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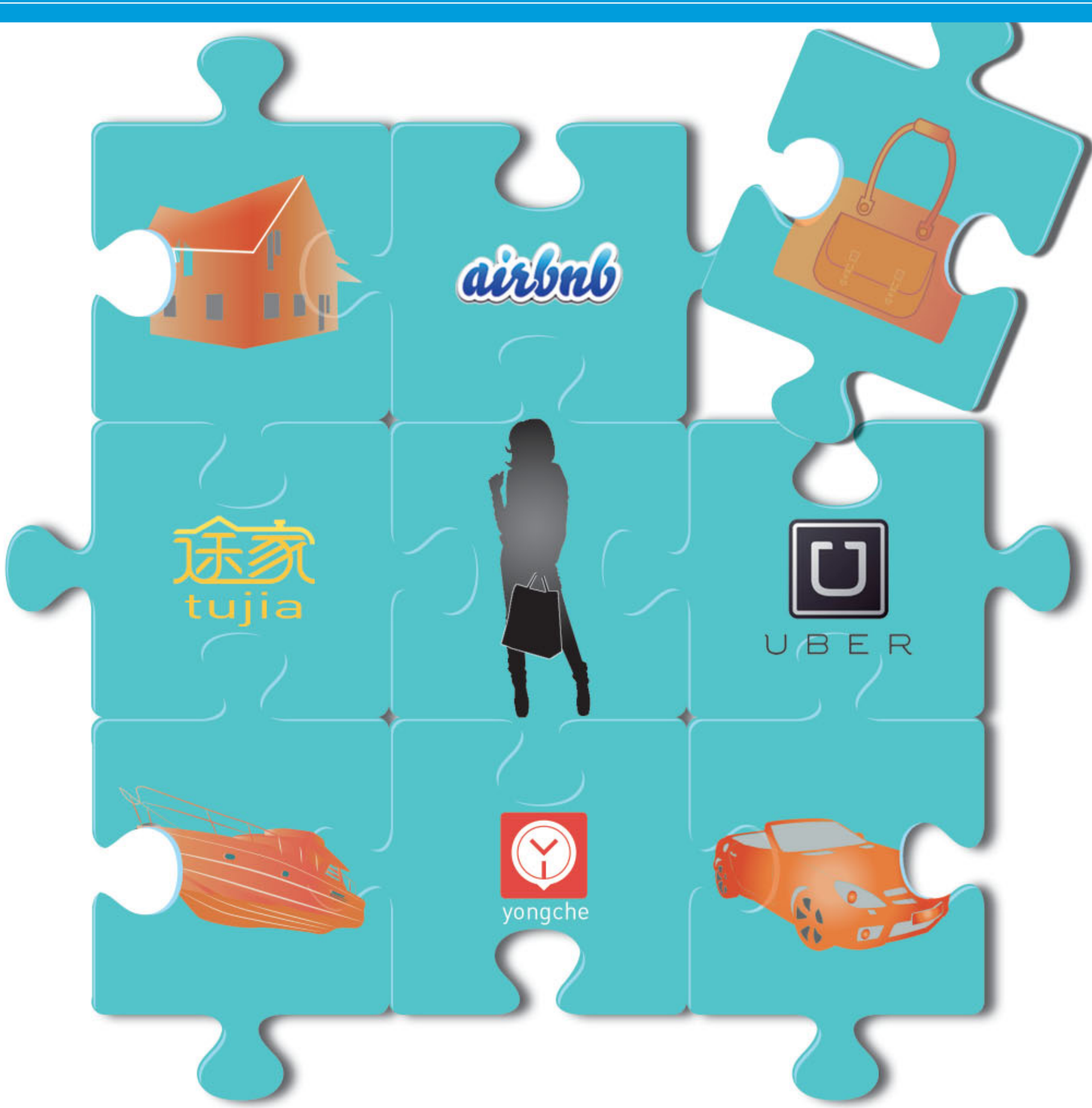

China Embraces the Sharing Economy

The sharing economy has challenged traditional notions of consumption, and now it's making inroads into China

- Has China developed its own Silicon Valley rivals?
- Amazon takes a second crack at the China market
- Economist Nicholas Lardy discusses the decline of the state's role in China's economy

Table of Contents

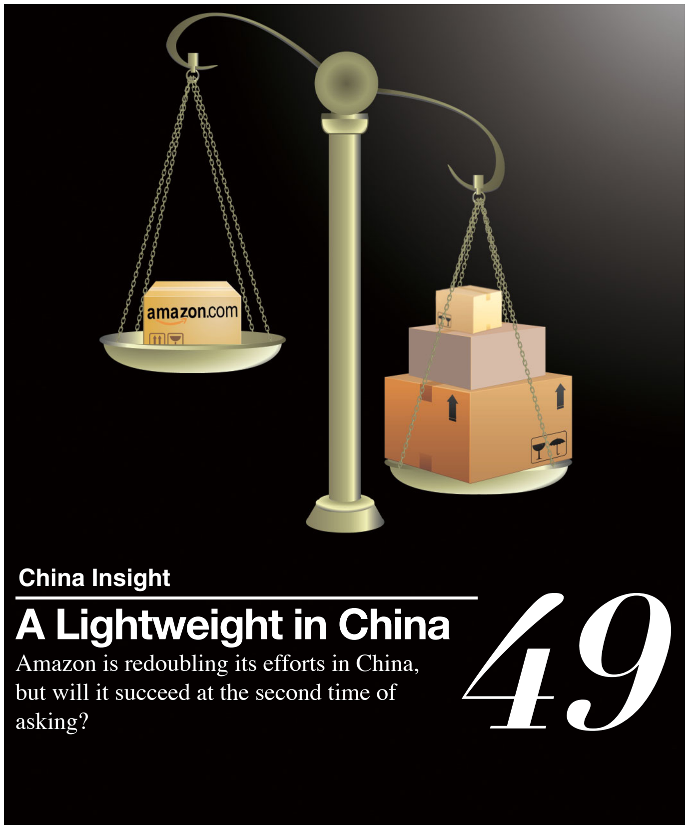

Table of Contents

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What's Mine is Yours

On my recent visits to New York, my hospitable American colleagues were so kind to book me cars via Uber that I did not have to wait for yellow cabs in the bad weather. After one such ride, my colleague, asked me with a hint of pride, "Do you think such a business model would work in China?" He was a bit surprised when I answered: "Yes, such models started in China about four years ago".

I then told him about my experience with Yongche, an Uber-like company that one of our EMBA alumni started with an initial investment from his classmates. I do not think the founder knew about Uber when he founded Yongche as one of the reasons why he started the company in Beijing was because you need to enter a lucky draw, with millions of other people, to buy a new car and it is extremely difficult to get a taxi during rush hour.

Great minds think alike, and so do entrepreneurs and in some ways, consumers, even if they live in different countries. The concept of the sharing economy, the basic model behind Uber and Yongche, has gained immense popularity in the West and has made inroads into China at the same time. The idea of being able to use something without having to buy it is proving to be attractive for some consumer segments. Seeing China as potentially the biggest market in the world, the likes of Uber and Airbnb have already entered the country and are competing with Chinese companies like Tujia and Yongche.

But will the sharing economy idea take off in China? The success or failure of this model in China will be based on a rather complex interplay of economic, social, cultural and ideological factors. Let me not give away any more here. Please turn to our cover story on page 22 for an interesting analysis of the sharing economy in China.

This September e-commerce juggernaut Alibaba became a household name in the West after its mega IPO on the New York Stock Exchange. The company has already achieved massive scale in China, controlling more than 80% of the country's e-commerce market. This year on November 11, the so-called "Singles Day", $9.3 billion worth of transactions were done via Alibaba's e-commerce platform. Does any other company in China have the size, might or potential to take Alibaba's crown as China's largest e-tailer? BAT is a common nickname for the triumvirate of Baidu, Alibaba and Tencent in China. Earlier this year, Wanda, one of the country's largest real estate groups and the company that acquired AMC Theatres in the US, set up an e-commerce alliance with search engine giant Baidu and the gaming and social media company Tencent. But there are also other entrenched players within e-commerce, such as current No 2 Jingdong (JD.com). Turn to our story on page 30 to see if any of these companies have it within them to become No 1.

Chinese tech companies are making waves globally. Recently Lenovo finished its acquisition of Motorola Mobility and became the world's third-largest smartphone manufacturer. Xiaomi, a company that is barely four years old, is now the world's fourth-largest smartphone maker. Both these companies came out of Zhongguancun, a technology hub in Beijing. Which brings me to the theme of another one of our stories: 'Where is China's Silicon Valley?' Clearly, Zhongguancun has already produced some stalwarts. But there are other high-tech hubs in Shenzhen and Shanghai, for instance, that have an interesting confluence of just the right factors—ideas, capital, manpower and an enabling ecosystem. So which one of these high-tech hubs deserves the crown of China's Silicon Valley? Turn to page 10.

As always, we have curated an interesting selection of interviews for you: Gary Hamel, easily the go-to guy on management strategy, tells us what's wrong with the DNA of organizations (page 57), Veronica Wu, Vice President of Tesla China, talks about the company's China strategy (page 54), and China scholar Nicholas Lardy busts some myths on China's state capitalism (page 64).

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/

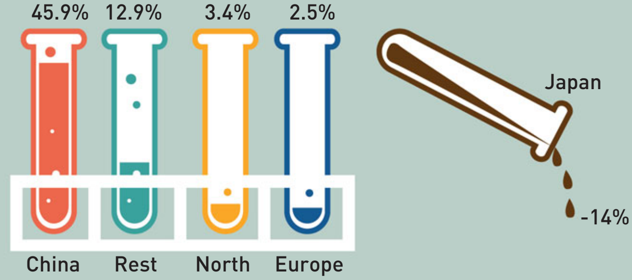
China Data

The stats you need to know [from October and November 2014]

Racing to Catch Up

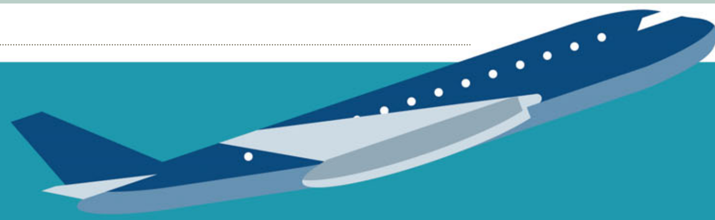
Growth in research and development has slowed or decreased around the world, but China continues its surge in spending as it tries to catch up.

Change in R&D spending by region, 2013-2014



Source: Strategy&

Preparing for Take Off?



China's national civil aviation authority says it will need to train **500,000** civilian pilots by **2035**.

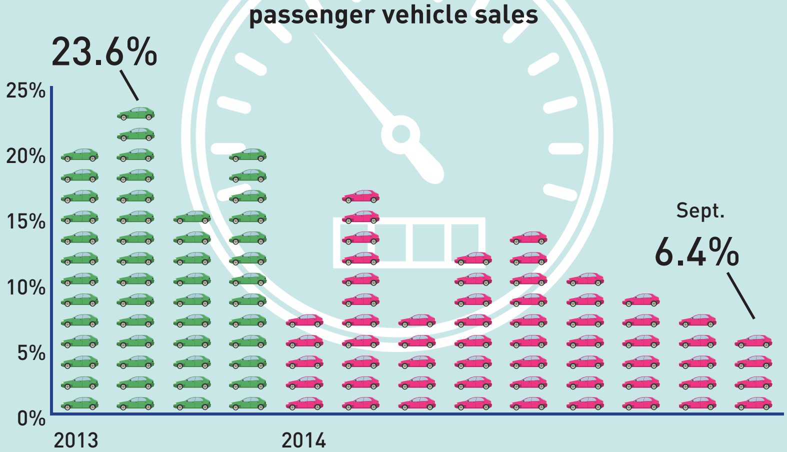
But the aviation authority's school can only train up to **100** pilots per year.

Source: Reuters

Shifting Down a Gear

China's growth in passenger automobiles eases off the gas, with the smallest increase in 19 months coming in September, typically a strong month, as the industry feels the effects of the economic slowdown and the government's austerity drive.

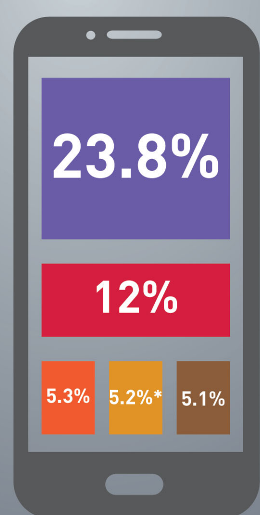
Change from a year earlier in China's monthly passenger vehicle sales



Source: China Association of Automobile Manufacturers, Wall Street Journal

Fighting for Third

2014 Q3 Share of Smartphone Shipments



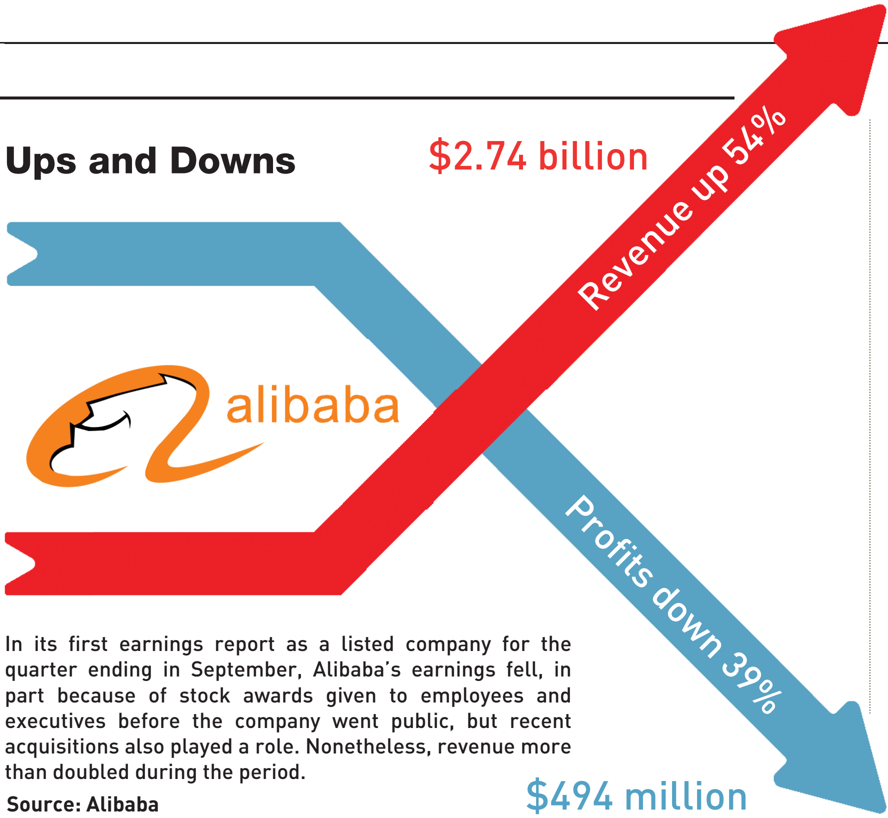
In the close battle for third place in the number of smartphone shipments, Xiaomi came out on top, only to see its title snatched away a few hours later after Lenovo confirmed the purchase of Motorola Mobility. Their combined market share is now 8%.

- Samsung
- Apple
- Xiaomi
- Lenovo
- LG

* Lenovo now represents 8% and so is No.3, not No.4

Source: IDC, Bloomberg

Ups and Downs



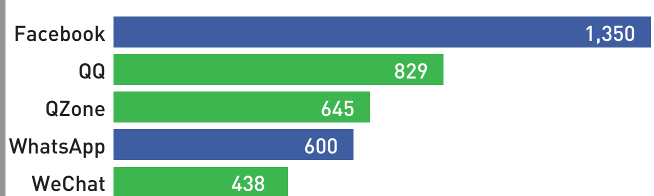
In its first earnings report as a listed company for the quarter ending in September, Alibaba's earnings fell, in part because of stock awards given to employees and executives before the company went public, but recent acquisitions also played a role. Nonetheless, revenue more than doubled during the period.

Source: Alibaba

Who Has the Most Friends?

As of November 2014, Tencent (in green) owns three of the world's top five social media platforms. Facebook (in blue) owns the remaining two.

Number of active users, in millions



Source: We Are Social

Hiding Something?

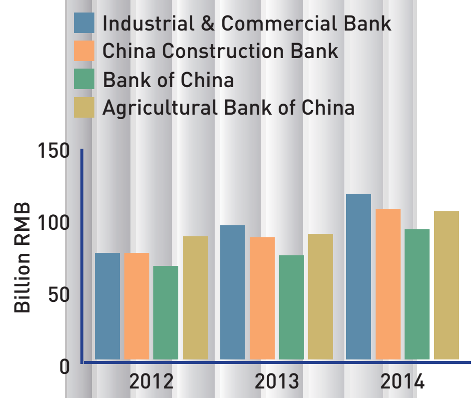
In September, China's exports of precious metals reached **$10.8 billion**, compared to **$1.39 billion** a year earlier, with Hong Kong overtaking the US as the number one destination for shipments. Analysts have speculated that part of the export of precious metals, particularly gold, was being used to mask capital inflows.

Source: Bloomberg

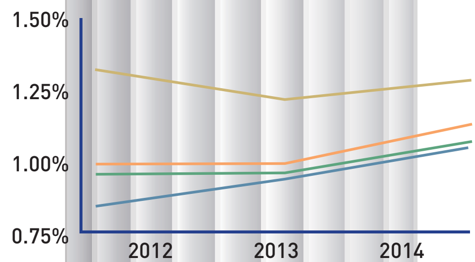
Malignant Growth

Although still only a small part of their balance sheets, bad loans are on the up at China's big banks.

Total non-performing loans



Non-performing loans as a share of total assets (Q3)

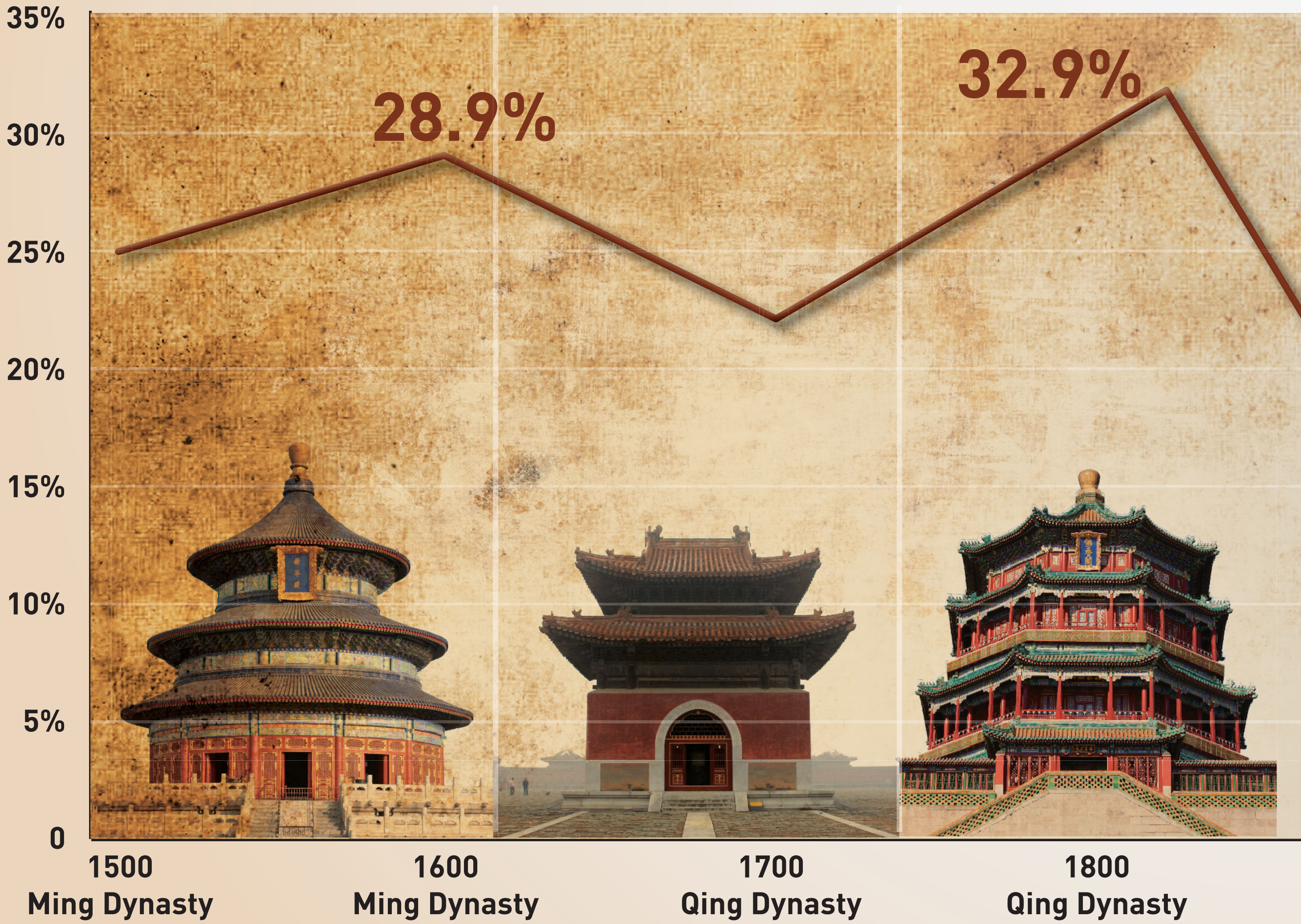


Source: The banks, Wall Street Journal

The Big Number

China's gross domestic product (GDP), and the rate at which it changes, is one of China's most closely-watched statistics; the base from which so many economic and business decisions are made. The breakneck growth in GDP that China has achieved in the past three decades has often reached double digits and continues to define perceptions of its role and status in the world. But as the economy now slows, there is handwringing over the government's target of 7.5% annual growth in GDP, and how it can be sustained. Nonetheless, China is now the world's largest economy according to the IMF when measured by purchasing power parity (the US represents 16% of the global economy). This is not the first time the country has been in this position—China has had a huge share of the world's GDP from time immemorial, probably peaking in the early 19th century. However it still lags behind in other measures, and extending the fruits of this re-emergence to the Chinese people is now one of the government's main challenges.

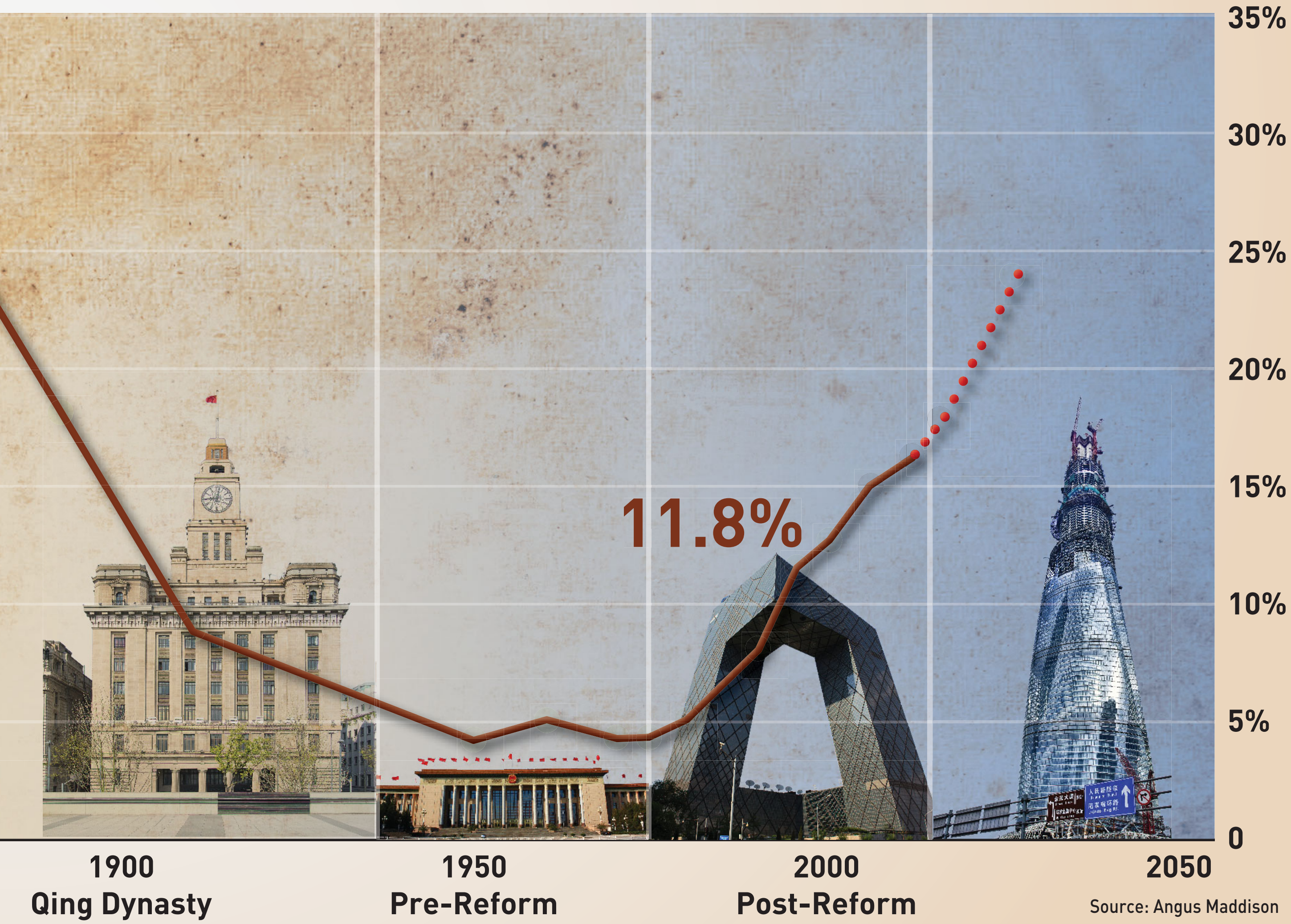
China's Proportion of Global GDP Through the Ages



	China's GDP per Capita (current $)	China's Annual GDP Growth Rate	Top 3 Countries by Share of Global GDP*
1980	193	7.9%	US, Japan, Germany
1996	703	10.0%	US, Japan, China
2004	1,490	10.1%	US, China, Japan
2012	6,093	7.7%	US, China, India
2019	11,071	6.3%	China, US, India

Source: IMF, World Bank, Angus Maddison

*by purchasing power parity



Source: Angus Maddison

Where is China's Silicon Valley?

As China seeks to innovate and upgrade its economy, where in the country can be compared to the US tech hub?

By Chris Russell

The people in the packed room listen intently as the speaker spells out the virtues of adaptability, creativity and his own personal refusal to box himself in with a job title on his business card. Those standing at the back of the room crane their necks to hear his words. The last of eight speakers drawn from tech companies and venture capital firms, at the end of his talk members of the crowd begin conversing with one another over bottles of beer, tech buzzwords dominating.

It sounds like a scene from Silicon Valley, but instead the event, hosted by start-up incubator Chinaccelerator, took place in the newly opened shared office space of People Squared in Shanghai's Jing'an district, its third such space in the city.

In China's drive to transform itself into an economy centered on innovation, these grassroots scenes full of eager, ambitious start-ups will play a crucial role.

Such is the government's desire to foster technological innovation that the Politburo, China's top decision making body, took the unusual and significant step of holding a study session in September in Beijing's Zhongguancun, an area routinely hailed as "China's Silicon Valley". "We must enhance awareness of unexpected challenges and grab the opportunity of the science and technology revolution. We cannot wait, hesitate or slack," Xi Jinping, China's President, said.

For all that urgency, just how close is any one place in China to claiming the mantle of Silicon Valley, a place that represents the confluence of money, talent, entrepreneurship and an unwavering belief that any problem can be solved through technology?

More than One

Unlike in the US, where tech innovation is largely clustered in California, the picture in China is much more fragmented, leading to the existence of several candidates for the appellation "China's Silicon Valley". Nonetheless, a few key locations stand out.

"If I had to name the three key areas for innovation, I would say Beijing, Shenzhen and Hangzhou," says Anna Fang, General Manager of ZhenFund, a Beijing-based seed fund.

It is Beijing, and specifically Zhongguancun, that is perhaps most similar to Silicon Valley. Initially an electronics street, in the 1980s Zhongguancun developed into a nascent tech hub, before later becoming the subject of government policy designed to foster innovation. It became China's first high-tech park in 1988. In that year, the park had 527 enterprises, according to the Zhongguancun Science Park, as the park is now known. By 2012, it was home to just under 15,000 companies, down from a peak of 21,000 in 2007.

Today, among these thousands of companies are giants such as Baidu and Lenovo, and Beijing's broader ecosystem is supported by a plethora of research institutes, multinationals, angel funds and incubators like former Google China CEO Kai-Fu Lee's Innovation Works. The two elite universities nearby, Peking and Tsinghua, have also played a role that in some ways mirrors that of Stanford's to Silicon Valley.

"I would definitely say Beijing really far outpaces Shanghai and Shenzhen, in terms of the number of entrepreneurs, number of investors, number of events," says Rui Ma, the Greater China Investment Partner for 500 Startups, a venture capital seed fund and start-up accelerator. "Beijing is really up there [in Asia] in terms of innovation and activity."

An example of Beijing's status as a leading hub for tech start-ups is the dating app Momo, which allows users to communicate with nearby strangers using their phones. Founded in 2011, the company claims to have reached 120 million registered users in 2014. Meanwhile Momentcam, a photo app that allows users to turn people into comic-like drawings, has attracted Series A funding from Alibaba. Then there is Xiaomi, the newly dominant smartphone brand on everyone's lips.

But if Beijing leads the way on deals and activity, then it is the southern city of Shenzhen, itself the base for tech giants such as Tencent, that has the edge when it comes to hardware, a fact connected to its position in the manufacturing hub of the Pearl River Delta.

It is home to a burgeoning group of so-called "makers" (DIY manufacturers and entrepreneurs) who have been drawn to the city due to its access to parts and manufacturing knowhow. In April 2014, Shenzhen hosted its first major Maker Faire, a gathering of makers, engineers, students and business people that originated in the US and has since spread around the world.

"The ecosystem in Shenzhen provides makers with advantages in aspects such as sourcing, manufacturing and logistics, making hardware start-ups scale easier," says Eric Pan, the founder and CEO of Seeed Studio, a Shenzhen-based hardware innovation platform. "Ordering electronics here is now like service in a restaurant."

Shenzhen's unique access to parts and manufacturers greatly reduces production timelines, allowing for greater experimentation. Such endeavors are then bolstered by the likes of Pan's 'hacker space' Chaihuo and Haxlr8r, an accelerator exclusively for companies working with hardware.

The experimentation and innovation evident in Shenzhen has its roots in the city's vast electronics malls, which provide access to a mind-boggling array of parts, and also the region's *shanzhai* (counterfeit) culture. Although intellectual property (IP) theft has been the bane of many companies manufacturing in China, *shanzhai* nonetheless inculcated knowledge and flexibility due to the way information was freely shared. This, when combined with the region's advanced manufacturing infrastructure, has given entrepreneurs huge flexibility to operate at many different scales.

Following a well-worn path of moving from follower to leader, companies in Shenzhen now stand to bring the lessons of *shanzhai* into the arena of innovative and legitimate business, fusing the entrepreneurial spirit of a Silicon Valley start-up with the knowledge and workcraft of Shenzhen manufacturing, allowing for a high degree of experimentation.

An example is DJI. Its drones, or quadcopters, are at the premium end of the market and have found a following around the world. Another is OnePlus which has taken advantage of Shenzhen's unique position to produce what *Time* magazine described as the "Phone of Dreams", all the while selling it at an ultra-competitive price point.

Shenzhen has strengths in other areas beyond hardware. "Because Tencent is there, they also have great gaming companies and great social networking companies. I mean, Shenzhen is really stellar," says Fang. In 2014, Shenzhen became a national innovation zone, the fourth one in the country and the only zone created on a city-wide scale.

The cities of Shanghai and Hangzhou also lay a claim to being tech hubs, albeit not on the same scale or with the same vitality as Beijing and Shenzhen. Hangzhou benefits from the presence of e-commerce giant Alibaba, while Shanghai boasts tech parks, top universities, the hacker space XinCheJian and Chinaccelerator.

A huge number of national high-tech zones are also spread across the country and are intended to artificially create tech clusters. According to the Torch Program, a government tech entrepreneurship scheme, by 2012 there were 105 such zones. Unlike the DIY hacker spaces of Shenzhen however, these zones are dedicated to serious, high-level research and development—in the case of the Xi'an Hi-tech Industries Development Zone this has attracted major firms such as Huawei, Siemens and IBM.

Driving the development of these tech hubs around the country has been the growth in the overall ecosystem—the networks of venture capital firms, incubators and shared working spaces. According to the Torch Program, in 1995 the number of tech incubators was a mere 73. By 2012, that number had grown to over 1,200.

Similarly, the volume of venture capital funding has increased significantly since the late 1990s, more than doubling between 1998 and 2004 according to an OECD report, with the emergence of university-backed venture capital firms in 2000 being a significant milestone. However, since 2011 numbers have shown a decline, largely because China's initial public offerings (IPO) market was closed for 14 months from October 2012 to December 2013—in 2013, the total amount of invested capital was $3.5 billion according to Ernst & Young, down from $5 billion in 2012.

The Hand of Government

For all the importance of grassroots entrepreneurship and experimentation, the Chinese government plays an important role in tech innovation. The primary vehicle for this has been the Ministry of Science and Technology's Torch Program, which has provided funding, created innovation clusters, established incubators and supported venture capital firms.

Smaller, more localized schemes also exist, such as the Inno Way "innovation street" in Zhongguancun, which offers space and assistance with business services, including faster company registration; the Shanghai Technology Entrepreneurship Foundation for Graduates and the Phoenix Project of Beijing's Chaoyang district. This last scheme, which aims to attract overseas talent, saw its subsidies for start-ups in 2014 doubled to RMB 100,000.

According to Rui Ma, these initiatives are not the primary driving force for innovation, but nonetheless make a beneficial contribution.

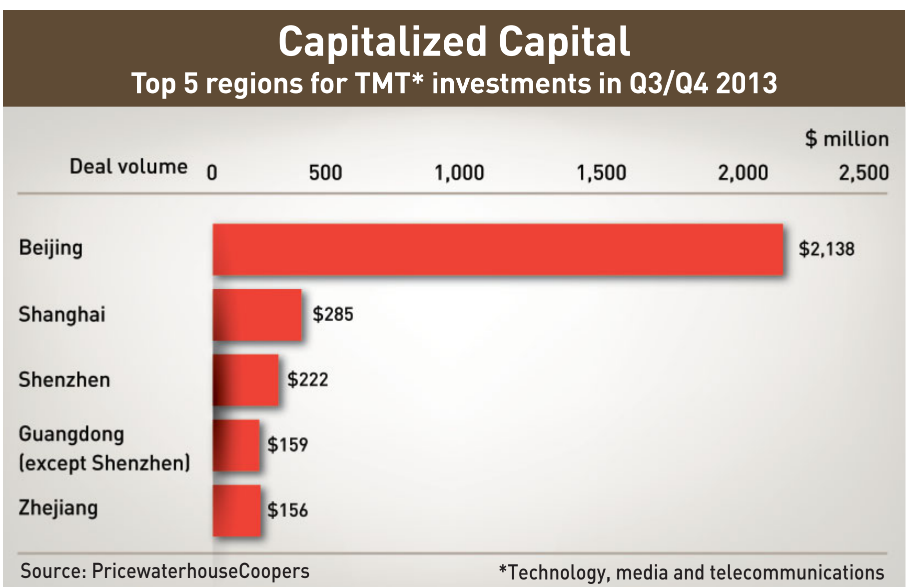
"The things they do that make it easier for businesses to get started or easier for early-stage investors to take a little bit more risk are really helpful. We're big supporters of government initiatives that invest in funds, invest in private capital and let the private capital money managers then disperse the capital," she says.

As with any government programs, bureaucracy and myopia remain problems, and the schemes often focus largely on high-tech to the exclusion of other areas of innovation. According to Anil Gupta, Professor of Strategy and Entrepreneurship at the University of Maryland's Robert H. Smith School of Business, research and development (R&D) funds aren't always distributed based on scientific merit. Relationships playing an important role, and there is also a focus on quantity rather than quality.

"We're far less enamored with government initiatives that try to disperse funds themselves, because after all it is a very different industry," says Ma. "There are a lot of government initiatives where [the] government will clear a street or create a finance park—I don't think those are as helpful. They take a really long time to trickle down because generally those are not the resources that entrepreneurs need. Generally what they need is smart capital… just providing space, we haven't seen it really work anywhere in the world."

More than Money

Although China's tech sector has witnessed success and innovation through Tencent's wildly popular WeChat application, which has also begun to gain some traction globally, and with smaller companies, these success stories are still far from the level of Silicon Valley. But there is still plenty of money finding its way to Chinese tech companies, and Fang describes the funding



situation for start-ups as "excellent".

"For certain types of businesses, I'm seeing valuations that are actually higher than the US, and the amounts of capital being raised are very comparable," says Ma, although she warns that this situation has led to some talk of a downturn around the corner, with investment activity not always being justified given the fundamentals.

"It's a lot of dumb money, at the end of the day," says Todd Embley, Program Director of Chinaccelerator. "[The investors] can't help them build a business, because they have no idea how to do it themselves."

According to Fang, for most successful start-ups IPOs have historically tended to be the most common way to cash in on investments—the Zero2IPO Research Center put the figure at 89% for 2011. However that is changing, in part because of the IPO freeze, but also because Baidu, Alibaba and Tencent are leading the way in mergers and acquisitions (M&As), while in 2013 the number of venture capital-backed M&As increased to 20 from 11 the previous year according to Ernst & Young.

"Some [M&As are] strategic, increasing their distribution channel—Baidu really wants to increase their source of distribution and their users," says Fang. "Very rarely some people acquire for talent, I think it's very rare… If it's something [big tech companies] could do internally, and there's not that much of a barrier, then they would probably just prefer to do it themselves."

This underscores the fact that copycatting remains a real threat to start-ups, even if in some ways it was a boon to Shenzhen's development. Imitation can come from rival start-ups or from China's technology giants, with the effect of not only undermining business models, but also skewing the ways in which acquisitions happen.

According to Embley, China's big companies have the resources to easily recreate the work of other companies, which, in turn, allows them to dictate unfavorable terms to the companies they look to acquire, unless they are fortunate enough to have a critical, defendable piece of IP, or the crucial knowledge, resources or relationships needed to make it a success.

"If you don't have all of that to defend what you're doing, and they have to have you, they can just very easily recreate the game or the social app or whatever the hell it is you're doing, and they've got the resources to make everyone go and download it and totally destroy you," he says.

> "For certain types of businesses, I'm seeing valuations that are actually higher than [in] the US
>
> Rui Ma
> Greater China Investment Partner
> 500 Startups

Another driving force in this dynamic is the scale of China's largest internet companies and their desire to have a presence in all areas of the market, while for smaller companies easy access to capital, an aversion to risk and the ease with which imitation can be done leads to a rash of companies in the same field, each offering similar iterations of the same basic idea.

Weak IP enforcement also makes China less attractive as a base for high-tech companies. "My assumption is that weak enforcement of IP laws is the result of deliberate government policy rather than an inability to enforce the laws," says Gupta. "Such a policy… slows down China's move up the technology ladder." He points out that technology companies have far bigger (R&D) operations in India, even though China spends more money in this area.

The state of education, both in formal terms and that of mentorship from older, successful entrepreneurs (a key aspect of Silicon Valley's ecosystem), also provides a challenge to China's capacity to develop a Silicon Valley rival. With a system largely based on rote learning and exam preparation, the Chinese school system does little to engender creative thinking, while the lack of experienced mentors makes it harder for inexperienced entrepreneurs to navigate a challenging business landscape.

"The entire education system is not optimized for very fast-changing technologies like computer science," says Ma. "The number of qualified developers, I think, is lower—it's lower than a lot of people think in China." Embley agrees that education isn't what it could be: "[Chinese children] aren't raised to be good entrepreneurs."

The issue of mentorship, and the associated problem of a lack of quality C-suite level talent, might be solved by the trend of Chinese people returning to China after going abroad. "A lot of the ones for example that we've invested in, they've worked at Facebook or Google and they came from Stanford, so they've seen the best in terms of technology… and they've been at the best tech companies," says Fang.

China hasn't yet been able to match Silicon Valley in the areas of disruptive innovation and numbers of top level companies—China ranks 29th on the 2014 Global Innovation Index, below the likes of Slovenia, Estonia and Malta—but despite that, it has the money, and there are still plenty of signs of energy and enthusiasm. The fact that this energy isn't all concentrated in a single place also undermines assertions that any one location can claim to be China's Silicon Valley equivalent.

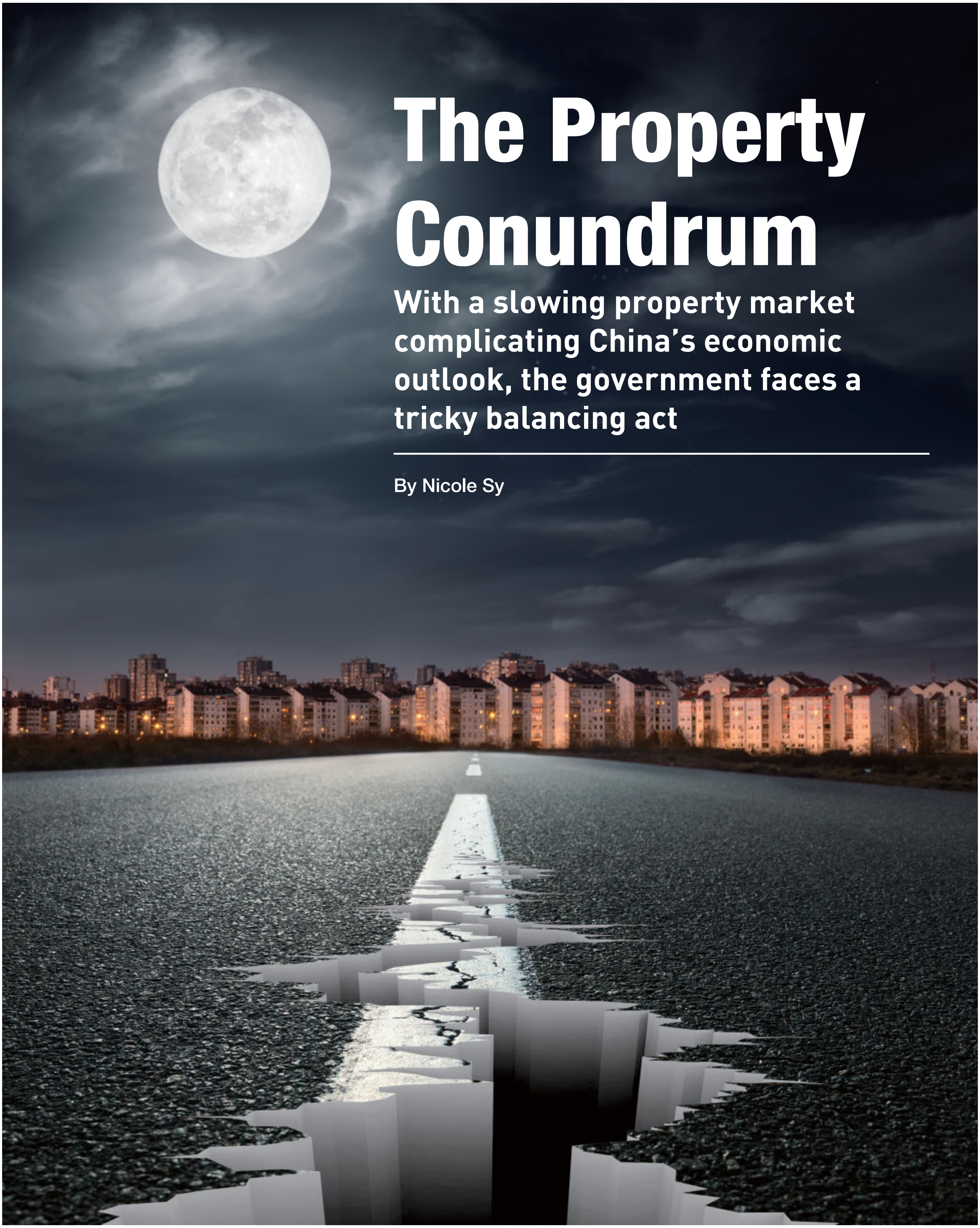
"Generally speaking any comparisons to Silicon Valley are wrong—there is no other Silicon Valley at all," says Embley.

But if Silicon Valley has claims to uniqueness, so does China's southern tech hub. One day, we might ask where a country's Shenzhen is.

The Property Conundrum

With a slowing property market complicating China's economic outlook, the government faces a tricky balancing act

By Nicole Sy



China's property market, long identified as one of the key fault lines in the country's economy, has moved into one of its most testing phases yet. Eight out of 10 economists surveyed by CNNMoney in July named the real estate sector as the area posing the biggest risk to China's slowing economy, and analysts and investors who subscribe to this negative view include Nomura, UBS and George Soros. The importance of real estate to the Chinese economy is not in dispute, nor is the existence of bubble traces, at least in some parts of the country. The only uncertainty comes over the scale of the problem and how the Chinese government will handle it.

A string of developments in 2014—but set into motion years earlier—have highlighted the growing need for some sort of controlled adjustment. With cash flooding into the property market thanks to a massive 2008 stimulus, and for want of better investment options available to investors of every stripe in China, the government's attempts at market adjustment have in turn discouraged, then encouraged prices to balloon as local governments got cold feet.

Measures since then have helped mitigate the damage in the short-term, but in light of the problems spawned by the 2008 stimulus—among them the very property bubble being dealt with now—another broad stimulus is no longer an option in the eyes of top leaders. With stability on the line and pieces of the policy puzzle now falling into place, the government's intention to play a more active role in coaching the market to a more sustainable state is starting to come into view.

Brought to the Boil

China's property bubble can be traced back to the global financial crisis in 2008, although prices had been rising solidly for years before that, says Shengxian Qin, Deputy Research Director for J Capital Research, a Beijing-based firm. China largely escaped the impact of the 2008 crisis by pumping a RMB 4 trillion ($585 billion) financial stimulus package into the economy, which included loosened lending conditions and lowered interest rates. By early 2009, property sales and prices were skyrocketing.

This put further pressure on ordinary Chinese, for whom property now serves as a storehouse of value. Beijing resident Florence Fu, 40, owns two apartments. Her family lives in one, and the other they rent out. She and her husband bought the second apartment 10 years ago, when she says it was much cheaper than it is now. Like most middle-class Chinese then, they bought it as an investment. "Because of inflation, there are no other ways to make your money grow," Fu says. "If you invest in property, you can also get income [from rent]."

Societal pressures also play a role in new home purchases. Parents try to support their children until marriage, especially sons. A house or apartment is one of the three unofficial requirements for a bachelor to be considered marriage material.

Cao Loubin, 47, is another Beijing resident with two apartments, but is saving up to purchase another one. "I need to prepare it for my children's future use," he says. "If I don't buy it now, when the children grow up, property prices may be too expensive to buy." Like Fu, he believes his investment will only grow as property prices in the city rise. Fu likewise plans on eventually passing her second apartment down to her son, now aged 10.

Buyers were not alone in thinking housing prices would indefinitely rise—many property developers assumed the same. However, the ones who jumped on the bandwagon too late, especially in cities with more sluggish demand, caused a surge in excess properties throughout the country.

While the infrastructure-building boom that resulted from the stimulus had many positive effects, the lowering of restrictions on loans also led to many risky business decisions, especially in the real estate development sector. China has a paucity of investment outlets, pushing people towards the only viable investment vehicle: property. "Their stimulus actually helped finance property developers and made people buy more," says Qin.

Home sales rose at an average rate of around 30% each year from 1998 to 2009, according to Centaline, the country's biggest real estate brokerage, before slowing to about 10% from 2010. They briefly flattened in 2012 due to government policies that sought to control bubble tendencies, but took off again in 2013 when the policies were relaxed.

Further signs that China's property sector could be forming a bubble came when it was revealed by China's National Bureau of Statistics (NBS) that in 2013, the value of new home sales rose 27% to RMB 6.8 trillion ($1.1 trillion) from 2012.

Headlines of "China's Ghost Cities" were continuously replayed in the media alongside images of empty, immaculate developments without a single person in sight. Abandoned, half-constructed residential and commercial units were also a common sight, as demand suddenly dropped.

The weak sales, oversupply of units and falling demand were all unhealthy signs that a bubble had developed in China's property market.

Action and Reaction

In an attempt to stave off the growing property bubble, local and regional governments, one by one, began implementing purchase caps. The caps differed slightly from city to city, but their purpose was the same: bring an increasingly unruly drive upward in property prices under control.

As these purchase caps were being implemented, a nationwide campaign headed by President Xi Jinping was rolled out to eradicate corruption, with the National Development and Reform Commission (NDRC) at the helm. The corruption crackdown affected the property sector as many officials had accepted houses as bribes, although exact numbers are hard to come by.

Heads began to roll and those fearing NDRC scrutiny not only ceased buying properties, particularly luxury units, but also began offloading them at heavily discounted rates. And to make matters worse for luxury developers, a Barclays' survey in September of individuals with $1.5 million or more in net worth found that 47% of Chinese respondents want to move to another country in the next five years. These two things combined to put a dent in real estate's most profitable sector.

By May 2014, housing prices in half

of the 70 cities monitored by the NBS registered decreases. This was the most they had fallen since May 2012 when the government first tried to rein in the growing property bubble.

With signs that efforts to control the bubble had actually been too successful, local governments quietly or openly began discarding purchase restrictions. In early August, 32 out of 46 regional governments relaxed or scrapped limits on the number of properties a person could own, according to *Caixin* magazine. By late October, *Bloomberg* reported that only five cities had the restrictions in place.

Housing prices had continued to fall, with August's figures showing the lowest drop since the NBS changed its calculating method in January 2011. Sixty-eight cities registered a drop in property prices that month, down 1.1% from the month before, after dipping 0.9% in July, according to *Reuters'* calculations based on the NBS figures. The next month, all but one of the 70 cities monitored by the NBS registered a drop in property prices.

Home sales fell 11% the first nine months of 2014, as per *Bloomberg's* calculations based on the NBS numbers. Additionally, the China Land Surveying and Planning Institute reported slowing growth in residential land prices for July-September, the third consecutive quarter that this had happened.

The runaway growth in prices had been successfully contained, but the change had been too quick for the government and investors to be comfortable.

Old Problem, New Measures

Investors' fears of an uncontrolled crash were somewhat soothed when the People's Bank of China (PBoC) distributed RMB 500 billion ($81 billion) to the country's top five banks in the same week that the low August NBS figures were announced.

The national Golden Week holiday, annually celebrated from October 1-7, typically results in a cash crunch due to an uptick in consumer spending at this time of the year. Some analysts speculated that the RMB 500 billion stimulus was for liquidity issues that would arise with the holiday, but because giving RMB 100 billion to each of the banks was large enough to lower the banks' reserve ratio by 0.5%, easing pressure on mortgage lending, others thought that it might well be connected to the country's ailing real estate industry.

"Basically this is a small stimulus," says Liu Jing, an accounting and finance professor at the Cheung Kong Graduate School of Business. "There are lots of uncertainties. And under the situation where there are lots of uncertainties, people don't invest," he says. "When this happens, the government needs to stimulate a little bit and it's been doing it for a while."

Lending further weight to this view, on the eve of Golden Week the PBoC and the China Banking Regulatory Commission issued a statement allowing banks to lower mortgage lending rates to people buying second or third properties. This was the first time property restrictions had been loosened since 2008. It was becoming clearer that the government was taking steps to address the deflating bubble.

Previously, the government had been taking steps to cool an overheated property market, with loan conditions for those looking to buy a second or third piece of property being made more onerous to discourage borrowers. The statement now allowed second property buyers a 30% discount on their mortgage rates—previously only available to first-time buyers. Down payment levels were also cut more than half to 30%, and restrictions for third-time property buyers were similarly loosened.

These actions were enough to see a small rally. Poly Real Estate, one of China's top five developers, reported that their sales from October 1 to 7 reached RMB 7 billion ($1.14 billion). Stock indices of both Poly and Vanke, China's top real estate developer, surged at least 2.8% the week. However, analysts predicted the gains would be short-lived. True enough, Poly's stock fell the succeeding week by 2.1%.

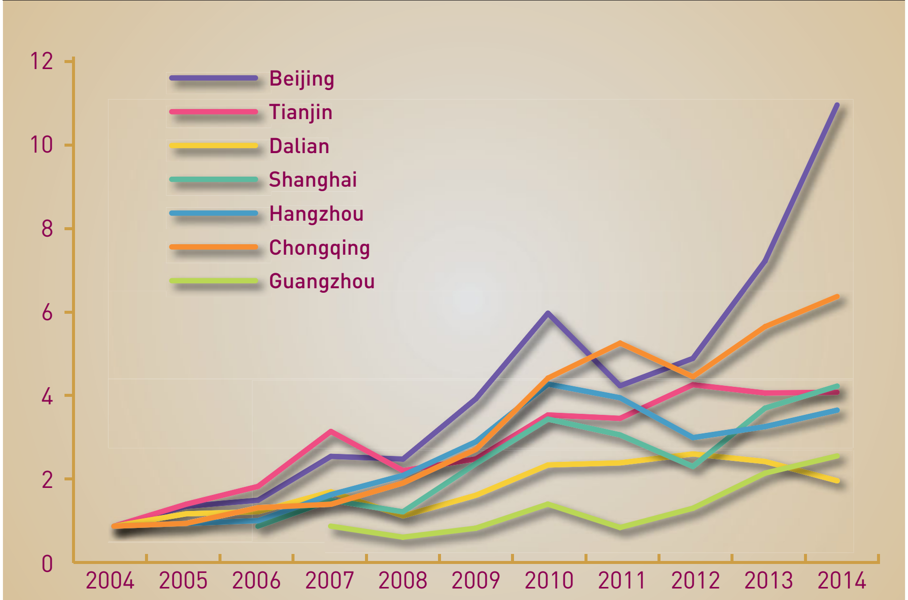
Complications: Numerous

In part, this is because the policies are not sustainable, according to Qin. "I don't think this will prompt too much demand to purchase properties. There will still be a large amount of inventory in the market."

"Our checks show that inventory in some low-tier cities is already higher than the actual population," says Qin. "We interviewed many people in lower-tier cities and

Can It Keep Going Up?

Index of Residential Land Prices in Chinese cities



Source: Wharton/NUS/Tsinghua Chinese Residential Land Price Index most people have more than one unit. Some have 2-3 units." The danger lies in there being little or no migration into those cities to absorb the surplus.

The effect a housing bubble has on wealth is further reason to correct it. "The housing bubble generates a substantial degree of resource misallocation and welfare losses, prolonging economic transition and slowing aggregate economic growth," said a working paper by the Federal Reserve Bank of St. Louis titled 'The Great Housing Boom of China'. The authors of the paper, Kaiji Chen and Yi Wen wrote: "Such welfare consequences offer an additional explanation for the Chinese government's concerns over the great housing boom and its policies to contain the bubble."

"Housing investment is one of the largest investments people have in China," says Liu. "If the price [of land] goes down, you can wipe out so much wealth."

However there are stark contrasts between market sentiment in first-tier cities and everywhere else according to Liu. "The higher end markets, for example, in larger cities, are still holding up quite well. But in second-tier, third-tier cities, I think that probably prices have gone up too much and are coming down fast," he says.

Qin emphasizes that prices are falling because of excess supply. "The government wants to help developers de-stock their inventory," she says, but some prices are stubbornly high. "The buyers cannot afford the market prices. Investment demand will be squeezed out in the long-term and short-term."

Prices that are inflated and too high, like in the lower-tier cities, can distort the economy, according to Liu. An ideal situation would be the government letting the air out of the housing bubble slowly and in a carefully controlled way. "Maybe not too much," he warns. "You don't want to have a crash situation, but it should go down or they'll have a bigger problem down the line. It is better to correct it now."

In for a Long Landing

Strong signals have been coming from the government that it has learned a hard lesson from its 2008 borrowing binge. Premier Li Keqiang's speeches at the Summer Davos meeting and a Germany-China business forum in October shows that the government has come to grips with its slowing economy and understands that its previous investment and export-led growth model is not sustainable.

> Where there are lots of uncertainties, people don't invest
>
> Liu Jing
> Professor of Accounting and Finance, CKGSB

"This new leadership is very cautious. They acknowledge that the past stimulus has been excessive," CKGSB's Liu Jing says. "In 2008, the stimulus was rolled out under a panicky situation. That's why they're doing things very slowly," he says, referring to the targeted stimuli.

Premier Li emphasized the need to get used to China's "new normal". For 2014, the country would target 7.5% growth, but Liu says it will be difficult to reach. The Chinese real estate market plays a large role in the country's GDP, making up approximately 15% of it. According to a UBS calculation, every 10% drop in property investment is equivalent to a 2% drop in GDP growth.

Michael Pettis, Professor at Peking University's Guanghua Business School, explains on his personal website that it would be better if the government aims for a long (not hard) landing. This would involve controlled growth declining sharply but at reasonable rates like 3%, as opposed to few years of still impressive growth at 6-7% followed by a hard landing.

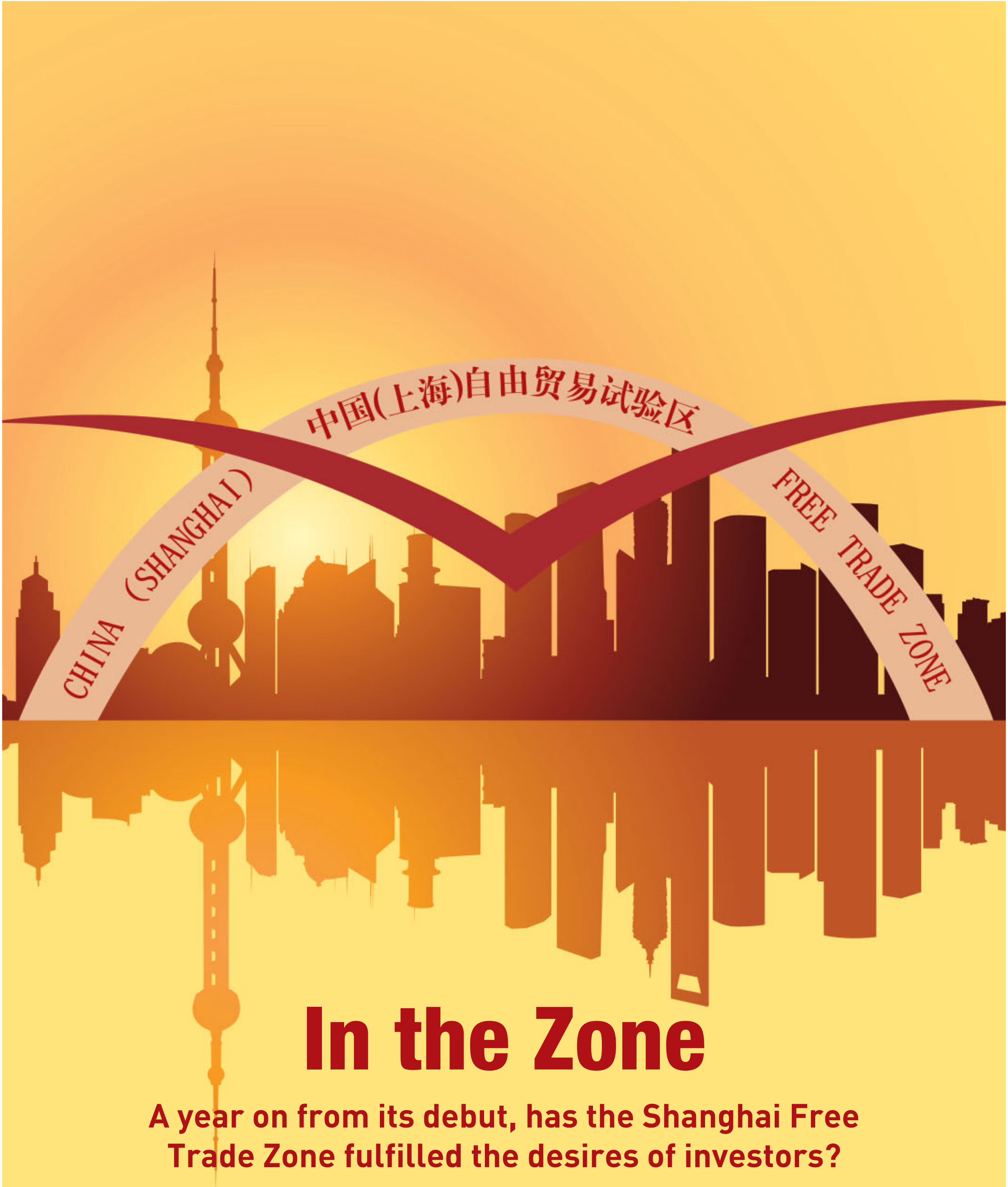
Falling investment growth in real estate would cause unemployment to surge, he wrote in September post, because of its connection to about 40 separate industries. That would affect household income and consumption growth, representing a challenge to an orderly adjustment.

"China's real estate sector is undergoing a major revamp," writes Phei Chen Chin, CEO of Sino-Singapore Guangzhou Knowledge City Investment and Development Co., in an email interview. "It will eventually lead to healthier development in the future with moderate but more sustainable growth in line with China's economic development."

Despite uncertainties, it appears the government will continue playing an influential role in controlling the state of the property market, at least for the time being, and in late October the government declared its support for the market, although details weren't forthcoming. Property owners can breathe a little bit easier knowing it is in the government's best interest to avoid a disastrous property collapse.

According to Chin, the growing pains currently being felt are a bitter medicine that has to be swallowed today in order to guarantee a healthier property market tomorrow. "It will allow the government to reduce direct interference in the real estate market, giving more room for market forces to determine real estate development," he says. "However, for the foreseeable future, the government's policy influence is still essential for maintenance of stability."

The present may be shaky as the government irons out the countless wrinkles accumulated from longtime overuse of housing as a storehouse for value, and it may have a tough time weaning China off its real estate addiction in the short term. However, there seems to be little doubt that so long as stability comes first the authorities will step in when needed to ensure health of the market—and the country.



In the Zone

A year on from its debut, has the Shanghai Free Trade Zone fulfilled the desires of investors?

By Hudson Lockett

The run-up to the launch of the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ) was a story of both supply and demand: lots of interest, little detail. By the new zone's debut date of September 29, 2013, excitement had reached fever pitch. Investors' anticipation could be felt, even quantified: the financial press reported that real estate prices near the zone had risen immensely, and that companies with Shanghai in their name had seen their stocks skyrocket by billions of dollars in the months between the zone's July approval by China's State Council and its debut.

A year on, reception has been mixed. "I think there certainly are people within the government that are disappointed in terms of what has happened with the zone to date," says Timothy Lamb, Managing Director of Sovereign China, a firm that aids international companies entering China. "I think Li Keqiang in particular expressed his disappointment at the lack of progress." After six months without much progress from the zone, President Xi Jinping publicly urged FTZ officials to make bold moves, according to a Xinhua report in March.

Despite those misgivings, since its launch the zone has actually been home to some legitimate success stories. Reforms there have removed the registered capital requirements for establishing a new company on the mainland, a move that proved so successful that it was expanded nationwide in March. The State Administration for Industry and Commerce credited that policy change for a boom in new company registration in the period from July to August, which saw 1.5 million new firms and branches open across the mainland.

But a long list of industries off-limits to foreign investors and slow going on promised relaxation of capital controls have dampened enthusiasm among both business interests and reform-minded officials. The recent dismissal of the FTZ's leader Dai Haibo raised questions about the direction of the zone. However, a ray of hope for the FTZ did come from China's President.

Addressing the party's leading group on overall reform in October, Xi said he wanted the lessons learned in the zone—"seeds" of economic reform—to spread throughout the country. "We should plant these seeds in more land so that flowers will blossom and fruits will be harvested as quickly as possible," Xi told the group's members.

Whatever sprouts will likely hew closer to Chinese officials' standards than those of offshore investors. Zhou Chunsheng, Professor of Finance at the Cheung Kong Graduate School of Business, says that while the zone should be better utilized to facilitate more international trade, he believes that it shouldn't be held to the standards established during the pre-launch hype, including assumptions about the list of forbidden industries. That itself constituted a real step forward from a model where everything was assumedly forbidden. "It's not surprising that the list is below the expectations of foreign companies," Zhou says. "But from China's perspective, it's good progress."

Great Expectations

Still, foreign investors were viewed as one of the key stakeholders in the zone, and the initial negative list of 190 items struck many businesses as absurdly large given its stated purpose of minimizing the areas where foreign investment was forbidden. The list covered practically all the areas foreign investors had long been eager to enter. The government trimmed the list to 139 items in July, but it remains a daunting barrier to further foreign investment.

In September a State Council circular revealed that more than 20 extra sectors would be opened up to overseas investors in the FTZ, although logistics-related revisions would have limited impact due to the zone's size. Still, foreign participation in the zone is still just a sliver of the total number of firms registered there: *Reuters* data shows that in June only 6% of firms were based outside of Greater China.

"People are placing their hopes on a new version of the negative list expected late this year or early next year," says Howhow Zhang, Head of Research at Z-ben Advisors. He says he has seen great demand for more deregulation from the investment side of the financial industry. "It will be interesting to see whether regulators will respond to those hopes."

At times, the zone did see greater openness than the rest of the mainland, only to see policy go national. A February notice told FTZ-based businesses they could create a two-way cash pool of RMB, and let individuals at these companies engage in cross-border trade settlement using the yuan. But those measures soon went nationwide after introduction to the zone. From one perspective these could be considered success stories, but they also raise questions about its necessity. A key promise to introduce a market-based interest rate mechanism in the FTZ also remains unfulfilled.

Zhang says that progress was made when China's central bank expanded an FTZ policy removing the cap on foreign currency deposit interest rates to greater Shanghai in June. "It's not impossible that banks registered in the FTZ will be given more authority when it comes to what kind of [RMB] deposit rate they can offer to their clients, using it as a trial platform" that can be later expanded, Zhang says. Based on the currency arbitrage that now occurs near the Hong Kong-mainland border, he adds, "I'm sure people will find a way to arbitrage from this discrepancy."

Whatever progress the FTZ made early on was not enough to keep its erstwhile leader, Dai Haibo, above water. His dismissal came just before Li Keqiang's visit to mark the FTZ's anniversary. Dai was supposed to bring to bear his technocratic expertise and the ability to attract foreign investment—instead his tenure was dominated by slow progress and widespread investor ennui.

Zhang suggests that slow progress for investment-related business might be exactly what local government regulators wanted. This lack of ground-breaking reform in the zone may indeed be connected to its distance from pro-reform figures in the central government. Han Zheng, Shanghai's party boss, told business magazine *Caixin* after the FTZ's launch that the negative list at the time was "the 2013 version… Then we will have the 2014, 2015 and 2016 versions". This sounded less like Li and Xi's pledges and more like the default attitude of Chinese officials: slow and steady.

Whatever caused Dai's ouster, it could eventually prove helpful in inculcating an environment more receptive to change—a rarity these days amid an anti-corruption campaign in which officials keep their heads down in all respects, and a macroeconomic environment that would challenge even the steeliest of wills bent on reform.

Measures of Success

The FTZ's anniversary also marked another turning point. Li-Gang Liu and Hao Zhou, the Chief Economist for Greater China and China Economist at ANZ respectively, wrote that the last-minute launch of an international gold trading board by the Shanghai Gold Exchange, the biggest bullion bourse in the world, was "a milestone initiative of China's ambition to push forward RMB internationalization".

Zhou tells *CKGSB Knowledge* that while there hadn't been significant progress on liberalization beyond this yet, "I think going forward we can expect more from the FTZ for the RMB's internationalization." That has been restricted between the FTZ and offshore market for early on, he and Liu wrote, reflecting China's caution toward capital account openness. Officials also plan to open up eight international platforms to trade commodities—oil, gas, iron ore, cotton, liquid chemicals, silver, bulk commodities and non-ferrous metals—by 2015, *Xinhua* said in an August report.

Xinhua also claimed that the number of businesses operating in the zone over the past year has grown from 8,000 to 20,000. Hao Zhou suggested this likely had multiple causes: first, the initial rush to the zone helped create a cluster effect. Second, registration and administration systems there are much more relaxed than in the rest of the mainland, so the barriers to entry remain low even after other reforms went nationwide. Third, it's now easier to find professional talent in the zone.

Shanghai's logistics sector has gotten a boost as well. An October 2013 report from real estate firm CBRE found nearly 90% of the enterprises in the FTZ were related to trade and logistics, with a total of 780,000 square meters of high-quality warehouse space in operation. While vacancy rates then stood at around 20%, CBRE expected the zone to add another 210,000 square meters of warehouse space by 2015. A key benefit of the zone cited by the company was the ability to ship goods there before going through customs, reducing processing time and lowering costs.

Lamb at Sovereign China says other industries that could benefit from the zone include hospitals, which the government has opened up to foreign ownership, and entertainment, another sector available within the zone. While Lamb says that the industries that opened up by cuts to the negative list might not be earth-shattering, he also questioned the emphasis many have placed on foreign investment as the yardstick of the FTZ's success.

"This is not intended specifically to draw foreign investment. It's essentially a laboratory for the government to try out different reforms," Lamb says. "And so it's really a mistake of seeing this as something that's focused on foreign investment." A better view on the zone, he adds, was as a way for authorities to tinker with specific policies many view as central to reform—like floating interest rates.

Other Roads to Reform

Economic reform in China tends toward the gradual, making it too early to write off the FTZ just yet. Its national prominence shouldn't be overlooked either, with many provinces and cities exploring the idea of opening similar zones, and the examples of policies that have spread across the nation following a trial period in the zone show that the FTZ is playing a role in the thinking of officials across the country.

But that also raises the question of the zone's actual purpose. The precedent of the Qianhai special economic zone remains instructive: officials positioned it as a potential global financial hub that would push forward the yuan's internationalization, but it ultimately became isolated thanks to tight regulation. Those measures were born from a fear of arbitrage destabilizing the financial system. Today, as in Qianhai, reforms that take place within Shanghai's own zone can't spread to the rest of the country if they stay similarly confined—yet in the areas that are key to the next stage in China's financial reforms, it seems some officials are wary of them doing just that.

Economic experiments do not fail or succeed based on immediate results, but they do require a clear purpose and strong leadership. Even Shenzhen's Special—and ostensibly export-oriented—Economic Zone, saw an alarming spike in imports following its launch, but ultimately succeeded because of continued support from Deng Xiaoping. Recent supportive remarks from Xi and Li bode well for the Shanghai FTZ's future, but its biggest reform was a year in the making, and came only with a visit from China's premier. If every such success requires a visit from the top leadership, they may look elsewhere for a champion, as they arguably have with Qianhai.

FTZ Report Card

Experts give their verdict on the FTZ

Source: Experts polled by CKGSB Knowledge

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No Purchase Necessary

The sharing economy has been threatening traditional industries in the West. Now it's gaining a foothold in China.

By Colin Shek

In between mouthfuls of street-side noodles on a breezy October afternoon in Shanghai, Joyce Chen is explaining the conveniences of Uber when her smartphone blinks awake with a message. The marketing consultant, who has become a devotee of the online car sharing service since its debut in China in February, checks her phone, which tells her: "Your Uber has arrived!"

On cue, a sleek, black Audi sedan pulls up. Joyce stands up—her face creasing into an apologetic smile—and with a quick wave goodbye to her companion, slips into the waiting car.

You may not know it, but the expensive-looking car that whisked her away is part of a trend that is upending industries and livelihoods across the globe—and which may have an even more profound impact in China. It's called "the sharing economy".

The Sharing Revolution

From food to rooms to cars, people are increasingly sharing or renting out what they are not using. Tapping into growing participation in this pool of shared resources, companies have sprung up to serve as technology platforms for people or firms looking to give access to their possessions and make use of any spare capacity. San Francisco-based Uber, for instance, uses its own smartphone application to connect passengers with drivers of high-end vehicles—including supercars like Ferraris and Porsches—for hire.

At least some investors are clearly convinced the sharing economy is for real. In November, the *Wall Street Journal* reported the company plans to raise $1 billion in funding, five months after it raised $1.2 billion, at a valuation expected to be in excess of $30 billion.

"The sharing economy is an economic concept founded on the idea that different people can share their resources. The resource can be shared time, shared vehicles, shared housing, shared hobbies, anything," says Fanny Cao, Principal with strategy consultants Roland Berger, who co-authored a recent study on car-sharing in China. "It's kind of peer-to-peer, an economy that connects between different people."

Herman Zhou—founder and Chief Executive of Yongche, a company with a business model similar to Uber's and present in 73 mainland Chinese cities—says the sharing economy is the evolution of a business model that melds online and offline services, or O2O for short.

"O2O 1.0 is an online-to-offline presale business pattern, such as group purchases, public accounts on WeChat… O2O 2.0 is a sharing business model to promote the concepts of innovation, sharing, rental and so on," says Zhou. "And Yongche's concept of Mobility on Demand (MOD) represents the era of O2O 3.0. MOD is the trend of individuals being liberated from organizations gradually and to provide personalized service freely. To consumers, MOD can better satisfy their demands in real time."

Baby, You Can Drive My Car

A comparison of two of the top car sharing rivals in China

	Yongche	Uber
Founded	August 2010	2009 (entered China in 2013)
Availability	73 mainland Chinese cities + New York, San Francisco, Los Angeles, London, Moscow, Hong Kong and Taipei	6 mainland Chinese cities + Hong Kong, the Americas, Europe, Asia-Pacific, Africa and the Middle East
Investors	ZhenFund, Morningside Ventures, Qualcomm Ventures, CDC Capital, Ctrip, DCM	500 Startups, Menlo Ventures, Google Ventures, Kleiner Perkins Caufield & Byers, Summit Partners, BlackRock, Wellington Management, Fidelity Investments, Benchmark, First Round, TPG Growth, Innovation Endeavours, Lowercase Capital, Summit Action Fund
Users	2 million registered	437,000 active weekly*
No. of cars	50,000	N/A

Source: The companies, Valleywag (for Uber users only)

*based on a 4-week span Oct/Nov 2013

Uber only entered the Shanghai market this year, but other well-known services staked a presence in the Chinese market much earlier without even really being here in a traditional sense. Airbnb has property listings across China—including lodgings in second- and third-tier cities, such as Wuhan and Xi'an—for short-term holiday or business rentals, but still does not have an office in the country.

Ming Nu Tan is a planner in Shanghai with global advertising agency Havas Worldwide, which published a white paper this year on consumerism in the sharing economy era. She says peer-to-peer sharing is centered on 'collaborative consumption', which mainly comes in three forms.

"The first one is product service systems, which is about utilizing goods and services without actually owning them," she says. The second is recycling or reselling goods no longer needed, now known under the new rubric of the 'redistribution market'. The main destination for hosting these transactions is Alibaba's Taobao platform. Thirdly, there is the collaborative lifestyle, where users discover each other through mutual interests.

Tan points to people who were willing to queue for hours to purchase a new iPhone on behalf of someone else, in exchange for money, as an example. "That's the collaborative lifestyle. It wasn't really business, more like a personal thing. They exchanged less tangible assets—their time, their space, their skills, and so on," says Tan.

The sharing economy has grown rapidly in Western countries such as the US and the UK, and has also established firm footholds in Asian countries including Singapore and South Korea—whose capital, Seoul, in 2012 declared itself to be a "sharing city". But the concept is still largely foreign to China. Roland Berger's car-sharing study found low awareness among Chinese consumers. More than three-quarters of 160 people surveyed in 2012 by the consultancy expressed interest but only 11% had heard of the idea.

Only in 2014 did Chinese sharing economy firms start to gain traction as they style themselves after well-established Western counterparts. The closest homegrown competitor to Airbnb is Beijing-based start-up Tujia, which was founded in 2011 by two former tech executives and raised $100 million in 2014. Also in the short-term rental space are Mayi and Xiaozhu, which both have big-time venture capitalist backers.

In ridesharing, meanwhile, Yongche is gaining more attention. With more than 2 million users and more than 50,000 cars in China, it has started looking overseas with expansion in New York, San Francisco, Los Angeles, London, Moscow and Taipei. Then there are other companies that riff off existing models, such as Atzuche, a popular car-sharing service that allows people to rent out their luxury vehicles, while Kuaidi Dache, a popular taxi booking app, launched a service in July called Yi Hao Zhuan Che that works in a similar way to Uber.

Even if it's early days, Zhou from Yongche predicts car- and ride-sharing will have a broader market in China than in the US. "There's a big developmental gap between different cities in China. From a first-tier city to a fifth-tier city, the differences can be seen in city infrastructure construction, transportation and so on. Such differences have created a basis for car-sharing demand."

These peer-to-peer services are increasingly seen as a 'disruptor' to traditional businesses of providing accommodation, transport and more, threatening firms from the Hilton hotel chain to taxi companies.

> "Differences… in city infrastructure … have created a basis for car-sharing demand
>
> Herman Zhou
> CEO
> Yongche

As the firms have grown, they have made their fair share of enemies. Uber, for one, has sparked riots in France, with disgruntled cab drivers fearful for their livelihood. Airbnb, meanwhile, has run afoul of hoteliers and local governments in many places who fear the loss of occupancy taxes collected from regular hotels.

Traditional companies need to adapt or face becoming obsolete, says Uber's Shanghai General Manager Davis Wang. "If they don't, Uber or someone else is going to change the industry. You have to evolve… otherwise you are out."

China, where the regulatory landscape can often be onerous, threatens to throw up many of the same roadblocks plus various cultural hurdles. Chinese sharing economy companies therefore risk a government backlash as they come up against mainstream companies.

Care to Share?

Such businesses will need to refine their offerings to hold their own as they challenge the status quo. Uber, for instance, has tweaked its ridesharing business model to stay on the right side of China's law. In other countries, it enables private drivers to hire out their cars, but in China Uber has had to lease cars from local car rental companies that provide vehicles approved and registered with the government regulator.

"In China, the regulations do not allow private car owners to provide this kind of service to end-users," says Cao. Even then, some habits die hard—users still find that sometimes Uber and similar services skirt regulations by using un-approved private cars, putting themselves at legal risk.

Tan speaks of one Uber ride where it turned out the driver owned the Audi A4 chauffeuring her. The driver was a daytime trader who would finish work at 6pm and then pull an Uber shift from 7pm to midnight. "He said it's an easy way to make money during his free time. He thought it was fun and he gets to meet new people," says Tan.

Wang argues Uber is merely a technology platform that connects drivers and riders. The company has signed contracts only with car rental companies. "We don't pay money to the drivers. We just pay to the rental company to make sure the car is properly insured. They need to figure that out on their side," says Wang. Regulators, however, may prove un-swayed by such buck-passing.

Uber's low brand awareness in China has also prompted the company to use a different approach in the market. It initially struggled to convince local users of its merits, and instead sought to capitalize on foreign users in China who had used the service back home, leveraging word of mouth on social networks and the widespread perception in China that foreigners, in certain contexts, are cool.

Uber's first city in China was Shanghai, and for the first few months after it launched in February 2014, expatriates represented 90% of the user base. They now make up less than 30-40%.

Domestic firms are also localizing business models originally honed in Western tastes. Car-sharing service Atzuche is tapping into insatiable Chinese demand for luxury by connecting people who want to drive a luxury car but cannot afford to buy one, with owners looking to turn a profit on their idle vehicles. The value-for-money luxury motivation in China contrasts with other markets, where environmental concerns over resource scarcity are partly behind car-sharing adoption.

Sharing economy services in China have so far been dominated by vehicles and homes. "China is a very interesting car-sharing market. Different companies are copying business concepts from the US and Europe," says Cao. Development has so far been slow, but cost and convenience partly explains why even some older people are becoming fans of peer-to-peer services. They embrace sharing and shun ownership because "they want a quality life and a quality lifestyle without paying the full price", according to Tan.

Sharing is the New Buying

Money also motivates millennials—typically defined as people born between 1980 and 1995. For proof, quickly glance at the displays of conspicuous consumption on social media. But different forces drive young Chinese adults, who are seen as pivotal to the success of peer-to-peer sharing. In China, these young adults are often dubbed 'Generation C'.

"Generation C is generation content," explains Havas Worldwide's Ming Nu Tan. "Generation C in China is very entrenched because it comes down to creation, curation, connections, and a sense of community. It's not restricted to age, it's just that they're more of the 'digital native'. Their lives are based online, day-to-day."

And while their parents may have savored the joy of owning their first car or apartment, Chinese youth are less wedded to the idea of ownership and at some level are willing to consider sharing resources rather than owning them. "Ownership leads to responsibilities and maybe in the sharing economy, there's an aspect of refusing to grow up," says Tan.

That is backed up by Roland Berger's study. Cao says that in first-tier cites such as Beijing and Shanghai, the 25-35 age group are most interested in car-sharing. "These people are normally white collar workers and they are very open to new concepts."

The group can be broken down further into three segments—budget-focused "smart shoppers" looking for cost-saving options, those seeking efficiency and convenience, and trendy types who own a nice car and want to try another one.

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> The government needs to be more open to the sharing economy… it's good for society
>
> Fanny Cao
> Principal
> Roland Berger

Car-sharing makes sense on a practical and economic level for at least the first two groups. Millions of Chinese have a driver's license but do not own a vehicle often due to the prohibitive cost of number plates, expensive car parking fees, traffic jams and inexpensive taxis. Personal car ownership remains a status symbol, but the cost of buying, insuring and maintaining a vehicle has also put many people off that aspiration.

"The need for having a private car is becoming more urgent," says Zhou. "However, almost all mid-to-large cities have taken traffic control methods to control the number of cars, and the supply of them cannot meet demand. In such an imbalanced environment, an increasing number of people have already changed from the traditional ownership concept and have started to accept the new concept of sharing."

Mobile technology and the internet are cornerstones of the lives of China's younger generation. Enabled by them, Chinese youth experience a participatory, collaborative culture from the get-go—making them more mindful of online- or mobile-based services and interactions. As a result, new concepts such as the sharing economy have a receptive audience among young Chinese, but are also actively spread.

Most sharing-economy watchers agree mobile technology underpins the sharing economy. Smartphones, with their application ecosystems mean that people, services and infrastructure are now increasingly connected, with real-time data available on demand through their phone.

"I think it's been the driving force," says Tan. "It's a major part of Generation C's lives. It gives them a sense of belonging. They can go for days not speaking to someone on the phone, but always have it with them, constantly updating how they feel or what they see or what they do."

Values such as sustainability and conservation transcend generational identities, and are forcing a rethink in consumer attitudes—especially in China, where there is a growing acknowledgement that overconsumption is unsustainable.

The trade-off from rapid economic growth has been significant environmental degradation across the board. "At the beginning, it was just being driven by monetary aspects. But I think because of the pollution, all that is changing their perspective a little," says Tan.

Contemporary China's hyper-competitiveness, stretching from the classroom to the workplace, is also at work. Success-obsessed young professionals are under pressure, as the chances of elevation into the middle class recede, while white-collar workers wrestling with time and money problems have rising expectations of comfort. Sharing-economy services help to fulfill those needs, providing this generation with the means to survive, flourish and enjoy life within their budget constraints.

Shifting consumer habits have also seen the Chinese become more appreciative of quality over quantity. Until fairly recently, possessions and the accumulation of them

Generation Share

Typical users in China's sharing economy

Age: 25-45 years old

Economic class: primarily white-collar, cost-sensitive, smart shoppers, efficiency/ comfort seekers

Location: typically employed in central business districts, reside in city center

Household monthly income: RMB 15,000-24,000

Other: own a smartphone, have a credit card or Alipay account

Source: Roland Berger, Uber, Havas Worldwide

assumed a central place in a person's life as evidence of high spending power and therefore status. Now, less is more. The gradual rise of a more savvy and individualistic Chinese, striving for autonomy and armed with the internet, has seen them become more informed. They are smarter consumers, and that often leads them to sharing-economy companies.

Trust Issues

Plugged-in millennials may be willing to participate in the sharing economy, but services in the space will also need to overcome cultural barriers if they wish to become mainstream. Signing up homeowners to take in strangers or to share their car with someone who may or may not take care of it is a tough sell anywhere. It is doubly difficult in China, with its crisis of trust at all levels.

"I think it has to be trust," says Tan, when asked about the biggest barrier to greater uptake. But at the same time, peer-to-peer players can draw heart from how e-commerce in China overcame trust barriers to notch up sales of RMB 1.3 trillion in 2012.

The biggest snag holding back e-commerce for years was a lack of trust. Consumers worried—quite fairly—that online firms were fraudsters, or that their credit cards would be abused, or that purchases would get swapped for counterfeits during shipment. This was overcome by credit and reputation systems—Alibaba, for instance, created Alipay, an online arrangement that effectively worked as an escrow system.

Fanny Cao from Roland Berger believes similar mechanisms must be implemented to put sharing-economy users at ease, such as displaying feedback on all registered members of a service—something already central to the Airbnb experience. And when it comes to sharing assets like homes and vehicles, a system would be needed that could prevent abuses, while at the same time effectively prove who the abuser was and then enforce punishments against that user.

"If we establish this kind of system for everybody, it would be an improvement at least," she says. But even so, she predicts some teething problems for the next few years, as both users and companies grope their way to a satisfactory equilibrium.

"Everyone felt e-commerce would not cross into China because people wouldn't really trust the quality of items from the internet. But now China is the biggest e-commerce economy. It's the same thing with the sharing economy. Chinese people very quickly adapt to new and different business models."

Zhou's biggest concern is how regulators will respond to the growth of the sharing economy. "To me, the biggest challenge is how to guide interested parties in this industry to have a clearer understanding of the industry reform trend and the value of such reforms to policymakers, industry competitors and the public. We are trying to show to the public the blueprint for a better world through our actions."

The regulatory environment will need to be eased to achieve that goal. Policies—such as the ban on hailing private cars in the ridesharing space, albeit on safety grounds—choke off a large base of people willing to provide services. But given that take-up and understanding of the sharing economy model remains in its early stages, it is unsurprising that government agencies have not yet updated or implemented corresponding regulatory policies.

"The government needs to be more open to the sharing economy," says Cao. "Of course, there are some certain boundaries that you need to set. But you need to leave room for the sharing economy because it's good for society. It's good for people, and the government is not working for companies, it's working for people."

Nevertheless, Cao says it would also augur well for companies to adopt a strategy of starting the conversation and initiating discussion around a best-practice model for regulation—rather than wait until potential disruption to traditional businesses panics officials into action.

Then, peer-to-peer businesses will need to see if they ultimately make sense in China. Taxis are already generally prevalent enough in urban areas and also cheap.

Some are sure to win. Tan believes that an emerging participatory culture and looming resource limitations will over time see peer-to-peer sharing become a driving force for a new breed of industry. Cao is also optimistic and predicts China will eventually have its homegrown giants to rival the likes of Airbnb and Uber.

"If we look out to five years' time, I can imagine that some of the companies will have grown to a similar size of Uber," he says. "If the regulatory framework could be changed or adapted, these companies will expand in a very popular way."

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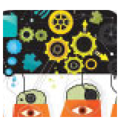

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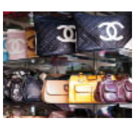

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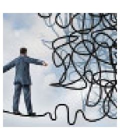

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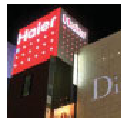

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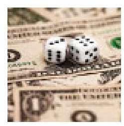

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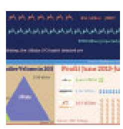

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The Davids vs. Goliath

With its huge scale and steps toward global dominance, can anyone rival Alibaba in China?

By Sarah O'Meara

When Alibaba made its initial public offering (IPO) in September this year, the results were staggering, with its IPO raising $25 billion—making it the world's biggest. While that may have stunned many around the world, leading them to scramble to understand this company they'd never heard of, for those in China who were familiar with Alibaba, this outcome hardly came as a surprise.

After all—in just 15 years—the internet giant started in 1999 by former English teacher and now Executive Chairman, Jack Ma, has transformed a disconnected nation of inefficient, small businesses into a streamlined, online retail marketplace with global reach, yielding a strong grip on China—Alibaba now controls more than 80% of China's lucrative e-commerce market. Underpinning that are its wide range of services that include everything from its business-to-business (B2B) sales portal Alibaba, to the business-to-consumer (B2C) and consumer-to-consumer (C2C) retail platforms Taobao and Tmall, to its payment system Alipay, which is used for half of all online transactions in China.

The company also runs Alibaba Cloud Computing, which has 980,000 customers, and a finance arm that controls Zhao Cai Bao, a lending platform for small businesses and individuals that has already created a RMB 14 billion marketplace. In addition to these are a range of affiliated businesses that help the core business, such as Alimama, an online marketing technology platform for sellers on Alibaba's marketplaces, and China Smart Logistics, a logistics information platform.

But Alibaba's online dominance has raised questions of who or what could ever effectively challenge it.

Earlier this year we got a hint of what might be to come when Wanda, Tencent, and Baidu announced a plan to invest RMB 5 billion in an online-to-offline (O2O) e-commerce company over the next three years with the intention to change the course of where shoppers spend their money in the future.

By banding together, they hope to imitate the vertical integration of Alibaba that allows CEO Ma and his team to offer customers a wrap-around online retail service, from product to payment, an approach that has been extremely successful.

So will such ventures and others succeed in troubling their main rival?

In Control

Historically, Alibaba has been adept at keeping revenue fenced off from competitors while keeping its customers happy.

In part, that was because of their ability to allay the concerns of consumers—Chinese customers are notoriously suspicious of the quality of goods you can buy online. To get around this, Ma set up Alipay—an escrow payment service that delays monies being exchanged until buyers are satisfied with the goods, with the added bonus for Alibaba that users need to sign up to Alipay before they can shop on Taobao.

Its ability to get ahead early on in the market has allowed the company to embed its various services in the minds of consumers, such that for many the alternatives are rarely a consideration.

"Definitely Taobao [is my preferred online shopping platform]," says Jessie Sun, an artist in Shanghai. "It's really convenient, safe and fast. They have almost everything that I need and I trust their service. I have been using it for about five to six years so I know how to get things on Taobao pretty well."

She adds: "I like some other online shopping sites too, but they are way smaller. I have never really bothered to learn and trust too many of those."

Likewise, for many business owners Taobao is central to what they do and a key component to their success. A spokesperson for Alibaba Group notes: "We have seen a number of brands that were built entirely online, through Taobao Marketplace or Tmall.com, our China retail platforms."

Zhu Chenyun is a tea shop company owner in Shanghai who operates an online shop on Taobao selling fruit jams. She says it has transformed her business. "I have been running two tea shops for over three years and started my handmade jam business on Taobao about two years ago."

With more than 200 loyal customers who come to her Taobao shop each month, the 26-year-old can support her offline tea shops and cover new product development costs: "I plan to build a bigger jam studio in Shanghai."

Alibaba's enabling of small businesses has led to the rise of so-called "Taobao Villages"—clusters of rural online entrepreneurs who have opened shops on Taobao Marketplace—and as of November, 2013, there were approximately 20 of them in China, according to AliResearch. A Taobao Village generally refers to rural areas where at least 10% of the households are independently involved in e-commerce on Taobao Marketplace and generating a total gross merchandise volume of more than RMB 10 million.

Ever Upwards

China is now the world's largest digital retail market. E-commerce shoppers spent $1.3 trillion online in 2012, a figure that is expected to grow to $3.3 trillion by 2015, according to the 2013 report 'China's E-commerce Prize' by management consultants Bain & Company.

While e-commerce might still contribute just a fraction of total retail sales in China, it plays an increasingly important role in driving overall domestic consumption. Offline retail development is lagging behind online growth. In 2013, online channels stayed strong, despite a slowdown in overall retail sales. E-commerce now accounts for 5% of all retail sales, with total online sales growing between 60-80% each year.

In 2014, Chinese and global consumers spent RMB 57.1 billion ($9.3 billion) in just 24 hours during the "11.11", or Singles Day, Shopping Festival on Alibaba's websites, smashing the previous year's record of RMB 35 billion ($5.7 billion). The 2013 record had equaled half of all China online and offline retail sales in September.

Further signs of the growth in the market can be seen in the proportion of GDP that e-commerce accounts for. In the first half of 2014, it was already 4.56% of China's GDP. While in 2013, the proportion of online retail sales made up 3.47% of GDP for the whole year, according to figures from Analysys International.

That growth has seen China reach a major milestone. According to Bain & Company, in 2014 the Chinese e-commerce market surpassed the US to become the biggest in the world, a trend driven by Alibaba's 300 million users—equivalent to the entire population of the US.

For all that rapid growth, there's still scope for it to continue even further. In 2013, only 48.9% of China's internet users were online shoppers, compared with 74.2% of the US, 77.6% of the UK, and 79.5% of Germany, according to the China Internet Network Information Centre. Also, just 45.8% of the Chinese population are internet users, compared with 83.2% of the US, 88.9% of the UK, and 86.1% of Germany.

This development means people are now using online retail for everything from getting their car serviced to designing furniture for their home. And Alibaba is currently the main beneficiary of such changing spending habits. At the end of 2013, the company's reported revenue was $3.06 billion, up 66% from a year earlier, with a net profit of $1.36 billion—up 110% year-on-year. And in the 12 months ending June 30, 2014, Alibaba's retail marketplaces (Taobao Marketplace, Tmall.com and Juhuasuan) had 279 million active buyers in total.

That paints a rosy picture for Alibaba, but the size of the market now means that the company's competitors are trying harder than ever to alter the situation. While the company's lead is undeniable, rivals are homing in on areas of potential where Jack Ma has little foothold, and may even be at a distinct disadvantage.

New Challengers

Real estate company Wanda, social networking and gaming company Tencent, and search engine company Baidu recently announced plans for a joint e-commerce platform focusing on O2O sales. Their hope is that Chinese customers will choose to browse online, and shop offline. In a press statement, Wanda's Chairman, Wang Jianlin, said he believes O2O is the "biggest pie in e-commerce," and added: "The pie has not been cut yet."

Meanwhile, mobile text and voice messaging service WeChat (owned by Tencent) is moving further into e-commerce and making a direct play to take some of Alibaba's market share. Tencent's latest app, Weidian (meaning mini-store), allows users to sell items over WeChat, a development which could have far-reaching advantages for existing e-commerce users. The company has also augmented the platform's e-commerce offerings by forming an alliance with JD.com (also known as Jingdong), Alibaba's chief rival online retailer. The deal will create an exclusive shopping channel for JD.com on WeChat.

These moves mean that WeChat is quickly evolving into something that could potentially disrupt the monolithic Alibaba marketplace model that is the current standard. The company's new Weidian store offers many enticing features for online retailers. These include the facility to receive payments from customers from a range of banks (not just Alipay or Tencent), to move your store from Taobao, and a commission payment for WeChat friends when they recommend a product to their contacts.

"If you look seriously at Weidian, [it's] actually Taobao but on social media," says a principal from one of the world's largest consultancies and a specialist in Chinese e-commerce—she is not authorized to speak publicly about specific companies.

"But there is a difference. They're tending toward the micro-purchases, not high-value," she says. "Weidian actually helps small enterprises and consumers. [They] will help you track your logistics, they help you with your payments tools, they help you if you link to a logistics company and things like that."

The principal points out that social media has become "inherent" to Chinese life. "Buying things on social media is much more convenient and smoother than having to go to Taobao or Tmall. Personally I think that will be a new trend we will see very soon," she adds. "Social media is very strong in China, much stronger than just the buying and selling of things."

Alibaba's investments in social media have so been far less successful than its retail ventures, making this a particularly vulnerable area for the company. Last year, it launched chat app Laiwang (after banning Alibaba sellers from using WeChat) and has also invested in Sina's Weibo—China's Twitter and a Tencent rival. But Laiwang has 10 million users in comparison to WeChat's 350 million monthly active users and excitement around Sina Weibo has died down ever since a crackdown on the platform's content.

As mobile internet already exceeds PC use among the Chinese, Tencent's move into mobile e-commerce signals perhaps the most direct challenge to Alibaba's grip on power yet. And the addition of shopping channel JD.com to its platform is also central to this challenge as it establishes an en-

Many Contenders, One Clear Leader

The size of China's B2C market (RMB) and companies' market share

2011		2012		2013		H1 2014	
801.9 billion		1,320.5 billion		1,885.1 billion		1,085.6 billion	
Tmall	51%	Tmall	52.1%	Tmall	50.1%	Tmall	57.4%
Jingdong	18.5%	Jingdong	22.8%	Jingdong	22.4%	Jingdong	21.1%
Suning	3.3%	Suning	3.6%	Suning	4.9%	Xiaomi	6.5%
Amazon China	2.9%	Tencent	3.3%	Tencent	3.1%	Gome	3.0%
Vancl	2.3%	Vancl	2.7%	Amazon China	2.7%	Vipshop	2.9%

Source: China E-business Research Center viable range of services in one ecosystem.

"Some of the people [in the different groups I work with] feel that actually Jingdong is a viable competitor. Because Jingdong (JD.com) has the social media back up of Tencent," says the principal. "If I was Taobao, would I be afraid of Jingdong? Now that Jingdong has access to the users, I think yes, it's a trap," she says.

Teng Bingsheng, Associate Professor of Strategic Management at Cheung Kong Graduate School of Business, thinks that Jack Ma is aware of the danger.

"Alibaba has a lot of money and with that money Jack Ma's going to buy even more companies. Anything that's related to e-commerce," he explains. "He even bought a soccer team in China, and many people questioned the logic. But I think it's related to social media, which is a stronghold for Tencent. Jack will cast a wide net."

But for all that, Alibaba has one big strength: plenty of cash. With his pot of post-IPO money, Ma is now in a position to go on a buying spree and capture the rest of that market for Alibaba through strategic acquisitions and product development.

"Part of Alibaba Group's focus is on building upon our strength in mobile commerce to develop a broader spectrum of consumer offerings, including—but not limited to—location-based services and O2O services, in order to fulfill our vision of becoming central to the everyday lives of our customers," explains a spokesperson for Alibaba Group.

The company's $692 million investment in March in Chinese department store operator Intime Retail Group signaled a strong desire to take early control of the market, and this was followed up in July by the establishment of a joint venture between the two companies to develop an O2O business in China. And in October, Alibaba also announced the launch of ePass, a payment method Chinese consumers can use to shop on US retail sites.

It's not the only sign that Ma has his eye on opportunities beyond China's shores—in the past year, his shopping abroad has seen him make investments in Tango, a messaging app, and video game start-up Kabam of $215 million and $120 million, respectively.

"

For O2O, you will also need brands and traditional offline retailers to come to your platform. You can't do it alone

Weiwen Han
Partner
Bain & Company

The E-commerce Frontier

CKGSB's Teng believes that the Chinese consumer will lead e-commerce innovations, as their tastes become more sophisticated. And this has already started happening in the travel market. While the Chinese customers used to favor group bookings, the younger generation wants to travel independently, or with their family.

"The traditional offline travel agencies can do group bookings only, rather than individualized trips. So these companies are available online to help people design their own itineraries," he says. "It's these kinds of personalized, high-quality customer services that will grow."

June Lin (a pseudonym) is a partner in a Shanghai-based translation company, with a revenue of $52,400 each month. Changing needs of the middle-class consumer have dictated where she concentrates her energies.

"Online shopping is a trend. Almost everyone shops online, so you have to have an online presence. And I have to let customers buy using the most convenient app, which is WeChat, or they will go somewhere else."

For her, the messaging app has been an invaluable tool for building infrastructure, marketing and customer relationship management—precisely because her users feel comfortable and engaged with the tool already. She says the company uses it to maintain business connections and for promotional purposes by sharing advertisements and highlighting the company's recent activities and achievements.

Such social media-based entrepreneurialism happening outside of Alibaba's universe represents a real threat to the industry giant. Yet it's not just Alibaba that needs to be vigilant. The needs of consumers are changing rapidly and could catch out any of the market leaders, particularly as there is still much in store for this already lively sector. At present, the main players in the sector are fighting it out for the future of the market. But their relative success will also rely on winning over traditional retail to join their carefully formed strategic alliances.

"Neither Alibaba nor Tencent are retailers. They're online 'real-estate' players. So they set up an online marketplace that other people use to do business," explains Weiwen Han, a Partner at Bain & Co. Shanghai. "For O2O, you will also need brands and traditional offline retailers to come to your platform, and that requires a pretty big transformation. You can't do it alone, you need to build an ecosystem."

The principal agrees, saying that, given Alibaba's dominance of payments and various forms of e-commerce, "[for] any one company I think it's going to be fairly difficult". But that doesn't mean the challenge is insurmountable. "I think the company that will succeed is the company that will give the consumer the best user experience, or customer experience," she says.

With the battle to offer the Chinese public the richest and most convenient retail experience set to intensify, consumers look likely to benefit regardless of whether Alibaba keeps its treasure.

China + 1
Does it Add Up?

As China changes, manufacturers are being forced to weigh other options

By Chris Russell

Since opening up to the world in the late 1970s, China has transformed itself into the world's leading manufacturer, a veritable global workshop. But 'made in China' isn't always what you see on labels anymore. Instead, other Asian countries are increasingly fighting to be the makers of the world's consumer goods, and this shift reflects broader changes in China that have significant implications for its role in the global economy.

This is the world of 'China Plus One' in which manufacturing capacity is not necessarily moved, but diversified beyond China, usually to countries in Southeast Asia. The idea had been discussed and inconsistently implemented by manufacturers for years, but China has now reached a point where, for many business leaders, diversification is no longer just something to conjecture about over dinner. Instead, 'China Plus One' has moved to the top of the list of strategies, with Intel, Samsung, Nike, Foxconn and a range of Japanese companies including Canon all having pursued the idea to various extents.

"A 'China Plus One', or 'China Plus Two' strategy is definitely an essential component of any large brand-buying operation due to rising labour costs and shortages in China," said Judith Mackay, Asia Apparel and License Compliance Manager at New Balance, when commenting on the idea to *Bloomberg*.

A Changing China

This trend is being driven by many factors, but the main reason is higher labor costs, with wages having risen significantly in the past few years, particularly in the coastal regions that have long served as China's manufacturing hubs. A Standard Chartered report based on a survey of non-mainland manufacturers operating in the Pearl River Delta predicted wages in the region would rise 9.2% in 2014, having increased 8.4% in 2013.

Underlying the increasing labor costs are two factors—changes in population and shifts in government strategies.

China is getting older—the workers that have powered its economic growth are nearing retirement age, and the so-called one child policy means that they won't all be replaced. In 2013, the working age population decreased by 2.4 million according to China's National Bureau of Statistics, the second year in a row that the total workforce declined. As workers become scarcer, those left are in a position to ask for more.

The other factor underlying rising labor costs is the government's desire to shift China towards a consumption-oriented economy. Wages in many regions are constantly nudged higher by local governments increasing the minimum wage.

Financial pressures aren't just limited to wages—higher real estate and compliance costs have also played a role.

But beyond a desire to keep costs down, the 'China Plus One' strategies of manufacturing companies are increasingly being driven by other factors, particularly risk diversification and the awareness that there are other markets to address beyond China.

"Companies are much more conscious about trying to have robust supply chains in which you can continue production even if your principal site of business is facing some difficulties," says Peter Petri, the Carl Shapiro Professor of International Finance at Brandeis University. "You want to have a geographically diverse supply base, you want to have access to markets in many countries and you want to protect yourself against a wide range of risks."

Added to this is the recognition of the development of Asia as a whole—the growth of a middle class in many Asian countries, and thus a growing body of consumers, which makes having a manufacturing presence in those places a much more sensible idea.

For some foreign companies, it can also come down to simply being made to feel welcome. Some Southeast Asian countries have also been rolling out the red carpet for foreign businesses, offering incentives and competitive tax rates. This has come just as the business environment in China has become more challenging for many foreign companies, with labor strikes increasingly common and a new government that some have claimed are targeting selected foreign companies on antitrust grounds.

"A lot of people are sick to death of China, and angry at China, and feel like they can't get a fair shake, and feel like they're not really wanted there anymore," says Dan Harris, a partner and founder of Harris & Moure, a law firm with years of experience in China, and co-author of the widely respected China Law Blog.

The shift towards the adoption of a 'China Plus One' strategy is not necessarily limited exclusively to manufacturers. According to Chris Devonshire-Ellis, founder of Dezan Shira & Associates, a specialist in foreign direct investment practices, the trend applies to all companies in China, even service companies such as sourcing entities. "It's not just a handful of companies or a niche," he says.

Alternatives to China?

An indicator of this growing interest in Southeast Asia is the fact that in 2013 foreign direct investment into the ASEAN-5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) outstripped FDI into China, according to Bank of America Merrill Lynch. It has happened before, but the difference was more substantial than previously. This statistic cannot be taken as ultimate proof—the bulk of the money was flowing into Singapore, not a 'China Plus One' destination—but it is still indicative of an overall trend. In addition to the leading ASEAN countries, Cambodia, Bangladesh and, less credibly, Myanmar are also touted as 'China Plus One' candidates.

But the country most often put forward as the alternative to China as a manufacturing base is Vietnam. Intel, Samsung and Nike and other multinational manufacturers have expanded into the country in recent years, attracted by the much cheaper labor on offer there, as well as attractive tax incentives. Intel spent $1 billion on its Ho Chi Minh City facility and has committed another $21 million to high-level workforce training, while Samsung's $2 billion factory in the north of the country was granted four tax-free years (the following 12 are half price). In addition, Vietnam has stated that it will reduce its basic corporate tax rate to 20% by 2016, five points lower than China's.

A quick glance at your clothes might

reveal the growing preference of garment manufacturers for Vietnam, but the presence of giants like Intel and Samsung attests to its appeal far beyond the cheap labor costs always sought by textile makers. The Vietnamese government is very consciously targeting companies in the high-tech sector with its IT Master Plan, which aims to improve infrastructure and help the country meet international standards. Vietnam also appeals to companies because of its growing consumer market (the country has a population of 90 million) and its geographical position close to global supply chains.

Other countries have their own strengths too and each place has advantages that appeal to different industries contemplating 'China Plus One'. Peter Petri cites the strength of Thailand's automobile-related supply chains and expertise, and Indonesia for its rich natural resources as industry-specific strengths of the two countries. "The important point is that in several Southeast Asian countries there is now very good local industrial infrastructure with which you can work to make this happen," he says.

But 'China Plus One' strategies are at this point mainly the preserve of large multinationals and are much harder to implement for small and medium-sized enterprises because they don't have the same level of resources to call upon when contending with the challenges that undoubtedly remain in these 'China Plus One' countries.

Southeast Asian countries have also benefited from the development of new trade agreements in recent years. One of these is the ASEAN-China free-trade agreement, which reduces tariffs on 90% of imported goods, although not all countries are compliant—the remaining ones, including Vietnam, are expected to be by the end of 2015. This will have the effect of opening up the China market to manufacturers looking to access consumers there, while still allowing them to take advantage of what the Southeast Asian countries have to offer.

"[The ASEAN-China free-trade agreement] will have a significant impact on the relocation of light manufacturing destined for the China market," says Chris Devonshire-Ellis.

However, the ASEAN-China trade agreement is viewed by some as quite a modest step, and not necessarily the key driver for businesses weighing up 'China Plus One' strategies. "Although it probably helps to smooth some of the linkages between China and ASEAN so that you could divide your supply chain a bit more comfortably… it's not an especially ambitious agreement," says Petri.

Perhaps of greater importance is the proposed Trans-Pacific Partnership (TPP), a proposed US-led free-trade agreement in the Asia-Pacific region, for which both Vietnam and Malaysia have participated in negotiations and which China has been excluded from. According to Petri, one of the key benefits for these countries that will flow from TPP is access to US markets, particularly in terms of textiles and garments where US tariffs are still quite high.

"That agreement will be amazing for Vietnam, it's almost like it was written for Vietnam," says Dan Harris. "A lot of people are excited about what TPP can mean for Vietnam, and they're doing exploratory missions to Vietnam because of TPP."

No Time Soon

But for all this, China still has huge advantages, and the countries looking to cut into China's dominance of manufacturing are still bedeviled by a long list of problems of their own.

For one thing, China has deep manufacturing knowhow, experience and the most sophisticated supply chain platforms on the planet, something that rival manufacturing companies simply can't compete or replicate. Its infrastructure and industrial clusters give it a huge edge, and China is where a lot of components will ultimately be sourced from anyway. It is perhaps unsurprising then that at the same time as opening its new factory in Vietnam, Intel opened an even larger facility in Dalian, with this factory dealing with the actual manufacturing of chips—the Vietnam factory merely handles assembly and testing.

"China is just so ready, I mean it's so easy," says Harris. He points to the sheer wealth of choices that a company has in China when choosing a manufacturing partner, even in a single region, and the country's ability to produce highly complex goods in such phenomenal quantities.

Moreover, China is a huge country with many places, principally inland, where labor costs still haven't reached the same heights as those in the coastal regions, for

China vs Southeast Asia

How China compares to 'China Plus One' countries

Country	Ease of doing business ranking	Monthly minimum wage	October manufacturing PMI
China	90	$136-296	50.4
Vietnam	78	$89-127	51.0
Malaysia	18	$240-270	N/A
Indonesia	114	$75-202	49.2

Note: Minimum wage varies by region

Source: World Bank Group, WageIndicator Foundation, Malaysia Ministry of Human Resources, HSBC/Markit

PMI: Purchasing Managers Index

manufacturing to potentially move to. In Standard Chartered's survey of Hong Kong and Taiwan manufacturers in the Pearl River Delta, a shift to inland areas was greatly preferred to moving capacity out of China.

An HSBC Global Research report in September identified three such areas: Beijing, Tianjin and Hebei (nicknamed "Jing-Jin-Ji"); a "New Silk Road economic belt" with strong links to central Asia that includes nine provinces, five of which are in the northwest; and a Yangtze River economic belt upstream from the traditional manufacturing hub of the Yangtze River Delta.

In October, Airbus announced plans to open a completion center for its A330 planes in Tianjin, and Foxconn jointly opened a laptop production facility in Chongqing in 2012. However skepticism remains for many companies over the idea of diversification solely within China given the concerns that go beyond wage costs. Infrastructure cannot match that of the coastal regions, and a high-profile strike at Foxconn's Chongqing factory in October also raises questions of how viable these inland areas are as alternatives.

However the fixation on costs also overlooks the appeal China has because of its growing market. "I think what keeps companies in China is above all the future," says Mats Harborn, Vice President of the European Union Chamber of Commerce in China and Executive Director of the Scania China Strategic Office. "The clear shift is that companies are now in China for exploring the Chinese market—companies are not in China for having China as a production base for export… that is the way we perceive it."

Beyond having to compete with China's strengths, the countries that can potentially benefit from the 'China Plus One' strategy come with their own flaws. Infrastructure tends to be less developed than China, and for Vietnam and others, a huge issue is skill shortages. "Despite impressive literacy and numeracy achievements among Vietnamese workers, many Vietnamese firms report a shortage of workers with adequate skills as a significant obstacle to their activity," noted the World Bank's 2013 Vietnam Development Report.

> "
>
> How many [companies] are actually pulling the trigger? Not that many. But they're getting ready
>
> Dan Harris
> Partner and Founder
> Harris & Moure LLP

Organizational structures of businesses also affect the prospects of 'China Plus One' gaining traction. Devonshire-Ellis considers the management of many firms operating in China as being too China-centric and so oblivious to other opportunities in Asia. "I think there's a knowledge gap of the financial incentives and tax incentives that are available," he says, adding that many in senior management have a vested interest in staying in China. "There's a danger for global manufacturers that are in China and relying too much on their China-based executives [and] Chinese executives to dictate the future of the China operations."

The practical limits of 'China Plus One' strategies are also revealed by examples of companies that talk about it, but have so far not actually made the move. In February 2014, Foxconn signed a letter of intent to invest $1 billion in Indonesia, claiming that more detail would be forthcoming within three to four months, but as yet no actual investment has materialized. In September, Chatib Basri, the then finance minister of Indonesia, told *Reuters* that Foxconn's demands for free land and generous tax incentives were unrealistic.

That is not to say that China should be sanguine about the situation, even if 'China Plus One' perhaps doesn't represent an immediate and significant threat to mainland manufacturers. The fact that talk of such strategies refuses to die down, and on the contrary has become more intense, illustrates the very real concerns of some companies about China's business environment.

"How many of those [companies considering 'China Plus One'] are actually pulling the trigger? Not that many, not a large percentage. But they're getting ready," says Harris.

The concerns are part of the overarching shifts in China's economy as it moves from being the low-cost workshop of the world to being a country based on consumption and higher-value manufacturing.

In fact, if anywhere does look set to take the "factory of the world" mantle from China, it is perhaps a country that, although sometimes mentioned in the context of 'China Plus One', is nonetheless too large and full of potential to be merely a supplement to a neighboring nation's manufacturing might: India.

India today finds itself in the same demographic sweet spot that China was in years ago, and it currently benefits from a strong, business-friendly national government with a mandate for reform. Devonshire-Ellis points to China's agreement in September to invest $20 billion over five years in Indian infrastructure as a sign that China is ready to "pass the baton".

"If you have an increasingly wealthy Chinese society, that still means they need cheap goods, and if Chinese labor is becoming expensive and cannot provide that, then China's consumers need to be able to obtain those cheap products from another market," he says. "Frankly, it's only India that has the workforce size and the cost base that is able to provide the huge Chinese market with the low-cost products it requires."

First Response

As technology and consumers mature, firms in China are finding crisis management has become a must-have skill

By Jen Swanson

China's notoriously tricky business environment is becoming ever tougher, with the past few years having seen companies become engulfed in all sorts of scandals and crises. From false alarms and set-ups to genuine health scares, global names such as McDonald's, Fonterra, Nikon, Apple, Starbucks and Volkswagen, as well as lesser-known local brands, have all found themselves in the crosshairs of Chinese public opinion.

The difficulty of handling a crisis in China is particularly acute for foreign businesses, putting them in a situation where their handling of a scandal at times struggles to replicate the efficient and proper response they could deliver on their home turf. Although certain crisis management ideas might cross borders, China demands its own set of tools and responses—in terms of dealing with its rambunctious social media, increasingly discerning consumers and a powerful government, there is plenty for businesses to get to grips with. Along with exercising due diligence at operational and strategic levels, it is essential that companies come to China with a proactive crisis strategy in hand.

For those that don't, the costs can be severe: McDonald's, rocked by a tainted food scandal in July 2014 after its Chinese supplier was recorded repackaging contaminated meat, saw sales in the Asia, Middle East and Africa region fall 7.3% that month. Meanwhile KFC is still struggling to rebound from a 2012 scandal that found the company peddling chicken with elevated levels of growth hormones, followed by charges that the brand's ice cubes were dirtier than toilet water. Clearly, with the rewards of the Chinese market so great and the reaction to any scandal strong and swift, much is at stake. China's growing team of crisis specialists have become a vital source of guidance in this treacherous environment.

Damage Limitation

Even the most stellar operators in China aren't immune to outbreaks of bad publicity. "I think, number one, I want to say: every single company has the risk of crisis," says Linda Du, Managing Director of APCO Worldwide's Shanghai office. To Du, a specialist in developing corporate communication programs in China for 17 years, crisis prevention is always preferable to managing a scandal that's already broken. "If time and budget allows, I'd like to put 80% of the time in crisis prevention instead of crisis management," she says. "If any issue or problem escalates to a crisis situation, your company's interests and brand have already been damaged."

> "Crises move at the speed of a tweet, and that can mean a thousand of them a second
>
> Brian West
> Managing Director of Reputation Management, FleishmanHillard

To avoid such a scenario, Du suggests companies take an internal audit with management, legal, PR and department heads from across the company to identify different areas that could escalate into crisis. This includes studying the experience of similar companies. "Know your risk," says Du, and then put your crisis management systems in place. This includes training executives, implementing a media and monitoring alert system and making sure that everyone, from the China teams to staff back at headquarters, knows how to respond.

"Global teams should adopt the crisis management role consistently across the company and know how to alert all of the regional players," she says. It's also important that the China team knows how to work with the other global players.

If a crisis arises, a quick response is of the essence, even if it's simply to acknowledge that an incident has occurred. A common blunder is to jump to conclusions or try to cover up the incident entirely. "Nobody expects you… to know what happened [within a few minutes or within an hour]," Du explains. "But acknowledge there's a problem," she says. A simple statement that recognizes the issue and promises to follow up with more information demonstrates transparency and control.

"It's good to have a reaction plan in your top drawer," says Torsten Stocker, a Partner at A.T. Kearney and based in Asia since 1996. This includes anticipating various crisis scenarios, many of which vary by industry. "For a food company, issues with suppliers are obvious," he says, referring to China's infamously fragmented supply chains. Meanwhile, clothing companies should consider what happens if chemicals seep into the product line. "Know who needs to do what, who you need to call," he says.

"People want to see a company in control, and proactively manage a situation rather than see them avoid communication and try to hide," says Du.

Consumer Rights Day

Just as some crises can be anticipated, one particular date—Consumer Rights Day, on March 15—carries a particularly high risk of scandal. Riding a rising tide of consumer sentiment, the event is celebrated in China with an annual expose broadcast by the state-owned channel CCTV devoted to publicly shaming companies allegedly short-changing Chinese consumers.

Recent programs have accused McDonald's of repackaging expired meat (the company had faced the same accusation in 2012, along with Carrefour), Volkswagen of selling cars with faulty gearboxes and Nikon of selling cameras with defective lenses. Two years ago, Apple was accused of passing off sub-par warranties and recycled phone parts to Chinese customers.

"The CCTV World Consumer Rights Day broadcast has been around since the nineties but it has definitely become more prominent in the last 4-5 years," says James Roy, Associate Principal at China Market Research Group in Shanghai.

Du, for one, puts in plenty of prep time on the eve of CCTV's annual report, also known as the 3.15 Gala. "We plan a number of scenarios for them," she says of her clients, describing crisis simulation exercises that account for hypothetical issues with the storefront, the food, employee compliance and various supplier problems. A draft statement, pre-approved by Legal, is ready to be filled in with specifics and pushed out. "You can't just sit there and have the print-out guide[s]," says Du, noting that crisis simulation, once unique to high-risk industries like chemicals, has become a new trend among companies in China. "Through exercise, the management team learns a lot."

It's also important that brands identify a local decision-maker to make the tough calls—"the person who can say, let's recall this product, let's shut down this store," says Du. "If you don't have a decision-maker in the region, all the good systems, all the good media relations won't work."

Complicating matters is the complexity of China, where language barriers, the political structure and cultural nuances only add to the time delay. The traditional command-and-control structure—where senior management issues directives from the corporate headquarters, which may be many times zones away—also wastes precious time, compounding the crisis unfolding in the online world and lending additional brand damage.

"You have to empower people on the ground," says Brian West, Fleishman-Hillard's Managing Director of Reputation Management, Asia Pacific. Not only because they are working in real time, but because "local teams understand the social and political nuances of the market they're working in."

The New Order

Each year CCTV's consumer rights program elicits a heated discussion across China's online platforms, where millions of increasingly vocal Chinese gather to voice their opinions and frustrations. For the unfortunate stars of the broadcast, this social media chatter sets them scrambling to mitigate brand damage and emerge with their reputations intact.

"Chinese consumers have always followed product safety scandals very closely but social media, especially Sina Weibo (China's Twitter), since posts are public and searchable (unlike the more private WeChat), has really amplified a lot of the discussion around brand exposes and focused more attention on programs like the March 15 program," says Roy.

Companies that find themselves enveloped in scandal as a result of the CCTV gala have found the timeliness of their response makes all the difference. Revelations from the program are quickly reposted, leading to a lively, heated debate over Weibo, in turn generating thousands of comments and re-posts.

When McDonald's was targeted in 2012 over allegedly repackaging expired meat, within an hour the company had posted a sincere apology and promised an investigation and immediate closure of the offending outlet, all the while welcoming government and media supervision. Carrefour offered a similar response after facing the same accusation, but because their statement was posted 30 minutes later than McDonald's, it was accused of being "a follower" and "less sincere", according to joint research by Ogilvy and CIC.

In this digital landscape where scandals can quickly erupt and go viral, social media confronts brands with risks beyond an annual consumer rights program, but also opportunities.

"The threat of social media is clearly that it's a game-changer that one person can ignite the crisis and amplify it around the world," says West, describing what he calls the "new order of crisis management". In this new order, speed is of the essence.

"Before we used to talk in terms of the traditional news cycle," he explains, drawing from three decades of experience in the field. But whereas companies once worked against print publishers' daily 3pm deadline, social media has transformed the

How To Limit the Negative Buzz

Volkswagen's (VW) swift response to a CCTV expose minimized damage to its brand

Source: Ogilvy, CIC

business landscape so that modern companies don't even have that long to respond. "News no longer breaks, it tweets," he says. "Crises move at the speed of a tweet, and that can mean a thousand of them a second."

Pointing to 2013 research from the law firm Freshfields, West says that because 28% of crises go global within the first hour, there's no longer such a thing as a local crisis. "But it still takes corporations on average 21 hours to issue a meaningful response," West explains. And in today's era of instant communications, that's no longer fast enough.

Meanwhile, a misstep can prolong a crisis by days or weeks. In 2012, the 3.15 Gala accused both Volkswagen and Apple of selling defective products. After the report aired, the automaker instantly apologized and soon recalled over 380,000 vehicles with faulty gearboxes, nipping the crisis cycle in the bud after only 24 hours. But Apple, which had been accused of issuing sub-par warranty policies and phones made with recycled parts, initially ignored the report. It was 14 days before Apple finally gave a comprehensive apology and updated its iPhone warranty. By that time, Tim Cook, CEO of Apple, was running full page apologies in Chinese in a desperate effort to restore the brand's image.

"Safety issues aside, consumers are increasingly demanding higher levels of service," says Roy of China Market Research Group. "They want to be respected. The perception that Apple offers different warranty policies in China than it does in the US hurt its image. While there's no surefire way to avoid being at the center of a brand crisis, one thing brands can do is offer the same levels of service in China as in their home markets and around the world that shows respect and is always viewed as a positive by consumers."

But the opportunities that come with social media include allowing companies to bypass traditional media channels and connect directly with customers. "They can use social media to respond quickly—but also directly—to key stakeholders," West explains. "They no longer have to rely on traditional media filtering the news or running their side of the story."

Now companies can post a video of the CEO to their website or channel on a video sharing website, then tweet or blog about it to drive traffic just as people are starting to form opinions about the brand. "You can intervene in that conversation and drive traffic to your website where the facts are," says West. "That's really taking control of your destiny and using social media for that ability to communicate direct." But these digital "newsrooms" are complements, not replacements, to the traditional crisis management structures.

Last fall, when Starbucks was accused by CCTV of charging higher retail prices in China, the company leveraged a variety of media channels to successfully steer the conversation. "They managed it really well through their social media," says Du, recalling how the Seattle-based retailer took to social media shortly after the CCTV report. There the coffee giant casually pointed to China's larger social issues—including pollution, and housing—and poked fun at the broadcaster for using a foreign brand to deflect attention from China's more pressing concerns.

"It was kind of casual teasing," Du says, intended both to shape popular opinion and enlist support. But the company's official statement was very different as it adopted a more polite, courteous tone when addressing the government. In the end, popular opinion tipped in favor of Starbucks, and people chided CCTV for failing to grasp basic market principles.

"It's very interesting to see this company, over the years, how they've learned how to handle crisis in China," says Du, referring to Starbuck's first China crisis back in 2007, when public outrage led the company to shutter a controversial outlet in the Forbidden City in Beijing.

That incident also demonstrates the variety of external risk, on top of the usual operational challenges, faced by companies in China. And if an industry suddenly pops up on the government's radar, as was the case in a recent string of anti-monopoly cases that targeted foreign auto-makers and IT providers this summer, there's little companies can do. "If there's a drive on the government agenda, then the whole industry will face challenges," says Du.

West agrees: "Remember who's the boss. That's the reality you've got to deal with. You've got to understand the environment you're going into and be sure your business model and everything else stacks up."

Due Diligence

Avoiding scandal requires regular reviews of policy on the part of companies, says Jeremy Gordon, Director of China Business Services and author of *Risky Business in China*. "They must also conduct due diligence and testing on the supply chain to ensure that faulty or dangerous materials do not slip in unnoticed."

The reality that food suppliers are responsible for their supply chain due to being the interface to their customers has burned many multinationals working in China, including KFC and McDonald's. McDonald's latest food scandal, when a major supplier was charged with serious food safety violations, was compounded by that fact the company didn't initially realize it was expected to handle the supplier's PR crisis. That company, OSI, which is also based in the US, operated under the outdated command-and-control model, rendering them unable to deliver an adequate or timely response.

McDonald's later stepped in try to salvage the damage, but valuable time had been lost and the crisis had already spiraled out of control online.

"China is a fast-moving market, and old assumptions can quickly become outdated," Gordon says. "It is important to make sure that market research and risk analysis is up-to-date, and specific to the business's needs." Business intelligence and good relationships (better known in China as "*guanxi*") can also help reduce the risk of a crisis occurring in the first place.

But when a crisis does hit, proper preparation can still save the day.

"In our industry, the success is not to lower or shorten the crisis period," says Du. Rather, the successful cases are the ones nobody ever hears about. "We kill them in our war room."

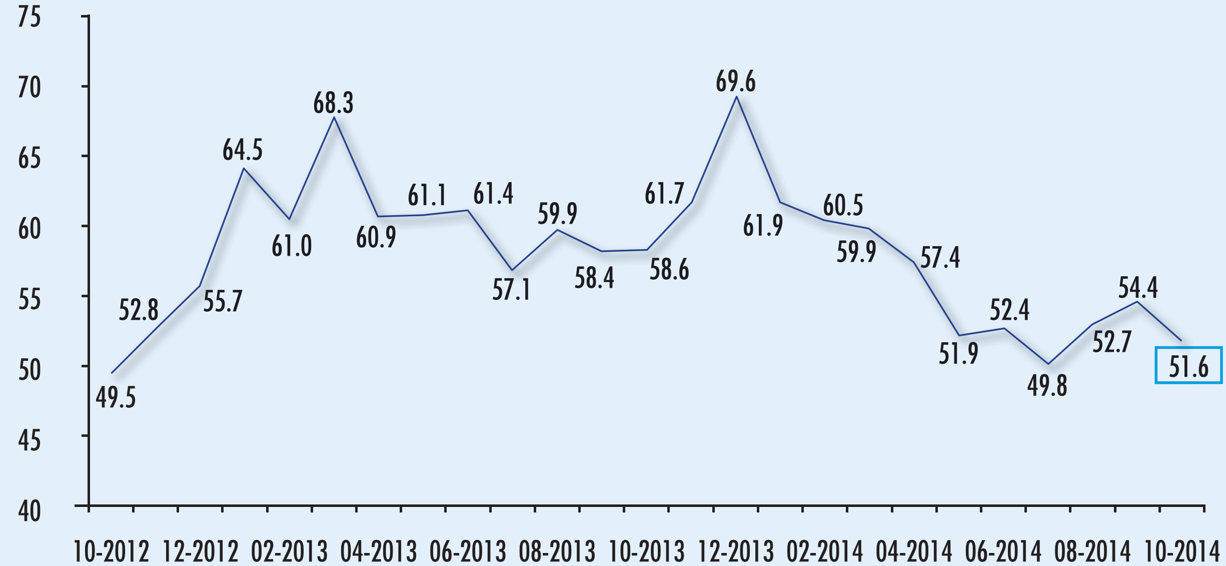
Tempered Optimism

After a challenging year, entrepreneurs have regained some of their confidence, but only just

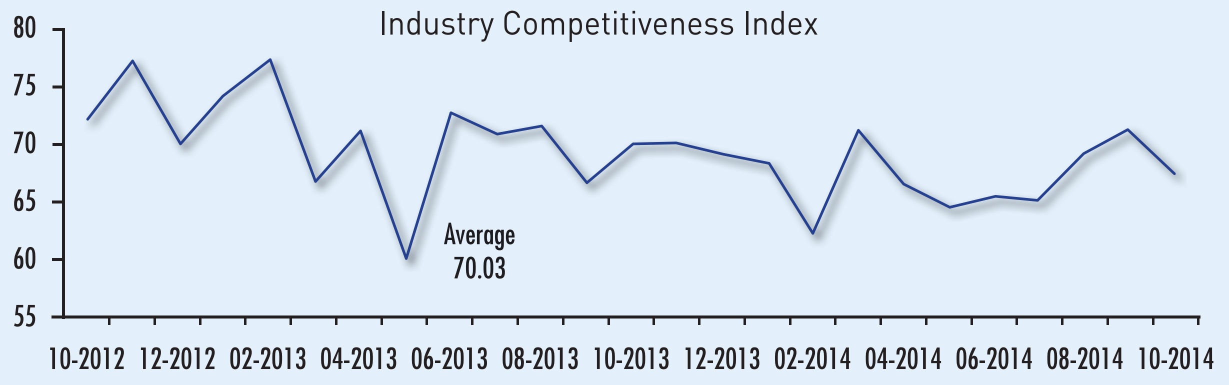
The CKGSB Business Conditions Index reads 51.6 in October, lower than last month's index of 54.4, but still above the confidence threshold of 50. Each month CKGSB's Case Center and Center for Sustainable and Inclusive Growth conducts a survey of leading entrepreneurs in China to gauge and track changes in their business sentiment. The result is the CKGSB Business Conditions Index (CKGSB BCI), directed by Li Wei, Professor of Economics and Emerging Markets Finance, which provides a barometer on the state of the economy as viewed by China's entrepreneurs. While a downward trend set in during the first quarter of the year, Q2 and Q3 have seen data rising. China's macroeconomic conditions now appear to have stabilized. But compared with last year, risks of a downturn remain. In the questionnaire respondents indicate whether their firm is more, the same, or less, competitive than the industry average (50), and from this a sample competitiveness index is derived (see Industry Competitiveness Index). Consequently, as sample firms are in a relatively strong competitive position in their respective industries, so CKGSB BCI indices are higher than government and industry PMI indices. Users of the CKGSB BCI index may thus focus on data changes over time to forecast trends in China's economy.

Some confidence is back...

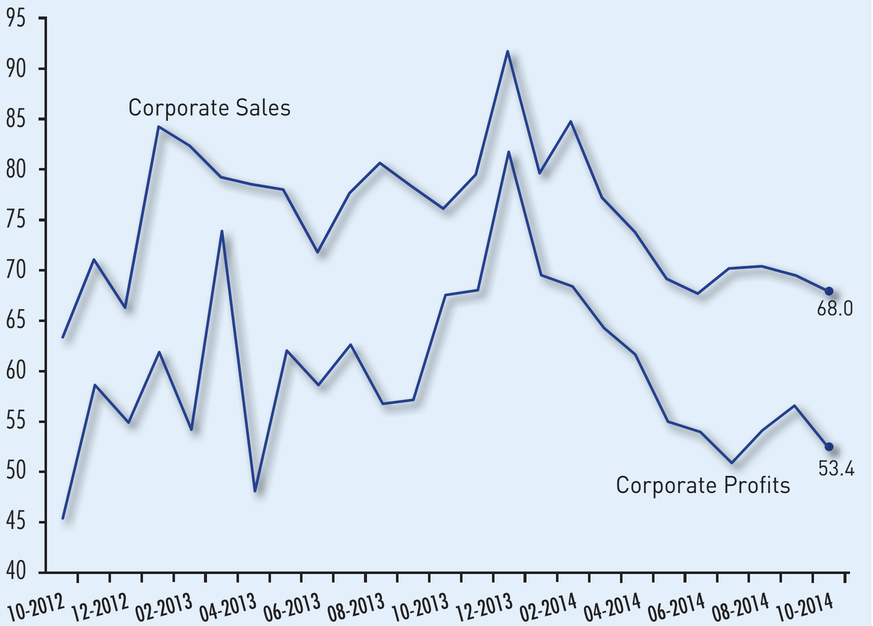
CKGSB Business Conditions Index



...even as indicators are worsening

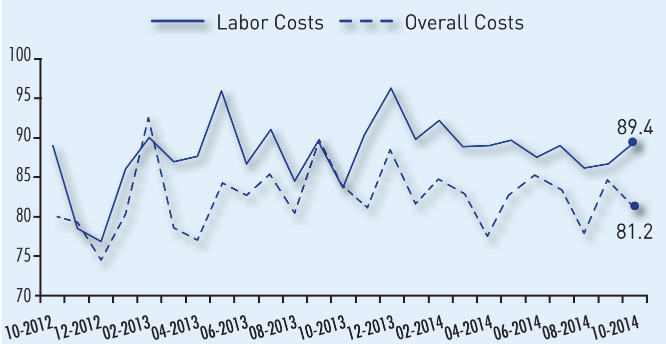


Sales and profits maintain their downward trend...

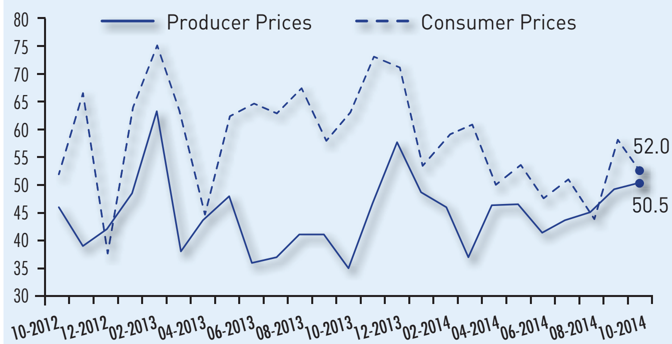


Looking to the four composite indices, corporate sales have fallen slightly from 69.5 to 68, indicating companies are still optimistic about sales in the next six months. The profits index has fallen from 58.2 to 53.4. Survey respondents expect labor costs to increase, based on the index rising from 87.2 last month to 89.4 this month. Total costs are expected to fall, with the index dropping from 84.7 to 81.2. These costs indices have wavered, but as they have remained consistently high, this is not particularly significant. The consumer price index has fallen, registering 52 this month, a drop on last month's figure of 58. Entrepreneurs expect consumer prices to rise marginally in the next six months. The producer price index has risen from 49.2 to 50.5, crossing the confidence threshold for the first time since December 2013. The inventory index has rebounded, implying that overcapacity has eased.

...while costs continue to fluctuate



Producer prices creep up and consumer prices take a dip



Why The Seeds Of Humanity Must Flourish In Business Education

Business schools typically have a commerce focus, but the study of humanities is essential for the next generation of business leaders

By Xiang Bing, Founding Dean of CKGSB

China's economy has become truly globalized over the past 30 years, but the mindset of Chinese business leaders has not always kept pace. Multinationals from across Europe, America and Asia have contributed significantly to the economic progress of China thus far, but for companies that wish to remain competitive in this economically open and globalized China, an ability to leverage resources globally will be critical. This, in turn, will require a global mindset and perspective.

Another pressing issue facing us today is the collective myopia of humanity. No political or business system in either the East or the West truly encourages and nurtures long-term planning. Climate change is one such manifestation of this structural governance problem, but this myopia could lead to even more catastrophic problems. In this respect, we urgently need to instill the values of a long-term vision into our political and economic governance systems.

In response to these two critical challenges, CKGSB became, in 2004, the first business school to systematically incorporate humanities courses—namely religion, philosophy and history—into its management education curriculum. I am a firm believer that a serious commitment to the humanities, alongside more traditional business-oriented courses, is crucial in developing next generation business leaders. The focus of the humanities on a broad range of cognitive and emotional worlds, and moral and ethical complexities, will help our future business leaders to work with global and diverse teams.

The benefits that this brings are numerous and varied. Notably, our alumni will have a more holistic view on how and why to do business. Regulation in the business environment is essential in today's world, but correct practice should start from within, and study of the humanities can help ensure this element of proper conduct.

At CKGSB, we believe that tomorrow's business leaders need not only be globally competitive, but they need to compete and collaborate with empathy and compassion. The seeds of humanity are also essential in this regard, providing inner strength and substance to our leaders that they cannot find in other areas. But we need to go beyond traditional cross-cultural communications skills to develop that inner strength: the next generation leaders must be able to function well in increasingly more complex ethical situations that require both principled and open-minded systems of corporate conduct.

Perhaps the most unsettling trend in the world today is the complete absence of long-term consideration, as we hurtle down the path to disaster, oblivious to what we will find at the end of the road. This collective myopia of humanity can be found in every political system from East to West, whereas what we need instead is a long-term view of not just 10-20 years, but of 100-200 years. The responsibility to instill this much longer perspective in the next generation of business leaders inevitably falls on business schools around the world. The humanities can impart this long-term outlook, which can gradually work to mitigate the myopia.

The proliferation of so many new technologies and social disruptions in today's world has created unforeseen challenges, as evidenced by the Occupy movements, street protests, ethnic tensions and problems caused by a widening income gap. Exposure to the humanities will be valuable to business leaders who can anticipate and demystify the potential impact of these economic, political and social disruptions.

The rise of the East necessitates deeper two-way traffic with the West, and the promotion of the humanities also plays a role in this dialogue. The West has long been the dominant partner when it comes to science, technology and economic development, but the East must show that it can now contribute on an equal footing. As we continue to grapple with sustainability, among many other issues, we may need to redefine the relationship between man and nature. CKGSB Humanities Professor Tu Weiming has taken a leading role in this area, through his exploration of Confucian Entrepreneurship, which focuses on the dialogue between Confucian scholars and entrepreneurs to enrich the identities of our business leaders.

Finally, many of our students are already rich when they come to our school, but I want our alumni to also lead an enriched life, and, if possible, an enlightened one. My hope is that they will be individuals who are full of passion as well as responsibility, joy as well as profit. A thoughtful synthesis of the humanities together with business courses is an important step to helping leaders develop such a synthesis in their lives and their businesses, resulting in a better world for us all.

Farewell, My Consultant

Western consultancies are facing questions in China. Can Chinese companies capitalize on the moment?

By Suzanne Edwards

On June 9, 2014, in an interview with *China Daily*, veteran management consultant in China and Founder of Gao Feng Advisors Ed Tse had some choice words for American executives in his industry of management consulting, claiming that CEOs "just want to sell the same thing everywhere".

Tse, who had previously served as Chairman and Managing Partner of Booz & Co.—before it was acquired by Pricewater-houseCoopers to become Strategy&—and Boston Consulting Group (BCG) respectively, would later soften his stance, but not back down from the idea that there was a detachedness that was endemic to foreign consultancies in China.

If true, China arguably needs to build the profile of its own consultancies, such that they can compete not just domestically but internationally as well. "China has no representation in the knowledge-based industries outside of China," Tse says, hoping that his still-young Gao Feng can change that status quo.

Tse is apparently not the only one who's seeking to reshape the consulting landscape in China. In May, the *Financial Times* reported that the central government had banned state-owned enterprises (SOEs) from having ties with US consultancies, which was seen as a tit-for-tat move after the US government's indictment of a handful of People's Liberation Army officials. To compensate for any consulting gap, the same report stated that the government was in the process of forming its own consulting institute of sorts.

The government's moves unearthed a question that undoubtedly crosses every consultancy client's mind at one point or another: what value are the household name consultancies bringing in China, and is there an alternative?

Zennon Kapron, founder of Kapron Asia, a financial and technology consultancy, says the entanglement of the big-name consultancies and say, the state-owned banks for example, is significant, and not without good reason.

"The level of penetration that [these consultancies] have with some of the banks in China leads me to believe that there's a significant benefit to having the companies involved," says Kapron. The enterprises wouldn't go out of business if no longer allowed access, but some of the significant growth that has occurred over the past five years as a result of those relationships would definitely slow.

A Country Un-consulted

Emerging from the pre-reform era without any significant expertise in management, China represented fertile ground for the titans of the consulting industry.

"Twenty years ago, there was no notion of what management was," says Tse. "A lot of [good] management principles came from the large consultancies in the past."

And those prospects for growth still hold true. In 2013, the market grew to roughly \$2.9 billion in size, a 10% increase from the market size in 2012 according to UK-based Source Information Services. But numbers can vary widely from one research report to another. In 2012, IBIS World estimated that total revenue from the industry stood at \$14.7 billion. Nonetheless, industry insiders and researchers agree that overall, the domestic management consulting industry is young, and can only grow going forward.

A few things contribute to the lack of consensus on what this industry is worth in China. Firstly, the most well known firms are private companies, making information contingent upon their own openness.

That said, they do give some indication of the scope of their operations—on its website, McKinsey states that its Chinese operation has 55 partners, over 300 consultants, 100 research staff and more than 200 professional support staff. The company states that it has 9,000 consultants in total.

Others are less forthcoming, but BCG still reveal that they have 250 professionals and 200 clients, while Bain and Company say they have 150 consultants in China.

The second reason for the lack of clarity surrounding the consulting industry is that the definition of management consulting can vary, but it is generally understood that there are two different kinds.

One is operational management consulting, for example supply chain optimization in the fabrication of medical equipment parts. The other is strategic management consulting, which deals more in overall strategic questions such as market entry, marketing and change management.

The former has typically been the province of Chinese consulting firms says Tse, as they're more connected to the operational players. The latter on the other hand, has been cornered by large Western firms. In either case, consultancies can benefit from China's numerous fast growing industries

For Chinese companies, the benefits of large Western consultancies can sometimes be reduced to share-price padding. When a Chinese company has an interest in an IPO in the US, hiring a big-brand consultancy is one way to boost the initial valuation of the shares—it instills confidence in investors that the company in question has a handle on their strategy. However, at times a company may have no intention of using the services provided by the companies in earnest, and merely use the consultancies as window dressing, says Ken Zhong, Business Development Director for building materials company CRH in China.

"This can make their image to the public a little better," says Zhong. "The value is still there, but I think that if I just weigh the recommended strategy, whether it [can] work or not, there's no guarantee [of the value beyond branding]."

Window dressing may be the starting point, but the 'high-caliber' organizations will make good on the opportunity to show what they can really do, solving one problem and identifying several more along the way, says Kapron.

Looking the other way, regulatory pressure on foreign tech companies has them seeking out more consulting from providers who can anticipate the chess moves of the government and correctly interpret the implications of them. For consultancies, these companies' woes have a silver lining—now more than ever these foreign tech companies in China need boots on the ground to assist in navigating hostile regulatory waters, says Kapron.

What the People Demand

There are a few different categories of consultancy consumers.

Firstly, there are Western companies wanting to enter China for the first time. For all of the punditry claiming the end of China's appeal to foreign companies, the country hasn't completely lost its luster yet. Foreign direct investment actually rose in the first half of 2014 by 2.2% reaching \$63.33 billion according to official government data.

The second category is smaller private Chinese firms looking for operational consulting in niche areas, the demand that really drives smaller and more specialized Chinese consultancies such as Shanghai-based Younger Niche Logistics, which consults mostly on companies navigating customs in China. Another example is Beijing-based HeJun Consulting, which focuses on IPOs.

Tse says smaller local consultancies thrive in this area as small and medium-sized enterprise owners really seek consulting services through personal relationships, and these clients want a how-to guide on implementing the strategy set forth by the consultancy. This varies from what strategy-focused consultancies tend to offer.

Western clients, however, want strategic consulting without the follow-through guide, whereas Chinese clients want a practical guide to implementation.

The third category is the most contentious: SOEs. The banks in particular have benefitted at home and abroad from their work with large Western consultancies according to Kapron. They are of no small importance to the consultancies either—McKinsey's website states that 30% of the clients in China are SOEs, with only multinationals making up a greater proportion of their client list.

As such, it's doubtful that any of the big consultancies would want to compromise these relationships. Kapron says it's highly unlikely that McKinsey, Bain or BCG would risk corruption compliance to provide Chinese company secrets to the US government or US corporations, which was no doubt a consideration when the reported ban was being brought in.

These relationships don't only have a short-term value, and Kapron feels that SOEs are extremely important to the long-term expansion of a company like McKinsey. The mutual desire to collaborate is driving some Chinese companies to go through intermediaries that are fronting for the larger consultancies in order to avoid any illicit collaborations, according to Kapron.

> “China has no representation in the knowledge-based industries outside of China
>
> Ed Tse
> Founder
> Gao Feng Advisors

End of an Era?

There's been a demographic shift in the talent at large consulting firms, according to Tse. Whereas in the past companies favored the recruitment of seasoned industry experts, now they have evolved to favor young talent fresh out of business school. Tse says that upmarket strategy consultancies now prefer to train up young recruits, made more appealing by their markedly cheaper salary requirements.

The workforce also tends to skew toward the young in the big consultancies in part because of the culture—given the cost that comes with hiring them, consultants are expected to put in the work, leading to burnout for many, and expectations of rapid progression results in a high turnover when inevitably some don't make it up the ranks.

Whatever the exact reason, this tendency towards younger personnel suits Western clients that are seeking strategy consulting, where business fundamentals play a bigger role. But for Chinese clients who want a practical growth guide, this personnel make-up does not instill confidence.

Large consultancies like Bain, BCG and McKinsey have been called out over the course of decades for simply recycling proposals from previous clients for new ones, no matter how different the circumstances. Such was the accusation of Martin Kihn's 2006 ex-insider memoir *House of Lies: How Management Consultants Steal Your Watch and Then Tell You the Time*, which was published after having worked a three-year stint at Booz Allen Hamilton.

Tse philosophizes that the Western companies don't have the Chinese market in their business "DNA". It's a criticism that the large consultancies are no doubt aware of and familiar with—McKinsey boasts that over 90% of its consultants in China "are of Chinese descent and speak fluent Mandarin as well as one or more dialects of Chinese".

Not that Zhong, Tse or Kapron shy away from professing that the consulting agencies mentioned in the *Financial Times* report have added great value to their clients' business, including SOEs.

A spokeswoman for BCG told *Fortune* in October that there has been no discernible change in their China business since the May *Financial Times* report. As predicted, in the absence of an official announcement, SOEs are proceeding with their established relationships. If the government has truly reneged, that's a strong affirmation of the importance of the consultancies to China's national champions. But experts agree that there is an increasingly high premium placed on practical implementation issues, where Chinese firms have an edge.

Ultimately, though, Chinese consultancies will have to rely on their own prowess and evolutions in the marketplace to make a place for themselves in management consulting, since the government is plainly not intending to undermine some of China's largest companies, at least not yet.

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A Lightweight in China

Amazon is redoubling its efforts in China, but will it succeed at the second attempt?

By Ana Swanson

If Amazon and its Founder, Chairman and CEO Jeff Bezos have one single guiding principle, it's relentless expansion. From e-commerce to drones to web services, Amazon has resolutely extended its reach across a whole range of sectors. But there's one place that its ambitions have hit the buffers: China.

In contrast to its gargantuan market share in the US and many other markets, Amazon has been operating in China for roughly a decade with dismal results. In 2013, Amazon's China site Amazon.cn had a miniscule 2.7% of the business-to-consumer (B2C) market, according to tracking by Observer Solutions, an e-commerce research and advisory firm.

"It's alive, it's doing reasonable business, but it's a very minor player in China," says Justin Ren, Associate Professor of Business Administration at Boston University School of Management, of Amazon in China.

What frustrates Amazon shareholders and amazes many onlookers is that this unimpressive performance comes in one of the world's most promising markets. The Chinese e-commerce market grew a stunning 41% in 2013—three times faster than overall Chinese retail sales—to reach nearly $300 billion, according to the Ministry of Commerce.

Despite still being a developing market, China is already one of the most wired retail markets in the world. In 2013, online shopping accounted for 6.3% of all retail sales in China, compared with less than 6% in the US, and this figure is expected to at least double by 2015.

As Alibaba, Amazon's chief rival in China, was preparing for its IPO earlier in 2014, Amazon China made a series of interesting announcements hinting at a concerted turnaround effort. In May, it unveiled a $20 million investment in Yummy77, an online grocery sales site. In July, it appointed Doug Gurr, a former Amazon global vice-president in the UK, as its new China president. Then in August, it revealed that it was setting up operations in Shanghai's new free-trade zone (FTZ), an innovative move that would allow it to both import more goods from abroad into China, and export more Chinese-made products to consumers around the world.

In a statement to the BBC just after the FTZ announcement, Gurr said: "We seek to be the most customer-obsessed online shopping platform with vast selections, competitive price and most convenience in China." He added that the newly announced FTZ partnership would help realize that ambition.

But for all that intent the question remains: why has a company that is known around the world for innovation lagged so far behind in China? And can Amazon's new venture in the FTZ actually help turn its performance in China around? That is the multi-billion-dollar question.

History Lessons

Amazon's time in China since 2004 has been dogged by troubles—delayed product launches, onerous regulations, problems with piracy and fierce competition.

Amazon first entered China through its purchase of an online bookseller named Joyo.com for $75 million. At the time of the acquisition, Joyo was China's largest online retailer of books, music and videos, but rampant piracy of such products in China quickly stymied Amazon's new venture. Many Chinese websites were already offering e-books for free, and local e-readers competing with Amazon's Kindle often came preloaded with hundreds of books. All this made people unwilling to pay much—or anything at all—for Amazon Joyo's products.

This situation was a particular challenge for Amazon, says Ren of Boston University, as it turned its American business model on its head. In the US, Amazon sells hardware like the Kindle almost at cost, but then makes money by selling content for that device. In China, that strategy stood no chance.

Instead, Amazon's Joyo gradually shifted into other product segments where counterfeiting was harder, such as clothing and electronics. The company continued with direct sales, but also offered a platform for independent buyers and sellers. In 2011, Amazon dropped the Joyo brand entirely and rebranded itself as Amazon.cn.

Then came regulation issues and product launch problems. It took many years for Amazon to gain regulatory approval to launch its full suite of e-reader and tablet products because in China a wireless product requires approval from three different government agencies.

Regulatory hurdles also delayed the launch of Amazon's cloud service, meaning that the company launched its China e-bookstore in December 2012 without even a release date for its Kindle e-reader. Amazon didn't launch its Appstore in China until May of 2013, more than two years after other countries. And before the Kindle was launched in July 2013, Amazon was only able to sell books in China through Apple or Android devices—all competitors' products.

Regulatory barriers may hobble Amazon China in its next phase as well, especially in the hot field of internet finance. Chinese companies like Alibaba, Baidu and Tencent have begun offering online investment products and payment solutions to attract consumers to their platforms, innovations that have helped these companies increase and solidify their market share. And all three now also offer their own online payment tools similar in functionality to PayPal, facilitating smooth and easy e-commerce purchases. Amazon doesn't have Chinese regulatory approval to participate in such a business, and it has not revealed any plans to join the market.

"Once the payment circle is closed, it's going to significantly advance people's propensity to shop on [Alibaba's consumer-to-consumer (C2C) site] Taobao and

Tencent," says Sun Baohong, Professor of Marketing at the Cheung Kong Graduate School of Business.

Finally, tough competition from local players has played its part. Joyo's market share fell from about 10% in the mid-2000s, as local companies recognized the opportunity presented by online retailing. Alibaba has long been the dominant player in China, but it has been joined in recent years by brick-and-mortar stores like Suning and Gome, online retailer JD.com, internet companies including Tencent and Baidu, and e-commerce sites such as Vancl, Yihaodian and Dangdang, which specialize in clothing, groceries and books, respectively.

Customers in China tend to see Amazon as being a respectable but very minor player. When asked about Amazon, consumers say positive things about the company; the problem is that typically they do not think much about Amazon at all.

Irene Zhang, an avid online shopper who hails from China but now works as a consultant at the World Bank in Washington, D.C., says Amazon.cn has a good reputation in China for selling books, CDs and DVDs. "I used it when I was in China," she said. "My impression at that time was that Amazon China was only good if you want to buy books. If you want other products, it was better to go to other websites like Taobao."

Also illustrating some of Amazon's difficulties is Monica Chang, a frequent user of Taobao from the northeastern city of Dalian. She says she wishes she had more online shopping choices "because different places have more services, such as express delivery, global sales and customer service rights." However, when asked about Amazon, she simply responded that it was unpopular in China.

A Common Fate

Amazon's difficulties in China are not unique. Experts say the company faces challenges common to most foreign technology companies operating in China—the difficulties of localization, regulatory issues and fiercely competitive Chinese rivals.

Success stories of Western companies abound in many product segments, from automobiles and smartphones to high-end luxury goods—but e-commerce is a notable exception, says Ren of Boston University. "Apple, GE, Motorola, they all have made a lot of money [in China]. But other titans of the US economy—Amazon, eBay, Google—they all kind of failed."

> "Amazon China's major challenge is that it can't react quickly… it is a global company and China is only part of the business
>
> Will Tao
> Analyst
> iResearch

Ren says there are a few main factors behind this. "The first is that they didn't understand truly the characteristics of the market they are entering. That's the main lesson … Second, internally, they don't have a really good leader in terms of management and understanding the market and getting the right people to do the right thing, and making quick decisions to compete with local competitors."

eBay, in particular, is a notable case study of what not to do in China. The company entered China in 2002 by buying EachNet, then China's largest C2C site, spending heavily in the process. But it soon found itself undermined by Taobao, which was launched the following year and was better suited to the Chinese market. By December 2006, eBay merged its China operations with internet portal Tom Online, effectively exiting the market.

Other US technology companies have not done much better: regulatory issues and tough local competition have hampered Google's business, which now holds just 3% of the Chinese search engine market. Expedia, Groupon, Yahoo and Microsoft have also all failed to earn much revenue from China. Western sites like YouTube, Facebook and Twitter have been banned from China entirely.

Years of experience in technology and other markets do not necessarily give an online company an advantage in China in the same way that, for example, experience in manufacturing cars might.

E-commerce companies "don't have the time to really understand the Chinese customer, and by the time they think they understand them, things have changed," says Ren.

Localization is another issue. Many Western technology companies came to China with a simple strategy, says Sun: exporting their success story from the US. "They refuse to act fast to the changing demand of Chinese consumers… [and] they don't know how to work with the government," she says.

Experts are divided over how successful Amazon has been in localizing its business. Sun believes that Amazon's localization efforts are the reason the company is still in China at all, "even though it's not making money," she says. But others are more critical.

"I think Amazon wasn't doing very good homework in terms of understanding the e-commerce landscape," says Ren. He attributes these shortcomings to weak local management, as well as the lack of a clear strategy or commitment from US headquarters.

Will Tao, an analyst at consultancy iResearch, agrees. "I think Amazon China's major challenge is that it can't react quickly," he says. "It arises from the nature of the company: it is a global company and China is only a part of its business."

Teng Bingsheng, Associate Professor of Strategic Management at CKGSB, adds that Amazon's model is higher priced and more focused on quality and service than its competitors. While Chinese consumers are evolving in this direction, Teng expects it will be another decade before these considerations win out over the focus on price.

"People vaguely know that [Amazon] is the largest e-commerce company in the US, probably in the world. But other than that, most people don't have any direct experience with them. They think that the products available on their China store are not so attractive and tend to have higher prices," Teng says.

What does the Future Hold?

Amazon may have failed so far to win over many Chinese consumers despite a solid reputation, an efficient logistics network and high quality products, but the company isn't giving up easily. As China continues to develop rapidly and become more integrated with the global economy, it is a market that Amazon, in its goal to be a global titan of e-commerce, cannot ignore.

But putting pressure on that aim is Amazon's recent financial performance. In the third quarter of 2014, the company witnessed a $437 million net loss—the same quarter the previous year saw a $41 million loss. That has led some shareholders and analysts to question Jeff Bezos' policy of relentless expansion, with Aram Rubinson, Managing Director and senior retail analyst at Wolfe Research, saying in a note that "the time has come to abandon China". But this summer's announcements make that highly unlikely.

The FTZ initiative will open Amazon's global platforms to Chinese consumers, allowing them to buy products that are normally unavailable in China and will leverage China's position as workshop to the world. The company is opening a logistics warehouse to help export Chinese products to consumers abroad, as well as launching a new initiative for cross-border payments.

The venture could be a promising one, since it taps into fast-growing and underserved market—the demand for foreign products. Rising incomes, greater awareness of foreign brands, and persistent quality problems with local products all contribute to a growing demand for foreign products. A 2013 report by PayPal and The Nielsen Company estimated that China's cross-border shopping market would nearly quadruple by 2019, growing from $35 billion to $163 billion, while the number of Chinese consumers participating in the market will double from 18 million to 36 million. Sun of CKGSB calls the business "an almost untapped segment".

But here too, Amazon faces tough competition, in part from Western retailers like Wal-Mart, which recently boosted its appeal by tying up with online grocery site Yihaodian, while Alibaba, flush with cash from its recent IPO, launched a competing site earlier this year called Tmall Global. Finally, Amazon's service will compete with vast numbers of individual buyers who market their services through Taobao. These people, called *daigou* (meaning "buying on behalf of"), buy foreign products in stores abroad and then ship them directly to consumers in China, often evading expensive customs taxes in the process.

Amazon will also face significant start-up challenges in the FTZ, including integrating its international merchants into its China platform, and ensuring international deliveries are fast and seamless, says Julia Q. Zhu, the founder of e-commerce advisory Observer Solutions. Eliminating counterfeits, selecting the right products from abroad to market to Chinese shoppers, and dealing with potential regulatory hurdles will be additional challenges.

Amazon's partnership with the FTZ might represent a turning point for its fortunes in China, but the onus will be on Amazon to make use of the opportunity in a way that its rivals cannot.

Because of the uncertainties presented by such a dynamic market most analysts are hesitant to predict what proportion of China's online retail market Amazon could aspire to based on the FTZ initiative. But most experts say that it might allow Amazon to at least maintain and probably enlarge its China market share.

CKGSB's Sun predicts that the venture, if operated well, will increase Amazon's sales, though "by how much is hard to say". Teng of CKGSB also sees it as a way to improve business, though he says its success hinges on when consumer attitudes mature and higher quality products become a higher priority for shoppers.

But analysts see other potentially lucrative areas of expansion for Amazon's China business. Sun identifies the company's provision of data services and cloud computing services for other foreign companies as a potential growth area. And Zhu suggests that Amazon could reap rewards by expanding a service called Fulfillment by Amazon, which helps small businesses process orders, ship goods and provide customer services and business analytics to China.

In the near future, however, Amazon China seems unlikely to catch up to the country's larger e-commerce players. Most notably, Alibaba's recent IPO has given it substantial funds to expand its reach globally and in China. Experts including Tao of iResearch, Teng of CKGSB and Ren of Boston University say Alibaba and Amazon's businesses are likely to essentially mirror each other: they are likely to retain the dominant share of their home markets, while achieving only limited success in one another's backyard.

The American and Chinese e-commerce markets have enough growth potential to keep both e-commerce giants busy for quite a while, but in the longer term there is the prospect of aggressive global competition between them.

While Amazon's prospects in China appear somewhat limited, the company is probably going to continue striving to expand its China business and make the most of its unique value proposition of importing its goods from abroad—and that would make sense. Amazon's slice of the China online retail pie may be small, but it is a pie that is set to continue growing at a phenomenal pace.

Conversations

"Some of the customers have this misperception. They think we're a big company, whereas in fact we're actually very small and very young"

54

Veronica Wu

Vice President, China, Tesla Motors

57

"It is fundamentally dangerous for an organization's adaptability when a single executive has the power to act as the judge, jury and executioner on a new idea"

Gary Hamel

Management thinker and author of What Matters Now

"[Timeless brand building is] a little bit denigrated these days in relation to the digital engineering that is happening at the most innovative technology companies"

60

Tom Doctoroff

CEO, J. Walter Thompson Asia Pacific and author of Twitter is Not a Strategy

64

"The idea that state companies are getting cheaper capital than private companies really turns out not to be the case"

Nicholas Lardy

Author of Markets over Mao: The Rise of Private Businesses in China

Charging Up

Having brought its innovative technology to China, Tesla now faces the challenge of making it work in the world's largest auto market

By Chris Russell

In April, Tesla, undeniably one of the hottest and most closely watched companies in the world right now, began delivery of its Model S car in China, the world's largest car market. It was a significant step—Elon Musk, Tesla's Chairman and CEO, told *Bloomberg* in early 2014 that China could match sales in the US by as early as 2015, and it may well need to if Tesla is to hit its sales targets—the company expects to build more than 60,000 cars in 2015. But since the launch it hasn't been a smooth ride—disgruntled customers, frustrated by delays, and misunderstandings about the car given its luxury price tag, unusual for electric vehicles (EVs)—have been a feature of the company's time in the country. Moreover, China has had at times an uneasy relationship with EVs, despite strong government backing and subsidies, support that Tesla is currently ineligible for. These factors may well necessitate moving some production to China, especially if demand matches Musk's prediction, and it is something he has indicated this is something the company will consider.

But according to Veronica Wu, Tesla's China chief, these setbacks obscure the success the relatively young automaker has had in not only a new country, but also in what is still something of an emerging field. In this interview, Wu discusses what it's like to operate in the spotlight and what China means to the company.

Q. How important is educating people in China about the brand and how will Tesla achieve this? How has the early response to Tesla been compared to other markets, such as the US?

A. It's a little bit difficult for me to compare to the US in the sense that I wasn't there at the very beginning. But I think there are some similarities. You still need to educate the customer, because it's not a cheap car and there are still many similar concerns or customer issues that you have to address, for instance charging: how do you charge? A lot of the people are used to the mindset "I need to get to a gas station". So with the charging station, how am I going to deal with it? You need to educate them, to say actually you have a gas station at your home, and if you can charge actually at home, then most of the time you don't need another charging station. And then once they kind of understand that, they start to kind of change their mindset, they start to be like "Oh, it really isn't that difficult". That whole thing is still in transition.

We still need to get a lot of people to

understand it's a very different product because it functions much more like an electronic device than it is a traditional car. So we don't have maintenance, we don't have a lot of the mechanical parts they are used to. Therefore it's very economical and more practical from a usage point of view because the actual ongoing cost of using the car or driving the car will be much lower.

So from that perspective, you still need to educate people. When [consumers are] comparing you with something similar [in terms of price], you have to remind them that on an ongoing basis they'll spend much less, to bring out the value of the car even more.

The other thing I think is the technology aspect of the car. We can update the system on an ongoing basis; we can push out updates and things like that. But in China right now we still don't have navigation in our car because the map system in China is different—we can't use Google Maps in China, which means we means we have to redevelop a whole navigation function for the software and that, and also whole different mapping data. It is quite a bit of an effort, it's not an insignificant amount of effort to do this, so it is taking us some time to introduce the product. Right now, they can do a few things, but once they get the navigation and the voice recognition feature, this product will feel even more like a technology product.

Q. What are your plans for charging in China? What have the main obstacles been in expanding the charging network in China?

A. Actually I think we've been very, very successful in expanding the charging network, and if you look at the destination charging (charging spots are hotels, restaurants, etc.) I think we're already the second-largest country, basically outside of the US we are the largest country for the number of charging spots available (the company has 29 supercharging spots in China listed on its website), and we [only] started delivering cars at the end of April. So I think we've been fairly successful in doing that, we've seen a lot of support

This car isn't designed for [luxury], this car is designed more as a [piece of] tech

from very different organizations… we've worked with Yintai, the real estate conglomerate, Unicom has been one, Minsheng Bank is another one that has agreed to work with us. So we've actually been fairly successful in working with people to actually get charging in place and we already have I think close to 30 superchargers in probably 12 cities now. So the speed at which the charging network is developing has been quite well.

One thing I think going forward is going to be interesting is that as China still hasn't up to now really finalized a charging standard that is interoperable across all electric vehicles—that's even for domestic ones, they're not completely finalized yet—so [the authorities] look to finalize it by the end of year, so we hope by next year that there will be a standard that will finally be interoperable across all electric vehicles, which we can then also work around. So as other people put in their infrastructure, people will be able to put up charging spots that will then be able to be leveraged by all electric vehicles. We can offer our customers a solution that they can also use.

Q. The price of a Model S in China is the same as in the US, with only the shipping, duties, taxes and VAT added on. Regarding this flat pricing strategy, how has that affected the response to Tesla in China and how does it affect the way in which Tesla is positioned in the Chinese market?

A. I don't think it's really created that much impact. It helps us a little bit in terms of when we have that conversation and say, if you look at the same priced cars [from other companies] in the US they would probably be 50%, or at least 30% more expensive than our car in China now. And for a car that's 20% cheaper [than Tesla in the US], in China they're selling at about the same price [as we do in China]. So it allows us to accentuate again the value that our customers are getting. But it still starts at RMB 623,000 and it goes all the way up now to RMB 1.2 million, so from that perspective I don't think it hugely differs in terms of the main, core buying group who are looking at the car.

The only thing is the Chinese consumer is slightly different because a lot of people still don't know Tesla very well. There are some people who just compare us to a luxury brand, someone who's manufactured cars for over 100 years. I think the people who understand us are more appreciative of the innovation and… the features that we're going bring in the car, the innovation that we're able to bring. There's definitely a style element to it I think—some people who can afford luxury cars, they're looking for a certain luxury feel of the car. This car isn't designed for that, this car is designed more as a [piece of] tech, it's simplistic styling. And that sometimes doesn't always work well with that segment.

And also I think there's definitely a segment that's driven, versus driving themselves. The backseat, we've made improvements on the backseat now on the new P85D, the dual motor version, but on the Model S before the backseat wasn't meant for you to sit in for a long time. A couple of those features tend to get accentuated, if you will, or people would tend to compare theirs because there's definitely a significant segment, a portion of that segment that looks for those types of features. There's the education [we need to do] so that they understand where Tesla is coming from, why we designed the car the way we designed it, and also just being able to make a fit, a lifestyle fit, whether they're the right fit for this car, because not every car is meant for everybody. So if they don't drive and they are primarily sitting in the back, then maybe this isn't the car for them at this moment.

Q. Localization is a real buzzword in the auto industry, and this adjusting of the backseats is one of the main things that a lot of car manufacturers are doing to accommodate the Chinese market. Are there any other aspects that you would be looking at in terms of localization for the models that you sell here?

A. I think we've already done some localization, for instance we have a Chinese UI (user interface). This is the first localized UI we've provided worldwide actually, because worldwide we only have an English UI, and this is the first market we've provided actually a local language UI. If you look at this as a connecting device I think there will be more localization because the navigation features I was talking about require working with local partners. And going forward as we introduce more of those features I think there will definitely be more. This thing is more of an intelligent device, if you will, a smart device kind of category, and China has a lot of localized services on the internet. So I think on the software element it will definitely shift on and will see an increasing amount of localization on that front.

On the hardware side, we're still learning, in terms of what people are like. If China is significantly different from other places, that may be a harder thing for us to consider—the volume, the scale just isn't there.

Q. In China for a lot of EVs, there are subsidies, but these don't apply to Tesla at the moment. How big an issue is that for Tesla and by what process can Tesla become eligible for them?

A. If you look at the requirements for these there are a number of things we still need to work through. Actually, if you look at the list, none of the important EVs have actually qualified. So this is a bit of a policy issue. I think, a lot of the import EVs still have certain variations from the current GB standard (China's national standards). That standard is being revised and updated. The relevant China organizations will have that completed by the end of the year. So we're hoping that finally there'll be something that is, if you will, more set and complete, a complete set of standards that we can then be working towards in terms of making our car compliant with those. We're absolutely committed to making our cars compliant with these things, it's just that we need to wait for some of these standards to actually settle. So we wanted to make sure that we get to a point where we're comfortable and also the standards are not changing so fast or so quickly. It just so happened that we're at a time where these things are still moving pieces.

Q. How does Tesla plan to expand its distribution network in China? The standard model has been that Tesla has sold directly to consumers, so how has that affected things? But you have also just recently opened up a store on Tmall, so what was the thinking behind that?

A. Actually I think Tesla will maintain the fact that we're going to sell directly ourselves, so Tmall is just a foot-warming event. But usually we don't sell through any resellers or any channel other than our own.

Q. How big of an opportunity does the Chinese market represent for Tesla?

A. I think China is already the largest automobile market in the world, so from that perspective it's obviously a huge opportunity, potentially. If you look at China, the total market, it's already exceeded 20 million cars a year. So when you look at a sliver of that, I think 5% of the cars are above RMB 600,000, that's still a very pretty significant number of cars there. So I think if Tesla is able to achieve even a very small market share, a sliver of that share, it's still pretty significant. [In] the recent earnings release Elon mentioned that even if we didn't have China we'll be able to meet our targets for phase three. But I think China will be a very nice upside if [Tesla] China is able to achieve even a sliver of that market.

Q. EVs have struggled in China, I think it's fair to say, but what do you think will make Tesla different?

A. Well, I think EVs have struggled in general across the world, it's not just China. So what makes Tesla different is the same as what helped it to be successful elsewhere. One is the range. I think that's a huge difference—most of the customers after driving this car realize that there is no range anxiety with this car because it's just so long you don't need to worry about it. Plus you don't even need to necessarily charge it every day.

Q. What challenges unique to China have you faced, since Tesla has come into the country?

A. I'm not sure a lot of it is unique. I think there's definitely a little bit of an over-hype, if you will [laughs]. I don't know if maybe because Tesla has been successful already in the US market and there is a lot of hype about it—in the US when it started, Tesla didn't get this much coverage—so I think one thing that's very challenging for us is anything that's to do with Tesla gets lots of press attention and like I said some of the customers have this misperception. They think we're a big company, whereas in fact we're actually very small and very young. We're really quickly building the organization, we're very much an entrepreneurial organization and we haven't been in this industry for a long time, and from that perspective there's going to be imperfections, or we're going to make mistakes. But we try to deliver the best experience we possibly can, we always try to make up for those mistakes, but people tend to focus so much on Tesla that everything gets blown out of proportion. I think in the US people did that as well, but more maybe later on, not so much early on, whereas in China I think we're always under the spotlight, under the scrutiny of the spotlight, since the start of our delivery. So I think from that perspective it's slightly more challenging.

Unleashing Another Revolution

Gary Hamel, the Godfather of Management 2.0, on rethinking the DNA of organizations

By Neelima Mahajan

For three decades, strategy guru Gary Hamel has been on a crusade to replace antiquated management ideas and practices with ones that adapt to the times. His early books *Competing for the Future* and *Leading the Revolution* were about strategic innovation and competition, but his new books *The Future of Management* and *What Matters Now* address more fundamental themes few management theorists dare to explore—organizational DNA and the need for Management 2.0.

"I could see many organizations found strategic renewal very difficult. They often hung on to an old strategy long after the point it was starting to produce diminishing returns," says Hamel, a professor at London Business School. "I began to realize that there was something very deep inside organizations that made innovation difficult and made renewal difficult." In this interview, Hamel, who ranked 19 on the 2013 Thinkers50 ranking of top management thought leaders, discusses how and why traditional management models must be reengineered.

Q. You say traditional management models need to be reengineered to be based on market principles. Why?

A. It [is] so hard to get organizations to be truly innovative on a consistent basis, to get them to change ahead of the curve rather than only once the crisis [strikes]. So I ask the question: what problem was management attempting to solve? Management was invented to solve the problem of efficiency at scale. And we did this. Today there are 1 billion people in the world who own automobiles, that's almost inconceivable. The traditional management model that was focused on efficiency and productivity has made an extraordinary contribution to human prosperity.

Today organizations face new problems that are not simply about efficiency, discipline, alignment and scale. That whole organizational model was built primarily to solve that single problem. [Historically] we solved, the problem of efficiency of scale by building organizations where we deskilled work, put people in silos, specialized their activities, created a very tight matrix of rules and procedures and valued conformance above everything else. To create very efficient organizations, we had to drive variety out. We wanted organizations that were as efficient as machines and that meant we needed human beings who would behave like machines. Then you wake up in a world and you discover it's the irregular people with irregular ideas developing irregular strategies that create the irregular wealth, and our organizations were never built to encourage those behaviors. If you don't change that management model at its core, anything you layer on to it—an idea wiki, a skunk works for new ideas or a corporate incubator—is not going to be effective. We are now facing a set of problems—of accelerating change and hyper-competition and so on—that lie outside the performance envelope of that old management model.

[So] what principles do you use to reinvent management? The ideology of management is controlism—it was built to drive control and conformance, and every organization needs some of that, but if you want to build an organization that is capable of more than that, you have to start with a different set of principles.

If we need organizations that can change as fast as change itself, where do you look to see this in action? What are the systems that seem to be resilient and adaptable? One is markets. Markets are very good at moving resources to new opportunities because capital is always seeking the next big opportunity. People may sell their shares in Google and buy Twitter, and then sell shares in Twitter and buy something else, and that decision making in a market

The ideology of management is controlism—it was built to drive control and conformance

is highly decentralized. So no one executive can stymie new ideas. On average, decentralized decision making results in better allocation of resources than top caliber decision making. It is fundamentally dangerous for an organization's adaptability when a single executive has the power to act as judge, jury and executioner on a new idea.

The idea of markets and using market mechanisms to make decisions is only one of the principles that we need in Management 2.0. The web, [for example], is extraordinarily innovative and as a platform for innovation, it is constantly evolving, adapting, spawning new business models and new forms of social organization. You see an emphasis on experimentation built around a meritocracy where people attract followers in social media only if people want to follow them—there's no top-down assignment or distribution of authority. We have to look at markets, at biology, at the web and anything that is highly resilient and adaptable, and we have to mine those things for the principles that will help us build organizations that are more adaptable than the machine-like organizations we inherited.

Q. What role would managers play in this new management model?

A. That remains to be seen. We're in a transitional state, but I think more and more of the work that we traditionally thought of as managerial work [will] migrate to the edges of the organization. In most organizations we still have almost a kind of feudalistic system where there are executives—the leaders who set strategy, set direction, make key appointments—then the managers, who are responsible for translating strategies into specific goals and holding people accountable and coordinating operations, and then the actual operators, the doers. There was this implied distinction between the thinkers and the doers. That distinction has started to blur.

One of the great innovations of Toyota, [more than 30] years ago, was the principle of *kaizen*. You could take ordinary employees and turn them into sophisticated problem solvers. It represented a profound shift of power from factory managers to first-level employees. The same is happening now in managerial work and executive work. For example, software company Red Hat's strategy-making process is open to the entire organization.

[For that to happen], we have to give people the information they need to manage themselves, we have to make them more financial and business literate, we have to make sure that their actions and behaviors have consequences so they get immediate feedback on whether they are helping move the business forward or not.

Q. You've said that as an organization grows, more energy goes into managing its complexity. Is it possible to have an organization with the best of both worlds: massive scale, but also flexible and agile?

A. Historically, most organizations have faced a number of trade-offs: you could be large, or adaptable; highly efficient, or innovative. The challenge in reinventing management is to transcend those trade-offs.

The secret to doing that is distinguishing between ends and means. Bureaucracy was a way of getting control, and it used narrow job descriptions, highly specified rules and close supervision to make sure people were doing the right thing. [I think you] can get that level of discipline without having all of that bureaucracy and supervision.

Some organizations today are both highly disciplined but also are not very bureaucratic. They're using peer-based models. For example, they will ask employees to rank each other by their value added and then they use that to drive compensation.

Can we get scale and resilience and entrepreneurship at the same time? We're still trying to invent that, but I think there are very promising examples like Haier. You cannot have a resilient organization if the operating units are very large and monolithic. Big things are not adaptable. So Haier (which has 80,000 employees) divided itself into 2,000 business units. [In Haier] increasingly coordination will come from lateral communication and social networks where peers across the organization can discover for themselves where coordination needs to happen, where they need to work together and solve problems. They're creating a lot of lynchpin roles where for small operating units they let individuals coordinate. Because we can move and share information laterally so easily, you can get coordination and the benefits of scale without having multiple layers of management.

Q. Companies overinvest in what is, rather than what could be. How can companies manage the present without losing sight of the future?

A. One, leaders need to ask themselves what things are changing around the world that are still small but are accelerating and [may] one day affect our business. It's very important for CEOs and senior leaders to set aside 3-4 weeks a year where they are in parts of the world where they have a chance to be surprised by the future, where they are not talking internally, or to their peers, or the usual government ministers, but where the outward change is happening—technology, regulatory or demographic. Because as a leader, when a young person comes to me and says, here's something new that we could do, I have to know how to calibrate what I'm hearing.

The second thing you have to do as a leader is make it safe for people to dissent. An organization cannot challenge the status quo if individuals cannot challenge leaders. Often organizations fail because the leaders fail to write off their own depreciating intellectual capital—their emotional equity is invested in the past and people don't feel confident in challenging them.

The last thing is you have to make it easy for employees to get small amounts of experimental funding to try new things. So if to get funding, I need to go to my boss and my idea has to fit with their priorities or beliefs, that's going to make it very difficult to start new things. I've been advocating the creation of something like an internal Kickstarter. Or perhaps in an organization of size, there are tens, maybe hundreds of people who take a small amount of their budget every year and support any project that seems to be interesting. So if I have an idea, there are multiple places to go for funding, rather than just one.

Q. Not every company starts with a business model like Morning Star or W.L. Gore, which seem to have got it right. Some firms have more traditional business models with long histories and legacies. If they want to future-proof their business models, where can they start?

A. Whether it's evolving your business model or evolving your management model, one of the most important principles is the same: experimentation.

If we want to create organizations that are truly post-bureaucratic, where meritocracy rules, where every idea competes on an equal footing, where innovation is an instinctive capability, where communities rapidly form around new ideas, moving to that goal is going to take probably at least a decade for traditional companies. Management 1.0 didn't, and Management 2.0 will not get invented overnight. The important thing is to encourage management experimentation, to go to these principles of transparency and meritocracy and openness and disaggregation and ask: how do I experiment with that in a small low-cost way?

Some years ago one of the largest food and beverage companies in the world wanted to become more open and transparent. They were conducting an annual meeting of senior marketing executives from all over the world and traditionally, those meetings are very carefully scripted in advance. There's very little opportunity for spontaneity, dissent or questioning. They started to recognize that's a problem. So they invited 20 young people to sit in, and asked them to live tweet with a particular hashtag their reactions to what they were hearing from senior leaders. They made it clear that they wanted to hear dissenting voices. That's not expensive or difficult. It takes a little bit of courage, but it starts to send the message: "We want to give young people more influence over our thinking and our policies".

My hope is that large organizations would be doing hundreds of experiments a year. You have to be able to imagine a radical alternative to the management status quo. At the same time you have that revolutionary goal, you have to take evolutionary steps because the management systems and processes we have, most of them are there for a reason. You can't simply blow them up, you have to experiment with the new in parallel to the old and in low-cost ways. The challenge in organizations is to make this kind of management experimentation legitimate, to encourage it, and then the things that work we'll propagate those. The things that failed? Well, we learned something and we won't make that mistake again.

The old model of top-down change is bankrupt. By the time a problem or an opportunity is big enough to capture the shared attention of the leadership group or the CEO, it's too late—that problem has either arrived on your doorstep or someone has already exploited that opportunity. So in most organizations, change programs are almost always behind the curve.

We have to think of change as something that's socially constructed, that's happening all the time in small ways and where change rolls up rather than rolls out or rolls down. That's true for changes that influence the business model and the management model. But if we can move to a [model that is] more socially open and unopposed to change, we'll have organizations that are adaptable and far more humane.

For the full interview, log on to CKGSB Knowledge: knowledge.ckgsb.edu.cn

Don't Ditch the Basics

Tom Doctoroff, CEO, JWT Asia Pacific, on why marketers need to embrace digital without forgetting the basics of marketing

By Neelima Mahajan

The explosion of digital platforms is causing many marketers to rethink how they engage with consumers. But, as Tom Doctoroff, CEO of J. Walter Thompson Asia Pacific, points out, sometimes in their hurry to embrace the digital world, companies often lose their way and forget the basic principles of good marketing and branding. "We furtively deploy the latest or hottest digital innovation without fully considering the basics of brand strategy or message consistency. Consumers end up more confused and less loyal," he writes in his latest book *Twitter is Not a Strategy: Remastering the Art of Brand Marketing*.

What Doctoroff is proposing is a strategy combining the best of both worlds: the 'new' of digital marketing with the tried and tested fundamentals of traditional branding.

In this wide ranging interview, Doctoroff talks about that as well as other issues that keep marketers and brand owners awake at night.

Q. In the late 1990s Hal Varian and Carl Shapiro said that the power of big brands would shrink due to better access to information. In recent times others like Itamar Simonson and Emanuel Rosen argued that brands are needed less when consumers can access information through reviews and expert opinions. To what extent do you think that traditional branding, as we know it, is on the decline?

A. If you measure it in terms of percentage of media spend, clearly digital is widening and traditional is declining. The crux of [my] book is the alignment between the new and the so-called traditional. If you take a look at traditional as media channels, then of course, it is going to be declining as the role of data increases. On the other hand, if you take a look at traditional branding as message clarity, as positioning, as the role of brands in life, and as the need for a compelling proposition and brand idea that forges order across different channels conceptually and executionally, then this is more important now than ever before as different engagement platforms proliferate.

If you define traditional branding as mass media, it's gonna be less important now than before, and it's declining in importance. But if you define traditional advertising as the conceptual craftsmanship that we have traditionally associated with building marketing propositions and enduring brand relationships with consumers, that's more important now than ever before. The role of a brand is for loyalty. Loyalty allows you to charge a higher price. With so many options that consumers have access to and the transparency of prices, the ability to charge a price premium is more important than ever before. Both in terms of confusion elimination or minimization and also the loyalty question in an era of proliferating branded and cheap alternatives, branding—traditional brand building if you want to call it that—becomes more important than ever before.

Q. We sometimes find that consumers are less loyal to brands. Where do you think this will leave the idea of branding?

A. That is the $64,000 question and I wholeheartedly reject it. All you have to ask yourself is: are there still products that people are willing to pay a premium for? That premium *ipso facto* is loyalty. When you think about brand loyalty, and declining brand loyalty, what you're talking about on the flip side is increased price sensitivity. So perhaps it's true, that as consumers evolve they become less brand loyal in some sectors, but more brand loyal in other sectors. As you scale the Maslowian hierarchy of needs, a cleaning detergent could be high involvement for you when you're relatively poor and you need clothes to shine. As you move up, what you wear in terms of a brand, your car or your mobile phone becomes more high-involvement for you and more relevant to your life and you're willing to pay a higher price premium for that.

> If you don't have a strong and cohesive brand, then the product becomes very important. But that [would be] a very vulnerable product

In emerging markets, you have waves of consumers entering different phases of economic development, so there will always be new consumers. With urbanization in China people are owning homes or moving to cities for the first time. So their brand choices are high involvement and then there's loyalty. Societies are always evolving. Different segments of societies' engagement with different types of categories is always shifting as well.

Q. Some experts are saying that people are often 'product loyal' rather than 'brand loyal' and it's easy to confuse the two. Is that a differentiation that we need to be paying attention to?

A. I disagree. I'm not saying that product attributes aren't critically important. We have to define our terms: what is a brand? A brand is the role of a product in life and it is the relationship that a person has with a product. That relationship is forged through both product engagement, but also from a clear proposition that is in many cases passively received and actively defined by the manufacturer. Ultimately a brand is an experience. So if that experience is not only multidimensional, but also consistent, that experience becomes a holistic brand. Take Lego. It's not just the fact that you have blocks that makes Lego a strong brand. It's that you have a clearly defined brand idea, a relationship between the brand and consumer of inspiring builders of tomorrow. So every time you come into contact with that brand—whether it's Lego Land, the Lego movie, the Lego retail experience, or the Lego toy itself—then you are reinforcing a predefined relationship. Once you start defining a brand as a relationship, you stop talking as if the product and brand can be separated. They can't. The brand is a relationship that is an alignment of function, emotion and role in life, so that it's all consistent. Of course if you don't have a strong and cohesive brand, then the product becomes very important. But that [would be] a very vulnerable product because people can simply out-innovate you very quickly.

Q. In your book, you talk of brand indifference and differences between the developed world vis-a-vis developing countries. What is that a function of, and how should big brands factor this into their strategies?

A. As consumers become wealthier and more able to digest communications and brand propositions, and less safety seeking and less in need of basic reassurance and reliability, they become more discriminating. That's a long-winded way of saying that because developed market consumers are more experienced digesting brands, their standards of what a brand experience should be to result in satisfaction are probably more multidimensional. Then the question is: does that mean that they are less embracing of good brands? The answer is no. There is still a great deal of loyalty for brands that have a significant role in life.

Q. The crux of your argument in the book is that the advent of digital marketing is creating a schism in marketing that is fur-

ther hampering the development of brands. Where are you really coming from and why?

A. I feel there's less confidence in people in terms of defining their future both personally and on a brand and marketing level. In our industry (advertising agencies) there are people that say we're not creatives anymore, we're inventors. Many advertising agencies [have] defined their mission without any direct or indirect association with ideas. But in the process I see us disregarding anything that is abstract. Brands, and timeless brand building is ultimately conceptual craftsmanship. That is, I think, a little bit denigrated these days in relation to the digital engineering that is happening at the most innovative technology companies. I'm seeing a loss of confidence.

Q. Can you give me an example of companies that have stepped too far away from the fundamentals of marketing into just a very extreme digital world?

A. What happens more often is you see lots of inconsistent messages. Inconsistency is often the fruit of an identity crisis. Adidas has lost its core message. A lot of Mercedes' digital activities have nothing to do with the core proposition. They're very tactical in targeting very direct and specific market targets for their specific variants or nameplates or sub-nameplates, but when you take a look at that versus BMW, BMW has maintained a much more cohesive brand idea across both broadcast and lean-back media and digital channels. In China Li-Ning's methods have shattered as a result of the advent of digital, as a result of the multichannel confusion.

Q. Can you take an example of a brand and explain how they got it right?

A. If you look at Axe deodorant (known as Lynx in some countries like Australia and China), its brand idea is about irresistible attractiveness for the ordinary guy. The insight [or motivation] is that young men are not confident in their ability to attract young women; Axe gives you the confidence. That's usually how its creative is expressed on television. If you look at the digital engagement platforms, they have a 'sexy alarm clock': a guy can have a beautiful girl wake him up every day and remind him to wear Axe. You can join an online air hostess club, a Mile-High Club, which again can be built into a loyalty program as well. So you're taking from insight to brand idea to creative expression, then to engagement platform to digital and non-digital means, the exact same relationship with the brand.

UNIQLO has an insight for Asians in particular that don't want to be defined by style, but want to have freedom in a framework. They want to be able to mix and match. So you have mix and match component clothing, and then you have a brand idea that is ultimately about your style, not ours. As you go into the digital platforms, you have a tick-tock clock called UNIQLOCK change your moves (UNIQLOCK is an online music and dance clock showing a four girls dancing wearing different combinations of UNIQLO clothes). It's reinforcing that same relationship.

Q. Some brands, like Li-Ning which you mentioned earlier, get it wrong. Is it because within the organization maybe traditional marketing is seen as a different silo versus what is seen as digital?

A. The fundamental issue is that in general—and I don't like using the word traditional—traditional marketing relies on lateral thinking. Digital marketing is much more analytic and linear. Corporations need to make great efforts to align a conceptual and a linear orientation. This difference could be further exacerbated structurally, though oftentimes digital and e-commerce would be in the domain of sales, whereas brand—particularly in Asia—is in the domain of marketing. Marketing is relatively unempowered relative to sales. The ultimate issue is corporate governance: the CEO [being] rewarded for long-term shareholder gains based on value propositions that yield higher profit. This type of leadership needs to be very strong and committed to brand building and the cohesion of a brand proposition. Unless he is, the structure of a corporation, the prominence of marketing relative to sales, where e-commerce comes into the proposition, where digital comes into the sales organization, whether it's just another channel or a new way of engaging with consumers, is something that is ultimately structural.

Q. You have been in Asia for about 20 years. In your opinion, how evolved are Asian companies when it comes to these issues that you're talking about?

A. Depending on the country, there's a broad spectrum of sensitivity towards the value of brands, as we define them in developed markets. Japan is very unembracing of brands for fundamentally cultural reasons. They define brands as two things: innovation and scale. But when it comes to an explicit definition of what a brand proposition or brand idea is, this violates some cultural tendencies: it's a very implicit culture where things are not expressed overtly. So the need in a highly harmonious society, that is relatively isolated, to define for the benefit of people who are not of the culture what a brand proposition is, is not fundamental.

If you move into China, Korea, and other Confucian countries, the acceptance of a brand and what it can do for pragmatic purposes is huge. Just to give you an example, our revenue in J. Walter Thompson China is at least 45% from local companies. In Japan it's been a much harder road to hoe. Chinese companies know that a brand is useful. The problem is that the structure of companies doesn't let them pass through the inflection point required for consistency. And that gets back to the structural issues: the emperor is a CEO managing not just long-term shareholder gain, but the political imperatives. So there are silos and Balkanization which keep the brand from being a unifying force. You've got a lot of people that want to have a brand as we know it in developed markets, but are not able to implement it operationally.

In Southeast Asia the companies are not as evolved as brand producers, but there is a much more easy embrace of it. Again, I think that there's a scale issue that has precluded that from coming together. India, of course, is very brand sensitive, because Indians are great conceptualizers.

Is State Capitalism Overrated?

Economist Nicholas Lardy discusses misconceptions about the role of the state in China's economy

By Major Tian

It's not hard to see why the West is afraid of China's state-capitalism: state-owned firms are gobbling up private ones at home, buying up global resources and 'destroying' the world's business order. And even when the headline-grabbing firms are not government-controlled, like in the case of Alibaba or Shuanghui (the pork producer that purchased Smithfield last year), they either have ties to elite military families or hidden financial support from state-owned banks.

It's a widespread notion that China's state-owned enterprises (SOEs) are so powerful that they determine the country's economic success and spearhead its global ambitions. While it's true that state monopolies do exist in almost all key sectors (it's a 'socialist market economy' after all), and the government still keeps a tight grip on a lot of industries, the communist state may not be as omnipotent as you may think. If you take a closer look at the statistics of the Chinese economy, you'll realize that the dominance of China's state-owned sector is oftentimes overblown by the media; and the growth miracle China has managed to achieve in the past three decades very much depends on its thriving private sector, which now accounts for the bulk of China's industrial output.

This is the key message in Nicholas Lardy's new book, *Markets over Mao: The Rise of Private Businesses in China*. A long-time China watcher and the Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics, Lardy argues that China is on track to become a more market-driven economy and there's no evidence that SOEs are enjoying a return of prominence. In this interview, Lardy dismisses some common misconceptions about China's state economy and provides a detailed look at the country's reform agenda.

Q. Can you explain what's considered private and state-owned in China?

A. Various hybrid forms of ownership have existed throughout the history of the People's Republic. But I think this has begun to be clarified because the statistical authorities are now classifying firms based on what they call 'control'.

The criteria is if a limited liability company has a sole majority or dominant state owner, then it is classified as state-controlled; and similarly if the sole majority or dominant owner is private, then it is privately-controlled.

Q. There have been many discussions about how powerful state capitalism is in China. What is you perception?

A. Particularly in the West, there are a number of misconceptions about the Chinese economy. One is that the state is very dominant, that it's the major part of the economy. Another misconception is that state firms are all very monopolistic, that they have a lot of market power, and that they earn what some people characterize as "astronomical" profits, and this enhances the role of the state. A third misconception is that the state is very large, and has a large, powerful bureaucracy. A fourth misconception is that the state enterprises absorb most of the lending from the banking system and that private players get squeezed out or starved for capital. A final misconception is that somehow [after fading under Deng Xiaoping] there was a resurgence in the role of state companies during the period when President Hu Jintao and Premier Wen Jiabao were in power—that then they enjoyed a return to prominence in the period, say, from 2003 to 2013.

When you look at the evidence, it turns out [these things are] not true. In terms of the dominance of state firms, in the industrial sector state firms used to be totally dominant and today they only produce a quarter of output.

In manufacturing, they only produce a fifth of output. The real source of growth in the manufacturing sector has been private companies. Similarly, in terms of employment, state-owned companies used to be responsible for a very, very large share of employment in urban areas. This has fallen dramatically. Most people are working for private companies. If you look at the growth of the labor force over the last three to four decades, almost all the growth is accounted for by the expansion of private businesses.

On the credit question, one of the reasons private companies have been able to grow fairly rapidly is that they have gotten better access to credit in recent years. It is true that historically SOEs did absorb most of the credit, but I think in the last 10 years that has changed. If you look at data for the last three years… [of] flow of money to enterprises, state companies are getting about a third of the money and private firms are getting a little bit more than half. So the empirical evidence doesn't really support the view that state companies have complete control of credit.

Finally, on the resurgence of state companies—particularly if you look at manufacturing—private companies grew twice as fast as state companies throughout the 10 years that Hu Jintao and Wen Jiabao were China's two main leaders. So it was a continuation of the trends of an early period when private companies, particularly in the industrial sector, have just simply grown much more rapidly.

I'm not against state ownership. What we need is competition. And if state firms can compete with private firms, they should continue to have a large role

Q. Why do you think the private sector has flourished in China?

A. The private sector has flourished primarily because it's more efficient. The return on assets is much higher. Most investment in China is financed from retained earnings. We have a natural inclination to focus on what the banks are doing, how much money's being raised through the equity market or the debt market; but most investment is being financed from retained earnings, and if you have a much higher return on assets in the private sector, they're going to have more retained earnings, which they reinvest, and that allows them to grow faster. In more recent years they've also gotten somewhat better access to bank lending.

Q. One popular perception is that SOEs enjoy extremely cheap credit from the banks, but you have some different findings.

A. In my book I look at that in some detail. The idea that state companies are getting cheaper capital than private companies really turns out not to be the case.

There's a lot of evidence that the difference in the interest rates that state and private firms pay is very, very small. A number of studies argue that state firms pay a lot less. But they have calculated the interest rates that the state companies paid on a fundamentally flawed methodology. They've looked at listed companies and what they're paying on their interest payments, and they divide that into their liabilities. But they made a fundamental flaw in the denominator of liabilities: they have a huge share of non-interest-bearing liabilities. Companies have payables, wages that are due, other payments that they have to make, so they're a liability on their balance sheet. But they're not paying interest on them. So once you correct for the fact that only a small share of any firm's liabilities are interest bearing, it turns out that these state companies are paying 6% or 7% just like everybody else.

It is true that some private companies are forced into what we would call shadow banking, or even worse the underground banking sector, and interest rates are much higher there. But the extent to which private firms are able to access bank loans, they're not paying much higher rates.

Frankly there's a good reason for it. Private companies have a much higher return on assets, and if you look at their interest coverage ratio today (their earnings relative to their interest payments), it is more than twice that of state firms. State firms have a relatively low return on assets, so their interest coverage ratio, which is a very good indicator of credit worthiness, is not very high. So there's no reason for banks to charge more to private companies they're lending to, because in fact they're more credit worthy.

Q. How will interest rate liberalization change the way enterprises are financed?

A. I still think interest rate liberalization, and particularly the liberalization of deposit rates, would be very important, because China has been for a number of years in a very capital-intensive growth process.

Because the central bank has held down deposit rates, banks have had a cheap source of funding. And borrowers have shared in that cheap source of funding because there's enough competition in the banking sector. One of the reasons the investment rate is so high is that the cost of borrowing money from the banking system is too low.

So liberalization of deposit rates, if we look at what unregulated rates are—like money market funds, wealth management products—they tend to be 200 or 250 basis points higher than bank deposit rates. If the ceiling on bank deposit rates were gradually phased out, banks would have to pay more for their funds; and if they pay more on their liabilities, they're going to seek to earn more on their assets. So they will try to charge higher interest rates on their loans.

This will be very positive for China's development for two reasons: it will lead to less capital formation, less capital-intensive growth, and it will also lead to an increase in the share of lending that is going to go to the private sector, because the private sector is better able to pay higher rates.

Since the private sector has a return on assets in manufacturing that is three times that of state companies, and in services at least twice that of state companies, the money will flow to firms that can generate better returns.

So this will help to sustain economic growth in China, even if the share of resources going into investment comes down. So you can moderate the growth of investment, and still keep the overall economy growing reasonably well if the allocation of bank loans is more efficient.

Q. You once said that the effort to create China's 'national champions' has failed. Why?

A. The efforts of the State-owned Assets Supervision and Administration Commission (SASAC) [have] not really worked out very well because the return on assets of these firms has declined very dramatically since SASAC was formed in 2003. These firms on average now earn only about half their cost of capital. So these firms had become a big drag on China's economic growth, and I think this is recognized at the top of China's political system because one of the components of the Third Plenum reforms was to eliminate monopolies except for natural monopolies.

Many of the SASAC firms do operate in highly monopolized sectors. A lot of the service sectors are monopolized—upstream oil and gas is monopolized, certainly telecommunications would be the best example—all those telecommunications companies are under the aegis of SASAC. So reducing the monopolies in these areas, increasing competition and allowing more access by private players is seen by the current leadership as a way of maintaining and sustaining China's economic growth.

Q. Will there be opportunities for private enterprises in sectors like power and telecommunications?

A. Well, certainly probably not in power distribution. Power distribution is what we would call a natural monopoly and I think the State Grid, for example, is going to continue to be one of the dominant players along with China Southern Power Grid. But power generation and financial services could be more competitive sectors. The authorities are already beginning to license a number of new completely private banks. Now these will be very small to begin with and they might only be able to operate in limited geographies, but establishing truly private banks for the first time, I think, is an important step forward.

If you look at value-added telecommunications services, private players are already entering into that space and some of the monopoly companies are being required to lease capacity on their wireless networks to allow the expansion of these private players. In the basic wireless service the three companies still have a monopoly position, but in a lot of the value-added telecommunications services, competition is already starting up. That's a very important sign. Even in upstream oil and gas, the fact that Sinopec is selling off a very large chunk of its distribution business to private firms is a big step forward.

Q. One of the current reforms aims to mix up the ownership structure of SOEs. Do you think it'll eventually work out?

A. If you look back over the last decade, the hybrid form of ownership has not really been a game changer in China. Yes, some big state firms were corporatized, a number of them got listed on the Shanghai market or maybe some external market; but the state retained a dominant ownership of those companies. And there wasn't really much change in governance. Hybrid governance is a step in the right direction potentially, but if the state is going to remain the dominant owner, it's not as transformative.

I'm hoping in this time the share of ownership that transfers into private hands will be somewhat higher. And there's an opportunity to really transform the operation of these companies, not just simply let private people buy into 20% or 30% of the shares. It will require the organization department of the party to step back from determining the composition of the top management of these firms, and let the boards of directors of these companies play that role.

Q. So do you think there will be resistance from officials or the current executives of the SOEs?

A. There will be some resistance in some quarters. On the other hand, some of the entrepreneurial people in state companies may even welcome the opportunity to operate in a more competitive environment and demonstrate that they can improve the efficiency of the firms that they're operating.

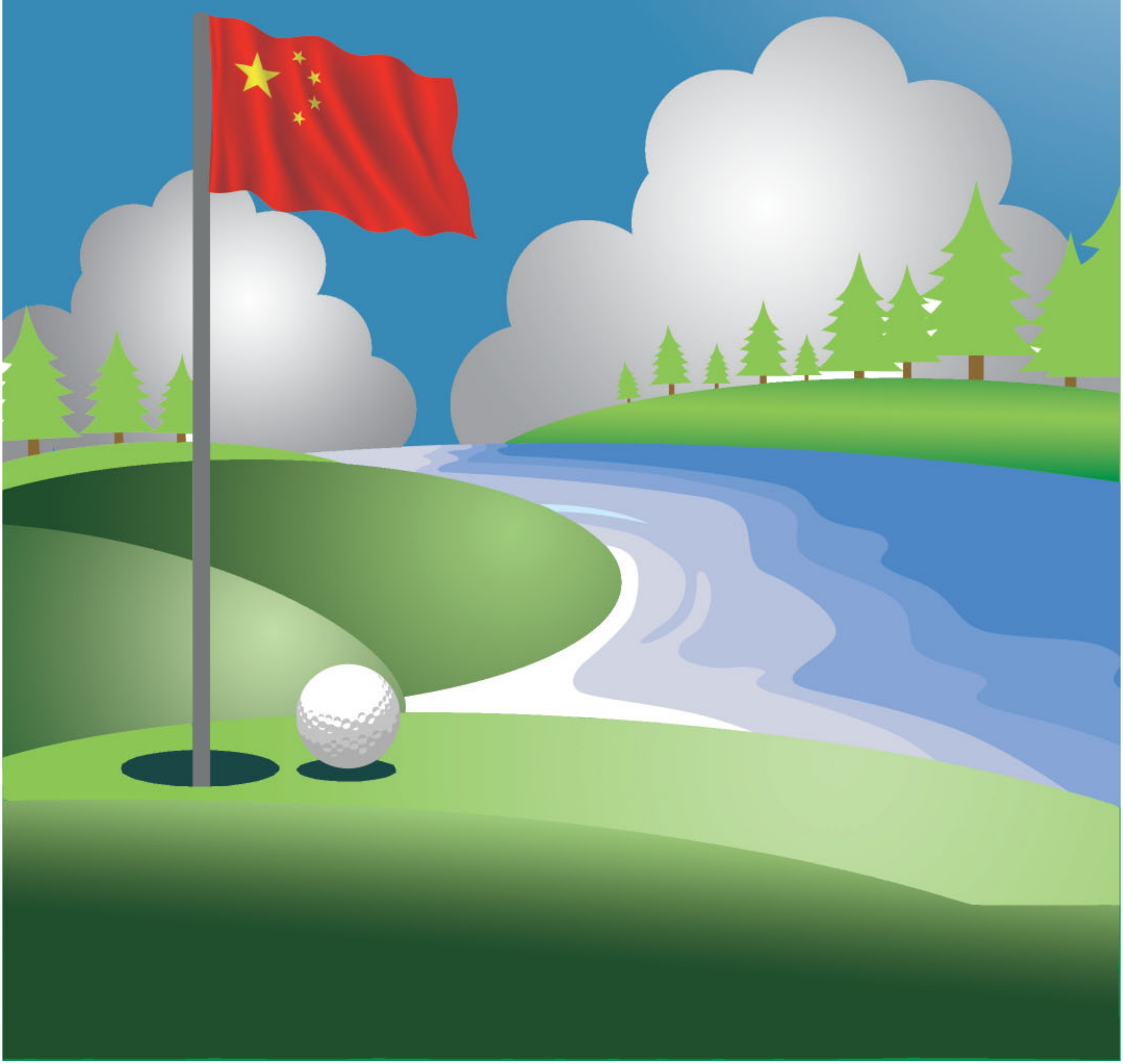
I'm not against state ownership. What we need is competition. And if state firms can compete with private firms, they should continue to have a large role. On the other hand, if they're not able to compete over time then they probably need to shrink, and perhaps some of them may be taken over by a more efficient private player.

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

A Chinese Tiger Woods?

China's golfing prodigies have burst on to the world golfing scene, showing just how far the sport has come

By Nathalia Hardie



In 2013, while most Chinese teenagers would have been busy studying for the country's seemingly endless conveyor belt of exams, the then 14-year-old Guan Tianlang was working towards something a bit different—his debut appearance at golf's Masters Tournament. While that might suggest an isolated and freakish level of ability, Guan isn't alone in making serious headway into the sport, and the presence of such prodigies show just how far golf has come in China and the impact they're beginning to have on the highest levels of the sport.

Unsurprisingly, these developments have caught the eye of the sport's establishment, with the legendary professional golfer Gary Player describing the progress of Guan on his blog for *Golf Magazine* as the "most historic moment golf has experienced in [a] lifetime".

All this from a player of sport that was banned as a capitalist pastime until as recently as 1984, and which saw a ban on the construction of golf courses in 2004. (The policy was an abject failure—between 2004 and 2011, the number more than tripled from 170 to over 600, according to HSBC's Golf 2020 Vision report.)

"If you look at the results from the big junior tournaments around the world, that's where you are seeing the impact of China because you will see a lot of Chinese names and some of them are doing quite well," claims Dan Washburn, Chief Content Officer at the Asia Society and author of *The Forbidden Game: Golf and the Chinese Dream*. "What you are seeing is that this is really the first generation of golfers in China that could play from a very young age and can afford to play and can afford high quality coaching and can afford to travel to international tournaments."

First came the Chinese golfer Andy Zhang, who qualified for the US Open in 2012, at the age of 14, after the player Paul Casey withdrew with a shoulder injury. He began playing at the age of six, moved to the US at the age of 10 and is a graduate of HSBC's Junior Golf Program in China.

And at just 12 years of age, Ye Wocheng became the youngest golfer to play in a European Tour event after he qualified for the Volvo China Open in 2013. "I've dreamed of this since I was a boy," he said at the time to some amusement. Neither Guan nor Ye had been born when golf superstar Tiger Woods won his first major title at the 1997 Masters.

Teeing off: Students play golf at a primary school in Hangzhou, Zhejiang province

The success of these wunderkids has not gone unnoticed by the Chinese public either. Fifteen-year-old Guan's star has risen quickly and he drew unprecedented crowds of spectators at the China Open in early 2014.

China's Golf Factory

As with many sports, China is now starting to use the incubator approach to golf to ensure a steady supply of talent into the future. Young kids with promise are being molded into golf prodigies under the watchful eye of their 'tiger moms and dads'. China's sudden explosion of wealth and its one child policy have intensified the anxiety of parents willing to go to almost any extreme to make their child stand out.

Chinese children can be seen at driving ranges around the country spending hours practicing their swing, sometimes under the guidance of foreign coaches. And although this investment may not yield a professional golf career, Chinese parents are aware that sporting talent can get their child into an Ivy League school and perhaps help in terms of a business career later in life. According to Washburn, "developing good manners and etiquette… as well as providing advantages for the child if he or she chooses to enter into the business world" are other reasons why Chinese parents are so eager to encourage their offspring to play golf.

"Getting a scholarship to a top American college is my expectation for her," says hopeful mother Xi Junling as she peruses golfing outfits for her 10-year-old daughter Xiaohong in Shanghai. "She really wants to

The Cost of Golf Equipment

Top items from prestigious brands based on sales volume

Golf clubs – RMB 6,880
Gloves – RMB 65
Golf bag – RMB 987
Polo shirt – RMB 499
Golf shoes – RMB 458
Golf balls – RMB 140

Source: Tmall

> “If the person has ever heard of golf, they would probably say: ‘Oh, that’s the rich man’s game’
>
> Dan Washburn
> Author
> *The Forbidden Game*

get into Harvard.”

Academies for talented children from as young as five years old are growing in popularity, and a report by *Xinhua* in May 2012 identified a school in Zhuhai, a city in the south of China, that offers free golf training to kindergarteners. At the other end of China’s income spectrum, some parents are now prepared to spend up to RMB 300,000 ($43,940) on lessons for their children. Meanwhile, the China Junior Golf Open Tournament held in Chengdu, capital of China’s southwestern Sichuan province, and sponsored by HSBC, continues to grow in popularity, along with other junior golf events.

A huge investment is being made into these children and the pressure is mounting, with the country eager to find a figure who can be a Chinese version of Tiger Woods, or raise the profile of golf as sports star Yao Ming did with basketball.

Moreover, golf’s inclusion in the 2016 Rio de Janeiro Olympic Games will only boost the game’s appeal further for this medal-hungry country. “Representing China in the Olympics would be the greatest honor,” chuckles 20-year-old Wang Bin from the Shanghai Jiao Tong University Golf club. “It is a dream. If only I was good enough, everyone would be so proud.”

The Chinese government has now invested in a national golf team as a way for China to jump start the process of getting more Chinese players to compete at international events, with the hope that one day China will be able to become a force in Olympic golf games and compete for medals. “China takes its Olympic medals very seriously. They are funneling an unprecedented amount of money into its national team. And this is an elite group of young professionals that China is paying for every aspect of their careers. No other country is doing this at such a scale,” says Washburn.

The Rich Kids Club

A growing number of China’s emerging middle class, with more money to spend on luxury goods and leisure pursuits, are in a position invest in training for their children, and for these new economic elites golf still has both novelty and prestige. Many Chinese business people also find golf is a useful way to bridge the gap between East and West when doing business deals.

Unsurprisingly then, the rich are more likely to play golf as a hobby, as is the case in many other parts of the world, and cost plays a role too. It is not simply a shortage of courses, competitions and coaching, but the high prices for all of them that make junior golf a zone of exclusivity. This is heightened by the fact that China lacks the scholarships, high-school programs and cheap municipal courses and ranges that other countries have.

“If you travel throughout China and you ask the average person about the game of golf, if the person has ever heard of golf, they would probably say: ‘Oh, that’s the rich man’s game’. And in China that is more true than anywhere else in the world,” claims Washburn.

Zhang Wei, a 26-year-old auditor at one of the big four accounting firms, laughs when asked whether or not he played the sport. “Golf? No way, that is only for those with deep pockets.”

His reaction comes with good reason; playing golf comes with a hefty price tag in China. Even starting out, some families spend around $30,000 a year on lessons, greens fees and travel for tournaments and training. Expenses increase sharply when families start traveling to the US for junior tournaments, enroll their children in full-time US golf academies or hire a full-time foreign coach in China.

China has everything to play for when it comes to golf, especially as it is just about to become an Olympic sport. To maintain the momentum, however, golf still needs to widen the sport’s appeal and improve training as the sports market in China becomes ever more crowded.

Digging Deeper

Joel Backaler tells us how to shed light on the topic of China and the process of writing about Chinese firms expanding into international markets

One of the best pieces of advice I ever received came from my high school English teacher, Mr. Kennedy. He challenged us to go out of our way to read books about a variety of subjects and writing styles and to never just stick to one genre. Throughout the years this relatively straightforward piece of advice has exposed me to many great ideas and topics that I would never have discovered had I only read books on topics that I encounter in my daily life. In fact, it was this advice that initially triggered my interest in Asia.

When I first flipped through chapter one of Peter Hopkirk's *The Great Game*, I was hooked. His detailed accounts of the historical quest for Central Asia opened my eyes to a part of the world I knew little about. I continued to read about other parts of Asia, but particularly China—eventually, leading me to learn Mandarin, first in university followed by intensive study in Taiwan and mainland China. I've spent the better part of the last decade living in Beijing, Shanghai, Taipei and Singapore, and regularly traveling back and forth for business.

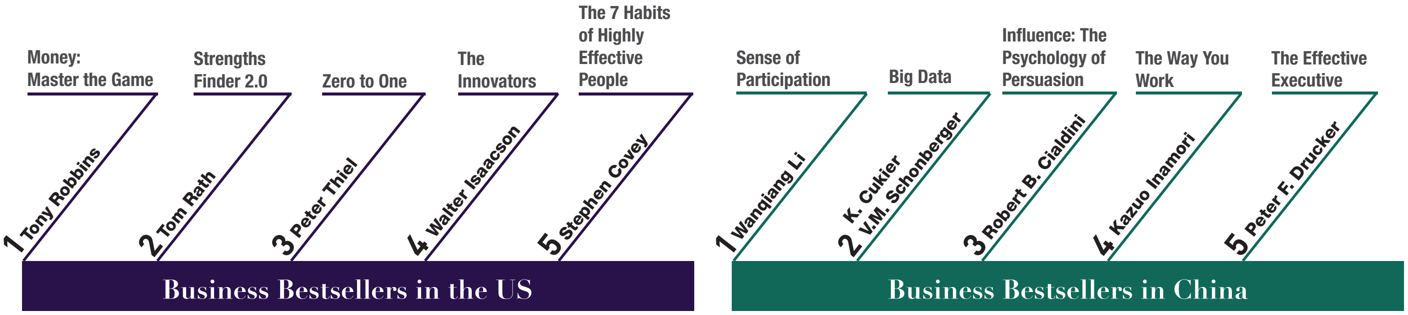
Over the years, I read many 'China business' books including Tim Clissod's *Mr. China*, James McGregor's *One Billion Customers* and Jack Perkowski's *Managing the Dragon*. However, in recent years I've been primarily concerned with topics relating to my own writing.

Despite that fact that I had read many books in my lifetime, until recently I had never tried writing a book myself. So before even beginning my research for that project, I read books about the book writing process such as Susan Rabiner's and Alfred Forunato's excellent guidebook *Thinking Like Your Editor*.

In other cases, my reading was directed at learning more about the topics I cover, such as Chinese companies building global brands. To learn more about marketing and branding in China, I read Tom Doctoroff's *Billions* and Karl Gerth's *As China Goes, So Goes The World*. But, I also read books about the fundamentals of marketing such as *Kellogg on Branding* from the faculty of the Kellogg School of Management, David Ogilvy's *Ogilvy on Advertising* and more recent books like Dan Ariely's *Predictably Irrational*. All of this allows me to provide a complete picture for my readers.

These days, I find myself with ample opportunities to catch up on reading books on other topics of interest during my regular business travel. I am currently reading Colin Powell's book, *It Worked for Me: In Life and Leadership*. I had the honor to meet him in person earlier this month at the Sino-US Political and Business Forum in Washington, DC. I was inspired by his talk, which covered his personal history working with China from taking the Trans-Siberian Railroad into China following Richard Nixon's visit, to his diplomatic visits in more recent years as U.S. Secretary of State. I have a long list of books that I want to read next—two China-focused books that I plan to read are Evan Osnos' *Age of Ambition* and Howard French's *China's Second Continent*.

Joel Backaler is Associate Vice President at Frontier Strategy Group and a member of the National Committee on United States-China Relations. He is the author of China Goes West



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