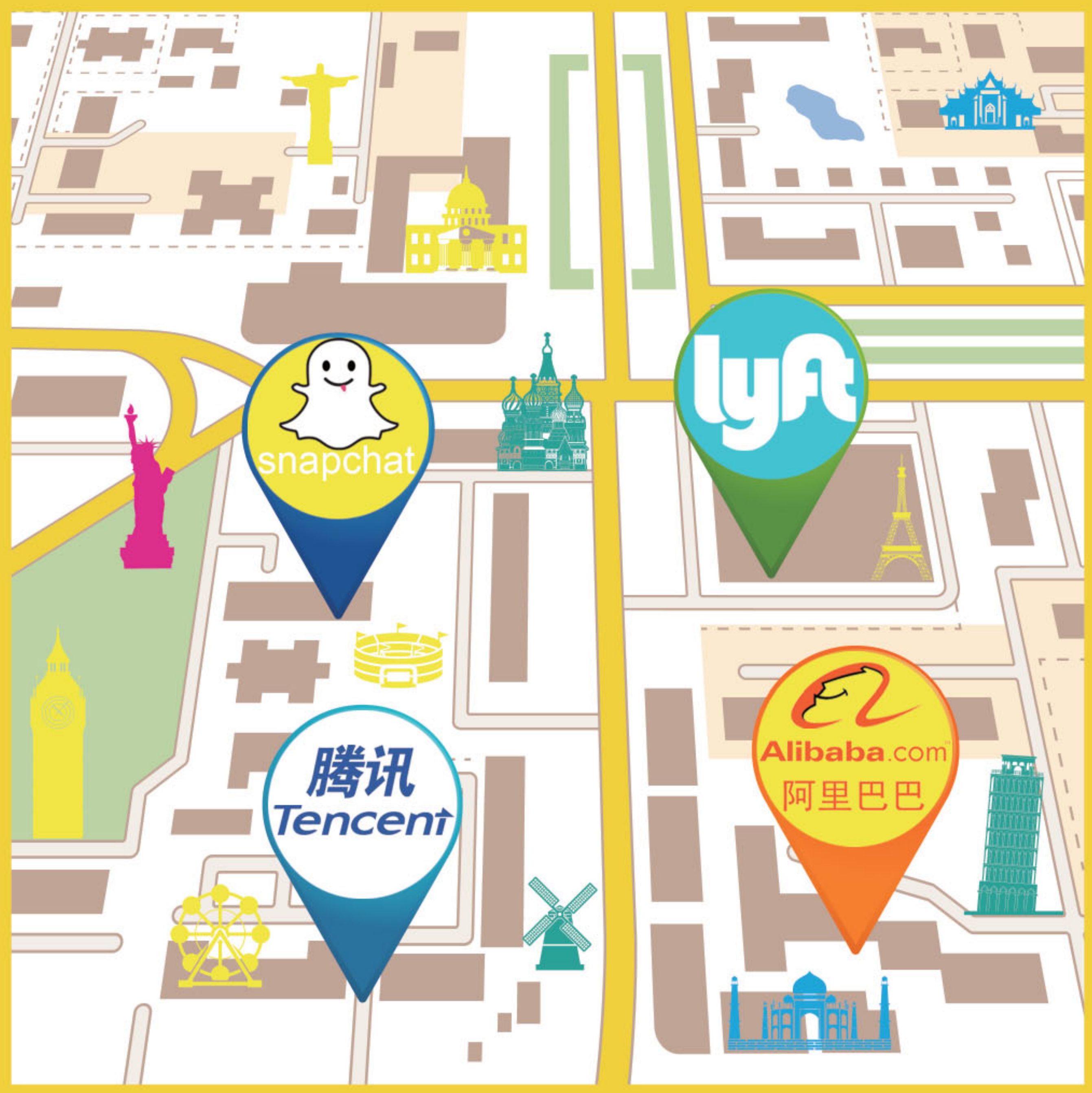
China's commercial civil aviation industry has undergone dramatic growth in the last two decades as infrastructure has improved and China's rising middle class has increasingly made its presence felt through domestic as well as international tourism. December last year saw the launch of a new airline, the budget carrier 9 Air, and in the same month Boeing confirmed that Air China, the country's flag carrier, has committed to buying 60 of its 757 jets. But the sector still has brakes on its development due to military control of most airspace and the fact the supply of pilots doesn't keep up with the rising demand. Moreover, the surge in demand has put infrastructure under strain, and for many passengers flying in China is a particularly unenjoyable experience—flights are routinely plagued by delays. Meanwhile, general aviation is comparatively underdeveloped.

Top Airports in China	Passengers (2013)	% Change*
BEIJING INTERNATIONAL	83,712,355	2.2%
GUANGZHOU BAIYUN	52,450,262	8.6%
SHANGHAI PUDONG	47,189,849	5.1%
SHANGHAI HONGQIAO	35,599,643	5.2%
CHENGDU SHUANGLIU	33,444,618	5.9%
TOTAL	754,308,682	11%

*versus 2012

PASSENGERS	PRE TAX PROFIT	NO. OF PASSENGER AIRCRAFT
77.7 M	RMB4.5 BN	477
79.1 M	RMB2.2 BN	451
91.8 M	RMB3.5 BN	551





Technology Gold Rush

Having established their dominance at home, China's leading tech companies are increasingly turning their gaze overseas

By Ana Swanson

Lenovo CEO Yuanqing Yang celebrated the tech company's acquisition of a Chicago-based smartphone brand in October in a distinctly Chicago way. His firm had just closed its purchase of Motorola Mobility from Google for $2.91 billion plus roughly 6% of Lenovo's shares. To mark the occasion, Yang, another executive and the smartphone firm's president chowed down a deep dish pizza decorated with a Motorola logo.

Lenovo's purchase was just one overseas acquisition in a busy year for China's technology industry. China Mobile invested more than a billion dollars in telecom companies in Pakistan and Thailand; Lenovo spent $2.3 billion on IBM's low-end server business in the US; Huaxin bought 85% of French telecom company Alcatel-Lucent; Alibaba spent $220 million for a 20% stake in mobile video app Tango and joined in a $250 million fundraising round for car service Lyft; and Baidu invested in Uber and opened a $300 million research and development (R&D) center in Silicon Valley to take advantage of local talent—to name just a few.

Analysts have been hesitant to label this a trend, but there are reasons to believe that China's recent boom in outbound tech investment will continue. China's tech sector is flush with cash, and the increasingly competitive domestic market has left companies anxious to acquire new technologies and capacities abroad in order to compete at home.

"Some people are going to be tempted to say the government has been pushing this for a long time, investing at home but also overseas, but I don't think it's really that," says Michael Clendenin, founder and Managing Director of China-based research company RedTech Advisors. "It's just business 101. Look everywhere you can under every rock for any type of resource that is going to help you further your business goals. It just so happens that Chinese tech companies are... looking under rocks all over the world."

Powering the Boom

China's investments abroad have in recent years continued to ramp up sharply, creating huge opportunities for partnership with foreign companies. Chinese outbound direct investment grew from $2.7 billion in 2002 to a stunning $102.9 billion in 2014, according to data from the Chinese Ministry of Commerce—a nearly 40-fold increase in only 12 years.

The potential for future investments is huge: Rhodium Group, which monitors Chinese outbound investment, estimates that over this decade Chinese outbound investment will reach up to $2 trillion. The government projects that outbound investment will soon be larger than foreign direct investment (FDI) into China, as Chinese firms increasingly venture out.

Chinese companies go abroad in search of resources their home country lacks, says Derek Scissors, a resident scholar at the American Enterprise Institute who studies Chinese investment. "They're going out, which is what firms classically do, and they're looking for stuff they don't have at home." According to Scissors, this includes natural resources, advanced technologies and even the stronger legal systems and property rights of advanced countries. Chinese companies with particularly cutting-edge technology may choose to invest abroad and develop new patents there, to avoid China's notoriously lax environment for intellectual property rights.

Furthermore, fast growth in their home market has also given Chinese companies ample cash reserves: they are looking for opportunities to invest and diversify their portfolios. And the global financial crisis has made assets in many developed countries much cheaper.

Meanwhile, China has been gradually relaxing its regulations governing outbound investment, giving private companies and individuals more opportunity to invest abroad. Private sector firms accounted for more than half (59%) of China's total transaction value in 2011 and 2012, and 70% of Chinese FDI in 2013, according to Rhodium Group.

China's early efforts at going abroad—beginning with the *zouchuqu*, or "going out" strategy, in 1999—focused solely on state-owned enterprises. Other businesses and sectors were still subject to tight regulations. But China's outward FDI regime has loosened significantly in recent years, removing many restrictions and red tape.

Part of the recent increase in technology sector investment is tied to this increasing freedom for private companies. Though they have close relations with the Chinese government, most of China's big tech companies are not state-owned. "If you look at the main internet players, and the tier-two internet players, 95% of them are totally private," says Clendenin of RedTech. "And that's just a totally different mentality—you've got to survive at any cost because you've only got yourself to rely on... So I think these guys are naturally more open to looking overseas."

Chinese technology companies are looking for a variety of things in their investments and acquisitions abroad. They may take controlling stakes or minority stakes in foreign companies to access new markets, to acquire useful technologies, capabilities or talented personnel, or just to diversify their investment portfolios.

Of all these goals, accessing new markets typically offers both the highest risks and highest returns. As Joel Backaler, the author of *China Goes West* and a director at Frontier Strategy Group, says, "There [are] some very real business reasons why these Chinese companies, particularly tech companies, are going out. The market [especially for smartphones or consumer electronics] is highly competitive within China. Therefore if you can take that kind of product and adapt it for other markets, it can be a good way to diversify your business and maintain your margins."

Chinese companies have tried their hands at both developed and developing countries. Companies operating in the former, such as Huawei, the telecoms manufacturer, and Wanxiang, an automotive parts maker, have had success focusing on hardware. While Baidu and Xiaomi, a company best known for its smartphones, have targeted the latter, with Baidu focusing on Southeast Asia, the Middle East, North Africa and Latin America.

But trying to carve out new market share is often extremely challenging. As Clendenin points out, accessing new markets requires successful product localization, integration of home staff in the target country, and overcoming the major local or international incumbent.

Compared with other types of investments, the success or failure of a bid to capture foreign market share is much more obvious, and attempts to win market share abroad have led to some of China's most notable failed acquisitions—from TCL Corporation's failed acquisition of France's Thomson Electronics, to Huawei's repeated blocked bids on US technology and telecommunications projects.

Study Abroad

According to Clendenin, Chinese companies are far more likely to succeed in foreign acquisitions if their ultimate goal is advancing in the Chinese market, where they have a lot more local knowledge and there is still great potential. "Invest to learn, don't invest to grab market share in a foreign country where you know nothing about the market."

This strategy seems to be increasingly the norm in the tech industry, with Chinese companies making investments to soak up strategic technologies, capabilities, talent and brands that they can then take home.

Both Backaler and Clendenin cite Tencent as an example of a company that has successfully advanced its position at home through investments and learning abroad. Tencent has long been known for rolling out its own versions of other companies' successful services, including everything from ICQ to FarmVille. In 2010, Charles Zhang, the CEO of rival web portal Sohu.com, dismissed Tencent as "a company that doesn't create anything". In the last five years, however, Tencent's copycat model has become a lot more legitimate—instead of copying, now it often tries to acquire them.

In 2012, Tencent invested $63.7 million in KakaoTalk, a Korean mobile messaging app. Unlike many mobile companies, KakaoTalk has successfully developed monetization strategies, including offering emoticons and games, features that have already begun to influence Tencent's mobile chatting app, WeChat. Tencent's acquisitions of foreign gaming companies like Riot Games and Epic Games were also directed at acquiring titles they could introduce at home. "They're essentially identifying hot games in the US market and then localizing them for the Chinese market," says Backaler.

Some of Baidu's recent acquisitions suggest the company is also interested in "studying abroad"—for example, its purchase of a minority stake in the Finnish company IndoorAtlas in September. IndoorAtlas makes a cutting-edge mobile product that allows users to map and navigate indoor spaces. Its President Wibe Wagemans explains how it could enable people to "find a friend indoors. You could find a booth or a product at a conference. You could search for shoes in the mall and it would take you all the way to the actual shelf."

Reaching Out

The value of China's tech investments* by country, 2013-June 2014

*Investments of $100m or more. These include portfolio acquisitions of equity stakes, not just direct investment, however defined.

Source: The Heritage Foundation and American Enterprise Institute's China Global Investment Tracker

The technology could have big potential for Baidu, which controls roughly 80% of the mobile search market in China and a little more than half of the market for mobile maps. "We're looking to introduce that technology into our existing product line," Kaiser Kuo, Baidu's Director of International Communications, says of IndoorAtlas.

It's not just the Chinese companies that learn something. In fact, they now have a lot to offer to foreign counterparts, in addition to the ample cash and access to the Chinese market.

In a post on the website *Medium*, Ted Livingston, founder and CEO of Kik, a social messaging app, wrote about his and others' desire to learn from Tencent's WeChat. "If you talk to me, or to Evan Spiegel [CEO] at Snapchat, we'll say the same thing: we want to be the WeChat of the West," he wrote. Tencent invested $60 million in Snapchat in 2013.

"They're very innovative," Allan Young, the founder of a San Francisco-based technology incubator called Runway, says of Chinese internet companies. "They're better than we are at building games and monetizing those games. Their viral coefficient is higher than our viral coefficient… I think in some areas of mobile, Chinese companies are stronger, smarter and faster."

There are still other reasons Chinese companies invest abroad: as Allan Young of Runway points out, the primary goal is not always advancing the technology of the investor. Sometimes, "it's to invest in companies they feel are relevant to their industry and they could help grow and make more valuable." This is the strategy behind ZPark Venture Fund's investment in California healthcare IT firm HealthCrowd, as well as Bank of China's loans to Zimmer Holdings, a medical device company based in Indiana.

In other cases, Chinese firms may also seek to tap the talent base and management experience of companies abroad, for example in Baidu's high-profile investment in an R&D center and artificial intelligence lab in Silicon Valley in 2014. "We want to go where the talent is," says Kuo. Not every great engineer happens to be located in China. Talent is distributed globally, and R&D should be too."

The Biggest Stumbling Blocks

In making acquisitions abroad, Chinese companies face myriad challenges. One of the biggest is simply a lack of experience managing and operating in foreign markets.

Backaler points out that many of China's early failed acquisitions were the result of Chinese companies with plenty of money going after assets that were failing for complex reasons. Chinese companies like TCL Corporation "weren't necessarily in a position to go overseas, let alone to bring a company facing tough times back to life," he says. He also cites Huawei as another Chinese company that failed to listen to the market, made mistakes in managing its image, and now is essentially barred from doing some types of business in the US.

On the positive side, Backaler says that Lenovo has done a great job of managing its US-based acquisitions. By retaining the acquired company's management and staff, and only gradually making changes to the business model, Lenovo has convinced its American employees at IBM and Motorola Mobility that it was ready to learn from their experiences and dedicated to managing the company for the long haul.

There are other obstacles to Chinese outbound investments: hurdles to financing and approvals within China, or potential security threats with high-tech investments. However, the biggest obstacle to Chinese outbound investment appears to be connecting interested Chinese companies with potential targets. Very often, investors and investees just don't know how to find each other.

"I think it's challenging, because on one hand there is tremendous interest on the Chinese side to go out, and then if you're looking from the American perspective there's a strong desire for that investment, however there's a really big gap in between," says Backaler. Typically, interested Chinese investors go on tours or attend conferences where they can meet investment

> In some areas of mobile, Chinese companies are stronger, smarter and faster
>
> Allan Young
> Founder
> Runway

targets, and foreign states, cities and other local governments set up organizations inside China to recruit investment. However, both methods fall short of connecting all the interested parties.

According to Young, another related problem is effectively monitoring an investment once capital is deployed. "If they don't have a mechanism to perform consistent monitoring of their investment… then you're not fulfilling one of the important functions of being an ideal venture investor," he says, adding these systems, having a presence on the ground and hiring good professionals are the biggest challenges.

Organizations are evolving abroad as a result. Young says Chinese companies are increasingly relying on a group of professionals in Silicon Valley, often native Chinese with extensive technology industry experience, to build out networks and contacts. And Backaler points to public-private partnerships, like the Greater Washington China Investment Center in Washington, D.C., that are helping potential Chinese investors access the US market.

But there are undoubtedly some who still aren't hitting the mark. "The short answer is that the investments are fairly opportunistic at this stage, and it's hard to identify which Chinese companies are really serious… Many [potential investors] are based in third-tier cities and we don't even really know who they are yet," says Backaler.

What Will the Future Hold?

The volume of Chinese technology investments is likely to vary a lot from year to year. 2014 was an unusually busy year; 2015 may not be. Still, there are many reasons that overseas tech investment and partnerships are likely to continue to increase. Investment regulations for the private companies that make up most of the technology industry are looser than ever in China, and the competitive Chinese market requires that Chinese companies stay sharp with the latest technological developments. Compared with executives in other sectors of the economy, Chinese technology leaders tend to be younger and more in tune with the international market, analysts say. Moreover, foreign companies are more receptive to Chinese capital than ever.

In general, the mutual benefits from Chinese collaboration with foreign companies are huge: Chinese interest allows foreign companies to sell assets at a higher price, contributes to funding available for R&D and supports the economy. In the US, for example, Chinese high-tech investments have created or sustained 25,000 jobs in the last few decades, according to Rhodium Group. Many Chinese companies have plenty of cash to invest; they may also offer their foreign partners access to the Chinese market and even innovative technologies.

Wagemans, the president of the Finnish start-up IndoorAtlas, provides a fitting description of the kind of opportunity that a Chinese investor can offer to its invested company. "The beauty about China is the market right now… is moving faster than the US," adding there is fierce competition going on between the big players in China.

That level of competition, the sheer size of the market and the R&D funds available are going to ensure that Chinese companies are going to remain attractive investors for some time to come.

Homeward Bound

Long the purveyors of advanced skills and knowledge, Chinese overseas returnees are now finding a different environment

By Colin Shek

Growing up in Mianyang, Stone Shi didn't always fit into his surroundings. He particularly found it hard to fit in at school in the city, the second-largest in the southwest province of Sichuan. "It was a lot of struggle," he says.

In junior high, while classmates buried their faces in textbooks, Shi began developing a "silly" interest in personal fitness. In breaks after the end of afternoon lessons at 4pm, he would cycle to the gym and work out before racing back to make the start of evening study. "I would eat my snack on the way, sometimes still eating when the class was starting," recalls Shi.

His reluctance to focus on schoolwork did not endear him to educators. "Everybody was study, study, study. I wanted to exercise and it was a huge issue in the class." The school called his parents in several times over the perceived problem, and eventually delivered an ultimatum—drop the fitness training.

He dropped China instead. In 2000, Shi left for the US at the age of 22. With a Master of Engineering degree from Texas A&M University and an MBA from Tuck School of Business at Dartmouth College in hand, he returned to China in 2010—turning down job offers from Google and a Silicon Valley start-up in the process—to launch his own business in Shanghai. The 37-year-old is what the Chinese call a 'sea turtle' or *haigui* (pronounced hi-gway), an overseas returnee who left home to study and work overseas before returning to a rising China.

Haigui are not a new phenomenon. Modern-day China is steeped in their legacy and the Communist Party arguably owes its existence to them. And in 2011 Sun Yat-sen returned from abroad to play an instrumental role in the establishment of the republic that ended thousands of years of dynastic rule.

More Chinese than ever are returning though, particularly since 2008 when Beijing hosted the Summer Olympics and the global financial crisis roiled Western markets. China's economic growth is drawing some back, while others are being courted by local businesses seeking top-level talent.

The leadership also wants to entice more Chinese expatriates home. "You are warmly welcome if you return to China," President Xi Jinping said in 2013. Previous appeals have worked in the past. "A lot of Chinese want to help the second generation or help the country to grow," says Hubert Tam from Sirius Partners, an Asian financial executive search firm.

> "There will be quite a bit of culture shock"
>
> Hubert Tam
> Managing Partner
> Sirius Partners

Returnees brought back advanced knowledge and skills in energy, agriculture and other critical industries. Others established new research fields, helping to restart the process of education, innovation and discovery that had been disrupted during the decade-long Cultural Revolution. Later on, others flooded into hi-tech fields, with e-commerce a prime example. Sea turtles have founded leading technology firms such as Robin Li's Baidu and Tao Zhang's Dianping (he also had a co-founder).

Overseas Chinese should heed Xi's call with caution though. The sea turtles of today have it tougher than their predecessors. Competition for the best jobs is ferocious. Returnees compete not only with each other, but also against the thousands of other workers who stayed in China to sharpen their skills and experience. Once a rare and fettered breed, *haigui* are no longer unique and their ubiquity potentially undermines their once-prized status.

Across the Ocean

The vast majority of *haigui* originally left China for educational reasons. China has been sending students and scholars to study abroad for more than a century, with government-funded education overseas dating back to the late 1840s. In 1978—when China's per capita GDP was less than $200, one-fiftieth of the US's—the government expanded the number of students permitted to study abroad. From that year to the end of 2013, a total of 3.06 million Chinese had studied abroad, and in 2013 alone, 413,900 students travelled overseas for further education—making China the largest source of overseas students—according to the Ministry of Education.

They were funded by the government or employers, or at their own expense. Most of them landed in the US, Australia, Japan, the UK or Canada. That figure was up from 399,600 students in 2012 and 284,700 in 2010. Meanwhile, 353,500 graduates returned with a foreign degrees and experience in 2013, raising the total since 1978 to 1.44 million.

Beijing continues to play an important role in helping people acquire an education overseas. The state-sponsored China Scholarship Council—a non-profit that provides financial aid to Chinese citizens to study abroad—will send 25,000 students abroad in 2015, 17% more than the 20,400 in 2014. This year's tally will include up to 8,000 more Chinese graduate and doctorate students. The council has sent a total of more than 160,000 Chinese students to study abroad since 1996, and 98% of them have returned home.

But far greater numbers pay out of their own pocket. Decades of economic growth in China have spawned an enormous middle class with the ability to fund expensive overseas tuition for their children.

That is partly reflected in data published by the Brookings Institution in August, which showed China's wealthiest cities were the biggest source of Chinese students in the US, while Beijing and Shanghai were the second and third-biggest source of foreign students in the US between 2008 and 2012—with 49,946 and 29,145, respectively—after the 56,503 sent from Seoul, South Korea. And of the nearly 400,000 Chinese students who attended foreign higher education institutions in 2012, around

380,000—90%—were self-funded.

It wasn't until the late 1990s that the number of returning Chinese students grew large enough to become a trend. That was arguably the golden period for *haigui*, as returnees typically had experience in economics, sciences or running large firms—skills China needed at that time. But greater affluence nowadays has allowed Chinese students to choose what they study, meaning that more *haigui* are returning with skills in less traditional fields, such as fashion and education.

"The number of *haigui* returning to China has been rising, just because there's more people going out," says Tam from Sirius Partners. "It's a numbers game. People are getting richer and they have the luxury to go out for education."

The reasons behind people choosing to leave have also evolved. The first people who went out and returned as China began its reform era were applauded because they left to acquire advanced skills or expertise that could aid the state.

But Chinese these days are more likely to be departing over frustration with the rigid methods and rote learning of the traditional educational system. Shi says grievances over the mindless memorization and competitive streak at school pushed him to look elsewhere. "It was quite disheartening and I really had huge trouble just fitting into the system... [which] I completely disagreed with," says Shi.

That is why after graduating from Mianyang's Southwest University of Science and Technology in 1999 with an engineering degree, Shi opted for graduate study in the US. Now more Chinese are following in his footsteps. Chinese students now make up 31% of all foreign students in the US.

Paddling Home

Family ties are a major reason for why *haigui* return to China. A survey conducted by British recruitment firm Hays last year shows the powerful personal pull of home. In a survey of 454 Chinese who are either studying or working overseas but considering a return to China, it found that 41% want to come back to live closer to family.

Impressive salaries and benefits attract some returnees who are in demand for their foreign experience and skillset, according to recruitment firms. A head-hunter lured Shi back to China with a job in product management at Cambridge Silicon Radio. Salaries in specific industries—such as finance and consulting—have grown rapidly to be competitive with the US and UK.

But higher taxes also mean a returnee can have more take-home pay than in the West. "The actual lump sum is bigger if they were working in the States, but what they actually take home at the end of the day after tax, expenses and everything is probably more in China," says Tam. Moreover, Chinese authorities have begun enforcing a rule, normally ignored, that Chinese citizens must pay tax on their worldwide income, not just on their earnings in China.

But job satisfaction is also a key consideration, with 31% of the people polled by Hays saying they would be willing to take a drop in salary if it meant coming home to a good job. Meanwhile, a quarter of respondents revealed they were attracted by the possibility of an accelerated career path in China. That resonates with Shi, who describes a 'bamboo ceiling'—like the so-called glass ceiling—for Asian males in the Western corporate world.

Another *haigui* working for a local company in Shanghai shared similar feelings, after growing frustrated at bumping up against career ceilings while employed at multinational firms. "I've worked in the US and Canada [and] it's very difficult to head up a very senior role in a foreign country. There's much more opportunity here—in Asia, in China—versus the US or the UK," says the *haigui*, who would only speak on condition of anonymity.

In contrast, Chinese companies can often entice sea turtles home by offering them better positions with greater scope for decision-making. Coming home also means being closer to the action when it comes to top-level decisions at a local firm—a level of involvement that can go missing at foreign peers, who may map out strategy back in Western headquarters.

Chinese companies are also finally beginning to match the big ambitions of sea turtles. "Family ties are a strong motivator to bring talent back home, but also people who have lived and worked abroad are often highly ambitious," says Sarah Jones, business director in north China for Hays. "If a couple of years ago, they looked to

Ins and Outs

Number of Chinese students departing and returning each year

Source: Ministry of Education

further their career, they went overseas. They're probably still as ambitious as they once were back then, and now they're motivated to achieve certain career goals by returning."

The globalization and increasing sophistication of China Inc. has ratcheted up demand for *haigui*, who are highly sought after for their ability to understand Chinese cultural nuances while being trained in Western practices. Their cross-cultural ability and global mindset—understanding both East and West—dovetails with the demands of local large-sized enterprises expanding into new markets. Five or six years of foreign experience is very transferable to China, says Tam.

JD.com, an e-commerce company, launched a recruitment scheme in 2014 called the International Management Talent Program, designed to hoover up the best MBA graduates from top business schools around the world, many of whom in practice, due to cultural reasons, will be Chinese.

In its maiden year the program scoured six universities, including MIT, Yale and Oxford, and attracted 10 graduates—most of who had at least a few years of working experience at Western companies such as Amazon, PricewaterhouseCoopers and Verizon Communications. With CEOs and vice-presidents as mentors, the candidates are groomed to become the next generation of leaders in the company.

But foreign companies also compete aggressively for top talent. For them, *haigui* are appealing because of their overseas education and training, and familiarity with local customs. Foreign businesses want to tap into the China market and in order to do that, "you need to be mainland Chinese," says Tam. Foreign financial firms, in particular, value *haigui* because they are bilingual and their experience abroad means they usually grasp the culture of the company more easily than a local.

In the Chinese financial industry, foreign companies trump local rivals when it comes to *haigui* intake. That is often down to the *haigui* themselves preferring multinational firms because "they know they have the edge", says Tam. That leverage frequently sees returnees offered better compensation at non-local firms. "*Haigui* expect more. Their expectation will be much higher because they got an education overseas and they expect it to be repaid," says a *haigui* at a large state lender in Shanghai.

Sunny Shores?

Some returnees dispute this, saying while some industries still aggressively recruit returnees, an overseas education no longer means a high starting salary or fast-track promotions. Moreover, employment at multinationals is not always rosy and can hinder a career in China in the long run.

"It's not really as good as people think," says the *haigui* with the state bank, citing the experiences of friends working at foreign institutions. They enjoy a salary premium over local hires at state-owned Chinese banks, but the basic wage makes up most of their compensation. "The base salary is better, but that's not the total. You need to see the whole package," says the *haigui*, who spoke on condition of anonymity.

Joining a foreign company also carries an element of risk. They remain subject to restrictions absent from their domestic counterparts, and not all of them survive China's tough business environment. Under this backdrop, for *haigui* to hitch their career prospects to a multinational can be fraught with long-term risk. The danger is arguably even greater now that conditions have turned chilly for foreign companies.

Opting for a foreign company can create another problem in the long run. Many sea turtles who have worked at Western companies for years experience culture shock when they join a Chinese company. "There will be quite a bit of culture shock," agrees Tam. "That's going to be a difficult challenge for *haigui*."

Turtles who have spent six or seven years working at a foreign business can find it "really hard" to switch to a state-owned company because their mindset is different, says the *haigui* from the bank. In multinationals, returnees frequently excel in the job by being quick, efficient and polished. But in state businesses, says the *haigui*, the job itself constitutes only a small part of one's employment. "The job is really the basic thing. You need to think more about relationships with different levels in the company. It's more about how to position yourself." That kind of mentality can sometimes go missing in *haigui*, who began their careers in job markets that emphasise transparency, meritocracy and ethics.

Today's turtles also face much tougher competition than the vanguard that went out 20 or 30 years ago. China's economic ascendance has stoked pride among the population while helping the workforce shed some of its inferior complexity. Local professionals that stayed behind can come out on top, with local market knowledge and contacts highly prized by domestic and foreign businesses alike.

The hordes of Chinese going abroad have also diluted the overall quality of *haigui*. In the 1980s, Chinese studying overseas tended to be an elite group at the graduate level. Whereas Ivy League universities would have once been de rigueur, more and more Chinese are ending up at less prestigious institutions. Between 2008 and 2012, the most popular American universities for students from China were Michigan State University, Purdue University, Ohio State University, the University of Illinois and the University of Southern California, according the Brookings Institution, representing a wide range in quality and ranking. "Now there're so many *haigui*. The quality is so uneven," says a manager with a Chinese Internet firm in Beijing.

As more *haigui* come home, they render themselves more ubiquitous and less unique. Their stock soared when they were a rare breed, but now they are confronting a China that no longer values their skills and experience as much as before. Those who stayed have quickly skilled up and are squeezing out the need for *haigui*.

But as China retools itself into an innovation-led economy and goes out into the world, returnees are finding new ways to stay relevant—using their cross-cultural ability to help managers understand both foreign and local nuances. As long as China continues to seek improvement, there'll always be a place for sea turtles carrying fresh ideas from foreign shores.

The Tax Crackdown

The tax affairs of multinationals are under scrutiny the world over, and now they are in China as well

By Helen Roxburgh

In November, shockwaves were felt when the Chinese government handed out an RMB 840 million ($140 million) fine to a US technology group over alleged tax evasion. The company, identified by Chinese news agency *Xinhua* as 'M', was widely believed to be Seattle-based computer giant Microsoft due to the background information the news agency supplied on the company. *Xinhua's* report alleged 'M' had admitted to booking profits in offshore tax havens, reporting a loss in China, thereby avoiding tax. It suggested the company had admitted to tax 'evasion'.

Although never confirmed, in a media statement at the time Microsoft said the US and Chinese tax authorities had signed an agreement in 2012, an "acknowledgment by both countries that Microsoft's profits are subject to the appropriate tax in China".

This incident has been interpreted as the start of a crackdown on certain tax structures by the Chinese government. *Xinhua* said 'M' was reporting losses averaging 18% over the past six years, while paying more than half of its profits to its US headquarters as development funds and franchise fees.

This practice, known as transfer pricing, is not uncommon among international companies, and is not a challenge exclusive to Chinese tax authorities. Multinationals can transfer profits to subsidiaries or separate arms of their company in another tax jurisdiction, which can be claimed as management fees, expenses or similar. This means a lower amount of profit is declared in the original tax jurisdiction.

"All countries face tax enforcement problems when dealing with multinationals, given the ease with which multinationals can shift profits across borders through transfer pricing and other means," says Roger Gordon, economics professor at the University of California, San Diego. "There is no 'right' measure for these transfer prices, making enforcement decisions rather arbitrary, and if you want, political."

Leveraging the Loopholes

Tax experts point out that although the word 'evasion' is frequently used when discussing transfer pricing, the practice is not illegal. It is generally considered to be 'avoidance'—a legal use of loopholes, or incoherent laws to eliminate tax burdens. But for others this practice is simply unfair, and it has been a political hotspot in many nations over the last few years. Multinationals such as Starbucks have faced media hostility and government probes, particularly in the US and UK. In many ways, the Microsoft case simply reflects a collective global mood.

"What would have happened in [the 'M' case] is that China would have been perhaps unhappy about the cost allocation left to China," explains Chas Roy-Chowdhury, Head of Taxation at the Association of Chartered Certified Accountants. "It doesn't mean to say it's anything illegal, just the nature of transfer pricing."

"One of those problems around transfer pricing is that information where you have got transactions going on between related companies is very onerous, very difficult to obtain," he continues. "There may be a number of shaded areas of grey."

With these grey areas, it is difficult to accurately calculate how much tax is being "lost" in China. Estimates from the Tax Justice Network suggest China may be losing up to $134 billion annually in tax revenue, although most developed economies struggle to accurately calculate their "tax gap". The UK probably comes closest, projecting that £34 billion ($51 billion) is the difference between what is and should be collected. That UK figure includes both evasion and avoidance, but also fraud and errors made by taxpayers or by the tax authorities.

"Chinese tax rates are roughly comparable to those in the US," says Gordon, and so without evasion, tax revenue as a percentage of GDP should be roughly the same. Prior to around 2000, this was around half the US's, but it has been growing steadily ever since, "suggesting a steadily declining amount of evasion from domestic firms."

The most recent figures from the State Administration of Taxation (SAT) showed that RMB 7,795 billion ($1,247 billion) in tax revenue was collected in the first three quarters of 2014, which is a 7.4% annual increase on the same period a year before, and matches economic growth.

"With the development of IT technology and strengthened cooperation between tax authorities and other government administration bodies, China's capability in tax collection is actually improving rapidly," says Matthew Mui, tax partner at PwC China.

And with its massive population, China needs its income to be steady. Government income as a share of GDP saw a huge decline between 1978 and 1998 as the economy changed, going from 32% to 12%, meaning tax is an even more important source of income. Yet *China Daily* reported that small firms been exempt from a total of RMB 37.1 billion ($5.95 billion) of taxes in the first nine months of 2014. These are popular decisions for businesses, but mean tax authorities need to shift focus to other areas to make sure tax income stays steady.

Local government revenue is also being hit by a slowdown in the property markets. Land sales in 2013 were equivalent to about 61% of local-government revenue, according to figures from China's Ministry of Land and Resources and the Finance Ministry. Figures compiled by *Bloomberg* in May 2014 said land sales in 20 major cities fell 5% in March from a year earlier.

One challenge has been improving the enforcement of domestic tax collection, a problem for many years. China's prevailing cash economy leaves it vulnerable to tax fraud, although the introduction of a lottery system on receipts, where consumers can win up to RMB 5,000, has helped.

The government has been reforming other areas of the tax system, including transforming a less efficient business tax framework into a newer, modern value-added tax (VAT) system. This is more in line with other countries, and has brought more into the tax system.

"As they make the direct tax system more clear and beef up the system for indirect tax, they are encouraging companies to come forward voluntarily because they want to claim back VAT on their indirect tax," says James Lee, Regional Director for Greater China at the Institute of Chartered Accountants in England and Wales.

With these measures tackling domestic taxpayers, the government is now paying more attention to global matters. Global Financial Integrity estimates that between 2000 and 2011 $3.79 trillion flowed out of China, more than any other developing country.

According to *Xinhua*, the SAT is now developing a system to track profit indicators of multinational corporations, after revenue recovered from tax-evasion cases rose to RMB 46.9 billion last year from RMB 460 million in 2005. Turning focus to multinationals is both practical and political.

"China raised the corporate tax rate on multinationals operating in China from half the domestic rate up to the full domestic rate a few years ago," says Gordon. "The favorable treatment in the past was presumably an inducement to bring modern technology to China, facilitating technology transfer to domestic Chinese firms." But that motivation has been lost as Chinese firms have progressed technologically. "Multinationals instead are now viewed more as competitors... leading to a more hostile environment."

There are fears that an increase in tax regulation could go the same way as the monopoly and antitrust campaign last year, which was widely seen as a crackdown on international companies—an antitrust investigation was even opened into Microsoft's local business practices last July.

A Global Concern

While targeting international companies can be popular for domestic reasons, as multinationals will no longer be seen to be getting special treatment, China's driving motivation is as much about international politics.

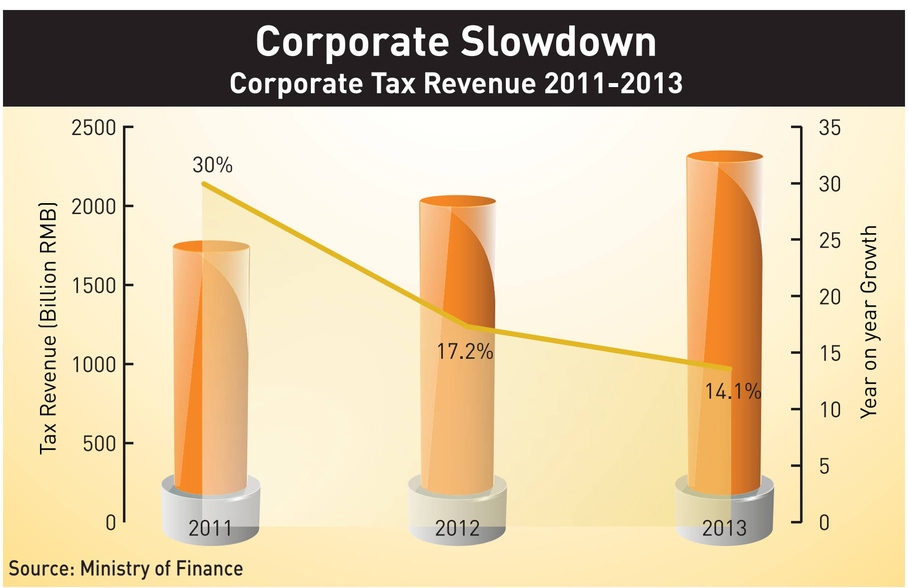
China is part of the G20 group of nations, which in 2013 asked the Organisation for Economic Cooperation and Development (OECD) to develop a plan to tackle the problems around multinational companies shifting profits between jurisdictions.

The subsequent Base Erosion and Profit Shifting (BEPS) proposals from the OECD include the exchange of information between nations, simultaneous tax examinations and assistance in tax collection.

"Most arrangements or structures identified as eroding tax bases of some tax jurisdictions take advantages of asymmetric features in domestic and international tax rules and are technically legal," explains Mui. As such, the BEPS Action Plans coordinate tax treaties and domestic tax rules, as well as the practices of multinationals.

China gave the OECD convention a boost when it signed up last August—56 countries have now given their support. At November's G20 summit, President Xi Jinping made a speech calling for greater global cooperation to clamp down on tax evasion. According to the SAT, this was the first time tax affairs were discussed by a Chinese leader at such a high-profile political event.

"[The] BEPS project is a very good opportunity for China to shift its role from international tax rule follower to an international tax rule participant or maker," adds Mui.



China has even signed up to global tax law FATCA (the Foreign Account Tax Compliance Act), which requires foreign banks to reveal details about American accounts holders, and reciprocal information about wealthy Chinese in America.

As nations work to secure as much tax income in their own jurisdictions, tax enforcers in China are becoming more proactive.

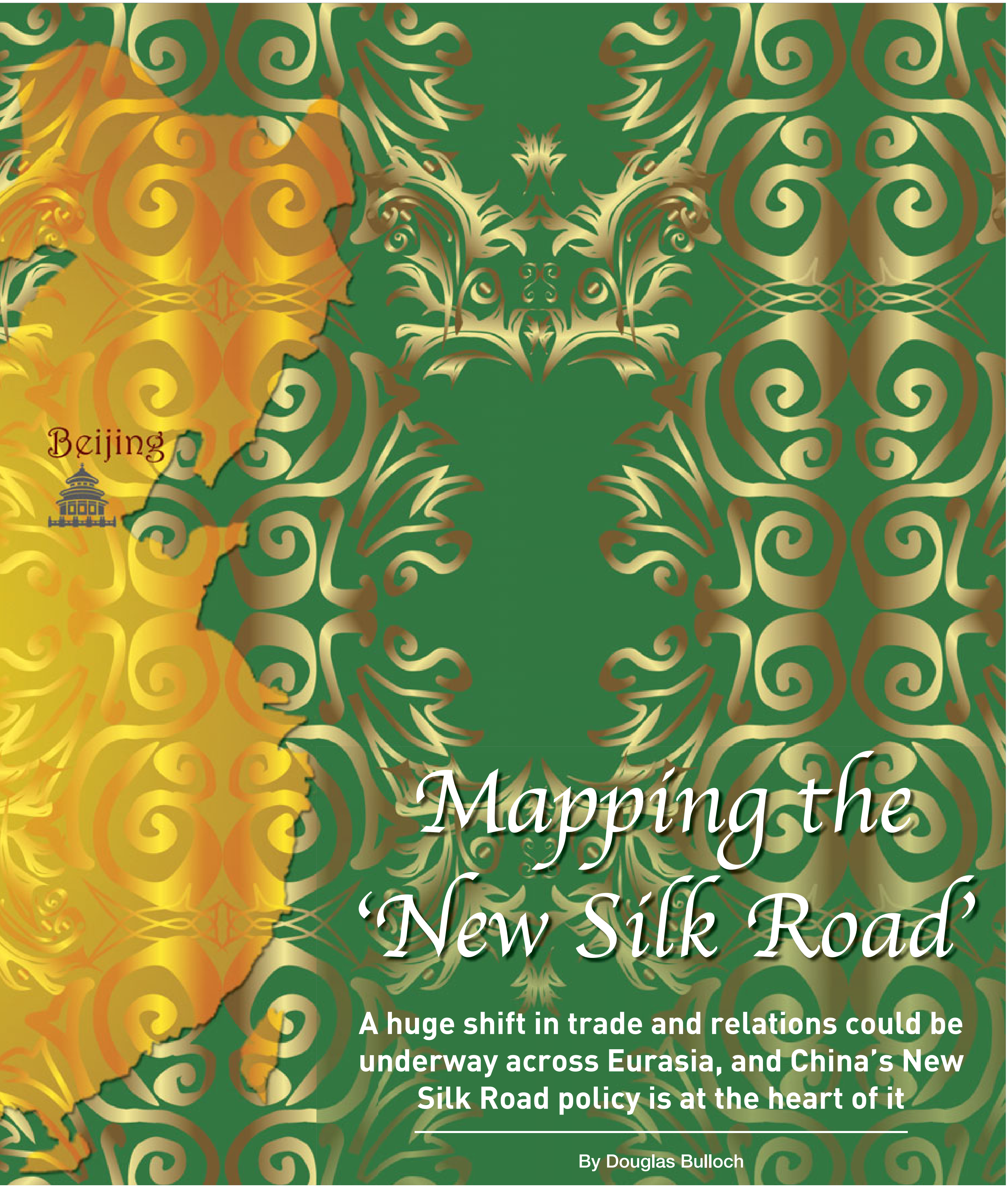
"In China there are a lot of tax areas where there have been regulations for a long time, but there was a lack of enforcement," says Lee. "In the meantime companies try to maximize their tax deduction based on conventional interpretation of the regulations. People are doing this as a method of just normal business sense. And if there is no interpretation from the tax authority, then it is very difficult for companies to draw the line over what level of tax to pay.

Lee says that China is reacting to the fact tax authorities in other countries are getting more aggressive, and they stand to lose out if they don't too. "They fear that if they don't do a good job at collecting their fair share of tax, multinationals [both foreign and Chinese] will just minimize paying tax in China so they can afford to pay tax elsewhere."

The changing tax landscape both globally and in China will inevitably have implications for business. According to Mui, they will need to monitor and address tax risks, transactions that might be challenged under BEPS and be aware of regulatory developments. That includes reviewing whether profits left in China are in line with global and domestic tax standards.

And as Chinese regulators get more aggressive, most experts expect there to be future enforcement orders like that handed out to 'M'. While bringing domestic benefits, some have raised concerns it might prove a disincentive for international companies to operate in China. But the international tax crackdown is also an opportunity for China to show its power on the global stage and expand its international tax collection network. As Mui puts it, "Both the global crackdown and China's self-motivated efforts are influencing the situation, and mutually influencing each other. China needs to participate in the world, and the world needs China's participation."

The Silk Road has a deep historical resonance, but its modern iteration is much wider and grander in scope



Mapping the 'New Silk Road'

A huge shift in trade and relations could be underway across Eurasia, and China's New Silk Road policy is at the heart of it

By Douglas Bulloch

As a historical reference point, the Silk Road continues to resonate, long after the trade route served any economic purpose. For Europe, it evokes the slow sway of camel trains across parched landscapes and the flow of exotic goods into the continent. And in China it brings to mind the touchstones of its imperial history and its connections to the outside world.

When China's president Xi Jinping laid out his plans to establish a "New Silk Road" across Central Asia in 2013, he was doing more than invoking China's distant past. Instead, he was sketching out a new direction for Chinese trade and investment, one that aims not only to improve China's links with Europe, but also to facilitate trade across the entire Eurasian land mass, an ambition welcomed by many regional leaders. President Nursultan Nazarbayev of Kazakhstan—when attending the opening of a new rail link between Kazakhstan, Turkmenistan and Iran in December 2014—said, "We have virtually created a new Silk Road running across our three countries and China to the Pacific Ocean."

However, for China the potential scope of the policy is larger than is often perceived, and the alignment of interests extends well beyond improved trade links. Indeed, if the policy gains traction, it will facilitate China's macroeconomic priorities, further open up China's vast interior and may help to reconfigure the nature of China's integration in the global economy. In that sense, the New Silk Road is less a trade route for the modern day silk of raw materials and manufactured goods, than a road map to China's future as a developed, open and free trading economy.

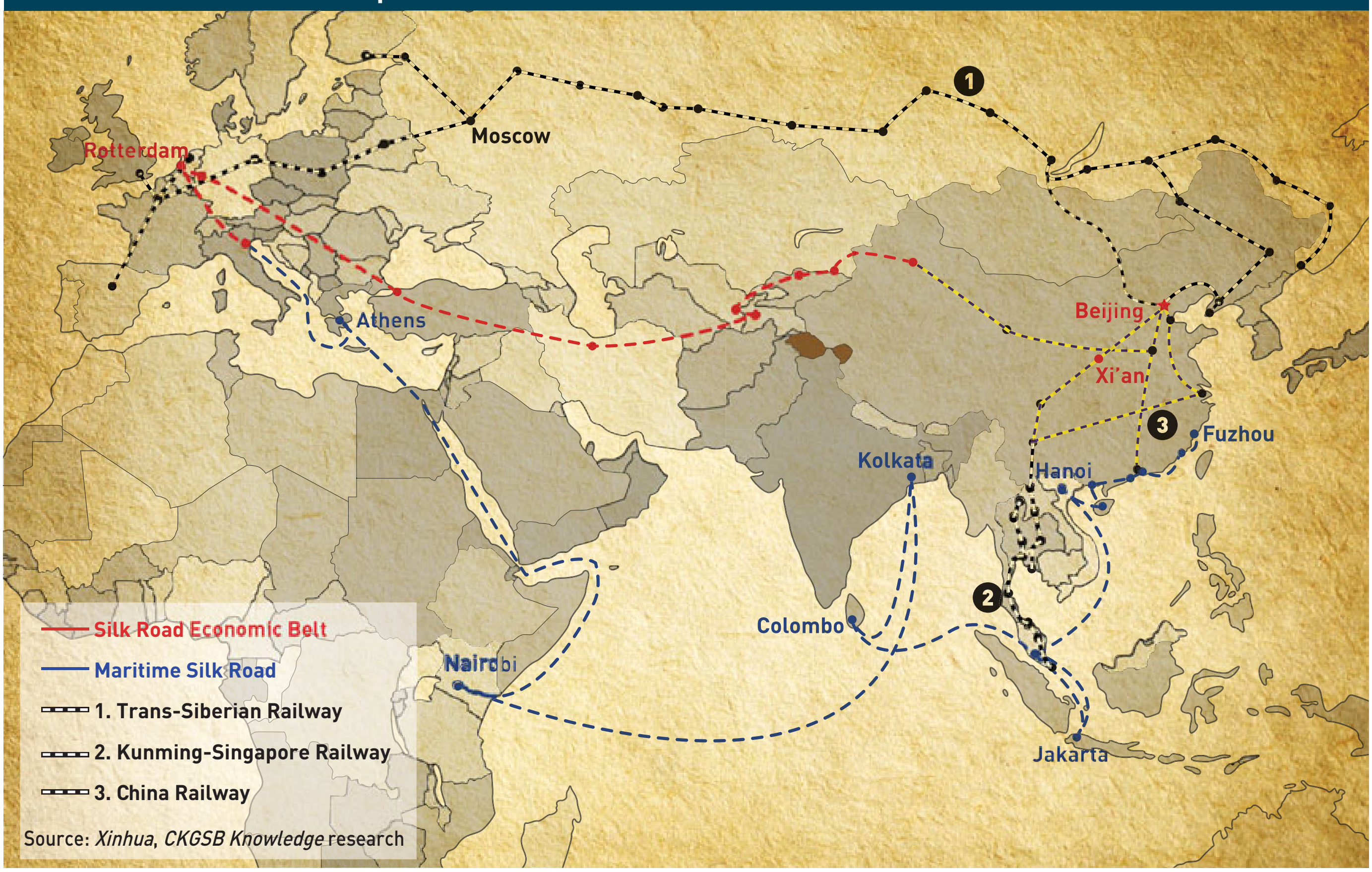
Wider, Ever Wider

When Xi Jinping announced the New Silk Road plan in Kazakhstan in September 2013 he made explicit reference to a "strategic regional thoroughfare from the Pacific Ocean to the Baltic Sea". At the time, commentators linked this to the long planned New Eurasian Land Bridge, conceived originally as a network of rail links west, from the coastal city of Lianyungang, through China to Kazakhstan, there linking up through Iran and eventually crossing under the Sea of Marmara in Turkey, creating an uninterrupted rail link to Europe. This route would be in addition to the Trans-Siberian route, which already hosts two regular freight connections between China and Germany and a recently trialed rail service reaching as far as Madrid in December 2014.

Xi went on to call for a "move toward the set-up of a network of transportation that connects Eastern, Western and Southern Asia", widening the scope considerably, and potentially involving all road and

Old Name, New Routes

The transport infrastructure that forms the New Silk Road initiative



Source: *Xinhua*, *CKGSB Knowledge* research rail investments in the region, including within China.

The following month, in a speech given in Jakarta, he made reference to a "Maritime Silk Road" focused primarily on Southeast Asia and both concepts have since progressed in tandem under the broad heading of the "New Silk Road".

Here, the value of a long-term strategic vision becomes clear, with the overall plan allowing China to progress in small steps, cultivating strong links with then President Mahinda Rajapaksa during Sri Lanka's diplomatic isolation following the end of the civil war, and being ready to invest in the port of Piraeus, Greece, just as economic collapse forced a fire-sale of national assets.

According to Song Gao, Managing Partner at PRC Macro Advisors in Beijing, "Chinese officials say there are three routes, one goes north through Mongolia and Russia to Germany, another goes to Central Asia through Xinjiang province, and the third one is the Maritime route." Which, if it remained simply that, would still sketch out a vast area. Importantly, it has the full backing of the leadership, so far gaining the status of a signature policy for Xi Jinping's presidency.

Both Xi and Premier Li Keqiang have made extensive visits to countries along the various routes, talking up the policy as the basis for constructive future relations based on trade and investment, with *Xinhua*, China's state news agency, providing routine fanfare.

The project is also backed with serious money. The new Asian Infrastructure Investment Bank (AIIB) and a new Silk Road Fund have seen Chinese capital totaling $90 billion established as seed capital, with a further $60 billion available from other funds. Clearly when China speaks of the New Silk Road, they mean business.

Trading Up

From the outset though, the New Silk Road initiative has been less about specific routes, than it has been a policy framework. And perhaps even before this it was a question of political symbolism. According to Song, "The announcement of the New Silk Road from a political perspective is a commitment for the new leadership to assure everyone that China still sees free trade as a way for China to achieve sustainable growth."

Moreover, it is a statement of intent to other countries. He Liping, a professor at the School of Economics and Business Administration at Beijing Normal University, suggests that "it is a reflection that China and China's leaders want to make friends with many countries around the world, particularly those that are geographically close to China," adding that, "in this sense it is a diplomatic effort".

However, even when reduced to transportation infrastructure investment, the policy creates alignments with other regional efforts, and indeed domestic initiatives.

For the Chinese interior, the promise of increasing westward transport volumes raises the prospect of faster development with less dependence on routes to the coast, helping to spread the so-far uneven benefits of Chinese growth.

On a regional level, deeper investments in transport connectivity across Southeast Asia, progress towards free trade with South Korea and emerging economic rapprochement with Japan all point to a possible future in which China is no longer simply a destination at one end of a trade route, but an enormous transportation hub in which trade flows in all directions, providing—for example—improved access to Central Asia for Japanese and South Korean exports.

The New Silk Road policy framework ultimately serves to unite this long-term vision with China's diplomatic and trade policy orientation, in order to coordinate many different government departments, state-owned enterprises (SOEs) and policy banks around the goal of loosening restrictions—both domestic and international—on trade.

Daniel Tobin, Lecturer in Chinese Business and Management at the China Institute, School of Oriental and African Studies, University of London, explains: "Economically at least, it's a very rational policy. Putting this thing on paper, using it as a selling point, getting people to talk about it and making trade easier is a very rational policy."

Chinese Horizons

But to focus purely on trade is to miss many other aspects of the New Silk Road policy. Of perhaps greater importance in the short-run are macroeconomic factors, something that has become more acute as economic growth has slowed and the need for some kind of stimulus has arguably risen.

"We're getting a good idea at this stage that the sort of consumption-driven growth that the leaders had in mind is not really materializing," says Tobin, adding, "if these are Chinese [investment] projects, carried out by Chinese companies… the leakage out of them is quite small I guess, so the money spent does come back into state coffers and it keeps growth going forward."

Beyond forming a kind of stimulus, the long-term project of internationalizing the renminbi is often mentioned in connection with the New Silk Road. "Something that makes trade easier is currency and removing currency restrictions and giving a lot of these countries quotas in renminbi… [is] quite a coherent policy," says Tobin.

Song Gao extends this analysis by highlighting that a "medium-term goal for Beijing to internationalize the renminbi is to make [it] a more important currency for trade settlement, especially regional trade settlement." And given that "a quarter of China's exports have been associated with countries along these two or three routes," the impact on the volume of renminbi trade settlement will not be trivial.

Thirdly, but perhaps most significantly, according to Li Haitao, Dean's Distinguished Chair Professor of Finance at the Cheung Kong Graduate School of Business, attempts to alleviate growing economic pressures on Chinese businesses plays a role in the scheme. "There is a huge amount of overcapacity in manufacturing and real estate and related industries… the New Silk Road, people refer to it as China's Marshall Plan to try to export this overcapacity to Central Asia, South Central Asia, Indonesia and Southeast Asia, all the way to Africa. That's a great idea if it can be successfully implemented."

Song further explains that "the New Silk Road is a scheme to convert China from a capital inflow country to capital outflow country". Consequently "China will put foreign reserves to much better use because it has been getting about 0% or 0.5% return on [US] federal bonds. Now, if they put the money into infrastructure in developing economies, it should give a better return for China's foreign reserves." Furthermore, this will allow China to "export some inflationary pressure and can—in that case—give the People's Bank of China (PBOC) more discretion in implementing domestic monetary policy."

Return on Investment

Inevitably, such a bold, long-term plan will face challenges, and those challenges will be commercial, economic and political. But although a focus on trade might seem like a "win-win" for all those involved, from the perspective of business, the benefits are not as clear cut. A senior source from the Asian freight industry thinks the direct benefits of better rail links between China and Europe would "probably not be much, based on cost. You're looking at a difference of 14 days into Europe as opposed to four to six weeks by sea, but of course at the moment the costs are much higher, so it really depends what sort of commodity you're moving, what value it has and how time sensitive it is, but it's certainly going to have an impact going forward."

This restrained skepticism is reflected in wider market-based views of the New Silk Road. "Although obviously we are interested in specific investments across the region, the 'New Silk Road' is the sort of strategic policy initiative that generates little in the way of obvious and direct tangible benefits," says Jonathan Silver, Banking and Finance Partner at the law firm Norton Rose Fulbright in Hong Kong. "So while business would generally welcome the potential benefits of the New Silk Road, most would only take a direct interest in the concrete results, as they arise."

However, the establishment of state-backed funds and policy banks to drive investment highlights at least one acknowledged problem with large-scale infrastructure investment—the difficulty of securing a return—and hence the need for such financial institutions, rather than commercial and investment banks, to provide funds. "When you come to think about what type of returns these projects are going to deliver, you could be very skeptical of something like putting a lot of money into a railway line upgrade. These things don't generate big returns in economic terms," says Tobin.

> "[The New Silk Road] may help [China's overcapacity problem], but it is not a panacea
>
> Li Haitao
> Professor of Finance
> CKGSB

Such doubts would seem to run counter to the grand historical analogies. But rather than contesting the underlying logic or direction of the policy, a lack of excitement stems from the fact the New Silk Road essentially follows a well established direction of Chinese policy of simply making trade easier.

"It certainly is making it easier to trade with these countries, makes for a nice announcement and it has a nice name. It involves a lot of capital expenditure, but it's not necessarily something new," says Tobin, who adds, "when you've been looking at these things for a while, you tend to get quite skeptical about the way things are packaged, the way things are announced and the names given to them… The control that the Chinese government has been able to exercise over investment is not very good. It's not a perfect lever for them… The policy is consistent in one sense, but the big problem always seems to happen with implementation."

Moving beyond trade and implementation, it is also clear that some of the hoped for macro-economic benefits will be difficult to realize. CKGSB's Li expresses particular skepticism that the New Silk Road will make much difference at all to the problem of overcapacity in China.

"When I first heard about this, I thought it was a brilliant idea to try to solve the overcapacity problem in China… but if you look at these countries on the Silk Road, just think about a country that is big enough, that has huge demand for infrastructure building, could be India right? It's the size of China, huge room for improvement, but do you think India would open its doors and let China in to build all the bridges and roads?" he says. "You have to transform India into China in order to take this overcapacity [but] they want to do it themselves."

"The bottom line—to me—is that there is no free lunch. This [the New Silk Road] may help, but it is not a panacea. There may still be some pain we have to endure to deal with overcapacity in China." Furthermore, Li reinforces the difficulty of making these investments pay, noting that "the government is reducing their holdings of US government bonds, and if you can export this capital and invest in real assets… that is definitely a good strategy. But having said that, if you look at the economies around the world, the US is the only bright spot."

Political Preoccupations

Setting aside the mundane matter of threading the whole idea together with actual steel, concrete and trade agreements, there is also the question of politics, or at least, the question of political perception.

"The political challenge being always associated with the general perception of Chinese diplomacy and foreign policy," says He Liping.

For Song the problem is potentially more serious. Focusing on the three basic routes that comprise the spine of the New Silk Road, he says, "If these three routes become so important to China's future sustainable economic growth and also become so critical to China's export of capital, that means these routes will bear significant national interests and will matter a lot to China's national security… This, naturally, will be at odds with some major global powers. Russia will definitely have concerns with China's expansion through Central Asia, and India, for the maritime route, China will have to secure the trading route through the Indian Ocean, that will at least be perceived as a threatening move."

Indeed, so threatening that India is developing its own strategic vision for the Indian Ocean region—so far called 'Project Mausam'—as a direct response to China's New Silk Road.

Nevertheless, there are signs the Chinese government is fully aware of these potentially negative perceptions. On December 15th, 2014 Li Keqiang suggested in a speech in Kazakhstan that the New Silk Road would need to resolve security questions through the Shanghai Cooperation Organization (SCO). In doing so, he openly acknowledged a security dimension to the New Silk Road, but framed it in terms of instability and terrorism rather than geopolitical competition. Furthermore, invoking the SCO as the vehicle for security cover acknowledges Russia's interests in the region while hinting that they may not always be exclusive; a cooperative position, and one that Russia will no doubt think carefully about, but a suggestion clearly intended to reassure.

One further advantage China has is simply that the scale of the New Silk Road means that opposition from anywhere will only ever be towards part of the whole. The US will not be concerned about Central Asian transport links, Russia will not object to the consolidation of trade routes in Southeast Asia, and India will have no direct interest in Northeast Asia.

To that extent, opposition will likely remain fragmented, giving China the great advantage of time and the opportunity to make progress step by step in different directions at different times, all in line with a simple formula which stresses the importance of mutual gains. As Li spells out, "You can make this compelling case. China is extremely important. We build this infrastructure link to you, you can trade with China. It will benefit you enormously."

Unfortunately, time can also herald unwelcome changes. China prefers stable, long-term relations with other countries, but some of the New Silk Road countries are democracies, at times leading to dramatic changes in governments.

President Maithripala Sirisena's new government in Sri Lanka has promised to review a Chinese-backed port project in Colombo that was launched by Xi Jinping in September last year, and which is already under construction. Ranil Wickremesinghe, the country's new prime minister, had previously said the project would be cancelled if his party came to power.

Meanwhile, in Greece, Syriza, the party that has just gained power, has just suspended the sale of the port of Piraeus to China Ocean Shipping Company (COSCO), who were planning to transform it into an important European hub on the New Silk Road.

Paving the Way

Prominent funds and banks contributing to the New Silk Road policy

Infrastructure Investment Funds	Billion $	Established/Announced
Asian Infrastructure Investment Bank (AIIB)	50.0	October 2014
Silk Road Fund	40.0	November 2014
New Development Bank (BRICS Bank)*	30.0	July 2014
China Development Bank (CDB)	16.3	November 2014
ASEAN Infrastructure Connectivity Funds (Managed by CDB)	20.0	November 2014
Total Funds	156.3	

* Initially capitalized at $50 billion but Brazilian and South African capital contributions exempted from figure of $30 billion

Source: *CKGSB Knowledge* research, *Bloomberg*, *Xinhua*

The End of the Road?

Ostensibly, the New Silk Road is about trade routes and infrastructure, and to that extent it is comprehensible, if very ambitious. But behind the detail of construction projects backed by policy banks, there lie trade agreements and a conception of China's development that looks beyond China as simply one end of a trade route. Indeed, as Song Gao makes clear, "It turns out that this vision will be much bigger than that, like turning the entire economy into a free trade zone."

Match this vision with the macroeconomic centrality the New Silk Road provides for both internationalizing the renminbi and providing a conduit for the export of Chinese capital, and the New Silk Road becomes much more than freight trains crossing wide desert plains. As historical analogies go, China as the Middle Kingdom might seem more appropriate, for the New Silk Road policy resembles less a road than a 'roadmap' towards China's future, and it is a map with China firmly in the middle.

However, as CKGSB's Li says, "the road is long, with many pitfalls", raising the prospect that the New Silk Road may be just as hazardous as the old one.


CUSTOM PROGRAMS
Learn what you need to know, from a tailor-made program focused on your industry and your company's needs.
BUILD A WINNING CHINA STRATEGY.
WITH COURSES BUILT AROUND YOU.
It's soon to be the world's largest economy. Yet shockingly, China remains a mystery to a majority of the global business community. At CKGSB, our Custom Programs give you an in-depth look at the realities of doing business in China, and with Chinese companies around the world. You will get the practical knowledge you need to succeed by learning from world-class faculty with access to China's top business leaders. CKGSB. Delivering deeper understanding, at the highest level.
Download your FREE brochure at business.ckgsb.info
CKGSB
长江商学院
CHEUNG KONG GRADUATE SCHOOL OF BUSINESS
CHINA'S WORLD-CLASS BUSINESS SCHOOL
BEIJING | NEW YORK | LONDON
HONG KONG | SHANGHAI | SHENZHEN

Baffling Bourse

Is the Shanghai Stock Exchange finally becoming a hub for global finance?

By Hudson Lockett

After a mainland equity collapse in 2007, investors the world over largely wrote off Shanghai's stock exchange as the lesser cousin of regional heavyweight Hong Kong. But tides have turned thanks to the Hong Kong-Shanghai Stock Connect, which allows traders at each exchange to buy and sell certain stocks in the other. After said market linkup debuted, the Shanghai Composite Index rocketed upward from around 2,500 points to break the 3,000-point mark in less than a month, even as interest in the Stock Connect faltered. The sudden surge set foreign investors salivating once more at the prospect of snapping up Shanghai stocks.

As local retail investors and equities experts abroad turn their gaze upward to track Shanghai's ascent, it is unclear whether most understand the financial foundations and regulatory system that underpin the workings of China's foremost native stock exchange. Nor is everyone confident its gains tally with reality.

"People are still far more trusting of the US stock market as a leading indicator of the economy," says Robert Blohm, a professor at China's Central University of Finance and Economics. Blohm, while noting positive developments in earnings at Shanghai's exchange, says that its erratic movements are similar to those of Tokyo's in the late 1980s.

"The problem with the Japanese stock market at the time was that it was irrational; it wasn't analysis-based," Blohm says.

To understand how Shanghai's exchange might move past that stage and overcome both a lack and overabundance of regulation requires a look back at its origins and often tumultuous development. How the Shanghai Stock Exchange became what it is today and how it is viewed both on and off the mainland by regulators and investors speaks volumes about where it is headed, and why.

Humble Beginnings

Shanghai's stock market is a key component of China's economic framework, as it was intended to be when it launched alongside the Shenzhen exchange in late 1990.

> "There's just more counterparty risk involved [in the Stock Connect] than people had expected
>
> Haohao Zhou
> China Economist
> ANZ

Its debut marked the beginning of a suite of capitalist mechanisms that would be rolled out over the course of the following decade. As major companies from the mainland were formed out of smaller regional government enterprises and began listing in Hong Kong with so-called H-share offerings, that city's exchange ballooned in size and importance to global finance. With experience gained there and in New York, mainland companies could then return to China to build the foundation of the country's current state-owned enterprise (SOE)-dominated model.

Unfortunately market conditions stagnated following the Asian Financial Crisis of 1998, and from 2001 to 2005 the Shanghai exchange muddled its way through a four-year slump until a series of big deals and protection from stock dilution due to a temporary ban on IPOs turned things around. By the end of 2006 the Shanghai index had leapt from 1,000 points to 3,000 points in the space of just 18 months—only to go bust after reaching a historic peak of over 6,000 points in October of 2007. The plunge ended with the index finishing 2008 down a staggering 65%.

A partial recovery fueled by the government pumping cash into the country's economy was not enough to rouse investor interest, and the composite index continued a chronic slump that, until this year, seemed doomed to continue. But it didn't.

Surging Stocks

The broader trend upward this year, as tracked by the Shanghai Composite Index, entered the foothills of its current rally in mid to late July after the announcement of the Hong Kong-Shanghai Stock Connect. The index has continued upward ever since, outside a dip in December that it later recovered from. State media certainly encouraged investor optimism, as China Securities Regulatory Commission President Xiao Gang told the Xinhua-sponsored China Securities Journal the Stock Connect would speed Shanghai on its way toward becoming an international hub.

The latest leap, in which the bourse went from around 2,500 to over 3,000 points in the space of about a month, began in mid-November, just before the launch proper of the stock market linkup. But as the rally drove on it became clear that the Stock Connect was not as user-friendly as many international investors would have liked, says Haohao Zhou, China economist for ANZ.

"There's just more counterparty risk involved than people had expected. It's a nominee structure," says Zhou, which means that the Hong Kong exchange acts as a clearing house. "If you want to sell your stock on a particular day you have to deliver all your stocks to the brokerage company before the trading kicks off. So you have more counterparty risk and most of the typical institutional investors in Hong Kong just do not feel comfortable enough with that."

Nor do regulatory hurdles end at China's borders, as many mutual funds out of Europe learned in November. Many were forced to hold off on participating due to their Luxembourg-based regulator having not yet given approval. But this is not the first instance of Europe playing catch-up with China's opening capital markets: when the first RMB-denominated scheme for foreign investment on the Shanghai exchange began in 2011, it took authorities in Luxembourg roughly a year to grant approval for any investment funds to begin buying mainland stocks.

The current surge is also unusual in that previously the A-share market—regular shares that are also available to foreigners—mirrored China's economy at large, growing and shrinking in tandem with broader macroeconomic trends. The key driver of the current uptick, in addition to attempts to profit off arbitrage between Hong Kong and Shanghai dual-listed stock valuations and an interest rate cut from the People's Bank of China, is likely the protracted slump in real estate throughout much of China.

For now, the downturn appears to have effectively ended the property sector's role as a dependable earner for institutional investors and profitable storehouse for value among retail investors—individuals buying and selling shares for their own personal account—at least outside of top-tier cities such as Beijing and Shanghai. That has left only one sector where profit is possible: equities.

Who's Driving this Thing?

Although the Shanghai exchange is often decried as a casino, the latest influx of willing investors shows that such concerns are not enough to scare off everyone, and without real estate to spread out the risk, investment has no other destination as attractive as the stock market. That many retail investors view Shanghai as being driven by speculation and liquidity does not change the fact that depositing money with traditional banks requires enduring low interest rates, or that the bond market is still not worth the effort.

Shares in the CSI 300 index, compiled by the China Securities Index company, quoted below RMB 5 at the end of September had jumped 63% by mid-January, according to one Bloomberg report, suggesting that much of the rally has been driven by inexperienced retail investors whose knowledge of trading began with "buy low" and ended with "sell high".

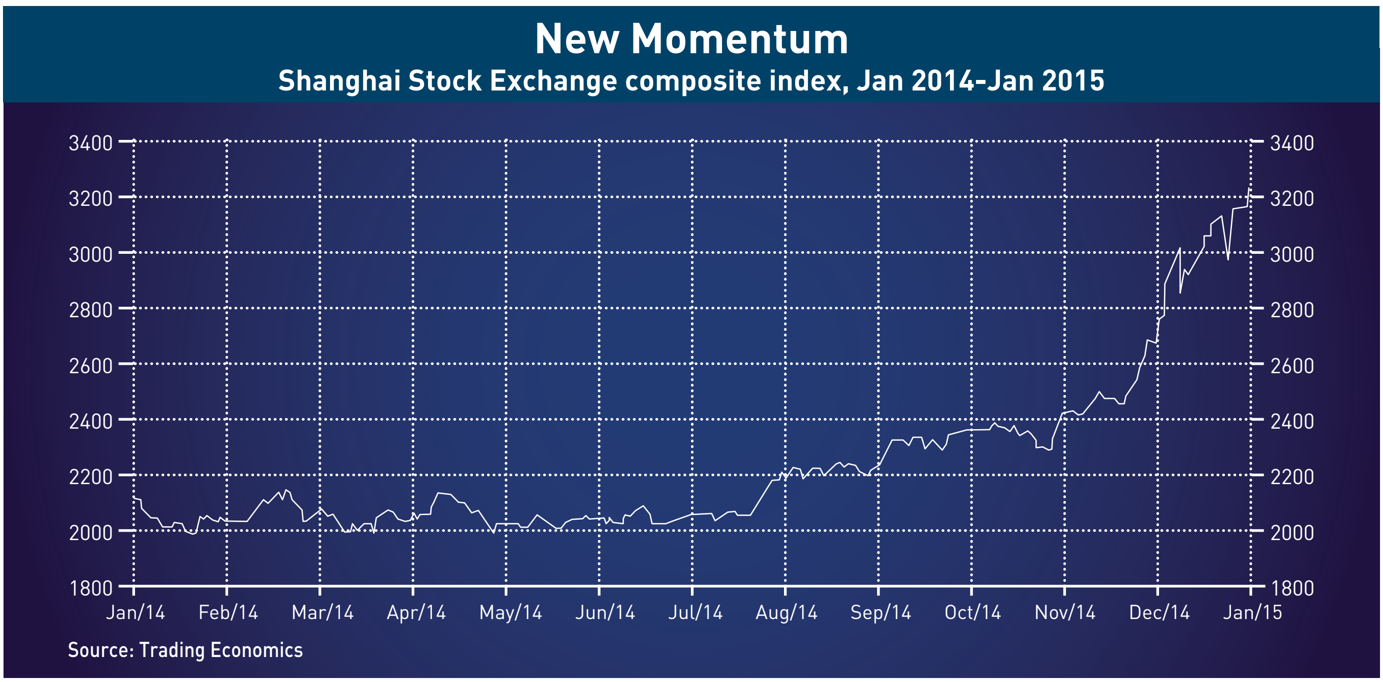
An auditor at a top Western accountancy firm, who declined to be named, says he'd been investing in mainland markets since his college days, and had snapped up securities firm shares in December on speculation that companies in the sector would cash in on the rally that month, in addition to SPD Bank stock he figured was undervalued. His stocks also included Ping'an—up nearly RMB 20 from his buying price of RMB 60 per share.

Meanwhile, a fellow auditor at the same firm had got involved in the market too, but was still new to equities and couldn't recall what he'd bought most of his stocks for. But he'd taken a beating from buying securities shares: like his colleague, he'd bought them in order to profit off the December rally, but his gains didn't last long as some securities firms slumped by as much as 30%. He was still holding onto the shares when he spoke, but at a growing loss.

Barriers Remain

Shanghai has entered global stock market indices, in a limited capacity, through the S&P China BMI, which measures all investible Chinese stocks available to global investors. After ups and downs from 2008-2011, the S&P has trended net positive to date, at least broadly speaking.

But the Stock Connect that kickstarted the current boom remains only partially opened to international capital, limiting foreign investment to 568 designated stocks out of the total 971 listed in Shanghai. Furthermore, there is the process of first going through a broker in Hong Kong. Those barriers are likely to come down in time, but



they point to a more central problem.

"Shanghai can't really become an international finance center until they've opened up the capital account and made the renminbi fairly convertible on that capital account," says Julian Evans-Pritchard, China Economist at Capital Economics. "In order to be an international financial center you need to be able to freely shift funds across the border and convert them into different currencies."

There is certainly a desire to invest, as much of the international exposure to mainland shares now seems to be coming from privately traded derivatives in Hong Kong. A recent Reuters report found that thanks to regulatory and technical hurdles to foreign investment in mainland firms outside of an approved list, most Stock Connect activity was occurring off-exchange as funds bought "synthetic" equity—financial tools that grant exposure to a stock's gains and losses—to increase their China exposure—this despite Beijing's hopes that the new program would curtail said footloose foreign funds' growth.

Zennon Kapron, founder and Managing Director of the China-based financial consulting firm Kapronasia, suggests that this focus on synthetic equity was likely to dissipate in the longer term as the market linkup's scope broadened and regulations were eased. He adds that China's lack of domestic derivatives was another factor that detracted from the Shanghai Stock Exchange's international appeal, even as its impact on the global financial system increased.

"There are certainly a subset of these investors that have not come into the [Shanghai] market because of the inability to hedge," Kapron says. "As we have seen in the latter half of 2014 and beginning of 2015, the Shanghai Stock Exchange can be quite volatile. Investors may not want to take a position in something that they cannot hedge, or they might not even be allowed to, based on investment rules."

Furthermore, in comparison to exchanges like those in London and New York, tight-fisted regulation has kept Shanghai's exchange comparatively undiversified. It generally favors heavyweight, state-owned firms, while smaller enterprises truly in need of willing global capital often get shunted to Shenzhen, which lacks a Connect of its own. Worse still, the abovementioned capital controls effectively rule out any international firms that might otherwise consider listing in Shanghai.

> "There are a subset of these investors that have not come into the [Shanghai] market because of the inability to hedge
>
> Zennon Kapron
> Founder and Managing Director
> Kapronasia

Still, domestic brokers' eagerness to invest abroad could serve China well in finally opening up with Shanghai at the vanguard, says Robert Blohm, from the Central University of Finance and Economics. That outward-facing mentality contrasts with Japan, where a preference of investing in local firms has kept the stock market in Tokyo from becoming more of an international listings destination.

"If anything there's an opposite propensity of Chinese to invest in foreign things," says Blohm. "Shanghai has a lot more potential for internationalization than the Tokyo exchange ever had."

Trust Issues

Global investor attention may have shifted to Shanghai's side of the Stock Connect, but Hong Kong has something that Shanghai truly lacks: a sense of trust and security. "I think the bigger issue is trust and faith in the legal system," Evans-Pritchard says. "It's harder to build that trust, and I think there's still quite a significant amount of wariness of how well investors' rights will be protected in the mainland. Investors want exposure to China but they don't necessarily want to deal with the legal uncertainties that would be involved in investing from within China itself."

But even after a drop-off in participation from both sides of the new market linkup, all of the economists contacted viewed the Stock Connect as a step in the right direction toward opening up China's capital account in a way that would benefit the international standing of the Shanghai Stock Exchange. It's also set to get better as the suite of regulations is revised and the investment process for international investors is smoothed out, says ANZ's Zhou. "The version that we currently have is not the final version," he notes.

Stock Connect notwithstanding, in light of the bourse's history and the latest trends in investment, it appears that while the Shanghai Stock Exchange may be of global interest, its offshore influence remains hobbled. Cumbersome controls that prevent global capital from flowing where it is most needed, and a murky regulatory environment keeps potentially willing international investors—or even international listings—off the table. The recent rally may have captured the world's attention, but its speed and contrast with wider macroeconomic conditions raise questions of its credibility.

This all may change in the long run as reforms are gradually rolled out. But so long as Shanghai's market lacks the global liquidity and institutional trust that underpins other major stock exchanges' financial fundamentals, its international significance will remain limited.

Hitting the Speed Limit

China's slowing auto market is reshaping the industry

By Christopher Beddor

Zhou Xiaogang, a resident of the southern Chinese city of Shenzhen, has been planning to purchase a car for some time. A 28-year-old graphic designer, Zhou has already saved around RMB 85,000 ($13,700), a step toward his goal to purchase a new car and an apartment in the city's suburbs.

On December 29, that dream became much more difficult. Shenzhen officials abruptly announced they would cap the number of new car license plates issued by the city government to 100,000 per year, effective immediately. Most plates will now be allocated either by lottery or auction. Last year, around 500,000 passenger cars were sold in Shenzhen, suggesting demand for plates will far outstrip supply.

The suddenness of the announcement generated much public anger, including from Zhou. "Sure, I'll register [under the new lottery system]," he says. "But [as to] when I'll actually be able to buy a car, I have no idea now."

Shenzhen is the latest city to implement a license plate quota system, following in the footsteps of Shanghai, Beijing, Guangzhou and others. Officials hope that by limiting the number of new cars on the road they can curb air pollution and traffic congestion, especially as public pressure to combat smog continues to mount. But these restrictions, although well intentioned, risk accelerating the cooling of China's once red-hot auto market.

Sales of passenger cars, sport utility vehicles (SUVs) and minivans grew 9.9% nationally to reach 18.9 million in 2014, down from a 15.7% gain in 2013, according to the Chinese Association of Automobile Manufacturers (CAAM), an industry body. Sales of all autos, including commercial vehicles, grew 6.9%, less than half the pace of 2013.

Few in the industry think a return to the go-go years is in the offing. "Everything is normalizing in China: the market growth, the volume growth, the margin growth," Karsten Engel, BMW's CEO, told *Reuters* in November. "The breakneck growth of 30 to 40% will not come back again."

The slowdown could have wide-ranging ramifications for an industry that has come to rely on Chinese growth. China made up 59% of the global net profit at Volkswagen, 45% at BMW and 37% at General Motors in 2013, according to data complied by IHS Automotive.

What this "new normal" means for various industry players is less certain, however. Chinese car brands will probably take the biggest hit, though in the long run, consolidation will be healthy for the industry. Foreign automakers should fare better, and appear to be investing for the long haul in what is still the world's fastest-growing major auto market. Even so, they too will need to rethink their approach to the Chinese market.

"The industry really is at an inflection point, and it's quite a major inflection point," says John Jullens, a Shanghai-based partner at Strategy&, a consulting firm. "The whole business model is going to have to change."

> The industry really is at an inflection point... The whole business model is going to change
>
> John Jullens
> Partner
> Strategy&

End of an Era

Until recently, China was one of the few bright spots in the global auto landscape. Auto sales grew at a compound annual rate of nearly 17% between 2003 and 2014, according to PricewaterhouseCoopers, an accounting firm. China's auto sales volume overtook the US in 2009, a year when sales surged a blistering 46%.

The China market has seen slumps before, usually as consumers delayed or accelerated purchases in response to government incentives. For instance, the phase-out of a car subsidy scheme led to a paltry 2.5% growth in 2011, but by 2013 it was roaring ahead again at 14%. Today's slower pace appears here to stay, however.

"The major impact is coming from the macroeconomic environment, which is not very strong," says Jochen Siebert, founder of JSC Automotive, a consultancy. China's economy grew around 7.3% in 2014, its slowest pace since 1990. The auto market also correlates strongly with real estate sales; as the property market has cooled, auto sales have fallen in tandem.

Increasingly tough restrictions on license plates are also taking a toll. Last year Beijing lowered its cap on new plates to 150,000 from 240,000 per year. By 2017, the city expects to issue just 90,000 plates to conventional cars, with the rest allocated to new-energy vehicles.

Meanwhile, officials in Shanghai have said they will issue around 100,000 new plates this year; the average auction price of a new plate reached RMB 73,798 ($11,900) in the fourth quarter of 2014. Other cities, such as Guangzhou, Guiyang and Hangzhou, have implemented similar quotas schemes, and more are expected.

The caps limit car demand in those cities, but the way they have been introduced—with little warning, in order to avoid a car-buying rush before restrictions kick in—could have knock-on effects across the country.

The new Shenzhen quota "will have a big psychological impact, because the local city government did not give any lead time or buffer," says Yale Zhang, Managing Director of AutoForesight, a research firm. If consumers in other cities think they will be next for a quota system, they may push forward their planned car purchases. That would make for a strong first half of 2015, but depress sales in the long term.

Namrita Chow, an analyst at IHS Automotive, thinks the combination of slower economic growth, plate restrictions and Xi Jinping's anti-corruption drive, which has depressed sales at the premium end of the market, will knock at least another percentage point off passenger car growth this year, marking something of a consensus among industry watchers.

Propping Up the Rest

Less clear is the impact the slowdown will have on automakers.

The hardest hit are most likely to be domestic carmakers, say analysts. These firms cluster at the low end of the market, with models priced at RMB 50,000-100,000 ($8,070-16,140). Their share of the passenger car market fell 2.1% last year to 38.4%, according to CAAM. That share will fall even further as restrictions tighten, possibly to near zero in big cities, reckons Zhang of AutoForesight.

"Consumers will think, 'I spent so much money on a plate,' or 'I went through the lottery system a million times and finally got this car plate, so I need a good brand that I don't need to upgrade frequently,'" he says. "So even if the original plan was to buy a local [car], after they get the plate they increase their budget—sometimes by double—and buy a foreign-branded car instead."

He adds that ironically, the quality of Chinese-branded cars is quickly catching up to the big automakers, but consumer perceptions take around a decade to adjust to reality.

Another source of pressure comes from foreign automakers moving down-market. Chinese regulations require foreign car companies introduce local "indigenous" brands, often produced in conjunction with their mandatory local joint venture partner, if they want to expand production capacity in China. The requirements are of the country's longstanding strategy to trade market access for foreign technology and know-how, says Jullens of Strategy&.

While the mass-market global automakers such as GM, Volkswagen and others usually sell cars for RMB 100,000-200,000 ($16,140-32,280), the regulations have spurred them to design cheaper models that compete directly with Chinese brands. "There's a major battle shaping up [at the low end of the market]," says Jullens.

Such competition is probably healthy for the industry in the long run. Jullens explains that when consumers think of Chinese car brands, they tend to think of the big state-owned firms (SAIC Motor, FAW, Dongfeng Motor, Chang'an Automobile and so on) or private players (Chery, Geely, Great Wall, BYD and others). In reality there are more than 170 Chinese automakers, and the bulk of these are a "fat tail" of small, inefficient car companies supported by local governments.

The National Development and Reform Commission (NDRC), China's state planning agency, has long understood that the industry needs to consolidate. In 2007, the government established a target for the top 10 auto firms to have a combined 90% market share in 2015, up from 80% at the time. But the agency encountered stiff resistance from local officials: small automakers are part and parcel of local government budgets, as well as a major source of employment.

Moreover, attempts at forced mergers have foundered. In 2009, Guangzhou Automobile Group acquired a 29% stake in Changfeng Motor for RMB 10 billion ($162 million) at the behest of the NDRC and the Ministry of Industry and Information Technology (MIIT), another regulator. The acquisition failed so completely that the company was eventually split into three, leaving the market even more fragmented than before.

Tougher competition and slower growth may finally do what regulators could not. "The pain threshold is going to get higher and higher for this long tail of smaller brands," says Jullens. But when consolidation does come, it will be a net positive development for the industry. "It's [a] process that will have to happen at some point," he says.

Wheeling and Dealing

Foreign brands are better-placed than their Chinese competitors, but they too face challenges amidst the slowdown.

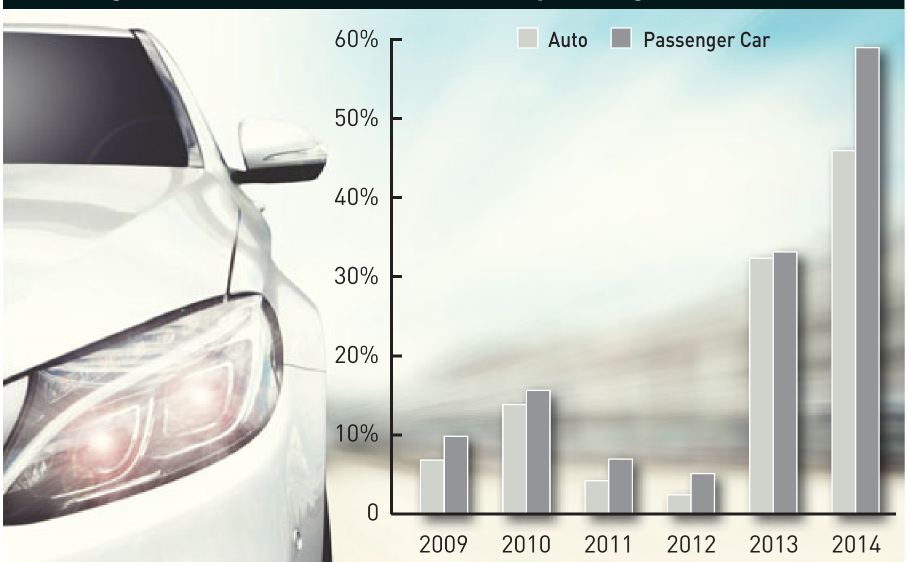
Among the most pressing is their relationship with local dealers, many of which are piling up inventory. The China Automobile Dealers Association (CADA), a trade group, reported that dealers had an average 1.83 months of inventory on hand at the end of 2014, a one-third increase on the year before and well above the 1.5 months of inventory analysts consider to be a "red line".

The problem is that many global automakers set year-end sales targets for their China dealerships (Chinese brands usually own their dealers directly, as in Europe). Dealers that reach those targets qualify for bonuses, which can account for up to half their profits, according to CADA. But the widening gap between targets and the slowing economy has led to friction at some firms. BMW, Toyota and Daimler dealer associations have protested publicly against what they consider to be unreasonable sales targets.

"We will see more of that happening," says Siebert. "We'll see it from Audi, from Lexus and others, because the dealers are much stronger than before."

Foot to the Floor

% growth in total auto market and passenger car market



Source: China Association of Automobile Manufacturers

New regulations from the Ministry of Commerce, which oversees auto sellers, have liberalized many aspects of the market, for example by allowing dealers to sell multiple brands or import vehicles without the manufacturer's permission. This, says Siebert, has shifted the balance of power towards dealers. Those dealers are responding by holding less inventory and demanding more subsidies from manufacturers.

"If [the dealers] don't get what they want, they get together with CADA, and CADA goes directly to Beijing, points their fingers at the [manufacturers] and says, 'They're not playing according to the rules,'" Siebert notes. "And in the end, they get what they want."

In early January CADA announced that it had persuaded BMW to shell out RMB 5.1 billion ($820 million) to its China dealers as compensation for lower-than-expected sales in 2014. Volkswagen and Daimler are said to have paid RMB 2 billion and RMB 1 billion to their Audi and Mercedes dealers, respectively. CADA declined to comment for this article, and the automakers will not confirm the figures.

Figuring out how to handle the relationship with local dealers "must be the number one priority" for foreign automakers in the near future, says Siebert.

Changing Tactics

Another challenge is the changing nature of Chinese consumers. Jullens of Strategy& says the big automakers have so far taken a "hunter-gatherer" approach to the market, making money by scouting first-time Chinese car buyers.

Yet the market is now shifting from one of mostly first-time buyers to repeat purchasers. This will require a "seed-harvest" approach, in which carmakers sell vehicles at relatively low cost, then earn profit through complimentary services like lease financing, warrantees, accessories, after-sales services and trade-ins.

Car brands will need to place more emphasis on customer loyalty and master the economics of after-sales parts and services, as well as the used-car market—a different set of skills than what has worked so far.

Even the premium end of the market, currently dominated by Audi, BMW and Daimler, may be in for a shake-up as the market transitions from targeting super-rich buyers to the merely affluent. These "mainstream" buyers are more invested in the performance of the car, rather than simply prestige, says Jullens. That could provide an opening for a raft of budding new entrants, including Ford's Lincoln brand, Nissan's Infiniti and Toyota's Lexus.

"You're going to start to see a new business model emerge," says Jullens. "The deck is being shuffled anew."

Increasing overcapacity will make that juggling act even more difficult. Nearly all the big global players appear to be doubling down on China. Chow says the top brand by market share in China last year was likely Volkswagen, followed by Hyundai and Buick (owned by General Motors). Of these, Hyundai announced in late December it would start construction on two new production plants, and General Motors said earlier in 2014 it would invest $12 billion to boost capacity 65% by 2020.

"These are decisions that were made some time ago, when it still looked like there would be no end to China's rise," says Siebert of JSC Automotive. "I think when the [automakers] realize over the next few months that maybe there will be some sort of crisis, you will see some revisions of those plans."

Finally, foreign car firms will need to meet a series of surprisingly tough fuel efficacy targets in China. Automakers must improve efficacy by 6% between 2015 and 2020 to meet the new requirements, says John Zeng, an analyst at LMC Automotive.

That will not be possible by simply tweaking existing car technology, so carmakers will have to choose from a variety of new technologies that might bridge the gap, including high-efficacy diesel engines, turbo-charged engines and new-energy designs. However, while the likes of Tesla and BYD have produced some high-priced all-electric vehicles, none of these options has yet proven commercially viable on the mass-market end.

"For the manufacturers, it's like gambling—you don't know which technology will win," Zeng says. He adds that some Japanese carmakers have opted for hybrid petrol-electric models, but those designs appear to be failing in the market.

Too Big to Fail

Such concerns do have merit, but China remains one of the few sources of serious growth left in the global auto market. While the US is gaining steam, margins in the American auto market are slim. Emerging markets such as Brazil and Russia are flirting with recession, and there is no end in sight to Europe's anemic growth. In this context, investing in a large market expected to grow 8% this year seems a reasonable bet.

Furthermore, many car companies have their eye on the long term. Auto penetration rates in China are less than a tenth that of the US and less than an eighth that of densely populated countries such as Japan, according to the World Bank, suggesting there is still plenty of room left for growth.

"In a long-term context, China still has significant growth potential," says Larissa Braun, a Beijing-based spokesperson for Volkswagen. "We expect China to remain the motor for growth for both the global automotive industry and for the Volkswagen Group."

Those remaining growth prospects, an entrenched position in the country and a lack of strong alternative markets all mean that China has to remain the companies' focus.

Zhang of AutoForesight points to the example of Toyota to illustrate how China has transformed from a zippy-yet-optional emerging market into an indispensable pillar of the global auto industry.

The Japanese carmaker sold 1.03 million cars in China last year, falling short of its 1.1 million target and sparking rumors that it was considering an exit from China. But industry insiders know the notion is nearly inconceivable, no matter how much growth slows.

"Think about it: if you lose a million cars a year, is there another market that can make up for it? Can they really do another million in the US or European market? I don't think so," he says. "Who can afford to lose this market?"

Countryside Commerce

China's e-commerce giants are heading down to rural areas

By Nicole Sy

The low-hanging fruit of China's e-commerce industry, the urban market, is running its course, as consumers become savvier and competition becomes more intense. As these initial boom years recede, companies are looking to expand and innovate in order to consolidate their positions.

To that end, e-commerce giants Alibaba and JD.com have begun branching out to harder-to-reach markets, namely China's rural areas. "Developing [these] is our first priority in the second half of this year," Liu Qiandong, CEO of JD.com, said in a CCTV interview aired in November 2014.

Meanwhile, Alibaba Chairman, Jack Ma said, "Alibaba plans to expend a lot of energy in the entire field of rural ecommerce," at a December 2014 event in Guangdong province. "We're really hoping to bring e-commerce to all of China's [many] villages, so that rural people can get a taste of the city life and sell their own products in the cities."

The case for such a move is clear. A report from AliResearch, Alibaba Group's research arm, released in October 2014 estimated sales from rural e-commerce would reach a value of RMB 180 billion ($29 billion) by the end of that year, and predicted that would increase to RMB 460 billion ($75 billion) by 2016.

That is not an insignificant portion of China's total internet retail sales, which reached RMB 2.4 trillion ($390 billion) in 2013, and is predicted to reach RMB 3.3 trillion ($530 billion) in 2015, according to consulting firm, Bain & Co.

Alibaba's Alipay Annual China Spending Report for 2013 also noted that consumption growth is gradually shifting from the country's prosperous coastal regions to inland provinces. Additionally, the company's first county-level economic and e-commerce forum held in May 2014 reported that e-commerce growth in counties and villages outpaced that in cities by 13.6 percentage points in 2013.

"This is one of the greatest growth areas in China," says Teng Bingsheng, Associate Professor of Strategic Management at the Cheung Kong Graduate School of Business. "So for these big internet players to position themselves as early as possible does make sense."

> "This is one of the greatest growth areas in China
>
> Teng Bingsheng
> Associate Professor
> CKGSB

"China's urban e-commerce industry is also saturated in terms of competition," says Wang Rui, Assistant Marketing Professor at Peking University. "Big firms are dominating the market, like Alibaba and Jingdong (JD.com), so new players like Vip.com, Yihaodian and Tootoo are targeting niche markets," she says.

Out in the Sticks?

Shen Haoyu, JD.com's CEO of e-commerce business unit, was quoted by *China Daily* in July 2014 as saying consumers in small cities are active shoppers and the company had to act aggressively. He also noted that JD.com's sales growth in third and fourth-tier cities already outpaced that in major cities.

These places feature heavily in discussions of Chinese rural e-commerce. "Usually when we look at the lower tier, we try to base it on the administrative classification. So they are typically the county-level towns, normally considered as lower-tier cities," says Kunal Sinha, formerly the Chief Knowledge Officer and Regional Cultural Insights Director at international ad firm, Ogilvy & Mather. "Rural is not just farmers, but you also get a great number of people who are either in construction, mining or also the service economy."

The classification of what is considered rural China is often a vague concept handed down from Maoist planners. It is relevant to note that although also classified as cities, lower-tier cities in China are more like towns in a conventional Western sense. Third and fourth-tier cities in China are more similar to large and small towns in more developed nations.

Marketing research firm, Millward Brown classifies third-tier cities as prefecture-level cities and fourth-tier cities as county cities. Of these, there are 238 cities with 32.4% internet penetration, and 388 cities with 27.7% internet penetration for third and fourth-tier cities, respectively.

At the end of 2010, only 20.1% of rural residents said they accessed the internet for online shopping, while 17% had used online payments. That low figure stemmed from low internet penetration rates in rural areas. By the end of 2010, users in rural areas had reached 124.8 million, according to the China Internet Network Information Center.

China had a total population of 1.35 billion people in 2012, with 47.4% of those living in rural areas, according to the 2013 *China Statistical Yearbook* by the National Bureau of Statistics. Meaning there is a rural market of 642 million people. Of those rural residents, 84.4% said they liked shopping online, according to the AliResearch report. The number equates to more than 542 million potential customers and retailers, and has skyrocketed in the last few years.

But there are numerous challenges.

Getting Online

Increasing internet connectivity is one. Telecom companies will effectively have to start from scratch, since these areas might not have the infrastructure already in place, which could constitute a huge investment.

Even more basic infrastructure is also lacking in some parts of rural China. Roads to ensure deliveries and other logistics; banks to facilitate online banking; and uninterrupted electricity sources to power computers and mobile phones, are not always in place.

"The infrastructure is different from a city's. Internet access, mobile [ownership] are all lower," says Wang.

Luckily, China's largest tech companies have deep pockets—Alibaba has a massive war chest from their record-breaking IPO in late 2014. The company announced in October 2014 that it plans to invest RMB 10 billion ($1.63 billion) for infrastructure and logistics outside the country's cities. It also plans on building "1,000 county-level service operation centers, create new services tailored to rural e-commerce, and to train retailers in rural areas, among others".

In December 2014, JD.com also announced a partnership with the Grameen Trust, Nobel laureate Muhammad Yunus' microcredit and social business initiative, to provide micro-loans for entrepreneurs in rural China. Micro-loans help those looking to start their own online stores, as items such as a computer, and insurance to be paid to platforms like Taobao, are unaffordable for most rural residents.

That's in addition to another initiative, the JD.com Hometown Delivery Program, created to empower rural residents and establish better logistics in lower-tiered cities and the countryside.

"We've been leveraging our couriers, who often come from smaller cities, to expand in these areas [with the JD Hometown Delivery Program]," writes Josh Gartner, JD.com's Senior Director of International Communications, in an email.

However, JD.com's most important partnership is with Tencent, which owns a 15% stake in the company, and is China's second-largest internet company by market capitalization. Tencent's social apps, QQ and WeChat, which JD.com is now integrated into, increasingly act as entry points for a large number of mobile purchases as shopping platforms. In their earnings call in November 2014, JD.com's Shen Haoyu said that most users of the two Tencent properties tended to be from lower-tier cities. He also said that mobile purchases made up 30% of all purchases in 2014 Q3.

The majority of lower-tier consumers' spending goes into their basic necessities, according to Sinha. But patterns emerge with their first purchases the moment they have disposable income. "The first kind of purchases would be mobile phones because it allows them to stay connected with each other," he explains. "And then there's moving on to the comforts of home. "

Convenience and choice are key points in the rise of e-commerce in lower-tier cities. Without the presence of large brands in physical locations, shoppers can access them, regardless of locale, and have them delivered, while at the same time comparing prices between brands.

"These markets have been traditionally underserved by brick and mortar retailers, so being able to get guaranteed authentic goods—including imported brands and food—quickly is a huge draw," writes JD.com's Gartner.

Another challenge is an intangible one: distrust in society. Chinese society's level of trust does not rank highly compared to most countries, and yet the online marketplace is an industry that survives on trust.

"In rural areas you would expect more people to take cash on delivery," says Sinha. It's an option that some e-commerce sites like JD.com have that removes the hurdle of having to navigate an online banking account, and addresses trust issues—buyers can physically inspect the product before paying.

Additionally, online marketplaces have engineered mechanisms to help allay consumer fears through seven-day returns, the feedback system and guarantees about the authenticity of their products.

Reinventing the Village

Rural residents benefit from the technology and education that has come their way, developing the regions and boosting employment.

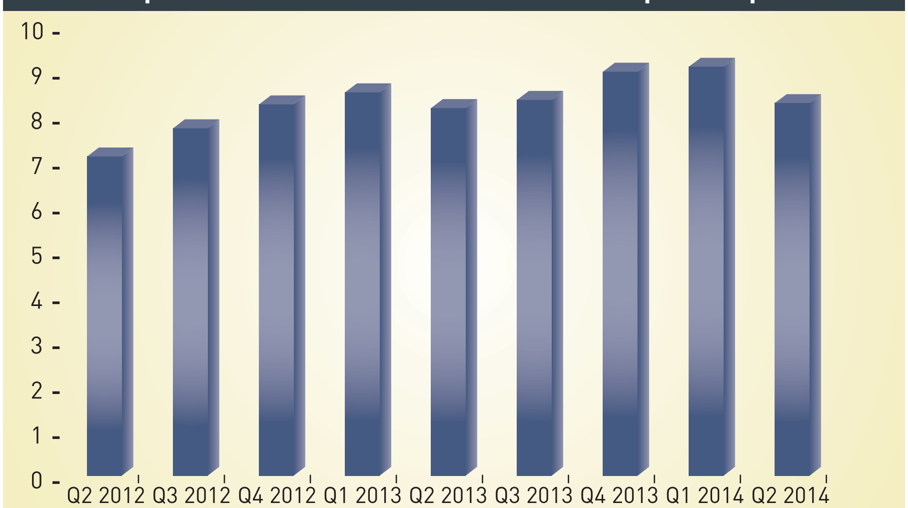
In fact, it has already begun with what has been dubbed as "Taobao villages": traditional farming communities transformed thanks to new jobs created around Taobao, Alibaba's largest e-commerce site.

AliResearch defines a Taobao village as a "cluster of rural e-tailers where at least 10% of village households engage in e-commerce or at least 100 online shops have been opened by villagers; and total annual e-commerce transaction volume in the village is at least RMB 10 million ($1.6 million)." According to AliResearch, the number of Taobao villages has grown tenfold from 20 at the end of 2013 to 211 at the end of 2014, and there are now some 70,000 Taobao village merchants. They also estimate that commercial activity from e-commerce provided 280,000 more jobs in rural China in 2014.

"E-commerce will help to close the gap a lot… these people can [now] not only get traditional jobs, or industry jobs based on urbanization, but they can also get internet-

Room to Grow

Taobao purchases as % of total rural consumption expenditure



Source: AliResearch

based jobs," says Teng. "I think it will also create a lot of job opportunities, not to mention logistics [jobs]."

Tencent also launched a program called "Sending a Dream to the Countryside" in late November 2014, where it aims to build the first mobile internet village in China in Tongguan, Guizhou province. It partnered with China Telecom and phone manufacturer, ZTE to build a transmission tower and distribute smartphones. Training courses were also provided on how to use the phones to communicate and sell local specialties.

Jiang Yu, a 26-year-old junior village official, was assigned to a post in Bishan village in Anhui province in 2011. "After we got assigned to this village and got to know the villagers better, I realized that tourism didn't help their financial situation," she says in the 2014 documentary, *Down to the Countryside*. "So we wanted to find a way to help them have a better life."

She and two colleagues helped villagers start an online store on Taobao, "The Young Village Official's Farm," which currently connects 27 farming households to customers all over China. Their online store sells local products like honey and preserved goods. "Now when I go to Bishan, I notice the villagers are happy," Jiang says.

It's also changing social attitudes in lower-tier cities, placing greater value on the goods it produces. It acts as a bridge, for instance, when farmers earn more when they can cut out the entire supply chain process and middlemen, going straight to urbanites concerned about food quality. "The biggest advantage is to link the rural areas with cities more closely," says Teng.

No Revolution?

Although Suning, an electronics retailer, and Wanda, one of China's largest companies, have joined in the rural e-commerce action, or announced plans to, some are skeptical there is even a trend worth noting. Anne Stevenson-Yang, co-founder and Research Director of J Capital Research, says she does not believe in the sudden relevance of going to the countryside.

"I'm not aware that it is a trend," Stevenson-Yang says. "You could have said the same thing 10 years ago or 20 years ago as well and found plenty of signs. Chinese companies invest a lot of money when they list; it's not a strategic thing." Both Alibaba and JD.com listed to much fanfare in 2014, the same year their rural e-commerce initiatives became more prominent.

E-commerce will spread to lower-tier cities, but definitely not at the same speed as it did in the cities, according to Wang Rui. "Don't expect the same fast growth. Urban markets had triple-digit growth when it boomed in 2010, and now are at about 30-40% base," says Wang. "It will even probably have double-digit growth for the next 10 years," she says of urban e-commerce.

"It does take a long time for e-commerce or a given segment to be ready for e-commerce," says Teng Bingsheng. "For the rural area, I think the risk is that it's not entirely ready. So if they move ahead of the curve, they might not see quick returns."

Rural areas have weaknesses that may hobble tech companies' push outside cities. For one, residents have much less spending power than their urban neighbors. Less spending power tends to drive out inhabitants, typically the younger generations, to the cities to seek better opportunities.

The drain of young blood in the countryside is a great threat to the burgeoning market. Contributing heavily to this is the country's rapid rate of urbanization. In 2012, for the first time, the number of urban residents outnumbered their rural ones, according to China's National Bureau of Statistics. Moreover, some of the areas rural e-commerce is being built to serve are literally disappearing.

"What people call urbanization in China is something quite different from what they mean by urbanization elsewhere," says Stevenson-Yang.

"Urbanization in China is all about paving over rural areas. They're not all about moving to cities, because… they're not allowed to just move to cities," she says, referring to China's household registration system that limits internal migration.

It is also a priority for the country. "Urbanization is a national policy of the Chinese government, and it will continue to play a very significant role in the next 20 years or so," says Teng. "So a lot of the people who now live in the countryside will be moved to small cities and townships."

Down to the Countryside asks the fundamental question of whether China's dying villages can be saved. It reports that in 2013, according to statistics from China's Ministry of Civil Affairs, villages across China are disappearing at a rate of 300 a day.

Then there's also the lack of regulation in online marketplaces. "With a kind of distributed production, what happens to quality control? Who is responsible for quality control?" asks Sinha. "Do small producers in the village have the knowhow to be able to keep quality at a certain level? On the consumer point of view, what kinds of assurances are there?"

Sinha believes online marketplaces cannot simply be a channel for these products. "The challenge is that in a lot of places, there are no unified and standard systems," he says. "You heard in the past how there's a national standard, and there's a local standard and many producers say that they're following local standards and then that's fine."

Increased competition from villagers in Taobao villages is also changing relations in rural areas as residents race to achieve a competitive advantage. In 2012 the *Financial Times* reported on one village in China's eastern Jiangsu province where one man registered patents for his and other villagers' products, sowing discord among his neighbors.

But given the cutthroat nature of e-commerce, it is understandable the e-commerce giants want to position themselves for wherever the e-commerce market might head. "I think this is really a move to be ready for the future," says Teng.

And that means that even if it's too early to call rural e-commerce a substantial trend, the companies involved are going to have to commit to the idea and stay the course given where it might lead.

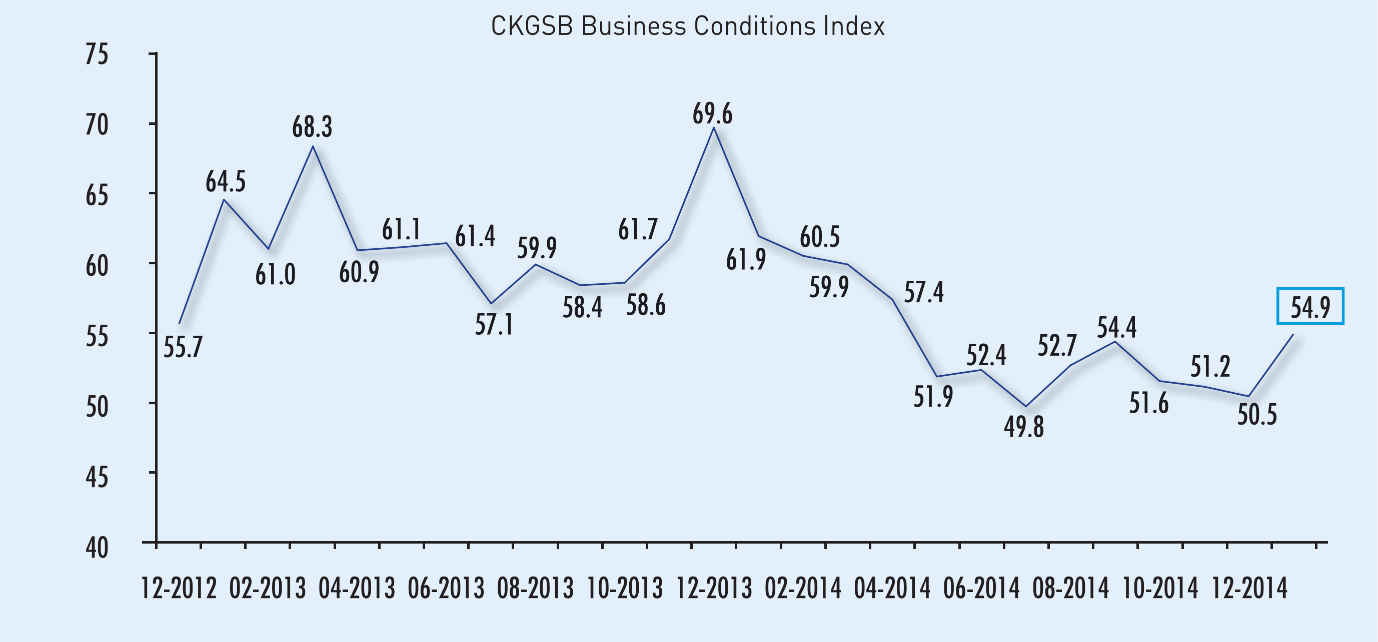
However, Jack Ma sees a bigger picture. "We think that China's economy will have undergone a fundamental change only when China's rural areas become wealthy," he said at the Guangdong event. "I want to say that what Alibaba is doing here isn't a slogan or a stunt, it's something genuine."

Holding On

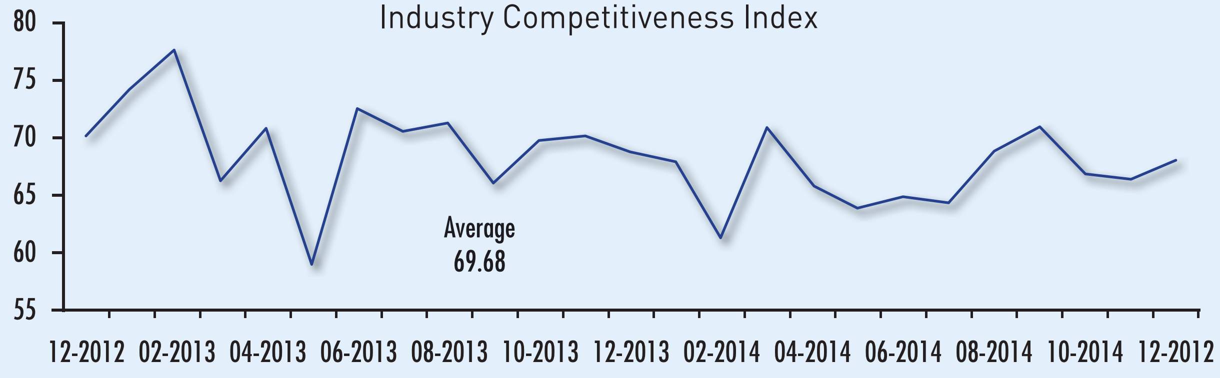
Private firms face a challenging environment, but for now overall confidence remains

The CKGSB Business Conditions Index (BCI) rose to 54.9 in January 2015 from 50.5 the previous month, above the expansion/contraction threshold of 50. Despite the slightly improved business conditions this month, the index remains notably below the average in 2013. The data continues to show that China's traditional growth engine is settling into a lower gear. Either the respondents are more optimistic than industry averages, or they are betting that the government is about to unleash another round of massive stimulus. Compiled from monthly surveys by the Cheung Kong Graduate School of Business' Case Center and Center for Economic Research, the BCI is generated wholly on the basis of statistics gathered from leading enterprises whose executives have studied or are studying at CKGSB. The BCI, directed by Li Wei, Professor of Economics and Emerging Markets Finance, provides a barometer on the state of the economy as viewed by China's leading cohort of entrepreneurs. The sampled business leaders are asked to indicate whether their firm is more, the same or less competitive that the industry average (50), and from this we derive a sample competitiveness index (see Industry Competitiveness Index). Readers of the BCI may focus on data changes since September 2012 to forecast trends in the Chinese economy.

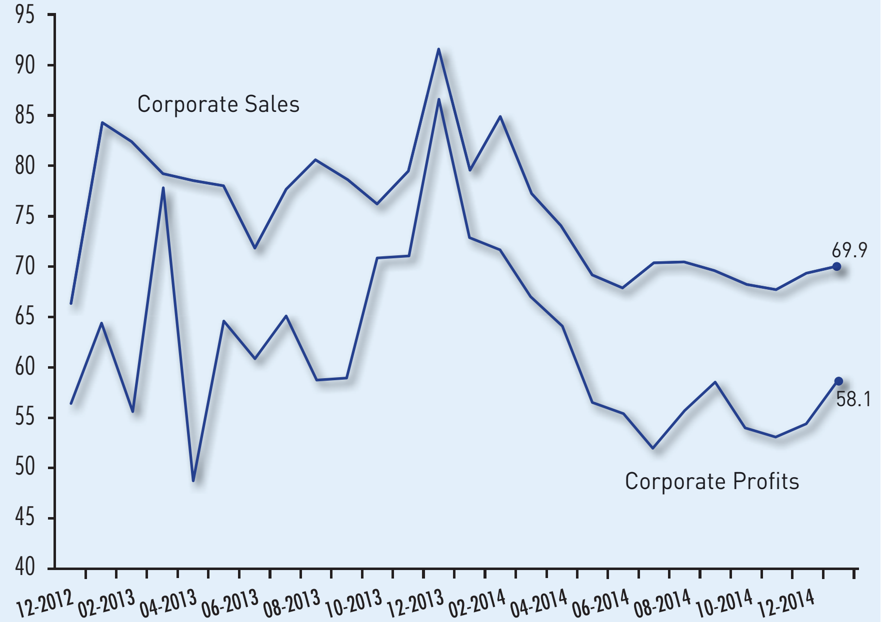
Confidence rebounds...



...even as industry competitiveness remains below average

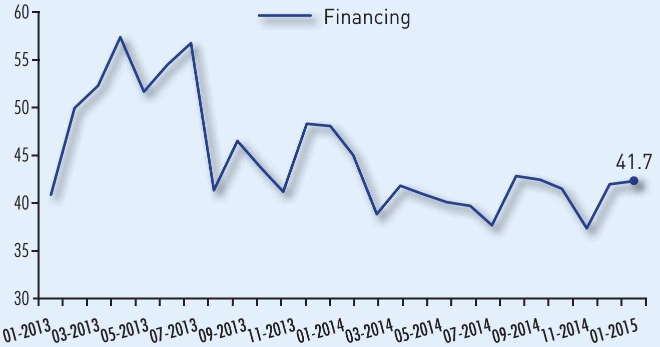


Sales have levelled off and profits are on the up

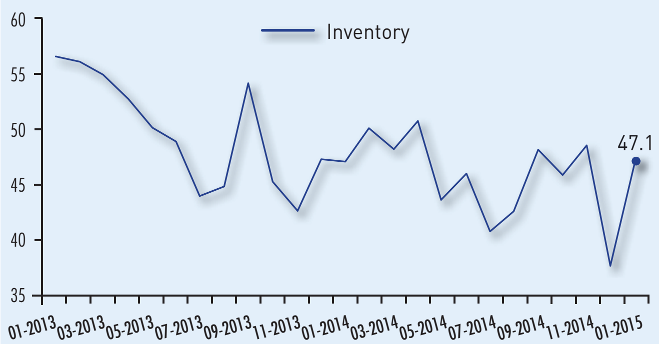


The corporate sales index registered 69.9 in January and the profit index registered 58.1, both up on December, indicating a positive outlook. The corporate financing environment index was below the confidence threshold of 50 in January, at 41.7. This shows private firms face challenging financing pressures. The index measuring inventory levels registered 47.1 in January, higher than December's index of 37.6 but still under the confidence threshold. Overall, the BCI has rebounded somewhat in January, but macroeconomic risks are still present. For private companies and small and medium-sized enterprises, financing, inventory and costs remain the major challenges. The central bank's loosening of interest rates is having a positive impact on the real economy. Investments should be considered very carefully, and plans should be made for responses to the government's continued implementation of economic reforms.

...while financing index remains below the confidence threshold



Inventory makes a recovery from a severe decline



Card Rejected

Long kept at arm's length, will foreign bank card companies finally get a fair crack at the China market?

By Chris Russell

Additional reporting by Milo Zhang

For over two decades foreign payment card companies such as Visa and MasterCard have been vying for a piece of an ever-growing debit and credit card market in China, which is expanding rapidly off the back of a move away from a cash-based economy. Standing in their way has been the state-backed bank card giant UnionPay and regulations that in 2012 were judged by the World Trade Organization (WTO) to be discriminatory against foreign businesses, with many accusing the company of acting as a monopoly. That same 2012 decision rejected that assertion, but its ruling against certain regulations raised hopes that finally the likes of Visa and MasterCard would have the access they crave.

Since then, the companies have largely been frustrated in their attempts to fully enter the country, with UnionPay continuing to dominate the scene—according to Datamonitor, in 2013 78.2% of debit cards issued were UnionPay cards. However, a ruling by the State Council, the country's chief administrative body, in October stated that China's payment clearing market was to be opened up to foreign competition, one of the key points of the 2012 WTO decision, again raising expectations about the prospects of foreign card companies in China.

But just as quickly as those hopes were raised, the People's Bank of China (PBOC), the country's central bank, introduced a compulsory new technological standard for certain bank cards, effectively blocking UnionPay's foreign competitors from China. In doing so, China risks running afoul of its WTO obligations, and as such a further WTO dispute possibly looms on the horizon. But even if the likes of Visa were to gain full access to the Chinese market, it is not clear whether they would stand a chance in the country anyway.

Golden Card

Established in March 2002 under the auspices of the State Council and PBOC, and owned by an array of Chinese state banks and entities, UnionPay was a means of modernizing the country's financial system while also establishing a 'national champion', with its roots stemming back to the Golden Card project in the 1990s. To this day, UnionPay maintains close links with PBOC, with many former central bankers going on to senior positions at the card company, not least Su Ning, UnionPay's former chairman.

> It will be extremely difficult to convince consumers to switch [cards]
>
> Tristan Hugo-Webb
> Associate Director, Global Payments
> Mercator Advisory Group

"By creating UnionPay, Chinese authorities would have a powerful tool in which they could influence the market significantly," says Tristan Hugo-Webb, Associate Director of Mercator Advisory Group's Global Payments Advisory Service. "Other reasons for creating UnionPay are decreased reliance on the international card networks and greater control over future initiatives like financial inclusion."

With the newly established organization in place, all RMB-denominated transactions were to be cleared using UnionPay's network, sowing the seeds for the disputes that were to later follow. Although MasterCard and Visa have had some presence in the Chinese market for a long time now—as early as 1987 the Bank of China had issued Visa and MasterCard-branded cards—they were required to partner with UnionPay as they were unable to process domestic transactions themselves, build their own networks or issue their own cards. As a result, when Visa or MasterCard bank cards were issued, they were co-branded with UnionPay.

Meanwhile, UnionPay was expanding internationally off its domestic strength and the increasing number of Chinese tourists going abroad, particularly those on luxury shopping trips. All of which was very much in line with the government's expectations—in January 2010, the-then President Hu Jintao visited the company and encouraged its international expansion (a plaque in the headquarters commemorates the visit).

Today, the company claims its cards are accepted by over 13 million merchants and 1.12 million ATMs outside of mainland China. UnionPay's global circulation of payment cards is expected to grow 51% between 2012 and 2017, according to the Nilson Report. By contrast, Visa and MasterCard are expected to grow 28% and 36%, respectively, during the same period.

Pushback

In the year before Hu's visit, UnionPay had begun to process international payments from Visa co-branded cards through its own network, rather than Visa's, thus reneging on the terms of its partnership with the American card company. This precipitated a deterioration in the two companies' relationship, and the following year Visa was blocked from doing business in China for a year, an event that led to a case being brought against China at the WTO.

Instigated by the US, and joined by Australia, Ecuador, the European Union, Guatemala, Japan, Korea and India, the complaint stated that China discriminated against foreign providers of electronic payment services, which, as per its WTO agreement, it was supposed to have opened to international competition by 2006.

In response to the 2012 WTO ruling, China scrapped five PBOC regulations in 2013, claiming that this was sufficient. But according to Bryan Mercurio, Professor of Law at the Chinese University of Hong Kong, a subsequent agreement between the US and China that extended the time to respond to the decision by 2015, indicates that China knew it was not compliant with the WTO ruling (although the document for this agreement has not been made public).

The October State Council ruling, without mentioning the WTO ruling, finally seemed to be a step towards opening the way for full foreign participation in the electronic payment clearing market, and thus compliance with the ruling, but it did not go into specifics nor give a timeframe. However, the *South China Morning Post* quoted an anonymous department head of Goldpac Group, China's largest credit card supplier, as saying this would be done by August 2015, and PBOC has reportedly submitted a draft regulation to the State Council following its decision.

Susquehanna Financial Group, an equity research firm, estimates that if these measures were implemented in time for Visa and MasterCard's entry into the market in 2016, that year they could see their revenues increase $260 million and $180 million, respectively. But just days after the ruling, in early November PBOC announced that all smart cards—payment cards equipped with chips—must conform to PBOC 3.0 standards. These standards govern the way account data is transmitted at an ATM or checkout, and PBOC 3.0 is only used by UnionPay. The global industry standard, EMV, is incompatible with it due to different encryption methods, and as such PBOC's decision would require Visa, MasterCard and other foreign payment companies to overhaul their businesses in order to participate in the China market, raising the question of whether China is in violation of its WTO obligations.

Mercurio calls this a "violation"—with caveats—of its WTO agreement, but with regard to the Technical Barriers to Trade agreement, as opposed to its Services agreement, where the case would be less clear. "In picking the home standard that's not the standard anyone else uses, it appears to me they're creating an unnecessary obstacle to trade," he says. There are some opt-outs to this, such as national security, but China has unsuccessfully pursued this approach before with its WAPI wireless standard.

To be successful in that strategy, China would have to demonstrate that the PBOC 3.0 standard was an improvement on EMV. "If the Chinese can demonstrate that the Chinese national standard supports a higher level of security than is possible with international standards, then there is no WTO violation even if that decision fragments the architecture of the international market for payment services," explains Jane Winn, Professor of Law at the University of Washington.

Mercurio points out that this then becomes a highly technical question, and so he is not in a position to answer whether it is or not, but says, "I think there are some serious doubts as to [whether it's an improvement]."

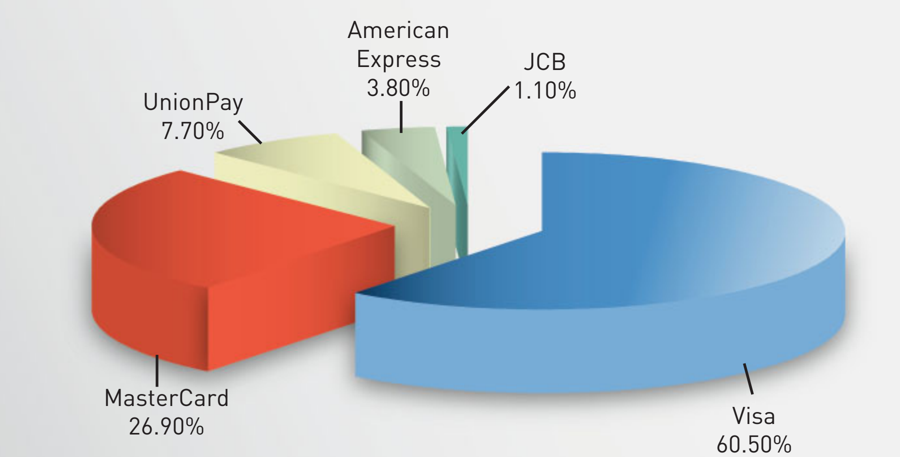
Given the US government's previous willingness to take the dispute to the WTO, Mercurio thinks it is "fairly likely" that will happen again, but this will in part be a political calculation by the government and Visa and MasterCard, who might be concerned about how it will affect their market access.

Winn is less convinced, noting that companies in many industries will be vying for the US government to take a case to the WTO, and Visa and MasterCard will be but two of them, if indeed they are keen for a case to be made. "Every major WTO member state has a long queue of private companies that want the WTO invoked to protect them, and they cannot file complaints on behalf of all of them. Governments have to balance the interests of competing domestic industries against each other and against larger national strategic concerns in deciding whether to file a complaint," she says.

"As a competitor coming in, you would call it a way of blocking [access]," says Arnie Cho, a consumer payments analyst at Datamonitor Financial. "I think it is a way of blocking it." But he argues that it is also a way of avoiding a reliance on foreign companies, a policy the Chinese government have pursued in other sectors. "They don't want it to be dominated by one single foreign company."

Global Standards

Market Share of Purchase Transactions Worldwide, 2013



Source: Nilson Report

Eyes on the Prize

By the end of 2013, 4.2 billion bank cards had been issued in China, an increase of 19% on the previous year, according to PBOC. That same year, bank card transactions valued RMB 423 trillion ($68 trillion), a 22% year-on-year increase. The average consumption amount per transaction was RMB 2,454 ($395), an increase of 6%.

Research by Nielsen published in 2014, and based on a survey conducted in August and September 2013, indicated that 71% of consumers in top-tier Chinese cities prefer to use cards. Moreover, 44% use two or more payment cards on a regular basis—the highest percentage out of any of the countries surveyed by Nielsen.

But the presence of foreign card companies in the market is minor. According to data from the Nilson Report, of all the cards issued by China's big four banks in 2013 in the Asia-Pacific region, only 3% were Visa or MasterCard (the banks only operate a handful of branches outside of mainland China). However the vast majority of money is still spent on debit cards, giving an indication of the potential for growth in credit cards, and this could be an area where foreign companies might still be able to make an impact, if they can get the access.

The growing e-commerce market also adds impetus. "There is no doubt that the Chinese e-commerce market is going to be the largest market in the world for the foreseeable future, making entrance into the market that much more crucial for the card networks," says Hugo-Webb.

But even if foreign companies might feel they have to be in the country, Chinese consumers and business owners might not mind if they're not. Julie Zhu, a restaurant owner in Shanghai, accepts MasterCard and Visa as well as UnionPay, but her preference for one of the three is clear. "I think UnionPay is more convenient… our biggest concern is it charges us less," she says.

UnionPay's relatively lengthy history in China and consumer recognition help give the company its dominance, and "because they have the market at scale in China, they are able to charge a much lower fee, and that's very crucial to the acceptance," says Cho.

While foreign card companies might struggle to compete when it comes to fees, that hasn't stopped them trying to appeal to consumers with deals and gifts that come with their cards. In January, Visa unveiled an array of product offers for their most affluent users in the areas such as hotels, travel, dining, health and education.

But complicating matters is the fact that both UnionPay and the foreign companies now face a threat from third-party payment services, which can cut the card companies out of the process by connecting directly to the banks. Alibaba has made moves in this area with Alipay, and last year Tencent received a private bank license for its WeBank.

UnionPay has already requested that

Foreign bank card companies have been forced to co-brand with UnionPay

banks move this activity back on to its network, yet at the same time it is reportedly looking to get a slice of the action by working with Apple Pay. Meanwhile, perhaps wary of the threat to UnionPay, in March 2014 PBOC ordered the suspension of online payments using QR codes and virtual credit cards in smartphone payment systems, citing security concerns.

"Many in the industry believe this was a move to protect UnionPay revenue," says Hugo-Webb. "With Chinese authorities still very influential in the marketplace, there is always the potential for authorities to attempt to intervene if they see UnionPay under threat."

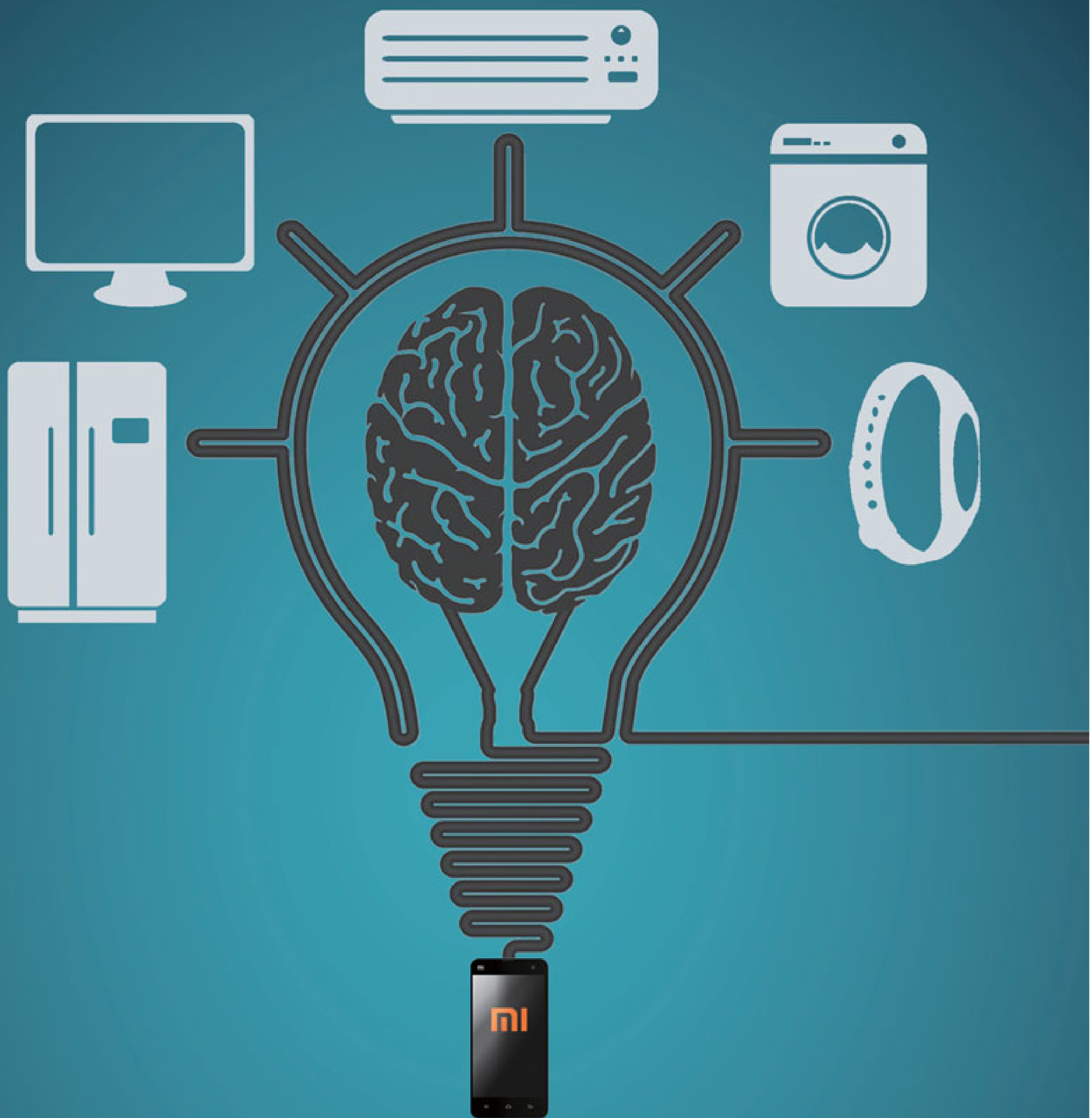
But Winn points out that PBOC aren't the only ones to express skepticism about the safety of some of these systems. "The US Federal Reserve has also highlighted the security risks associated with using QR codes to process payments. It is not unreasonable for a national regulator to require payment industry players to prove that the risks of a new technology can be managed before allowing it to be deployed on a large scale," she says.

Either way, Cho describes the emergence of these technologies as "bad timing" for Visa and MasterCard. If they were to try to run such services themselves, they would be up against issues of localization and their rivals' better understanding of the market.

"UnionPay and major third-party payment service providers are definitely entrenched in the market and it will be extremely difficult to encourage consumers to switch without major incentives, and that is not sustainable over the long run," says Hugo-Webb.

Given that, PBOC 3.0 will have achieved one of its probable aims. "It could just be a measure of buying a bit of time," says Mercurio. "There's too many technical and economic hurdles for Visa, MasterCard and others to capitulate and adopt the Chinese standard—I don't see it happening." In the meantime, the companies will have to attempt to find workarounds. In 2013, PBOC blocked MasterCard from processing RMB transactions through a partnership with the company EPayLinks that made use of "virtual" cards.

But given the prospects, Visa, MasterCard and the rest can't ignore the Chinese bank card market. Prolonged government protection of UnionPay will have put them at a huge disadvantage, but the foreign card companies will still want to fully participate in the market once they can. "China dares to do this is because of its market size," says Cho.



Mi – Mission Impossible?

Having conquered China's smartphone market, Xiaomi now wants to take over your living room—and the world

By Chris Russell
Additional reporting by Milo Zhang

Achieving a $45 billion valuation is an immense feat for any company. To do it within four years and without achieving significant recognition outside of your home country is an even greater one. Yet that is exactly what Xiaomi has done. Xiaomi, an upstart internet company that has generated fervent fandom in China, is now poised to shatter the longstanding image of Chinese tech companies abroad.

Founded in 2010, the company has since leapfrogged more established competitors such as Samsung and Lenovo to become China's top smartphone brand (at least for a time), until Lenovo's acquisition of Motorola, the third-largest smartphone brand in the world by shipments, all the while eschewing the standard tactics found in the sector.

But the company's approach goes beyond the smartphones with which it made its name, and it is now making its first forays into the much heralded 'Internet of Things'. It is off the back of this that Xiaomi achieved the $1.1 billion funding round that gave the company its mega valuation, and among the investors were the Singaporean sovereign wealth fund GIC, DST Global and Yunfeng Capital, a private equity firm co-founded by Jack Ma, Alibaba's Chairman. That $45 billion valuation is greater than that of Lenovo or Uber, the world's other hotly tipped start-up.

For all this, the company is now entering its trickiest phase yet as it branches out internationally and beyond its traditional smartphone base. Will it manage the transition and can it export its China success?

The Spread of Xiaomi

Xiaomi's meteoric rise is reflected in the company's rapid increase in its valuation, up more than 10 times from $4 billion in June 2012. Overseeing this growth has been co-founder Lei Jun, now Xiaomi's Chairman and CEO. He has played a significant role in drawing attention to the company and cultivating the diehard fandom amongst consumers that has been a key plank of the company's success. Comparisons are often made to Apple's inspirational founder Steve Jobs due to Lei's at times similar appearance and presentation. Lei has previous experience too in the worlds of tech and commerce having previously been the CEO of software company Kingsoft and founder of Joyo.com, an e-commerce site that was later acquired by Amazon. He has also become one of China's leading angel investors, with the online retailer Vancl being one of his investments.

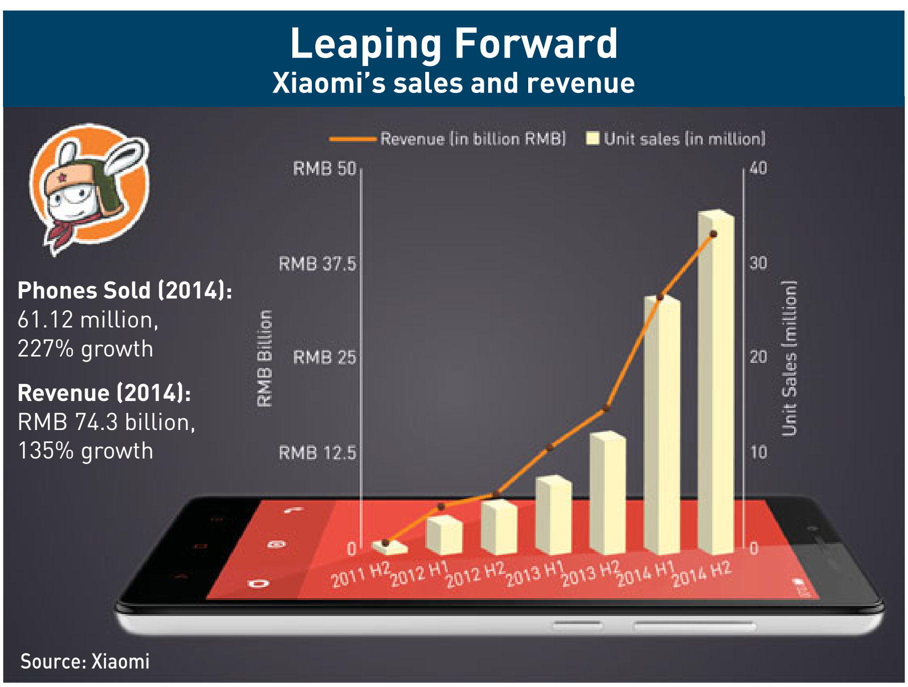
"He's made himself very visible as a tech entrepreneur, as a very successful person in China," says James Roy, Associate Principal at China Market Research Group. "He's a figure because of his success and his company's success as a Chinese company in a field that's has been much more dominated by larger international companies… and that's viewed by a lot of Chinese people, especially young people, as an inspiring thing."

Beyond Lei's celebrity, Teng Bingsheng, Associate Professor of Strategic Management at the Cheung Kong Graduate School of Business, identifies "three pillars" to Xiaomi's success. One of these has been its smartphones featuring high-end specifications, yet coming at prices significantly cheaper than their competitors. "They positioned their phones nicely," he says, noting Xiaomi's ability to compete with China brands on price, while still maintaining quality levels that are closer to the top end of the market. "For the money… you get [a] cell phone that's probably 80 or 90% of the functionality of an Apple iPhone or a Samsung."

While still primarily sticking to this strategy, in January the company made its first foray into the premium price segment when it unveiled the Xiaomi Note, the Pro version of which retails for RMB 3,299 ($530). Jingwen Wang, a research analyst at Canalys, thinks that this could be a successful move as Xiaomi's existing users develop more disposable income and wish to differentiate themselves more.

The second factor in its success is its strategy of selling directly to consumers online, making particular use of flash sales as a way of generating buzz and scarcity. This also has had the effect of lowering the company's costs by eliminating the need to maintain retail stores, the savings from which can be significant. "In China, the costs for the [retail] channel are particularly high and inefficient. Companies oftentimes have to give out 30% of the total revenue just to their channel," says Teng.

The third pillar is its strong social media presence, which it has used in lieu of traditional advertising, again a cost-effective strategy. According to confidential documents seen by *The Wall Street Journal*, in



2013 the company spent just RMB 876 million ($140.9 million), 3.2% of revenue, on sales and marketing.

"Marketing methods that have been used by traditional industries are a thing of the past in the internet age," said Lin Bin, the company's president, in an interview with the *Nikkei Asian Review*. (The company said it was unable to answer questions from *CKGSB Knowledge*.)

This social media focus has also fed into the company's product development, with the company routinely incorporating feedback from customers into future updates, further strengthening the bond with consumers and helping to give rise to so-called 'Mi fans'. Through the company's social media forums "[Xiaomi] will understand their consumers and quickly react to improve their software," says Ivy Jiang, a research analyst at Mintel.

Taken together, these elements have catapulted Xiaomi to the top of the smartphone market in China.

"[An] affordable product with [a] high configuration, understanding the consumers' needs, as well as quickly reacting to improve their software, I think that's what's made Xiaomi the top smartphone brand in China right now," says Jiang.

The conventional understanding of Xiaomi's business model is that it sells its phone almost at cost as a way of directing consumers to where it really makes its money—software and services. But despite the low margins, the documents seen by *The Wall Street Journal* showed that Xiaomi was still able to make a net profit in 2013 of RMB 3.46 billion ($556.8 million) from revenues of RMB 27 billion ($4.3 billion), with 94% of its revenue coming from hardware sales.

Nonetheless, this drive towards services plays an important role in Xiaomi's attempts to create stickiness, and is key to understanding the next steps in Xiaomi's strategy, evidence of which we are now beginning to see. Its wildly successful smartphones would likely not be sufficient to justify Xiaomi's high current valuation, and the key to understanding what does back it up lies in the ecosystem the company is rapidly creating.

"

They're confident that whatever they do, their true fans will follow and buy the product

Teng Bingsheng
Associate Professor
CKGSB

One Device to Rule Them All

Already Xiaomi has branched out into other devices beyond the smartphone including a smart TV, air purifier, TV set-top boxes, routers, headphones, wearables and even a light bulb. All of which is just the start, with other household consumer goods soon to bear the Xiaomi brand. This is part of the company's '100 Xiaomis' strategy that seeks to apply the lessons of its smartphone devices to other product categories.

To that end, the company has invested in a wide range of companies. In December, Xiaomi invested $200 million in home appliances maker Midea, while Xiaomi's light bulb and air purifier were designed by the start-ups Yeelight and Zhumi, respectively. Lei Jun has said that Xiaomi has invested in 25 start-ups.

But more than just representing expansion into new areas as the company grows, these partnerships and investments are about creating a full ecosystem. As such, they represent the firm's desire to fully participate in the so-called 'Internet of Things', with a Xiaomi smartphone lying at the heart of an array of devices. For example, the company's air purifier can be controlled through an app, with pollution readings and notifications of when to change the filter being sent to the user. And in January the company unveiled sensor panels for its smart home ecosystem.

"Xiaomi is now building an ecosystem through these investments and extending its business coverage to not only smartphones, but [also] to the whole smart home, and even some related hardware devices," says Jiang.

All of which serves to enhance loyalty and stickiness among its users as they buy into that interconnected Xiaomi ecosystem. Xiaomi's Android-based MIUI operating system that comes with all Xiaomi devices and which is also freely available for non-Xiaomi phones, plays a core role in tying all these elements together, as well as enabling access to Xiaomi content and services.

Teng compares this to how other brands have created worlds for their followers to "live in". "If you enjoy motorcycles then you may want to live in the world of Harley Davidson—they have everything surrounding you with the Harley logo," he says. "Xiaomi [has] a similar strategy. They're confident that whatever they do, their true fans will follow and buy the product. So the product itself doesn't need to have significant differentiation… with the Xiaomi logo, with this social media frenzy I think they'll be able to achieve significant sales regardless of what they do, at least in the short term."

This fandom and devotion is particularly relevant given Xiaomi's youthful demographic. Analysis by the mobile analytics firm Flurry shows that Xiaomi's users skew heavily towards business professionals under the age of 34. Not only is this a fast growing segment of consumers with significant spending power, but it is also one that is coming to a point where home ownership is a likely occurrence, and complete set of interconnected devices from a brand they have loyalty to will be an obvious choice when kitting out their home.

Beyond hardware, Xiaomi has also moved to position itself as a future hub for content. An investment in Youku Tudou in November 2014 for an undisclosed stake and value saw the creation of a strategic partnership between companies, which will allow Xiaomi to act as a gateway to entertainment content and also see the company participate in content production.

Not satisfied with its attempts to conquer the home, Xiaomi is also casting its gaze beyond China's borders, in particular towards emerging markets. Overseen by Hugo Barra, Google's former Vice President of Android Product Management, who was hired in 2013, Xiaomi initially made its way into Singapore in February 2014 before entering India, Indonesia, Malaysia and the Philippines later in the year. Brazil and Russia are the next candidates, according to Lin Bin.

These emerging markets are the places where the next wave of smartphone growth will occur, and it is particularly important for Xiaomi to harness that growth as China's smartphone market matures. Moreover, Jiang points out that consumers in these emerging markets are more price sensitive. Smartphone growth in these countries is primarily directed at cheap devices—according to IDC, in 2013 nearly half of all smartphones sold in India cost less than $120.

But here Xiaomi has had to diversify its approach, in some cases eschewing its direct selling approach, at least initially, and instead partnering with local vendors. In the case of India, it has teamed up with the country's leading e-commerce site Flipkart, although it now also sells its phones through its own site, and has even made its smartphones available in brick-and-mortar stores. What hasn't changed is the company's commitment to flash sales and social media, with Xiaomi making use of Facebook and Twitter as well as its own message forums.

Fertile Ground?

Xiaomi has worked hard to create an ecosystem that locks in consumers, but its success in this regard is by no means assured, and history shows plenty of former mobile phone giants—from Nokia to Motorola to HTC—who have fallen by the wayside.

"With the MIUI software, I think Xiaomi has already successfully made a lot of its young users invest money in it, so it means that even in the future if they want to transfer, all this money has been wasted," says Wang of Canalys. "That will be helpful to increase its brand loyalty."

But youth, Xiaomi's main demographic, are notoriously fickle and there is no guarantee of Xiaomi's status being maintained.

"If they keep doing what they've been doing, this can be sustainable for a while. But I think in three years they have to come up with something new, something that continues to get people excited, because young people, their focus can shift very quickly," says Teng. "If there is something emerging in the economy… then it's possible that Xiaomi might lose that cutting edge image. I think this is a big threat."

Zhang Zehua, a 22-year-old student, is a Xiaomi user. "I have used the product for a year now, I would say that I kind of like it. But like other electronic devices, they change too fast—I don't think I will use it for long," he says, adding that he would consider other, non-Apple brands when buying his next phone.

Wu Yunrei, a radio DJ in his twenties who isn't a Xiaomi user, is not convinced by the company's phones. "I wouldn't choose Xiaomi in the future, because I don't think it is good quality, at least some of my friends say so after they bought one," although he admits he would consider other Xiaomi products, such as its air purifier, because of Lei Jun's status and influence. "I want to see his ideas and creativity."

Rivals imitating its tactics might also be a threat, and Lenovo and Huawei have or are planning to introduce products aimed at young people backed with internet-driven marketing—Huawei has said it sold 20 million Honor smartphones, its handsets range that competes with Xiaomi.

Meanwhile, the company OnePlus boasts its own competitively priced, yet high-spec smartphones.

Teng thinks that this might prove to be a threat to Xiaomi, but it will be hard for any company to entirely mimic what they've been doing, particularly older phone companies that are still firmly tied to traditional business models, and social media buzz is not easy to create. "[Xiaomi] has a nice combination," he says. "[They] will still have a sustainable edge in the next few years."

Wang agrees: "In 2015 Xiaomi will continue to face all these kind of threats, but maybe they cannot be called too strong challengers."

But Xiaomi's international expansion has already hit stumbling blocks—in December, an Indian court ruled that Xiaomi had to suspend its sales in the country after Ericsson brought a patent complaint against it, although the ban was partially lifted until January 8.

Xiaomi possesses very few patents—in China the company has made use of patent licenses pooled by the chipmaker Qualcomm—and Wang, Jiang and Teng all identify this as being a major sticking point in the company's international moves.

Localization also presents a challenge. "The real challenge for Xiaomi is whether they can understand the local consumers' needs," says Jiang, while Roy points out Xiaomi's need to engage with foreign consumers on an emotional level if the company is to succeed. "How do you create fans, how does that work?" he says.

Wang also stresses the need to cater to consumers on their own terms, saying that localization of the MIUI operating system will be crucial, and she also points out that having the right talent in these countries will play an important role.

But if Xiaomi's expansion throws up some difficulties, it is nonetheless in pursuit of aims that will ultimately strengthen it as a business. By constructing a rich ecosystem and utilizing social media-driven marketing, it stands to maintain a brand loyalty that has eluded all phone companies except Apple, and its policy of targeting emerging markets represents a prudent decision based on these countries' growth prospects and Xiaomi's own strengths and weaknesses. However, it is this international expansion where Xiaomi is weakest—its position in China is strong, but the tactics that have got it there will be much harder to recreate abroad.

A private haven offering a spacious and open atmosphere, where guests can relax or be productive while enjoying panoramic views of Chang An Avenue, the formidable Forbidden City, Jing Shan Park and Chinese courtyards in the heart of Beijing.

The Grand Club Lounge offers Grand Club guests exclusive privileges and a variety of culinary delights, while staying at Grand Hyatt Beijing.

To reserve a room, please visit beijing.grand.hyatt.com or call +86 10 8518 1234.

ADVANCED AND HIGH EFFICIENCY AIR FILTER SYSTEM

Grand Hyatt Beijing and the entire Beijing Oriental Plaza complex has installed a new air filter system to successfully minimise PM2.5 pollutants, maintaining ideal indoor air quality per international standards, 24 hours daily for the comfort and well-being of our guest.

GRAND HYATT BEIJING AT ORIENTAL PLAZA
1 East Chang An Avenue,
Beijing 100738, People's Republic of China

Follow us on WeChat

Conversations

"You have to have a partner who is bringing the right things to the table"

54

Laurence Barron

Chairman, Airbus Group China

"To be worthy of lasting means that you have to be built on a set of values"

57

Jim Collins

Author of Built to Last, Good to Great *and* Great By Choice

"Change is accelerating so fast that the digital revolution got past our capacity as individuals, institutions and a society to comprehend it"

61

Don Tapscott

Author of The Digital Economy, Wikinomics *and* Growing Up Digital

"[A turnaround isn't] romantic. It's romantic after the case"

64

Peter Cuneo

Chairman of Valiant Entertainment and former CEO of Marvel Entertainment

High Altitude

Laurence Barron, Chairman of Airbus Group China, on the company's growth in China's expanding aviation sector

By Chris Russell

In China, the aerospace and aviation industries continue to soar higher and higher as its citizens increasingly take to the sky for business and leisure, both domestically and internationally. Playing a key role in enabling that boom has been the Airbus Group, which officially established itself in the country in 1994, and today China vies with the US for top spot as the group's largest single market.

Just as China has changed, so too has the company. Formerly the European Aeronautic Defence and Space Company (EADS), in January 2014 the group underwent a reorganization, bringing consistency, integration and a stronger brand to its divisions—Airbus (responsible for aircraft), Airbus Helicopters and Airbus Defence and Space—and in the same month Laurence Barron became Chairman of the newly rebranded entity in China.

Having previously acquired experience of Asia while working in Japan in the 1980s, Barron arrived in China in 2004, a country he describes as "a place that really is moving and shaking". This was just as Airbus' business really began kicking into high gear, and it now has 50% of the in-service fleet.

In this interview, he explains the need to develop local talent and stresses the importance of the Chinese industry to the company's business, which shouldn't come as a surprise.

Q. What have the main challenges been when it comes to manufacturing in China, and how has Airbus Group addressed these issues?

A. The main challenge in manufacturing anywhere other than your home base is people: finding the right people, then making sure that they have the right technical training so they can do the job properly.

Another concern specific to China is that in order to achieve that, particularly the training part, we need to bring in quite a number of expatriates, and that's very expensive. So you need to have a plan to get 'rid' of them. Bring them in to do the job, but not to keep them here permanently, to make sure they train the local hires to the level at least equivalent to what we achieve in our factories [at] home, and then let the expatriate return so that the extra cost part is limited in time.

Q. Airbus Group maintains partnerships with Chinese companies across many of its operations. What has your experience been working with such a range of companies across so many different areas?

A. It's taught us that it's not a question of one size fits all. We have effectively very different partners with very different projects, and you have to make sure that you get the right partner. We've had, generally speaking, quite good success. We have a joint venture (JV) with China Aviation Supplies, which was set up in the mid-90s, which is a training center and a support center, mainly for storage and distribution of spare parts. That was very successful—in fact… we extended it for another 20 years. Often JVs don't get renewed or they fail or one partner buys out the other, and in this case it's going to be a minimum of 30 years, which is a proof of a successful JV.

Another excellent example is our final assembly line in Tianjin, where we have two partners: AVIC (Aviation Industry Corporation of China) and the Tianjin Free Trade Zone, and Tianjin Free Trade Zone has been a really excellent partner for our project there, which has been highly successful.

Airbus Helicopters, they develop the EC175 on a co-development basis with AVIC up in Harbin, and that's not a JV, it's a co-development, each side does their own work. Last year they also signed the co-production agreement for the first 1,000 machines. Then with Defence and Space, we have a joint venture in Beijing that's called Beijing Spot Image… that's with a subsidiary of the Chinese Academy of Sciences.

You have to have a partner who is bringing the right things to the table, and as we have different activities, you have to choose according to the activity and make sure there's a sufficient amount of common interest that the JV will be durable.

Q. There has been tremendous growth in aviation in China. How much longer can that continue and what is your prediction for the growth in the number of aircraft that Airbus will sell in the next few years?

A. Our forecast for the next 20 years for China is over 5,300 new aircraft. When I say new aircraft, we're talking about mainland China and aircraft of 100 seats or more because we ourselves don't study the regional market. [That] splits into over

We were born into competition, we've always had to compete… why shouldn't we compete with someone else?

3,500 single-aisles, so that's A320-type aircraft, or A320 family, almost 1,500 twin-aisles, so we're talking about wide-bodied aircraft like A330 and the A350, and over 300 very large aircraft, so we're talking about A380-sized aircraft. Basically, we're saying there's still a lot to come. Because today you have to compare that to an in-service fleet of aircraft over 100 seats, today of around 2,200, of which we have 1,100 and Boeing has 1,100.

Q. What proportion of Airbus' global business do you think will come from China in the next five to 10 years?

A. That's difficult to say exactly. The trend for the last five years has been that over 20% of all our deliveries over each of the last five years have come to mainland China. If we be a little bit more precise, in 2014 it's over 150 aircraft, so nearly 25% of our overall production last year came to China. We would expect China to remain one of our biggest if not the biggest single market in the years to come. I believe [that China] represents around 17% of our global forecast. Take those numbers, those percentages and we're looking at China becoming the largest single market in the next 10 years. It's already number one for us alternately with the US. It depends on how many deliveries there are each year to China and to the US, but in 2012 it was number one, in 2013 it was the US, and [in 2014] I don't know what the US number is, but it's going to be one or two.

Q. Despite this growth, do you think there are nonetheless some things that are holding it back in some way?

A. Sure, there are many things here that have basically struggled to keep up with the fast pace of development—the market has been growing in double digit figures for many, many years, and that's put a lot of things under strain. The number one question [is pilot shortage]. There is effectively a constrained airspace. The need to update air traffic management. Airports, well that's being addressed because there are so many additional airports or extended airports being built.

Q. Airbus has grown its in-service market share considerably since the 1990s. What would you attribute that to, and how are you trying to make sure that you can grow it even further?

A. The answer is the three Ps—product, people and production. So product, there's no doubt that both the A320 family and the A330 have been extraordinarily popular here in China. If you fly [from Shanghai to Beijing], you [are] almost certainly flying an A330, irrespective of the airline. We all thought that yes, we had a better product with the single-aisle A320 family… but nobody anticipated the extraordinary development of the A330 fleet here. It is just about the ideal aircraft for most of the Chinese big airlines because they use it domestically, regionally and internationally.

People, I do believe we have had for very many years now a very efficient group of people here at Airbus China, and very stable—we haven't had a change in leadership every two or three years, we have a very low turnover in staff compared with most foreign companies, less than 5%.

And then production, what I mean by that is our industrial cooperation strategy, which has been to significantly increase our industrial footprint here in China, which of course is what the central authorities want to see because the civil aviation industry here is underdeveloped. So we've substantially increased our subcontracting… we've gone way beyond just the build to print type of subcontracting that we were doing when I arrived here 11 years ago. We have major components made here, such as the wings—A320 wings are made in Xi'an and now delivered complete to the final assembly line in Tianjin where they're equipped. In terms of aerostructure, [the wing] is the most complex part of the airframe to make, so it's not just making the nuts and bolts. Our final assembly line just in December celebrated [its] 200th delivery, and I think it's served as a model for us now [in] creating a fourth final assembly line center in Alabama in the US for the Americas. It's interesting that China should lead the way. All of these initiatives have allowed us to draw level with our competitor [Boeing], and then exceed them, which is obviously in the interests of [the] Chinese aerospace industry, and therefore in harmony with what the central government wants to see.

Q. You said that you have a very low turnover rate. How does the Airbus Group manage to retain people and maintain that continuity? Also, how important is it to develop local talent here?

A. It's extremely important to develop local talent. We have for many years now had a program in place to develop our best local hires and even send some of them for extended periods of time (1-3 years) to Toulouse to make sure they develop their own network in the company and become Airbus people through and through, so that when they return here they replace expatriates who are coming to the end of their expatriation. That is one way you retain people. If the Chinese staff here perceive that all the senior positions were always occupied by expatriates, then the best ones would eventually leave to go and work somewhere else where they have a better chance of promotion. We have a number of Chinese managers now. Then I think we have an exciting business, people like to work in our business—it's a little bit more exciting than, say, manufacturing shoes—and HR keeps a very close eye on remuneration and benefits, benchmarking companies in similar industrial areas, so that we don't fall behind and then we have people who are dissatisfied with their conditions. I mean, aerospace is not a place you get rich, aerospace doesn't pay particularly well, but we need to make sure we're at least competitive with our peers.

Q. Could Chinese-produced aircraft be a threat to Airbus down the road?

A. China is coming from a long way behind, but because China has the will and the staying power, they will get there. The word I object to is threat. We were born into competition, we've always had to compete—when Airbus was created, we had to compete with Boeing and Lockheed and McDonnell Douglas, Fokker and several others. Today there's only two of us—if tomorrow there are three, four or five, so what, we just keep competing, we've always been able to compete with the Americans, why shouldn't we compete with someone else? Why would it be a threat? Competition is good—if you don't [spend enough on research and development (R&D)] then somebody's going to catch you. In our case, the first guy that would catch Airbus would be Boeing, so we have to spend a lot of money on R&D and produce products that the market wants. In that respect, whether there's an additional manufacturer on the scene in the coming years, I don't think it changes our philosophy.

Q. Airbus Helicopters is the leader in China by some distance. What are you doing to maintain that? Who are your main customers and is that changing at all?

A. Airbus Helicopters today has 40% of the civil market here—civil basically includes parapublic (public sector services). It's a different market: today it's very small, because at the end of the year we're talking about 142 turbine helicopters manufactured by Airbus Helicopters out of a total fleet for the whole country of 358. Much like Airbus, we will continue with industrial cooperation. I think we will continue to develop that with maybe completion and delivery centers, or even final assembly, as soon as the market justifies it.

The market today for us is quite diverse—our biggest customer is COHC (Citic Offshore Helicopter), and they [are] getting close to 40 machines now, so they're very much the number one. But then we have the police, private operators, the state grid, [and] in October we delivered the first fully equipped emergency medical services helicopter to Beijing 999, a subsidiary of the Chinese Red Cross. That's the first fully equipped EMS helicopter in China, and in developed economies we reckon that you need one EMS helicopter per 1 million inhabitants. There is quite a large potential here just for that segment. I think the way things will go as the airspace is opened up [is]… we will see a development of the private sector.

Q. The EU arms embargo obviously limits what Airbus Defence and Space can do in China, but in spite of that what opportunities has it found?

A. It's not just the arms embargo, it's also US export restrictions, ITAR (International Traffic in Arms Regulations), because many, many components, whether it be aircraft or helicopters or satellites or whatever, have potential dual use for civil and military applications. So given that, I would say two significant businesses here in China that come under the Defence and Space division's umbrella. One I've mentioned, Beijing Spot Image, a JV which sells satellite imagery and the software to interpret it. These images and their software are sold to government agencies and all sorts of parapublic geographic people, planning people... So that's one business that has been doing quite well.

And the other is what we call secure communications networks, and we have quite a significant share of that market selling secure communication networks to police forces, metros, Beijing Olympics, the Guangzhou Games, and so on. We have basically half that market in China.

Based on a photo by Justin Stephens

The Building Blocks of Greatness

Jim Collins, author of classics like *Built to Last* and *Good to Great*, on great companies, managing in a networked world and leadership

By Neelima Mahajan

What makes companies great? And how do you define 'greatness'? These are questions that management author Jim Collins has single-mindedly explored for nearly 25 years now. In 1994, Collins shot to superstardom with the near-explosive success of *Built to Last*, a book he co-authored with Jerry Porras. The book, which aimed to identify the characteristics of visionary companies by focusing on 18 of them, went on to become a management classic and was on *Businessweek's* bestseller list for more than six years.

From there on, Collins authored several other books on the theme of greatness—such as *Good to Great*, *How the Mighty Fail* and *Great by Choice*. "This overarching question of what makes great companies tick just stayed with me for at least a quarter of a century," he says, talking on phone from his 'management laboratory' in Boulder, Colorado. "Each piece of work really became like another lens on this question." Much as his work has created a profound impact on companies, it has also come in for some scathing criticism. Part of the reason is that some of the original 18 visionary companies Collins and Porras identified have slipped badly over the years, and people have questioned the very relevance of the principles he outlined.

In this very rare interview, Collins talks about the significance of his work today, the eternal quest to build great companies, how the shift from organizations to networks will impact leadership and much more. Excerpts:

Q. You say that instability is the historical normal. How then do you get the confidence to say that a business enterprise is 'built to last'?

A. I don't say which companies are 'built to last'. Instead what our work is about is principles that last. If you continued to live these principles with great intensity, they would correlate highly with the enduring of a great company. Imagine you were studying athletes. You can't necessarily say which of them are going to continue to be great athletes because if one of them [suddenly] doesn't train in the same way, loses discipline, begins eating badly, doesn't go to the track anymore, they're not gonna be great anymore.

I look at our work as studying historical dynastic eras. Think of it like great sports dynasties where some team achieved a world championship status that lasted for a significant period of time. In the US it might be like the 'dynasty' of the New York Yankees of the 1950s or the UCLA Bruins basketball team of the 1960s. We find companies that at a given moment or era were a dominant, dynastic enterprise. At that time [they] met the tasks of being truly great and we study them in that era. We basically say what principles were they living that were different than others in that era that were not great.

In *Built to Last* we were looking [at companies which had] at least a 50-year run and an iconic status. I can't guarantee that they're gonna [have] a 150-year run but we can learn from these 50, [in some cases 100], years of exceptional performance. Companies may come and go but the principles that would correlate with great companies at any time should endure.

I go back to the idea the greatest leaders are [those] who want to build something that isn't about them and can transcend them

Q. You wrote Built to Last *in 1994 and after that global realities have changed.*

A. First, we have not discovered everything. When I think about what you learn as you go along, I view it as additive, as the idea that that things you learn before don't get overturned but they're just incomplete. There's a big difference between what you saw before that was right but incomplete, as distinct from what you saw before that wasn't right. The beauty of the *Built to Last* study is that we were looking for principles that cut across easily when you add up what happened across time—as much chaos and change than anything we're going through today. We have companies that were founded in the [mid to] late 1800s and the early 1900s, and they were able to become great companies and remain great through an extended period of time. [Between the late 1800s and the 20th century], we had two world wars. We didn't even have flying machines, instantaneous communication… microprocessors [or] transistors. IBM was getting started [and] it made butcher scales and time clocks. The idea of a computer wasn't even remotely on the horizon and you had massive social changes. Just take the amount of change that happened from the late 1800s up until the 1990s when we studied the *Built to Last* companies and through all of that change… the principles carried.

There's a second part to it: the duty of the historical analysis. If you can say why that principle was there in 1880, 1890, 1900, 1910, 1920, 1930, 1940, 1950, 1960, 1970, 1980, 1990, then it certainly applies at any given moment in history. The second thing is let's take companies that are in the most turbulent environment that we could find in the world of business and we still have to have a rigorous way of looking at things.

Q. If you were writing the book today, would the new list of great companies look any different?

A. Sure the list would be different if you were selecting it today. Let's go back to the definition of a great company. First, you have to have superior financial results, principally defined as return on invested capital over an extended period of time, at least a 15-year run of truly exceptional results when you do much better investing in that company than investing in the market

To truly be a great company, you can't have as your basic purpose, to make money. The companies that could endure understood this from very early on. The second output of great companies [is that] to be a great company, beyond the financial part, is a distinctive impact: if you disappeared… it would leave an unfillable hole. That's very different than just if you achieve great financial results—somebody else can just replace what you do, you've done nothing distinctive, you're not great.

The third is lasting endurance: you've the ability to be both distinctive and deliver of superior results. It means multiple generations of leadership and through multiple generations of markets and cycles and technology. Now it may not take very long to do the multiple cycles and technology or markets because they change so quickly. The critical one then becomes multiple generations of leadership. If your company can't be great without you, it's not a great company.

Those three things—superior results, distinctive impact and lasting endurance. If we were to do [the book today] and we start thinking about it, okay, so let's just take some Chinese companies who [have] got superior results, distinctive impact, and they couldn't just be replaced by something else. They're not just copying and doing something cheaper, they would be hard to replace and [have] lasting endurance. Which ones have the ability to say, 'We're not dependent on this leader we can do it with the next generation of leaders and the next after that'? When you look at a company like Amazon, it has a high return on capital, a distinctive role. If it went away it would really hurt, we don't know yet. [It's got the] next step to prove it can do well beyond Jeff Bezos.

Q. Companies are increasingly talking of concepts like shared value and conscious capitalism. The financial crisis especially forced them to do some soul searching and redefine their purpose. Will this impact the notion of greatness?

A. Our research showed that those who build companies have a real shot at being great. They're not focused on building something to last, they're focused on building something that's worthy of lasting. To be worthy of lasting means that you have to be built on a set of values. [These companies are] built on some sense of purpose that is not defined by economics. R.W. Johnson first started thinking about this in the late 1800s and then his son, R.W. Johnson Jr., wrote it down in the Johnson and Johnson Credo in the 1930s: our first responsibility is to the patients, second to employees, third to the communities we effect and fourth to our shareholders. David Packard said, the purpose of the Hewlett-Packard Company is to make a contribution that would make peoples' lives better and in order to do that, we must make a profit but we do not exist to make a profit.

They have this very deep set of values: I believe it is a moral responsibility that the people who help us create this company should share in the returns of this company and that we don't make good quality products because of a marketing strategy, we do it because we owe that to people. Bill Hewlett said to me: "One of the very few key things in life, Jim, is never stifle a generous impulse." What a wonderful line! We don't have to choose between making a contribution and making money, between taking really good care of our people and having a really efficient operation, we don't have to choose about being responsible to the things that we touch and making sure that our company is well cared for. We're gonna be so good, so disciplined, so creative, so intense that we can do both and that is the standard that we are going to live to.

[In] networks you cannot rely upon position and power

Q. You once said that we are moving to a world of networks well-led as opposed to organizations well-managed. What implications might this have on how organizations function?

A. Peter Drucker [observed] about 60-70 years ago, we were becoming a society of organizations and that would be the building block of the world. Drucker observed the rise of the organization and then the rise of the importance of management to make those organizations work and the rise of the knowledge workforce. [Today] instead of the building blocks being organizations, the building blocks [are] networks. We had to think about management but for networks we have to think about leadership. Historically, we have been confusing leadership power, personality, charisma, position. None of that is leadership. I've always loved what James MacGregor Burns said: "True leadership only exists if people follow when they have the freedom not to." Everything else is just power. Let's take General Eisenhower's definition of leadership: "Leadership is the art of getting someone else to do something you want done because he wants to do it."

[In] networks, you cannot rely upon position and power in the same way. The only way to organize is you genuinely have to lead. That would put a premium more on the sense of how do I get people, over who I do not have power, who are connected and dispersed, to want to do what must be done. That would be leading in a network as opposed to managing in an organization.

Wendy Kopp, founder of Teach for America and now Teach for All, is [taking] the Teach for America concept of getting young people to commit themselves to serve in our most underserved schools and to really help as many kids as possible get a great shot in life by that initial education. She's now taking it to the rest of the world, as much as she can [by] building a network. She has no power over kids to get them to sign up. She has no power over all the different places in the world where she's getting people to try to form these units to make this happen, but she's building a network and she's building momentum in that network. She's not a personality-type of leader, she's just a very authentic leader [who can] get hundreds of thousands of people to sign up to want to do what must be done. That is a marvelous example of a network well-led, as opposed to an organization well-managed.

Q. So these leaders need to be authentic leaders, but what else should they have?

A. In *Great by Choice*, [we say] the more that you have [the] chaos of a network, the more, in fact, you have to have fanatic discipline. It's so easy to get pulled in so many directions, if you don't have your sense of what marches you need to be on, so that you can stay focused on that march and not get pulled in a gazillion different directions.

The second is, it's not about innovation. A lot of companies have innovation. What's really hard is figuring out which innovations will actually work and which of those innovations to scale and make big. Your ability to scale an innovation and make it really big is really the distinctive capability. The third is productive paranoia: in a world that is networked and could be moving under your feet all the time, the need for tremendous vigilance to be able to absorb the unexpected shifts and shocks means having great financial discipline and conservatism.

The other [part] is what I learned in our study of leadership at the United States Military Academy at West Point. I went there to teach leadership but actually ended up learning a lot more. I stepped into an environment where people were so committed to what they were doing [that] I found myself thinking about what makes this tick. I began to realize [there is] a triangle: service, growth and success are the three points. The only way to really be exceptional is at some point you're gonna fail a lot and to view those failures as the opposite side of the coin of success is not failure, it is growth. It is the ability to throw yourself at things that are going to make you fail and then through that to grow and become stronger because if you aren't able to do that, the [vicissitudes] of our world [will] crush you.

But then why would you really go through this failure to growth? There's this thought that there is this tremendous ethic of service. And a sense of I am in service to something. I am giving my [service], in their case service to country and service to comrades, to each other. And a tremendous ethos of 'this isn't about me, this is about service to cause, and to the men and women around me'. To really thrive in the kind of world we're heading into, that sense of what you do in service is the only way you can activate those around you over whom you have no power. Because if they don't think you're in service, why should they be in service?

What I came away with from West Point was the idea of communal success. I was training for the Indoor Obstacle Course Test and the [cadets] were helping the old man try to figure out how to do it. Every cadet has to do it in a certain time period or you don't make it through West Point. Classmates [were] taking time out of their busy schedules to help their classmates accomplish the obstacle course and then those classmates would help other classmates accomplish their math courses and then those classmates would help [others] accomplish their leadership component. Everybody there is inadequate at something, but you help others succeed by focusing not just on taking care of yourself, but 'let me succeed by helping you succeed'.

There are pieces of that that I think would be very helpful [in a networked world].

Q. You often say, 'Leadership is our version of the Dark Ages' while others say that leadership is the one distinctive capability that all organizations should focus on.

A. Since I first said that my own intellectual understanding has evolved and I have a more nuanced, more mature view. What I really meant in saying that is that we tended to attribute everything we didn't understand to leadership. Now that we have understood so much more, I actually do share the view of leadership as being integral and important. I also think that we still have way too much of the leader as all-knowing hero mythology and that's why I go back to the idea the greatest leaders are [those] who want to build something that isn't about them and can transcend them. That is a non-egoistic approach. That kind of leadership is vitally important. If you ask a simple question: what is the real truth of that leader's ambition? Is their ambition ultimately about themselves? Or is it about the stuff that's in the end, not about them? I would hypothesize, if you go into any culture, you could look at [effective] leaders: it's those who are deeply ambitious for the cause or the company, the values, the quest, not themselves.

Q. You talk about taking an idea to a business, to a company and a movement. To what extent will the ability to create a movement be a defining factor of greatness?

A. [When you talk of] the progression of entrepreneurship, you tend to think of it as an idea. Maybe you will make that idea into a business. At some point, your business has to become a company, and then maybe you want to make it a great company and then an enduring great company. We began to realize that there's, in some cases, a bigger version of that. In *Good to Great*, we talked about the idea of the flywheel and that the way you built something great is you get your 'hedgehog' (Note: This is a concept which says do one thing and do it well) and you build momentum and you build momentum in the flywheel and that flywheel builds cumulative momentum over time. There's a way to accelerate the flywheel. Amazon is a flywheel effect: it's not a single instance; it is a building, cumulative flywheel. Kim Smith, who ran New Schools Venture Fund, said to me: "Especially in the social sectors, but I bet it's going to start applying to businesses, there are two flywheels. The flywheel of your enterprise or company. [And] the uber flywheel, the flywheel that's the context." So it's not just the flywheel of building a school or building Teach for America, but you have the uber flywheel of education reform. Steve Jobs [had] a flywheel of Apple, but he was always interested in the larger flywheel of the impact that technology could have to amplify the creativity of individuals and that notion of connecting people. Think about why Apple [was] so strong and was even able to endure those years when [Jobs] was in the 'wilderness' and not there. On some level it wasn't just a company. There was a movement behind. If you read Gordon Moore's articles from the early 1970s where he's talking about Moore's Law he obviously talks about Intel, he talks just as much about the tremendous transformative effect of doubling computing power over 18 to 24 months and what it would lead to in the way that society would work. Being involved in the semiconductor business wasn't just building Intel, it was also building the entire movement of what microelectronics could do to transform the world. So even far back then, there were people who were starting to think that way.

(For the full version, log on to CKGSB Knowledge: knowledge.ckgsb.edu.cn)

The Digital Disruption

The Digital Economy warrants a fundamentally new social contract, says Don Tapscott, a leading expert on business and technology issues

By Neelima Mahajan

Remember what life was like in 1995? You met your friends in real life and didn't just write on their Facebook wall. You bought books at your local bookstore—not on Amazon. News didn't break on Twitter—it came on TV or radio. If you wanted more details, you could wait till the next morning to read the newspaper. There was no iPhone in 1995, and you probably had a push button feature phone of the kind you wouldn't be caught dead with today.

Back then one man was miraculously able to see the enormous upheaval technology would bring to our lives today. In a book titled *The Digital Economy* (the 20th anniversary edition has just been released), Don Tapscott talked of seemingly futuristic things—like networked business models, technology and privacy, and the explosive impact of new media. Today 20 years later, as we discover, his analysis was spot on. Tapscott, a leading authority on issues like innovation, media and technology, literally coined the term 'Digital Economy'.

Tapscott, the author of 15 books including *Wikinomics*, *Grown Up Digital* and *The Naked Corporation*, is a well-known expert on the impact of technology on business and society. On a recent visit to China, he talked to *CKGSB Knowledge* about how we can cope with the disruption caused by technology and what the future has in store.

Q. How has your perception and understanding of the Digital Economy changed from when you first wrote about it in 1995?

A. The world back then was quite a different place. Google was five years away. Amazon and eBay came out just as I was completing the book. There was no mobile web because there was no mobility.

In terms of how things have changed, the most jarring change is mobility. Back then we barely had laptops and people used computers that were connected by a wire to a desktop, [and used] dial-ups [to connect to] the web.

I talked about promise and peril. Some of the promise has been fulfilled and nearly all of the peril that I worried about turned out to be true. On the promise side, the book talked about how the old media is different: centralized, controlled by powerful owners, and the recipients were passive. New media is not one to many, it's one to one, many to many, highly distributed. It's not controllable and it has this awesome neutrality. It will be what we want it to be. I was naïve when I said that because "we" is not a homogenous phenomenon: it includes people like you and me, but it also includes people with asymmetrical power… [like] Google, the government of Iran, the NSA or Goldman Sachs. In a sense, the digital revolution is encaptured by these powerful forces and the outcome is disturbing.

Lots of wonderful things have occurred: the rise of mass collaborations like Wikipedia, social networking which has brought people together and huge changes in terms of marketing.

But if you look at the main measures of well-being in society, there's a disturbing conclusion. All around the world, at least the Western world, there's structural unemployment, in particular youth unemployment. This growing wealth creation [has] been captured by tiny elites, and the benefits of the digital revolution are not distributed, so we have growing social inequality.

Then somehow we've all done a Faustian deal with the devil: I don't remember signing any document where we said, 'We're going to create all this data for these big companies: they get to own and do whatever they want with it.' The digital revolution was supposed to enable us to reinvent democracy and the first campaign by Barack Obama was very encouraging. He used social media to create a platform whereby 35,000 communities self-organized and he got to power. When his second election term came up, they shifted from social media to big data: from "yes, we can" to "we know you" and targeted all the swing voters. The bottom line was that young people are increasingly disengaged from the political process.

Data minimization… is a no longer a viable strategy because what happens in Vegas stays on YouTube

Q. How should we deal with the problems that come with the Digital Economy?

A. Each of them requires a different set of initiatives and "we" means all the pillars of society: government, civil society, corporations, individuals. Take the data issue. I was naïve [when] I said that one of the ways that you can protect your privacy is to be careful [with] release [or] data minimization. That is no longer a viable strategy because what happens in Vegas stays on YouTube. We're leaving this trail of digital crumbs and creating a virtual you, who might know more about you than you do: you can't remember really what you bought, what you said, or what movie you watched.

We're going to need a whole new approach and [that has] to be a social one. We need some new understandings and some new laws in society about what gets done with data. We have to think about the issue of ownership and have a whole bunch of principles adopted by all parties. For example, information is [used] for the purpose for which it was collected and not for others without my permission, and if there's some kind of monetization of my data, I get to participate in the wealth.

When we went from the Agrarian Age to the Industrial Age, all the main institutions in society came together and we figured out some things. As people move from the farm to the city, they need to be literate so we [had] public education. We figured out that there needs to be a social safety net in the city so we came up with ways of protecting people. We figured that huge monopolies needed to be controlled so we came up with anti-monopoly legislation.

I don't think we've done any of that today. You've got all the Uber types saying, 'This is the new paradigm, we're disrupting the old high-demand industries. Let market forces figure it out.' On the other hand, you've got the taxi industry saying, 'You're replacing all these good jobs with shitty jobs; [there isn't] any kind of protection, no safety standards. We need to stick with the old laws for an old paradigm and apply them to this new paradigm.' Both of them are wrong. We need a new social contract here [and that would be] a [sort of] combination of what both sides are saying.

Q. The Digital Economy has created radically business models, like crowdsourced work, where the company may be in the US but the work is being done all over the world. These new business models operate in a very different zone. How should they be regulated?

A. Again, you have this dichotomy of these two extremes and both are wrong. Some say, 'Hey, we are crowdsourcing and creating products around the world. All these women are now getting income.' [And] you have the traditional labor institutions saying, 'This is piecework. We're lowering the average wage. And it's being done with no health and safety considerations. There's no protection for any of these people on virtually every issue.' You can't apply the old labor legislation to this new environment. We need a new paradigm.

Consider these new business models, like the digital conglomerate: Google, Apple and Amazon. They can migrate into adjacent or non-adjacent industries and because they have this massive platform of data and this huge machine, they can move into this industry and provide way better value and way lower price and wipe out all these companies but leave behind 10% of the jobs.

Overall this [creative destruction] is good. But from a long-term point of view, there's no scenario where jobs get created at the same pace as the ones that are being wiped out. So this is the first time in history where we have economic growth but we don't have a commensurate growth in job creation.

I think we'll absolutely be moving towards a four-day work week, where you get paid for five days but you work for four. If we're creating wealth but it's not being distributed well, then we don't have a wealth creation problem, we have a distribution problem. We're going to have to distribute work more and wealth more too. Do we want to create a world where 0.1% of the population owns the majority of the wealth and they wall themselves off in secure communities and never really see the rest of the population? This is a social problem and it may seem like a long way from talking about the Digital Economy, but the Digital Economy is the economy.

Q. You talk about monopolization in the digital sphere. Do you think that a digital conglomerate, like, say Google can become too powerful for its own good and the good of society?

A. By definition any company can become too powerful. Now *The Economist*, in examining these digital conglomerates (they don't use that term), [concluded] that they are very different than the monopolies of the Industrial Age: they're much more subject to competition, they don't get synergies from various businesses they're in, and, in fact, Larry Page recently said that if a new business they're entering is not adjacent, that's fine. It means less integration and less hassle thinking about how to integrate it and manage it from a corporate point of view. I don't think there's a case to break up Google right now, but this is something of a great concern.

If you look at the businesses that Google is in, forget about advertising, most of them are very competitive. It has probably got the best technology for autonomous vehicles, so it's certainly going to become a dominant player but they've got to beat Elon Musk at Tesla and who knows, maybe one of the traditional car companies might actually start to innovate, or they could cooperate and place intellectual property above autonomous vehicles in a Commons.

Q. Is the Digital Economy changing corporate longevity?

A. It's speeding up the metabolism of business and competition. But the old idea, which I never subscribe to, [is] that you're one click away from losing all your customers. Is Facebook one click away from being wiped out by some other social network? No, because we've all got such a massive 'investment' in Facebook, my photos are there, everyone's there, my entire life is recorded, so the switching costs are intense. [But they] have vulnerabilities: private behavior is the Achilles heel of Facebook. They're caught between a rock and a hard place because the only value of Facebook's monetization strategy is to exploit data. That means a real tension between users and their needs for privacy and Facebook and its need to turn that data into money.

Q. So back in 1995, you told us what 2015 looked like. Today what can you tell us about 2030?

A. Greater change is accelerating so fast that the digital revolution got past our capacity as individuals, institutions and a society to comprehend it. So 20 years from now it's staggering to think what the world will be like. We're looking at Singularity, probably not [as] Ray Kurzweil would say that we are, but new kinds of machine learning and artificial intelligence, and very smart devices capable of doing all kinds of things. The impact on the workforce is staggering. The big debate over Uber is kind of [like] whoever wins it's a pyrrhic victory because nobody will be driving cars in 20 years. There'll be smart, autonomous vehicles.

You're looking at strong integration of the physical and digital world; a trillion inert objects probably in the world are smart communicating devices that are sensing everything, collecting data, never interacting. We'll be into all kinds of 3D stuff, like watching the football game on the floor of your living room or through some kind of glasses, but [not] on a screen. We'll have all kinds of wearable technology.

We're in a transition today where there's a physical world and a digital world. You'll see a full intersection of these where everything becomes smart and everything starts to communicate. The biggest one I see is digital currencies. The underlying technology for that block chain does hold the promise of finally bringing about these very profound changes to the deep structure and architecture of our institutions. Look at corporations and governments. They're pretty much still vertically integrated, command and control, hierarchical bureaucracies.

If you think about it, the current internet, [it is] good for collaboration… presentation of content, but it's not really that great for business. It's got flaws. There's massive fraud and identity theft. And then things get slowed down by these intermediaries [who] also take a lot of the value.

Bitcoin to me is just the first half of the next generation internet, and because the underlying technology, is a bulletproof technology for knowing what is occurring and what has occurred. When you think about business, that's a lot of what business is: who owns what, who's buying what, how much does something cost, who paid who? And you can't correct it because every block in the chain is linked to the block previously so you'd have to rewrite the entire history of commerce. So this could be applied to all kinds of things.

Something like half the world is not part of the economy. They don't participate because nobody's going to give someone a bank account if they have the equivalent of $9. If you don't have a bank account, you can't save, get credit, or create a business. But with digital currencies, it's just one of dozens and dozens of opportunities to bring half the world's population into the economy.

(For the full version, log on to CKGSB Knowledge: knowledge.ckgsb.edu.cn)

Turnaround Superhero

Peter Cuneo, former CEO of Marvel Entertainment, on what really goes into resurrecting a failing company

By Neelima Mahajan

In *The Amazing Spider-Man 2*, Peter Parker, Spider-Man's nerdy alter-ego, says, "I like to think Spider-Man gives people hope."

In real life, Peter Cuneo gave Marvel Entertainment, the company behind Spider-Man, hope in 1999. At that time, Marvel, which owns 8,000 fantasy characters and superheroes like Spider-Man, Iron Man, Wolverine, Captain America, the Avengers and X-Men, was just emerging from bankruptcy and its stock price was languishing at 94 cents a share.

After taking over as CEO, Cuneo unleashed a series of measures designed to extract more value out of the marquee characters owned by the company. He adopted a licensing model for movies, television and consumer products; divested some loss-making businesses; reorganized the company around five operating units; and reduced operating costs.

As a result, the company was sold to Walt Disney 10 years later for a whopping $4.5 billion, and at that time, the share price was $54.

In his professional career, Cuneo has engineered, not one, but seven turnarounds of entire companies or divisions at Clairol, Black & Decker, Remington and, of course, Marvel.

During a recent visit to Beijing, the mild-mannered and unassuming Cuneo, who is now the Chairman of Valiant Entertainment, sat down with *CKGSB Knowledge* to share his experience in company turnarounds. The bottom line: it is a lot of hard work. As Cuneo says, "When you look back, it's romantic and fun, but the day to day was not so much fun till you really feel the turnaround was done."

Q. From your experience, what leads most companies to the brink in the first place: poor management calls or more fundamental issues regarding the industry, business or products?

A. My experience in the businesses I've done turnarounds in—consumer products, media and entertainment—it's almost always very poor leadership. The leadership, for whatever reason, is just not willing to make the changes, and the hard decisions that need to be made as a business and an industry, and as competition evolves. Either they just don't understand the change or perhaps it's emotionally difficult to make a lot of people unhappy, but making radical change in a business is all about, unfortunately, making a lot of human beings unhappy.

Q. As someone who's been in that situation over and over again, what are your thoughts on what CEOs in similar situations ought to do first: focus on the hard numbers and financial targets first or look at the soft issues?

A. You have to do both. Obviously you want to understand the business, and the language of business, the blood flowing through the veins of a business, is the numbers, the financials, so, of course, you need to understand that.

But in turnarounds, you often find that the culture is completely wrong. The company may or may not be bankrupt financially, but the culture is bankrupt. It's one where the organization is used to losing, failing [and] underperforming. You have to change that, you have to give the organization pride.

There are a lot of ways to do that. One way is to simply be honest with the organization, be consistent in how you communicate and what changes you want to make. If you want to establish a new culture, back it up with actions. Talk is very simple, but most employees will not believe you until they see you behaving in a way that suggests that you really will act on the things you're saying. So if you say that lazy people will no longer be tolerated, you have to back that up by eliminating jobs when you see it.

Q. In such situations, time is a luxury and changing the corporate culture is a long drawn process.

A. Sure. I think you start on the culture immediately. In a number of my turnarounds one of the problems that existed was that these businesses—consumer products, media and entertainment—are highly dependent on new products. But when you go to a company, you find that nobody wants to work on new products because they believe that it's very risky.

To change that, tell people it's okay to fail. Statistics show nine out of 10 new products will fail. You want to have a better average than that if you're a leading company, but you will have failures, and that's okay. But [employees] won't believe you until you back it up. One of the things I used to do was that when we had a successful new product, I would hand out checks to all the people that worked on it at an all-employee meeting. It would be a team consisting of members from all the different functions: sales, marketing, manufacturing [and] technology. People start thinking, 'These people are getting checks for success—yes, we've had some failures but it doesn't seem like anybody's in trouble'.

It takes time: you cannot change a culture in a week or a month. If you're trying to work on a multinational company it could take years. But as long as you're demonstrating very publicly in front of all the employees what you're talking about and supporting the new values that you've been espousing, I think you'll do fine.

In turnarounds, you often find that the culture is completely wrong... the culture is bankrupt

Q. You are best known for the Marvel turnaround. When you took over the company was deep in debt and the share price was worryingly low. Can you walk us through the situation you encountered when you first stepped in, the challenges and the key strategies you identified?

A. Marvel was a public company on the New York Stock Exchange, and it really was a toy and comic book company. The whole comic book industry had created a collectability craze. Basically telling comic books fans that all these comic books would be worth a lot of money down the road and doing a lot of crazy things to promote them: for example, publishing the comic book with 10 different covers. Eventually the comic book community, the hardcore fans, woke up to the fact that this was not going to be collectible. Early in the 1990s the comic book business and all collectible business started to crash.

One of the problems I often see is that the management of consumer companies assumes that their consumer is stupid. That was what was happening here, and the consumer didn't like it very much when they figured this out. So the size of the business dropped dramatically. Even today, the comic book business is smaller than it was in 1993, in the US. The company had a lot of debt and couldn't pay its interest, and basically that resulted in the bankruptcy.

Also, during that period there was a lot of cost cutting. In creative businesses, in entertainment, your real power comes from creative people. In comic books, it's the writers, editors and illustrators. If you abuse them because you're cost cutting and they feel that they're not appreciated—this is what happened at Marvel—they will leave. So now you have another problem: the quality of your books is dropping dramatically.

In entertainment, content is what you create: a script for a motion picture, the layout of a comic book, the industrial design for a toy. What you want to do is connect your content with other people's engines. It's like an engine and the gas, you're creating the gas, a high octane gas. Lots of people have engines: television stations, movie studios, retail stores. You want to connect your content with the best engines. But if your content is no good, they're not interested because their engines won't run very well. So abusing talent is a major mistake.

So it's all about, in many ways, the obvious problems. You're starting to change the culture. You're trying to attract this high-quality talent that former management alienated. It's a very important part of it, as well as managing the numbers.

Marvel was in bankruptcy [and] came out of bankruptcy when I became CEO. Going through bankruptcy is like going through chemotherapy. You are supposedly cured but you are very weak. The company has lost all its hair. The best people have left. You have a talent drain.

Very often coming out of bankruptcy the capital structures are not right. They are a function of the pulling back and forth of the financial interests in a company and not necessarily designed in the best interests of the new version of the old company. So you have to cope with that as well.

At Marvel, though, it was pretty straightforward. We had to improve our comic books and we decided that the best way to re-launch our characters on a global basis, after they'd been damaged in a very long bankruptcy, was [through] motion pictures. Still today I believe motion pictures create the most excitement around a particular property than any other form of entertainment.

Q. What kind of role can the board play in a turnaround? You as a CEO are under pressure to deliver the numbers and the board is putting even more pressure on you, so how can that role be constructive?

A. I'm a big believer in having active boards. A lot of CEOs don't want active boards and, in fact, really don't want boards to know much about what's happening in the company. My attitude is very different. We had a great board at Marvel, very accomplished executives: experienced turnaround people [and] also [people] from entertainment and so on. We were getting world-class help for very little money—you don't pay the board anything close to what they're really worth. So I wanted them to be involved directly with the senior executives. They were there to give advice, not make decisions, of course. And that was very useful in difficult times, when you're trying to turn around a company.

Q. Should CEOs in such situations actively 'manage' the board, so to say?

A. Of course. The CEO reports to the board, so to say the CEO manages the board would be a little misleading. But manage in the sense that you want the board to be very aware of what the problems are, what's important. You want to have a very good discussion about strategy and strategy going forward. If you have a good board, you'll get a lot of strong opinions, some of them will differ with each other. I would much rather have people differing so we can really think about the alternatives than have everyone agree with me. That is actually the worst possible situation, when people say you're absolutely right about everything when you know you're not. I was very much dependent on the board for very sage advice.

We had a great board at Marvel... we were getting world-class help for very little money

Q. How do you handle tough situations at a time when morale is already low, people are sensitive, and you are also trying to build trust?

A. You want to be honest with people. When you come into a company where everybody knows the company is in trouble, they're worried about their jobs and there have probably already been layoffs even before you came. When they ask you, 'are there going to more layoffs?', be honest. The minute I say we won't have layoffs, I've lost the trust of all employees. Most people, even hearing potentially bad news, are a little more at ease than if they think you're kidding about something. I often had sessions with all employees, or small groups, where they could ask me direct questions. The first couple of months most employees are too afraid to ask you anything, but after a while when they hear from other people who did ask questions that didn't come back to haunt them, [or] expressed certain opinions and weren't suddenly out the door, then it gets a lot easier. People appreciate honest answers. That's part of changing culture: being honest and talking.

One of the changes was to make an atmosphere where it's okay to admit they have problems and challenges in [their] jobs. We can solve them together in 99% of the cases, but we need to know about them. What used to keep me up at night mostly was not problems I knew about, [but] other problems that I maybe didn't know about.

Q. What about the fear of failure and unrealistic expectations? Maybe boards think that you've turned so many companies around so you'll come and do some magic.

A. I'm always very careful to never think 'I've seen it all' because every situation is different and you have to be prepared. There are always new challenges and lessons. If you get smug or arrogant about your skills in this area, you're going to be in trouble.

Q. What is your advice for people in similar situations?

A. First of all, unless you're thrown into a turnaround, you really have to think whether turnarounds are right for you, whether you're suited emotionally to take these on, because they're not for everyone. The ones who do take these on are the weird ones. You have to think about the emotional price you may pay. I'm an operator—there are lots of people who [are doing] other things in turnarounds. They may be helping financially restructure a company, they may be consultants or temporary CEOs, they may be accountants, they may be lawyers. [They] help [in] a turnaround, but they don't live with the pressures day to day the way we operators do. When you're in a turnaround every day, people are unhappy, and people are unhappy with you every day even if they don't know you because you represent change. In extreme cases, banks are unhappy, suppliers are unhappy because they're not getting paid, customers are unhappy because your products aren't quality. You have to be prepared for that.

Having said that, on the rewards side, you can make a lot of money if you're successful. So it's all about that and understanding going in. It's not romantic. It's romantic after the case.

(To watch the video, log on to CKGSB Knowledge: knowledge.ckgsb.edu.cn)

Helping Hands

Long a country with a poor reputation for charitable giving, what are the chances that China will turn it around?

By Chris Russell
Additional reporting by Milo Zhang

On 28th April 2014 the *People's Daily*, China's top official newspaper, played host to a guest editorial by Bill Gates, one of the world's leading philanthropists through the Bill and Melinda Gates Foundation.

Gates urged his fellow elites to give more of their wealth to charitable causes. "Only when we help poor people break away from destitution and illness can we achieve sustainable development," he wrote. And this was just one of his interventions in the Middle Kingdom.

Yet just days before, Jack Ma and his Alibaba co-founder Joe Tsai announced plans to establish a charitable foundation focused on pollution, the environment and health, and funded by 2% of Alibaba's equity, which with the company's astonishing IPO, would put the charity's funds in the billions of dollars.

Both Ma and Gates, who along with some of China's leading givers met for dinner in Beijing in June 2014 to discuss philanthropy, stand at the heart of the debate around China.

Ma represents what those at the top are capable of while Gates serves as a frequent reminder of China's poor reputation internationally when it comes to charitable giving.

Whither generosity? China ranks a lowly 128th in the World Giving Index

Miserly Millionaires

According to the Boston Consulting Group, the Hurun Report and a report jointly published by UBS and the Singaporean research firm Wealth-X, China is home to the second-highest number of billionaires, behind only the US.

Despite that, its ranking for charitable giving is much poorer. The Charities Aid Foundation's 2014 World Giving Index found China languishing at 128th—the US and Myanmar topped the list. Nonetheless that was a slight improvement on its ranking the previous year of 133rd, although the country's miserliness is brought into sharp relief by Hong Kong's position at 17 that same year, and Taiwan's at 47 in 2014.

Compounding China's status as an ungenerous country are the actions of the country's elite, of which there are now so many. In 2013, China's top 100 philanthropists donated $898 million, according to the Hurun Report. In the same year, the US' most generous givers racked up $7.7 billion in donations, according to the *Chronicle of Philanthropy*, while *Forbes* research showed that Mark Zuckerberg and his wife Priscilla Chan managed to dwarf the contributions of China's elite through $991 million-worth of gifts.

The following year, China's record had improved significantly, totaling $3.3 billion, although here the numbers are skewed by the outsized contributions of Ma and Tsai's charitable foundation (the Alibaba chairman topped the Hurun Report's 2014 philanthropy list by some distance).

Beyond the numbers, the reputation of China's elite as being tightfisted when it comes to philanthropy was solidified in 2010 after media reports that many had turned down invitations to a dinner in Beijing hosted by Gates and Warren Buffet that was intended to raise awareness about philanthropy. Gates later said that two-thirds of invitees attended the event.

Rupert Hoogewerf, founder of the Hurun Report, says that for the wealthy, charity is "low down on the priorities". "They feel that… the best way they can give back to society is to grow a strong, healthy business."

One of the areas in which Chinese people can't be accused of shirking their responsibilities is disaster relief. Earthquakes in the southwest of China, notably in 2008 in Sichuan and 2014 in Yunnan, and particularly the former, have led to huge outpourings of donations. The *China Youth Daily* reported that by the end of April 2009, RMB 76.7 billion (then $11.2 billion) had been donated to the Sichuan earthquake relief efforts. In the case of the Yunnan earthquake, the Red Cross Society of China had received a total RMB 72.5 million ($11.7 million) five days after the earthquake.

These disasters lead to headline-grab-

bing spikes in donations, but by their nature are episodic. According to Scott Kennedy, Deputy Director of the Freeman Chair in China Studies at the Center for Strategic and International Studies, "philanthropy is dominated [by] two or three areas"—by far the biggest recipient is education, with the environment and healthcare the next two largest."

With Jack Ma's recent pronouncements, the spotlight is being shone on these areas to an even greater extent, and more is being done to encourage charitable giving at the top level, and in June 2014 Gates agreed to help Beijing Normal University launch a philanthropic education program, the aim of which is to raise RMB 100 million ($16.1 million) each year. But problems remain.

Trust and Transparency

One of the principal reasons for the lack of charitable giving in China is the low esteem in which charities are held. The image of the Red Cross Society of China was severely damaged in 2011 after a woman named Guo Meimei, who claimed to be a manager at the charity, repeatedly posted pictures of her luxurious lifestyle to social media, leading many to question whether funds were being misused. The Red Cross denied the connection, and later so did Guo, but the damage was done. In some cases, the public's lack of trust might be well placed: a 2013 report on transparency at Chinese charities by the state-affiliated China Charity and Donation Center said that less than a third of registered charities in the country met transparency and disclosure standards.

"I think charity is a good thing, but I don't really trust the charity groups," says Yang Yalong, a 21-year-old college student. Liu Ping, a 50-year-old customs official, agrees: "I don't believe charity groups at all. I mean, I will donate my money but I will definitely question them. The problem, from my view, is the system of charity in China; they are facing some serious trust issues."

Related to these trust issues is the fact it can be hard to run in a way that assures people donations will be going where they are meant to be, or to even establish a charity in the first place. By law, charities are required to have significant start-up funds, and in practice many aren't exempt from tax. "There are no clear rules about how funds are used, their taxability, about conflict of interest… that vacuum of regulation is also now hampering things," says Kennedy.

"As long as we promote a better system of laws and regulations, [and] we have a better standard for running NPOs [non-profit organizations], I believe one day NPOs can have a more transparent running mechanism, [and] people will have stronger confidence in NPOs," says Megan Li, Operations Director of the environmental charity Roots and Shoots Shanghai.

China is currently drafting a new charity law, says Kennedy, and has gone through several readings and revisions, and depending on its final content could have a real beneficial impact on the charity sector. "If it were to be issued… that would be a huge positive step forward."

Underpinning these regulatory difficulties is the fact that, relatively speaking, China's NPO sector is still in its infancy. Previously, NPOs were firmly a part of the state due to central planning and a lack of private entities, and even today the state maintains a large role in society. "Philanthropy essentially ceased to exist in the Mao era, [at least] in the way we think about philanthropy," says Kennedy. "You have a very strong, powerful state that dominates the public sphere and itself has been responsible for addressing social needs." As a result, that lack of a civil society means there is not as much space for charities as there is in other countries.

The system also doesn't help incentivize philanthropy, says Hoogewerf. He points to the absence of US-style inheritance taxes, from which gifts to charity are usually exempt, as a further reason why the wealthy don't donate as much as they could.

The desire of many of China's wealthy to keep a low profile, so as not to draw attention to their riches and the scrutiny it would inevitably bring, also works against significant philanthropic gestures. And when big gestures are made, they are often dismissed as publicity stunts rather than true philanthropy, as has been the case with Chen Guangbiao, an entrepreneur who made his money in the recycling business. "I don't know much about wealthy people's charity acts, but I do believe they want to promote themselves more than they really want to help people," says Liu, citing the example of Chen.

Jack Ma and Joe Tsai's recent charitable initiatives might well set a welcome example then, but at the moment there is no one else with quite the same visibility. "Somebody has to do something," said Ma in an interview with *The Wall Street Journal*. "Our job is to wake people up."

However, until the system of regulation improves and trust returns, likely through a worthwhile charity law, and charities are given greater space to grow, their actions are unlikely to represent a breakthrough in the creation of a widespread culture of charity.

Past and Future

Rui Ma gives *CKGSB Knowledge* the inside track on how to get to grips with China and the tech industry

There are three books I would recommend for anyone trying to penetrate Chinese business culture. The first is the *Romance of the Three Kingdoms* by Luo Guanzhong. I have never actually read the original, but have seen enough faithful screen adaptations to know the story. I think being able to quote fluently from this book and recognize and make allusions is critical. It gives you a lot of insight into what the Chinese value and practice in terms of hierarchy, loyalty, and other ethical measures of power and influence.

The second one is *China Emerging: 1978-2008* by Wu Xiaobo, which takes the most impactful event of each year from 1978 to 2008, talks about it in detail, and through these real events shows the progress of the Chinese economic and political system. A lot of these events have had incredible impact on Chinese society, and knowing and understanding them and being able to make or recognize references to them will truly mark you as culturally fluent. Plus, it's seriously fascinating. Sometimes living here most people get caught up in how far China still has to go, but this book really helps you understand how far China has come.

Finally, *Country Driving* by Peter Hessler, which is just a charming tale of a very open-minded expat who spends some time in the countryside of china with his newly acquired drivers license. There are a few main journeys, but I particularly enjoyed reading about the time he spent in a village not too far away from Beijing and the careful depiction of village politics. Many of us living in first-tier city luxury forget how disconnected the top four cities are from the rest of China, and this is a very warm and lovely but also honest portrayal of lives outside of the ring roads.

In terms of books that relate to my own industry, I am going to borrow a book that my boss often recommends, which is *Spent* by Geoffrey Miller, a professor of evolutionary psychology, who uses scientific research to explain why we consume goods and services the way we do. You can apply his theories to a lot of tech products that are consumer facing and has definitely helped me be more aware of both how I am the victim of marketing tactics and how to help my portfolio of companies exploit those same tactics.

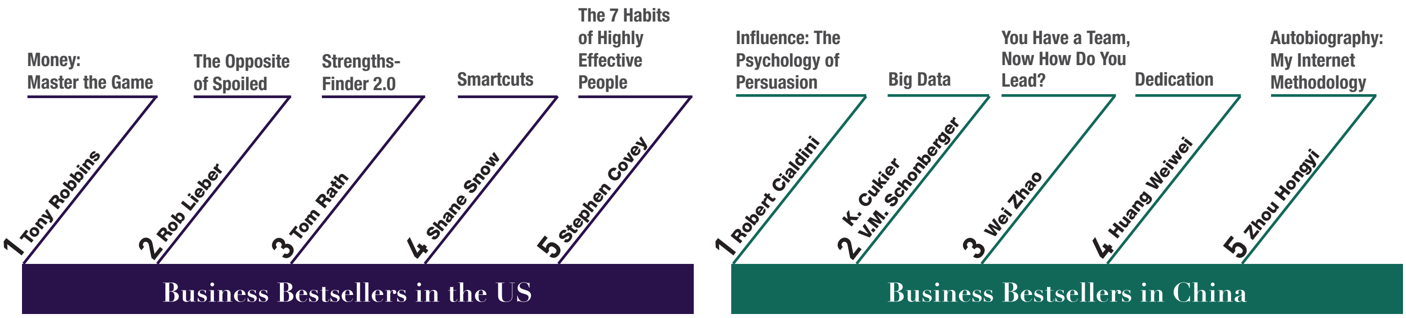
Another one is *Do More Faster* by Brad Feld and David Cohen, who co-founded an accelerator called TechStars, and it's just a great resource—I tell my first-time founders to read it all the time.

My favorite business writer overall though is Dan Ariely, a professor of behavioral economics. I've read all his books on the topic, and the way he explains how we are all a lot more irrational than we think, but also predictably so, is also crucial to many business situations and strategies. In particular I remember one chapter he had on dating—how traditional dating websites don't actually capture the dynamics of a budding relationship and the tests he did. I have definitely told some entrepreneurs who have pitched me about similar products to go read the results of that study and see if they can incorporate some of the findings into their start-up.

There are many recent books I've enjoyed a lot, but the one I've been raving about is *The Future of the Mind* by Michio Kaku, a renowned astrophysicist, who interviews experts in neuroscience and explains what has already been accomplished in this field, as well as what is likely to happen in the next 50 years (within my lifetime, hopefully!). He then extends this to what is theoretically possible, at least within our current understanding of the laws of physics—it's simply mind blowing stuff!

I just started on *Antifragile* by Nassim Nicholas Taleb, so that's first on my to-read list, and I've heard great things about *Capital* by Thomas Piketty. Too many books too little time!

Rui Ma is a Partner, Greater China, at 500 Startups



Source: Amazon.com

Source: DangDang.com