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CHEUNG KONG
GRADUATE SCHOOL
OF BUSINESS

Volume No. 9
MARCH 2013



The Idea Factories

**Chinese incubators tap
homegrown innovation**

- Yum! Brands searches for a new recipe in China
- The scramble for the Chinese smartphone market
- A talk with Nobel Prize winner Robert Aumann
- Western MNCs tap China's e-market

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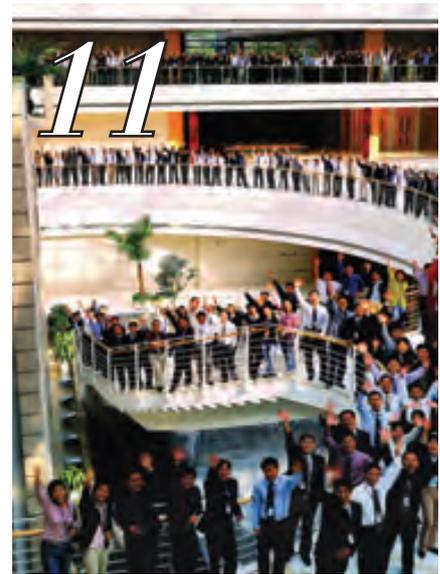


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Cover Story

Kickstarters

China's incubators set entrepreneurial spirit in motion



China Insight

Back To School

Chinese companies set up in-house universities to retain talent



China Insight

The Web Wise-Up

Sophisticated e-consumers push China's cyber retailers to the next level



China Insight

Banking Abroad

Chinese banks' steady march into international markets employs various strategies

China Insight

Smartphones For All!

Domestic smartphone brands are forcing foreign brands to question their approach

Snapshot



A History of Private Enterprise in China

The many developmental stages of modern private enterprise in China

8



20

China Insight

The Money Squeeze

The first signs of light emerge amidst the dark prospects for private enterprises in China's ever-tightening credit market

Issue: March 2013 Vol No. 9

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China Insight

44

Colonel Sanders' Recipe Gone Wrong?

Have Chinese consumers lost their appetite for Yum! Brands?



China Insight

Digital Promised Land

Can Western retail brands make it big in China's e-market?

70 **Bookshelf**

Reaching the World

WPP's Scott Spirit and his 'must-reads' for those in the ad biz

56



The Robert Aumann Interview

The Nobel Prize winner talks game theory and lessons from history with CKGSB's Mei Jianping

C-Suite

The Baidu CFO offers a look into how her company's navigates a rapidly evolving market

62



Q&A

65

Noted entrepreneur and philanthropist Sir Tom Hunter elaborates on his model of philanthropy



58

The Thinker Interview

Stanford's Jeffrey Pfeffer on human sustainability in organizations

48 **China Insight**

Cleaner China?

After record smog and a leadership change, what's in store for energy policy and green investment in China?



Downtime 67

Business on the Battlefield

The Art of War is the gift that keeps on giving in business strategy



Qi Daqing, CKGSB

Viewpoint 52

US SEC Versus Accounting Firms in China



Paul Gillis, Peking University

Sunrise Opportunities

The pictures of heavy smog hanging over Beijing's sky may be the first image you associate with today's China. Indeed, the pollution in most Chinese cities is alarming. However, one thing that makes all people—rich and poor, powerful and disadvantaged—equal in Beijing is that everyone breathes the same air.

This issue of *CKGSB Magazine* will help you peer through the polluted air, a by-product of China's fast economic growth over the past 30 years, and enable you to see more clearly the new green investment opportunities in China.

More importantly, we would like to help you identify the fundamental changes driven by the people who are working day-in and day-out in China's heavily polluted environment. They will reshape the landscape of the world in many ways.

With 3.2 million researchers, China has the world's largest army of R&D personnel, even though you may find the top engineers in Silicon Valley. China now is the second-biggest R&D investor, second only to the US. By 2030, however, China is expected to have up to 200 million college graduates, more than the entire workforce of the US. It is therefore important to examine the innovations taking place now and in the near future in China that can shape the world a few decades from now.

Acquiring top-of-the-world status may not take Chinese companies as long as you might think. Recently, I cast a cursory glance at *Fast Company* magazine's rankings of The World's Most Innovative Companies in 2013. I was pleasantly surprised to find Chinese companies like social media giant Tencent and Landwasher, a company that manufactures eco-efficient toilets, in the Top 50.

As our cover story this issue ('Kickstarters') will tell you, China is fertile ground for tech innovation, especially in emerging sectors like e-commerce and mobile internet. While the ideas and the enthusiasm is there, what's been missing all this while is support in terms of mentoring and seed funding. Incubators such as Chinaaccelerator and Jue.io are stepping in to fill this void.

While on the face of it, these incubators might look like their Silicon Valley counterparts, as our story will tell you, they are a lot different. I don't want to give everything away here. Please turn to page 26 to read our story.

Talking of mobile internet, one of the most innovative sectors in China, our story 'Smartphones for All!' examines recent



trends in China's vibrant smartphone market, which incidentally, is the largest in the world. Like me, you might be surprised that recent trends indicate that China's domestic smartphone manufacturers like Lenovo, Huawei, ZTE and Coolpad are giving the likes of Apple and Nokia a run for their money. What makes these companies tick, and how will the competitive landscape change in the future? To learn more, please turn to page 15.

On page 40, we break new ground in an article ('Digital Promised Land') that examines how and why multinational retail companies like Best Buy and The Home Depot are giving the traditional brick-and-mortar route a miss in China and leveraging e-commerce instead. We go deep into the different e-commerce models that are being tested out.

In this issue of *CKGSB Magazine*, we examine how Kentucky Fried Chicken, once the frontrunner in fast food companies in China, is losing its much-coveted slot, by analyzing the curious case of Yum! Brands' sudden decline in China. To read more of what we have unearthed, please turn to page 44.

As CKGSB gets better known in the world, we occasionally have some of the greatest minds around descend on our campus in Beijing. In this issue, we would like to share with you a profound discussion between Nobel Prize Winner Robert Aumann and our very own professor Mei Jiangping of themes like rationality and game theory, forgiveness and revenge, and the Second World War. In the interviews section, you will also find organizational behavior expert Jeffrey Pfeffer of Stanford, sharing his thoughts on 'human sustainability' with our editor Neelima Mahajan.

I hope you enjoy reading this issue. If you have any feedback, please email us at magazine@ckgsb.edu.cn.

Yours Sincerely,

Zhou Li
Assistant Dean, CKGSB

For more insights on the Chinese economy and business, please log on to <http://knowledge.ckgsb.edu.cn/>

China's top banker isn't backing down to age, Foxconn ushers in the long-dreaded moment of manufacturing automation, and the cost of air pollution in Beijing is hitting people where it hurts: their wallets.



Bringing in the Robots

Foxconn has ceased hiring at both its Zhengzhou and Shenzhen factories as well as many other plants in an apparent nod to its commitment to robotics and automation, following the Lunar New Year holiday, *China Daily* reported. "Our goal is to see the first batch of fully automated factories in five to 10 years and to eliminate simple and repetitive processes through automation in the next few years," said

Terry Guo, CEO of Foxconn, in a statement. Foxconn

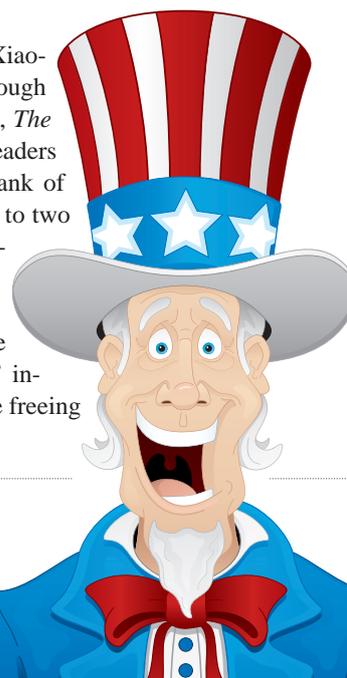
was quick to assuage fears of job loss by claiming an employee retention rate of nearly 97% after the week-long holiday, when employees typically return to their home towns in the 'world's largest mass migration,' *Forbes* said.

RETIREMENT



Not Over the Hill

China's central bank governor, Zhou Xiaochuan, will stay in his position even though he has hit the legal retirement age of 65, *The Wall Street Journal* reported. The nation's leaders agreed that Zhou, who has led the People's Bank of China for 10 years, should retain his post for up to two more years. Zhou's extension runs contrary to expectations, as many expected him to resign during the March meeting of the National People's Congress, which took place to cement the change in leadership. The step signals China's leaders' intention to ensure continuity in policy, such as the freeing up of the yuan.



Multimillion Dollar Vote of Confidence

Saudi billionaire Prince Alwaleed bin Talal raised around \$700 million from Kingdom Holding (a public holding company he controls), Canada's Ontario Teachers Pension Plan and some existing major shareholders to invest in Chinese online retailer 360buy.com, *Business Day* reported. The world's 14th-richest person enters the \$196-billion e-commerce market in China, joining Baidu co-founder Robin Li and Russia's Digital Sky Technologies. The money will go towards strengthening the company's logistics network, China's second-largest web retailer said. The company's unique same-day delivery offering likely appealed to international investors.



Making Friends with Uncle Sam

Okay, this didn't come as a surprise. According to *Fast Company*, Tencent's WeChat topped the list of the most innovative social media companies in 2013. Known in China as Weixin, the app now has more than 300 million users, drawn to the cheaper, clearer and quicker alternative to calling. Tencent is now looking primarily at expansion in the US.

The Hidden Cost of Airpocalypse

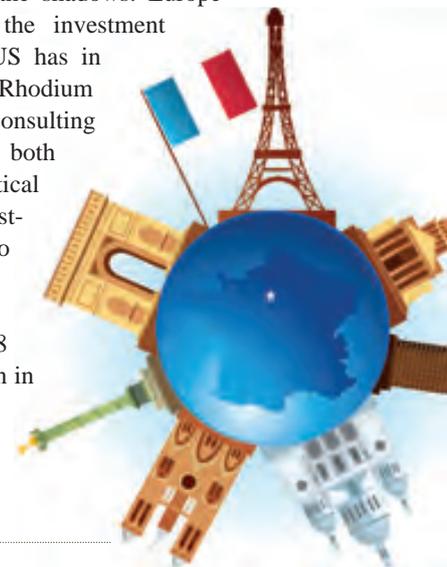
Even as Beijing reeled under the impact of a damning smog this January, a new estimate released by environmental experts and the Asian Development Bank have put the cost of pollution in fresh perspective. The cost of medical treatment for air pollution-related illnesses accounts for a whopping 1.2% of China's GDP each year! On January 12th in Beijing, the air quality index reached a record-breaking 755 on a scale of 500, more than 36 times the level deemed safe by the World Health Organization. The reading, combined with a widespread public outcry, prompted Vice Premier Li Keqiang to become the first Politburo official to speak out, pledging to act. The clean-up cost is said to be 2-4% of GDP over the next 30 years.

Ready, Set, **Search!**

Rivals watch out: e-commerce giant Alibaba has started flexing its muscles in the search business. The company's cloud computing business unit launched a search engine in February to rival Baidu and Qihoo 360, *ZDNet* reported. Aliyun, Alibaba's search engine, will include searches for web pages, news, images and maps. "Aliyun Search is a product developed and maintained by the Aliyun Business Unit under Alibaba Group," a spokesperson for the company said in a statement. In China, Baidu had an 80% market share in 2012, with the rest of the top five consisting of Qihoo 360, Sougou, Google and Soso. This is not, however, Alibaba's first stab at the search business—the company also owns eTao, a product search engine.

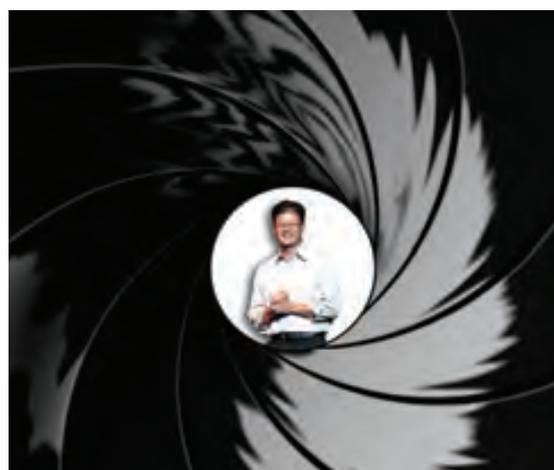
Friendlier Climes

As far as Chinese investors are concerned, Europe is in the limelight while Uncle Sam lurks in the shadows. Europe has attracted double the investment from China that the US has in the last two years. The Rhodium Group, a US-based consulting firm, attributed this to both commercial and political reasons. Direct investment from China into the European Union shot up from less than \$1 billion prior to 2008 to more than \$10 billion in 2012, while the US, only reached a record high of \$6.5 billion in 2012.



Bringing in the Big Guns

Yahoo! co-founder Jerry Yang is set to join the Lenovo board as an observer, to attend board meetings and contribute his expertise, but he will not be able to vote or exercise any directorial influence, Reuters reported. Yang, who co-founded Yahoo! in April 1995 and resigned from the board last year, will receive \$61,875 a year, as well as equity rights valued at \$130,000. Lenovo, the world's second-largest PC maker, is now looking at what it calls the "PC-plus era". It will look to tap global demand for smartphones and tablets, as well as expand its smartphone production in China. Yang resigned from Alibaba Group Holdings and Yahoo! Japan last year.



A History of Private Enterprise in China

From Deng Xiaoping's 'Opening Up' policy to the National Party Congress in March, private enterprise in China has gone through many levels of development

1979

Opening to Foreign Direct Investment

China allowed for the first time foreign direct investment in the form of joint ventures between a domestic and foreign enterprise. The first such business to be registered in the country was the Sino-Hong Kong Joint Venture Enterprise, Beijing Air Catering Company.

1980

Establishment of Special Economic Zones

China set up Special Economic Zones, which were areas that applied market-oriented policies in contrast to the rest of the nation. These regions were intended to attract foreign investment and technology and create jobs. Most of the output was exported, marking these zones as a step toward developing the nation's export capability.

1978

The Dual Track System

China moved away from its state-controlled price system in favor of a dual-track price strategy, involving the building up of a free market alongside the existing planned economy. For example, some enterprises were allowed to sell the surplus at a market rate after meeting their government-set output targets.

1984
~
1993

Decentralized Economic Control

China adopted various measures to decentralize state control, which involved providing municipal authorities with the freedom to experiment with policies to increase the pace of growth and the privatization of SOEs.

Shanghai Stock Exchange Reopens

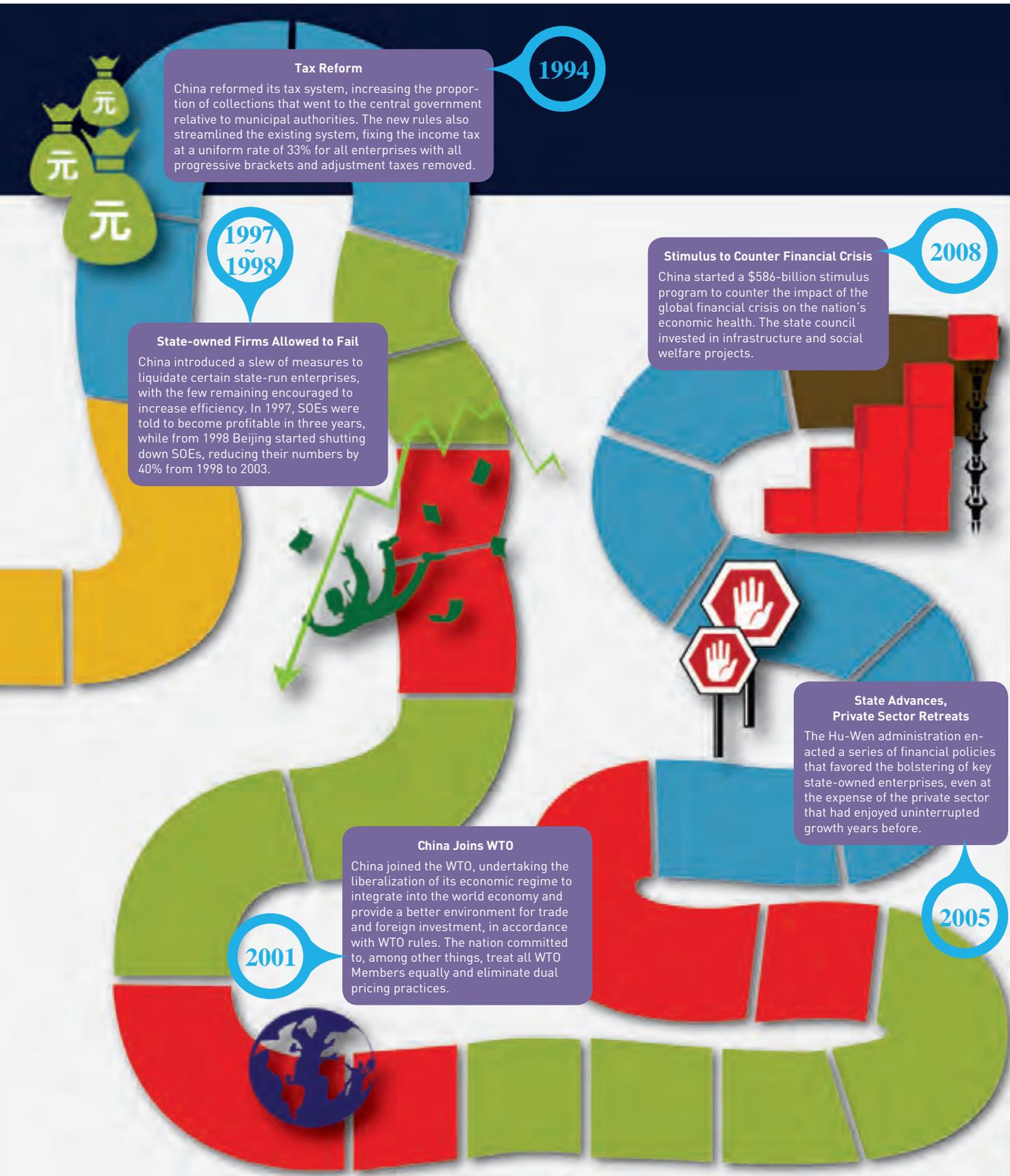
China re-established the Shanghai Stock Exchange, 41 years after Mao Zedong closed it. The exchange is not fully open to foreign investors and is currently the fifth-largest exchange in the world.

1978

Household Responsibility System

China adopted the household responsibility system for the agriculture sector, which gave families responsibility over the profits and losses on their farm. The new scheme lowered quotas and allowed surplus produce to be sold at market prices, whereas prior to this reform, the state set output levels and prices.

1990



CKGSB SHAPES GLOBAL

C-SUITE

LEVEL

BUSINESS THINKING ON CHINA

CLIFFORD
CHANCE

Cheung Kong Graduate School of Business creates innovative programs tailored to the needs of business leaders from organizations such as Clifford Chance, one of the world's leading law firms. CKGSB's Boardroom China Briefing equipped 20 of the firm's global partners with cutting-edge insights on the global implications of China's transformation.

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Back To School

Chinese companies ramp up training by setting up in-house universities to retain talent

By Virginie Mangin



Creating loyal Huaweiers: Students, faculty and staff at Huawei University's sprawling 275,000 square meters Shenzhen campus

A couple of students sit outside a state-of-the-art training facility enjoying their break over a cup of coffee in a chic café resembling a luxury version of Starbucks. Soon they will go back inside and sit behind their desks in modern classrooms, all equipped with flat screens and projectors.

They are two of the thousands of “Huaweiers” who pass through Huawei University every year: a vast Shenzhen-based campus equipped with apartments and amenities. Welcoming employees and students from both inside and outside the company, the university also grants outside engineers access to its facilities and courses.

Huawei University, which stretches over 275,000 square meters of land was founded in 2001, in response to the company’s major growing human resources needs. Huawei, just as other foreign and Chinese companies in China, was growing rapidly. It was in dire need of talent, both local and international. Trained managers were then, and still remain, a rare commodity. So the telecom equipment and services firm decided to create its own training centre to consolidate a loyal talent pool and immerse its ever-growing headcount in its strong corporate culture. In 2012

Huawei recruited 2,200 people worldwide.

“We have no choice. We had to invest in people. We have to match the development of the people with that of the company,” says Haiyan Chen, Director of the HR Talent Department for Huawei, while delivering a presentation on the university. The company today generates over \$30 billion in revenues a year and employs 140,000 people worldwide.

At first the model was based on what big Western corporations—including IBM or General Electric—had offered their employees, but Huawei has adapted the learning and training process to China’s unique human resources landscape.

In China, managers are young and few. They often lack the necessary experience and training, and are propelled to senior positions at a much younger age than in the West.

“There is a big gap between what we call technicians and top management. Effective middle managers are very difficult to recruit, in most cases old style Chinese management still prevails,” explains Yannig Gourmelon, Partner with Roland Berger consultants. The ‘old style’ management he refers to is a paternalistic practice of maintaining control at the head and not delegating to managers below.

Talent Shortage

It is those that are most difficult to find that companies are in most need of in China: well-groomed managers with good university degrees, able to take on responsibility and fluent in more than two languages. While the number of Chinese graduates from universities worldwide is increasing, the number far from fills the ever-growing needs of companies in China, where most graduates will seek employment.

“Employees know this. There is such a high need for talent. If you have the necessary skills you can write your ticket,” says Jim Leininger, a strategist with Towers Watson, a global HR consultancy with offices in Beijing.

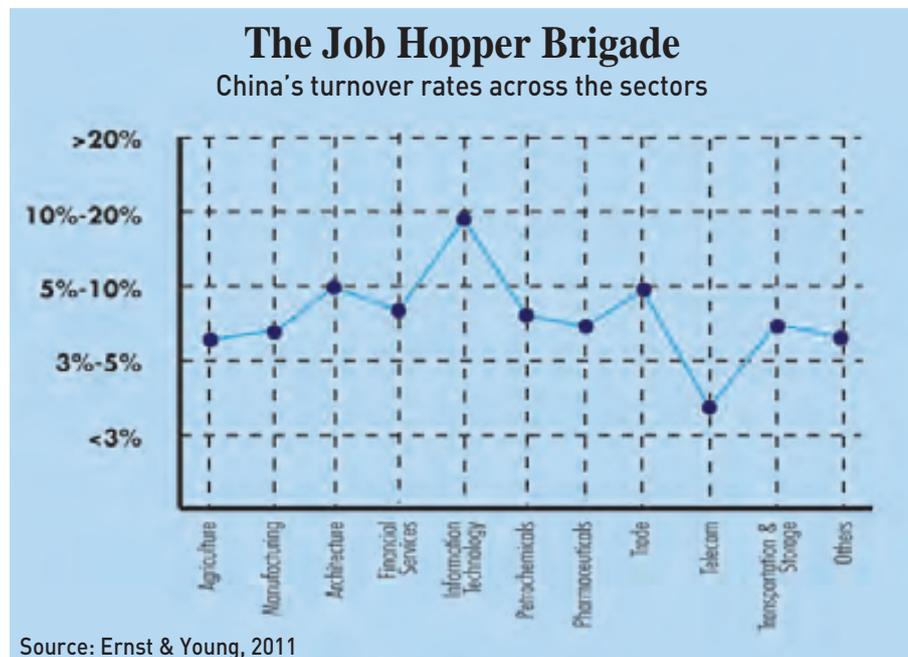
Chang Chun, a 24-year-old graduate student in sports management in the southern state of Florida in the US, is more than confident he can find a job easily when he comes back to China. He decided to pursue his education overseas for just that reason.

“There will be many opportunities for me to grow in China. The sports industry is just taking off. I know I can ask for a salary that reflects my education. But I will also be looking at the company culture, benefits and how much room there is for me to grow in the company,” he says.

In the US, new graduates are happy to gain any kind of employment in today’s job market, while US-educated Chinese, like Chang, have their pick of the litter. As such, Chinese management talent can afford to evaluate the more intrinsic aspects of a company, like culture and opportunity. This makes establishment of strong company identity a crucial component in the hunt for capable managers.

High Turnover

The first and crucial consequence of this war for talent is high staff turnover, the impacts of which range from loss in sales to loss of clients. Many Chinese people won’t hesitate to switch jobs three or four times the first year they enter the job market. They look for a job offering security, a career plan and opportunities, and figures show that loyalty is not a chief concern (See ‘The Job Hopper Brigade’).



China's Turnover Leaves that of the US in the Dust

Annual turnover for 2011 in China and the US

China's average turnover rate [2012]: 18.9%



Source: Aon Hewitt

US' average turnover rate [2012]: 3.0%



Source: US Bureau of Labor Statistics

Talent retention is a never-ending problem for both foreign and Chinese—state-owned and private—companies. Turnover rates in China are close to 20% against 13% in Europe, according to Roland Burger. As per the US Bureau of Labor Statistics, the corresponding figure in the US is 3% (See 'China's Turnover Leaves that of the US in the Dust'). As China's working environment changes, companies are increasingly trying to adapt to its volatile and mutating workforce. The issue for most companies is finding the right person to fit the job, responding to their demands and then making sure he/she actually does not hop to the competitor at the first sight of a higher pay check.

"The workforce is getting more sophisticated. You have to find ways to engage with the employee. Today the Chinese graduate is no longer satisfied with just having a job," explains Shalom Saada Saar, Professor of Managerial Practice at Cheung Kong Graduate School of Business.

Take Sissi Chu, who graduated from the prestigious Renmin University in Bei-



Today the Chinese graduate is no longer satisfied with just having a job

Shalom Saada Saar
Professor of Managerial Practice,
CKGSB

jing six years ago. She immediately found work in a global PR company with which she stayed an astonishing four years.

"I was emotionally linked to the company. They had great training, great management," recalls the 26-year-old who admits having had problems finding another job that provided such good conditions.

The human resources landscape is far different from what it was 10 years ago. In the 1990s when foreign companies first came into the new China in large numbers, they benefitted from a strong brand image compared to their Chinese counterparts. They also offered competitive employment packages and experience in working in an international firm. Every year from 2003-2007 as many as 40,000 foreign companies were newly registered in China; that number has now fallen to 30,000, but remains high. All these local operations of foreign firms are under pressure to contribute significantly to the global bottom line of their companies, all the more so since China has proven resilient to the economic headwinds in the West. Salaries have been rising between 9-11% per year to keep up with growth, a trend that shows no sign of slowing.

Now Chinese companies—both private and state-owned—are entering the same arena, and are often proving more successful at seducing staff than their foreign counterparts.

Many of them have started to realize the importance of retaining talent and are doing what it takes to keep employees within their walls, investing heavily in human resources and often poaching managers from companies overseas.

Managers from Chinese firms and government agencies such as the National Development and Reform Commission (NDRC) are enrolling in programs all over the world.

Innovative Solutions

Big Chinese corporations including ZTE, Haier and Alibaba have matched Huawei in terms of establishing innovative human resources programs by building a stronger company culture into the training process.

ZTE for example, which claims to have 500,000 international and domestic university participants, established its campus in 2003 in Shenzhen. Other company training centers that approach the ‘university’ model include Suning, Chi Chai, an agricultural equipment and services company and Chun Lan, a manufacturer of air conditioning units and dehumidifiers.

As early as 1999, Haier launched its own sprawling 12,000 square meter university in Qingdao, where it’s headquartered, with the aim of creating what CEO Zhang Ruimin calls “a China Business Harvard University”. Though his goal seems ambitious, it does show the importance the company places upon training. Just as with Huawei, classes are compulsory for all managers. Courses have the aim of creating loyalty amongst employees and dedication to Haier. In addition, an in-house promotion system assures the staff and managers have clear career paths.

At Alibaba, another Chinese success story, training and coaching rotate around the charismatic CEO and founder Jack Ma. He meets with his top managers monthly, ensuring targets are met and personal goals valued. He remains on hand for his staff via a Chinese version of MSN. Ma’s affinity for training and instruction is reflected in his recent resignation as CEO, and stated intention of mentoring the next

generation of Alibaba managers.

All in all, research shows that 50-70% of Chinese companies offer some kind of training to their employees, this can be anything from a brief one-week company introduction to courses which last several months and offer certification. Generally, training is well accepted and valued by Chinese staff who are keen to add value to their resumé’s.

“My company would let me do whatever training I wanted. I would sign up, [and] they would organize it for me,” says Chu, who enrolled in as many courses as she could. “Professionally, it was a great help.”

“The drive for learning is part of Chinese people’s DNA. Status does not come without knowledge,” says CKGSB’s Saar. “My rule of law is that companies should spend 3-8% of their revenue on training.”

Outgrowing Training Wheels

Although on paper training is effective in retaining talent, it is still far from guaranteeing retention.

“It’s not about how much money you invest, it’s about having a vision,” says Danny Yuan, Managing Director at Manpower Group China, an HR consulting firm which recently published a survey on training. The report shows that there is often a mismatch between what is offered and what employees actually want.

Companies in China are investing in specific training for new roles, but training is often in-house and viewed as ineffective by the employers themselves. More than 20% of participants polled in the Manpower survey admit that the success rate of completion of formal training programs is less than 50%.

Indeed, not all companies are going as far as Huawei, which clearly states its aim of creating out of every employee a loyal “Huaweier”. Most just offer a one-week crash course or a yearly catch-up, but don’t really invest in a proper career plan for their employees.

“Training in my view does not help,” says Bao Mingguan, Vice-President of Juxian, a head-hunting firm based in Beijing. “People want to learn from their bosses. They want to admire who they work for. One-on-one mentoring is much more effective in China than sitting in a classroom.”

In many cases companies are reluctant to offer that extra course which could really boost their managers’ profiles. They say it is too expensive and that all too often employees use the new credentials as a springboard for the next job.

“Training by itself is not self-sufficient. It has to be linked to future jobs, performance, and retention in the company. Otherwise it’s just ground for competition,” says Leininger from Towers Watson, explaining the tendency to gain credentials then seek a new job.

Hence, Huawei’s efforts don’t stop in the classroom. The company is also wholly owned by the employees, aiming to tie Huawei’s success to individual employee incentives.

“We offer employees strong career paths. Worldwide we’re hiring qualified staff and continue in attracting talents,” says Roland Sladek, Huawei’s Vice-President of International Media Affairs.

Last year, Huawei ranked fifth in China’s best places to work over IBM and Apple, according to ChinaHR.com, a jobs listing website.

Chinese companies struggling with retention could take a page from Huawei’s playbook.

The GE Way

General Electric’s Crotonville campus, the oldest corporate university in America, is often termed as the company’s ‘leadership factory’. This 59-acre campus in the state of New York attracts 9,000 leaders annually, both from GE and its clients. In 1981, GE’s legendary CEO Jack Welch undertook a mission to transform the company from a lumbering domestic company, into a nimble giant that would build shareholder value by leveraging competitive advantage globally. This required fundamental changes in the company’s

DNA. Welch leveraged the Crotonville campus to enable those changes by creating a breed of transformative leaders who could cascade new ways of thinking down the organization.

Crotonville has not only kept the company agile, but also provided GE with a ready bench of CEOs-in-waiting. It’s no wonder GE executives are much sought after to lead other companies as well.

Today GE spends roughly \$1 billion a year on training, a model duplicated in India and China as well.



Smartphones For All!

Domestic smartphone brands are gaining popularity in China's less-developed markets, forcing foreign brands to question their approach

By Don Weinland

It was a bitterly cold December morning in China's capital, with only a few pedestrians meandering along the icy sidewalk, lacking any great sense of purpose or urgency. The Apple Store they passed wore a forlorn look, which was surprising because this day marked the Beijing launch of Apple's iPhone 5. In the past, an iPhone launch meant that consumers would queue up in front of this store in the wee hours of the morning and anxiously wait for it to open. During the launch of the iPhone 4S, a riot nearly ensued before police intervention.

But this time only two customers were waiting for the store to open.

True, there may have been other factors aside from sheer rejection of the product, such as provision of an online pre-order option, but the thinning crowds revealed major shifts in China's smartphone market—in this case from international to domestic.

Apple's Loss, Lenovo's Gain.

Last November, a Chinese technology company pulled off a heist in China's smartphone market. Lenovo snatched the country's No. 2 spot in smartphones from Apple, surprising many industry watchers. As per IDC data, the iconic iPhone manufacturer fell to sixth place.

This is rather impressive given that only two years ago, Lenovo, China's biggest computer maker, was having trouble selling its low-end phones. A new line of smartphones ranging in price from RMB 800 to RMB 2,400 has since helped the company capture a tremendous 13% share of the market, up from about 1.7% a year ago, according to technology analysis firm, Canalys. Their phones are much cheaper than the latest iPhone 5, which retails for around RMB 5,000.

Lenovo's trajectory toward the top is a harbinger of deeper changes in the Chinese smartphone market. The center of gravity for digitally connected consumers is shifting rapidly toward smaller cities—away from the major metropolitan areas that have led sales up to now. In 2013, analysts say the most common smartphone in China will be a cheaper, entry-level device

made by a Chinese company—unless the foreign phone makers can find a quick way to ramp up sales in less familiar regions of the country

“That's fundamentally very different from what's happening in other markets. Everywhere else it's all about the latest and greatest, or the newest,” says Shiv Putcha, Principal Emerging Markets Analyst at Ovum, a London-based tech con-



Analysts say the most common smartphone in China will be a cheaper, entry-level device made by a Chinese company

sultancy. The market for smartphones in China expanded by some 100 million users in 2012, a jump from 85 million users in 2011 to about 185 million at the end of last year, and analysts project growth rates to continue in that range for a while. China, already the world's largest smartphone market with 330 million phones in use, is set to order 240 million more devices this year, or 29% of global demand, according to Canalys. The US, the world's second-largest market, will absorb only 125 mil-

lion smartphones in 2013.

But China's smartphone market growth rate hasn't translated into increased market shares for the winners of years past, which were predominantly foreign brands and dozens of no-name domestic companies. Instead, big-name domestic phone makers have swooped into the gap between the two and swallowed up large swathes of consumers who entered the market only a year before. A defining characteristic of China's new smartphone user is price sensitivity, and that is especially true of the smaller cities that will see the fastest rate of market growth this year, with purchases matching spending power.

“What that will translate into in China's case, if not today then very soon, is volume,” says Putcha.

Home Court Advantage

Most new consumers are primarily in non-coastal China, and the companies that first reach smaller cities with entry-level smartphones will prosper in 2013. Navigating the distribution channels in less-affluent China will test the brands' staying power, as will their ability to partner with China's network operators who greatly subsidize the cost for buyers.

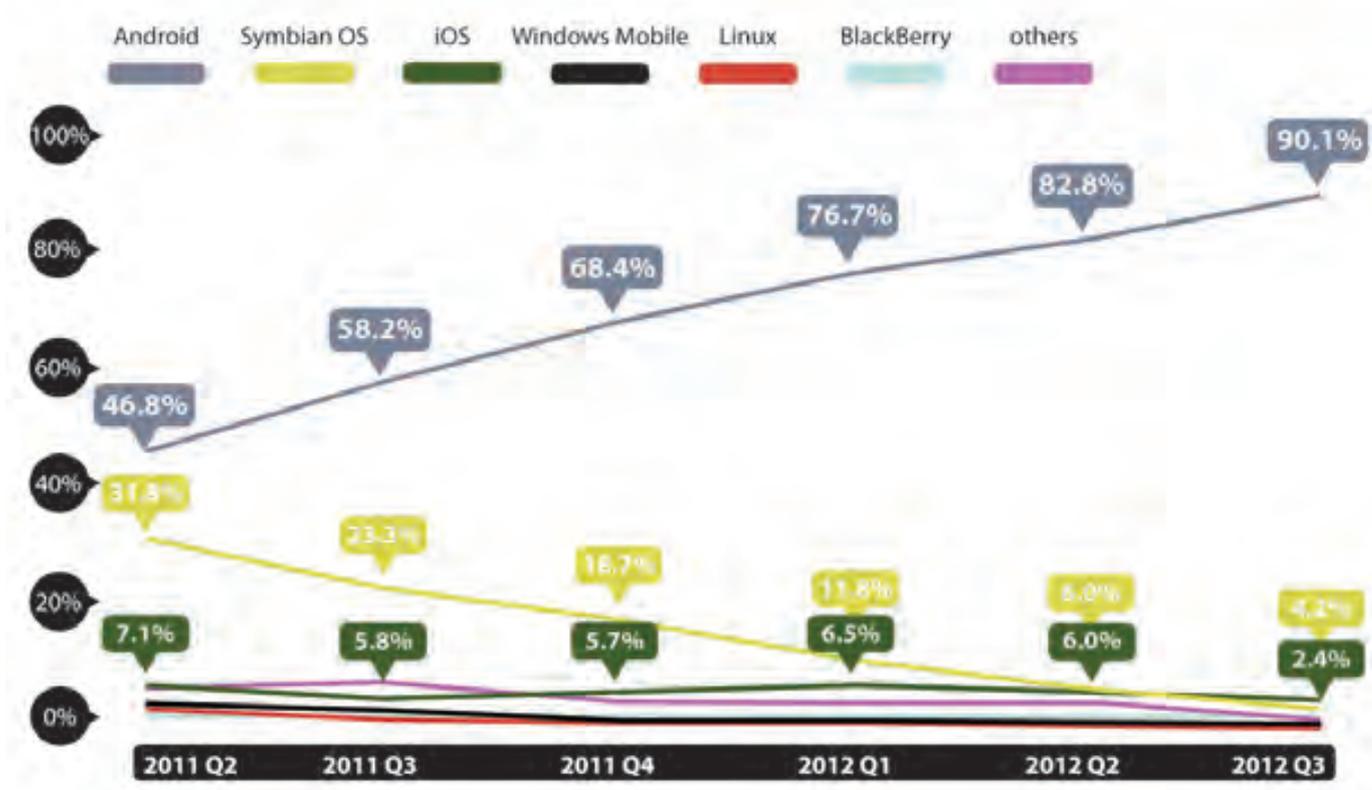
The surge in sales for Lenovo phones isn't an isolated phenomenon. Following close behind was Shenzhen-headquartered Coolpad, Huawei and ZTE, all domestic brands that rode the wave of demand for cheaper devices. By the third quarter of 2012, the four brands had captured about 70% of all shipments in China. The greatest purchasing activity in the market has been for phones at around the RMB 1,000 mark, a price all four domestic firms have targeted, while foreign brands—especially Apple—maintain far higher price levels.

Chinese companies seemed to have a home-field advantage, the result of channeling acute market intelligence to fast-moving research and production teams. Being based in China means these brands can leverage more resources faster, insiders say.

“Domestic players have a much deeper understanding of Chinese custom-

Android All the Way

A look at the dominant operating systems in the Chinese market (not including no-name brand phones)



Source: EnfoDesk © Analysys International

ers' needs," says Jeffrey Yang, Huawei's Vice-President and Chief Marketing Officer for China. "R&D centers are mainly located in the China market already. They can respond to customers' needs immediately. For the international brands like iPhone and Samsung... it really takes a long process to meet those needs."

But this latest trend hasn't been a disaster for all foreign mega-brand phone makers concentrating on China's major cities. Samsung's Galaxy series handsets were the best-selling smartphones in China last year, and maintaining that spot going forward is highly possible. But the market shift to volume over quality will impact the marketing models for international brands that have stressed high-tech phones at the highest prices. But another key factor in terms of marketing smart-

phones in China is the role of the three principal mobile network operators.

Subsidize Me

Chinese phone makers have developed strong, long-term relationships with the country's state-owned network operators. Firms such as China Mobile and China Unicom began subsidizing the cost of smartphones in the third quarter of 2011, the same period that saw consumers entering the smartphone market in huge numbers. Lenovo has partnered with all three network operators, undoubtedly contributing to its successful gain in market share. For consumers, the tie-ups typically mean two-year commitments to monthly phone plans in exchange for an often substantially cheaper phone. In 2012, China Unicom gave customers a free iPhone 4S handset

if subscribers signed up for multi-year contracts.

These partnerships have not only led to cheaper phones for the end consumer, but have also boosted the brands' marketing potential as they venture past third-tier cities into less-developed markets that have been ignored by big names in the past. Yang says vendors did not have "enough confidence" to enter those markets due to a lack of market data and the prevalence of small phone vendors.

Only two years ago, "white box" phones, or phones produced by a myriad of no-name brands, dominated in third-tier cities and beyond. That is changing as phone makers and network operators bind products and services. Support from at least one of China's three massive mobile operators facilitates the push into



Source: iimedia, eguan.com

these markets and the establishment of a brand presence, which is a crucial move for any manufacturer in the fight for volume in 2013, says Nicole Peng, Canalsy's Research Director in China.

"Whichever vendors have established their brand name in the third-tier to sixth-tier cities, they will benefit the most this year. The big four [Lenovo, Coolpad, Huawei and ZTE] have been trying very hard to build their channels into these places," she adds. These four brands have all ramped up their advertising in these markets, in addition to setting up phone shops in smaller cities and strengthening the logistics systems that serve online retail in rural areas.

Partnering with a Chinese mobile operator will be decisive for international brands this year as well. In early December, Nokia announced a deal with the world's biggest mobile service provider, China Mobile. The deal brings a subsidized Nokia Lumia 920T to a potential 700 million China Mobile users, a majority of whom have yet to buy a smartphone or use third-generation (3G) Internet technology.

Just as analysts hailed the Nokia-China Mobile tie-up as a winning move for the ailing company that dominated China's pre-smartphone era, the collapse of talks over a deal between China Mobile and Apple has boded ill for the iPhone maker in terms of market share.

At the end of December, China Mobile CEO Li Yue told the media he would not grant Apple access to the world's largest pool of subscribers without a deal that significantly benefited the Chinese firm. Although Apple has partnerships with the smaller firms, China Unicom and China Telecom, analysts said the China Mobile discussions were a make-or-break moment that ended disappointingly. Though the iPhone has slipped in market standing, the device is far from devastated. Apple's iPhone 5 sold two million handsets immediately after the launch in mid-December alone, exceeding iPhone 4S sales and analysts' expectations.

China Mobile is definitely the big fish with 300 million more subscribers than China Unicom and China Telecom combined, according to Barclays Research. But most of China Mobile's subscribers

use only 2G services, whereas in the 3G range the race between the three carriers is much closer. China Unicom has only 11 million fewer subscribers than China Mobile, at 76 million 3G users. China Telecom had 69 million 3G users.

The Windows Gamble

Binding services won't be the only game changer this year for international brands. In February, Nokia launched the Lumia 920T running the Windows 8 operating system. Despite a warm reception in big Chinese cities, the Windows system is not certain to succeed this year. Both Nokia and Microsoft will have to learn from past experience and work hard to push the Windows 8 devices to the forefront, analysts say.

When Nokia launched its first Windows phones in 2011, the Lumia 800 and

“Whichever vendors have established their brand name in the third-tier to sixth-tier cities, they will benefit the most this year

Nicole Peng
Research Director, Canalsy

710, they were essentially alien products in a market increasingly held by the Android operating system. Nokia led a solo marketing campaign for the product without Microsoft backing—in sharp contrast to the Google-powered strategy for Android to which many attribute some of its initial success. Results were poor for the first Windows phone, but that could change with this year's phone, says Putcha at Ovum. Microsoft has backed the launch of the Windows 8 phone, giving the brand substantially more marketing firepower and Nokia a chance at recovering some of its former glory.

The Windows 8 phone enters an environment currently dominated by Android. At the time of the first Windows phone launch in 2011, about 40% of China's smartphones used the Android system, according to data from Analysys International. At the end of 2012, that figure had climbed to about 90%.

"This is a major challenge for Nokia," Putcha says. "In the rest of the world, Nokia is struggling against Apple's iOS and Android, but in China, it's really Android that they are struggling against. There is too much momentum behind Android."

Nokia committed to the Windows phone as its "primary smartphone strategy" in 2011, saying that it would be too difficult to stand out using Android. Stand out it did. The company reported an operating loss of \$1.07 billion in 2011 and heavier losses predicted for 2012. In a recent media interview, the company's CEO Stephen Elop hinted that it could start to employ Android this year. Rumors circulated in mid-2012 of a possible buyout of the company by Samsung or some other major player.

Android Forever?

Android's current momentum in China is not necessarily the end of the story. China's four market leaders, as well as smaller brands, have adopted Android because it is virtually free to incorporate into devices and can be "scraped" easily, Putcha says.

Phone makers "scrape" operating systems to remove some elements of the basic system as provided by the developer,

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In the rest of the world, Nokia is struggling against Apple's iOS and Android. But in China, it's really Android that they are struggling against

Shiv Putcha
Analyst, Ovum

Google in Android's case, and customize the interface. This means that many Android phones in China often don't feature Google services, applications or even look like a Google product.

While Android is everywhere, actual face-to-face recognition of the system by first-time smartphone buyers, is rare, industry analysts and one Shanghai-based phone vendor say. For first-time buyers, a lack of distinctly Google characteristics combined with the availability of many different interfaces, make it difficult to distinguish between operating systems. Scraping allows for a higher level of customization. For the consumer, it means more perceived flexibility in the types of apps they can acquire.

But there are OS-aware consumers to contend with in major cities. Huawei's Yang says those customers are particular about the operating system on their phone. Apple's iOS has earned a reputation for being "fun", he said. Windows is geared more toward businesspeople, while Android covers the expanse between.

Depending on the joint marketing from Microsoft and China Mobile, the more OS-conscious customers may represent the sweet spot for Nokia's Windows Phone.

Staying Power

Sean Huang, a small Apple vendor at an electronics market in Shanghai, is unfazed by Lenovo's breakneck growth and Nokia's Windows 8 phone launch.

"I basically don't see them," he says. "There are so many Apple and Android phones around here."

But Android, unlike Apple, is poised to make good on both big and small markets. Samsung Galaxy and Lenovo's latest smartphone series both use Android, but Samsung's top spot reflects Android's first-tier market prowess, whereas cheaper Lenovo smartphones reflect its ability to reach the smaller growth markets. Rumors of a new Apple smartphone priced for emerging markets have circulated, but there's been no announcement as of yet.

Samsung's ability to stay at the top depends on its capacity to appeal to lower-tier markets, Peng at Canalis says.

"The question right now is whether or not Samsung will enter the low-cost smartphone market", she says. "With their resources and their production capacity, they would be able to maintain the number one spot if they are going for the mass-market aggressively. This is still very uncertain because in China Samsung is still a very premium brand. This is something they will really need to consider."

International phone makers are in for some long, hard thinking in the months ahead. They will have to choose between maintaining their roles as makers of up-market products for urbanites or higher market share, which means producing products for the smartphone-toting masses outside the major cities. ■

The Money Squeeze

The first signs of light emerge amidst the dark prospects for private enterprises in China's ever-tightening credit market

By Suzanne Edwards



It's been a miserable few months for financing in China's private sector. A growing number of debt defaults by companies has spurred regulatory crackdowns on the unofficial lending sector, sometimes called 'shadow banking', which has sustained (not in an entirely healthy way) the mainland's private small and medium-sized enterprises (SMEs) for decades. The bloom is now off the rose of Wenzhou's entrepreneurial miracle [see 'Wenzhou For Everyone?'], and the expected expansion of infrastructure investment is likely to only deepen the lending skew toward state-owned enterprises.

The wall of issues facing the country's large shadow banking sector came to a head in November when Hua Xia Bank clients took to the streets of Shanghai after the bank failed to pay returns on wealth management products totaling \$22.5 million. These wealth management products are typically run as off-balance sheet lending by the banks, which by the state's definition, is shadow banking.

There are even graver consequences than money loss when defaulting on an off-the-book lender, as Xue Jie, a lawyer with Shanghai DongDao Law Firm, says.

"If private loans are in default, the biggest problem is the person in charge can use various non-legal means, such as destruction of operations, or even threats to property and personal safety," he says.

Private SMEs, with or without official assistance, must find a way to break out of the cramped financing space in which



If private loans are in default, the biggest problem is the person in charge can use various non-legal means

Xue Jie
Finance Lawyer,
Shanghai DongDao Law Firm

they're currently operating if they are to free themselves of the risk-laden avenue of underground lending.

And cracks in the financial glass ceiling are emerging. Certain alternative financing methods are evolving, such as with the emergence of more scientific credit rating

systems, foreign banks recommitting to SME services despite the recent conformation to the national loan-deposit ratio requirements, and micro-loans via peer-to-peer lending platforms online.

The potential success of any of these channels depends on commitment from the Chinese government. One such channel that has been relentlessly encouraged (even while controlled) is the issuance of corporate bonds. But just how viable an option it is for China's SMEs is open to debate.

Bound Corporate Bond Market

The China Securities and Regulatory Commission (CSRC) has stated its support for SME financing, in addition to taking steps toward freeing up the corporate bond market. A statement published in the state-run *People's Daily* in June iterated its intentions toward private placement bonds.

"As corporate bonds, the private placement bonds meet the market demand of high-yield bonds but are not limited to it. It is legal to issue such bonds and it also is conducive to improving the financing facilities and means of small and medium-sized enterprises," the statement read.

But the question of corporate bonds being a viable option as a significant source of finance evokes staid responses, as some experts characterize the corporate bond market as hospitable primarily to state-owned enterprises (SOEs) and those contracted by the state.

Wenzhou for Everyone?

The March 2012 launch of the Wenzhou pilot financial reform zone had many a credit-starved entrepreneur celebrating what was potentially the first step along the path to an eased flow of capital and financial breathing room. The State Council brought lending institutions previously dubbed as 'shadow banks' into a regulated environment in the hope of bringing more liquidity to the nation's SMEs.

Lately however, many small business owners have revealed true colors by neglecting the terms of repayment on their loans, or skipping town in the more severe cases.

The result is an alarming increase in debt cases brought be-

fore the courts in the city, high enough in volume that much of the goodwill generated by Wenzhou in Beijing could wilt in response.

In Feb. 2012, the Intermediate People's Court and High People's Court of Wenzhou handled 19,511 cases on private financing involving approximately \$3.52 billion and settled 5,393 cases on financial lending disputes, *China Daily* reported.

Should legal reform be coupled with financial reform, investors could feel freer with their money and debtors would have to think twice before simply locking the up the doors and speeding out of the city. ■

“The issuance of corporate bonds is an unrealistic debt financing channel for SMEs”, says DongDao’s Xue. “There are strict restrictions in the issuing entity, offering amount, investment targets, interest rates, underwriting, raising methods and purposes.”

Liu Jing, Professor of Accounting and Finance at the Cheung Kong Graduate School of Business, explains that guaranteed corporate bonds mainly represent to investors a government-backed guarantee and a healthy relationship between the issuer and the guarantor, hence a corporate bond market that is still largely dominated by SOEs and local government financing vehicles.

“Certainly there is potentially a strong future for it (the bond market), but it’s still dominated by the state,” says Liu.

For what it’s worth, there is a clear and obvious campaign from the central government to stimulate and diversify China’s corporate bond market. The CSRC released a draft of proposed regulation changes to the *International Finance Review*, a research arm of Reuters, resulting from a series of soft-market consultation rounds, the latest of which concluded in early February this year.

According to the draft, the CSRC plans to allow non-listed companies to sell bonds through corporate private placements and to shorten the minimum tenor of privately placed corporate bonds to less than a year. Whereas only SMEs could issue private enterprise bonds as of the first half of 2012, under the new guidelines, any issuer could issue corporate bonds.

This is good news for the nation’s fund-starved private SMEs who may not be deemed eligible for an IPO in China. Under existing rules, the issuer’s outstanding bonds should not exceed 40% of their net assets. Private bonds, however, will not be counted.

Activity in the corporate bond market has increased considerably in recent years, starting in 2007 when corporate bonds were opened to companies listed in China or abroad on a pilot basis, and ending most recently with the CSRC’s debut of the

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Certainly there is potentially a strong future for it (the bond market), but it’s still dominated by the state

Liu Jing
Professor of Accounting and
Finance, CKGSB

fast-tracking issuance approval in 2012 and initiation of a high-yield junk bond market that requires only registration.

Different sources give different figures to illustrate the resulting growth of the corporate bond market. CSRC Chairman Guo Shuqing, said in January that corporate bond financing increased by 60% to RMB 3.62 trillion in 2012. According to the *International Finance Review*, the amount of outstanding corporate bonds rose 33% year-on-year reaching RMB 738.9 billion as of November 2012.

But figures indicating the percentage of corporate bonds issued by private SMEs are nowhere to be found.

Tri Tech Holdings Inc., a Beijing-based wastewater treatment company was featured in a *Forbes* article in October as one private medium-sized enterprise that

raised funds via corporate bond issuance.

Tri-Tech issued RMB 50 million of three-year bonds to investors, including financial institutions. But with a gross profit margin of 25.3% in September, revenue growth exceeding the industry average, and shares listed on Nasdaq, Tri-Tech bears little resemblance to other private SMEs, such as those comprising the 2011 Alibaba survey of 2,300 SMEs in Zhejiang Province showing more than 70% of respondent businesses recorded zero profits or small losses, and 3% closed down.

In addition, the *Forbes* report noted that Tri-Tech had a credit guaranteed from Beijing Capital Investment and Guarantee Co., which is controlled by the state. Exceptional as the Tri-Tech example may be, the state-sponsored underwriting of its corporate bond is indicative of a bond market still under the government’s direction.

No matter what liberalization measures the CSRC takes toward the corporate bond market, there is one domain the companies themselves have reign over that could make or break them in their investors’ eyes: information.

Shooting One’s Own Foot

Information asymmetry has been a buzzword in academic research conclaves dedicated to private sector development.

Zhou Wubiao, Assistant Professor of Sociology at Nanyang Technological University in Singapore, specializing in private sector development research, iterated the ‘information asymmetry’ problem for financiers in China in a 2009 *World Development Journal* research report.

“Since entrepreneurs possess information about themselves and their opportunities that lenders do not possess, lenders face high risks when lending to entrepreneurs because entrepreneurs may behave opportunistically toward them,” he wrote.

Chinese companies have been marked as vastly ‘asymmetrical’ in this regard thanks to a number of high profile investment fraud cases in the US stock market and the more recent bout between the US Securities and Exchange Commission and

The Low-down on Foreign Banks in China

Number of foreign bank branches in China



Source: Financial Times, China.org, Standard Chartered, Bloomberg

the CSRC over refused access to certain work documents of US-listed Chinese companies.

Even in the Wenzhou reform climate of legitimizing traditionally unofficial lenders, there has been a rash of entrepreneurs securing loans from the accepted non-bank lenders and then skipping town. Each such case serves only to increase the hesitancy with which banks regard smaller enterprises, not to mention private investors.

Information asymmetry, and flat out dishonesty, is one among several obstacles preventing China's private sector from fully optimizing some of the more globally common financing channels.

According to Alberto Forchielli, Founding Partner of Mandarin Capital Partners, it takes his team no more than a day to detect fraudulent information from a Chinese company targeted for investment or acquisition.

"If they tell a lie, we'll find out in 24 hours," says Forchielli. "You can be the best company in the world, but if you tell a lie, you're finished."

Facilitating foreign investment in

SMEs is challenging in every part of the world, Forchielli notes, and building trust is the make or break criteria at the end of the day.

Beyond foreign investors, foreign banks are also a resource, which, if given fair access to China's credit market, could up their contribution to the best of the SMEs trying to raise funds.

Banking Diplomacy

Foreign investment in China seems ever constrained by an intricate array of protectionist policies and regulations, but foreign banks are showing signs of willingness to embrace the opportunities.

The year 2011 saw impressive profits for foreign banks in China, a total of RMB 16.3 billion, signaling more than double the profits year-on-year, but their share of the Chinese banking sector is achingly low. According to PricewaterhouseCoopers' latest survey, 181 foreign banks in China hold just 1.93% of the market.

The good news is that as the foreign banks turn away from their original strategy of taking minority shareholdings in local China banks, there is greater incentive

for foreign banks to redirect their investment into expanding their own shops.

The Australia and New Zealand Banking Group (ANZ) did just that last year when it backed out of its plan to inject \$120 million into the Bank of Tianjin and instead invested \$300 million of capital into its own China operations after mainland incorporation in 2010, according to an *Australian Financial Review* report.

If this kind of capital redirection trends upward, it could add resources to financing in China's private sector. Generally speaking, the private sector in China, and SMEs in particular, should represent an irresistible opportunity for foreign banks. Their risk management and credit-rating systems are typically more developed and better equipped to handle the issue of information asymmetry than that of their local counterparts, plus, they hold the advantage in variety of financial products and international frameworks. The latter particularly benefits the export-oriented businesses, which many Chinese SMEs are.

UK bank Standard Chartered Plc CEO Peter Sands told Bloomberg Television in March that export-oriented SMEs are their

specialty and they do more lending than any other foreign bank in China. The bank expanded its SME loan book in the “other Asia Pacific” region, which includes China, by 17% to \$5.79 billion, the bank said in a filing in February 2012.

Citibank China is another bank that has targeted China’s SMEs. In 2004, Citibank China announced service offerings targeting smaller private enterprises. In 2010, it announced a new service that would allow small enterprise entrepreneurs one-stop access to both commercial banking services and personal banking services through a single manager, said their statement on the launch in 2010.

According to a 2009 editorial from *China Business Focus*, foreign banks were chomping at the bit to build their SME business in China and take full advantage of their five-year buffer from the China Banking Regulatory Commission (CBRC). The CBRC gave foreign banks an additional five years starting in 2007 to meet the same loan-deposit ratio requirement of 75% or less that national banks had been heeding previously. Now into 2013 however, foreign banks have contracted their lending in accordance with the regulation, and are seeking to compensate by expanding wealth management services and inter-bank lending.

So it seems that we have a one-step forward one-step back scenario, but the five years of relative loan-deposit ratio freedom observed by foreign banks shed light on the goodwill and zeal existing between these banks and China’s SMEs, particularly along the Yangtze and Pearl river deltas, where many of the export-oriented SMEs are located.

Provided foreign banks can develop enough channels to up their deposits, there will seemingly be only more determination to tap China’s SME lending market. More branch operations would also be a welcome move for financial services firms that specialize in cross-border investments.

“We try to stay away from getting local financing because it’s too burdensome, we’ll waste way too much time with it,” says Mandarin Capital Partners’ Forchielli, explaining that they’re “very discour-

aged” from seeking loans from local China banks due to an overly copious application and guarantee process.

However “burdensome”, the process has not yielded highly effective risk management systems in China’s big banks, though the lesser among them are starting to lead the way.

Hope from Minsheng Bank

One development this year that boosts hope for small and micro-sized firms is Minsheng Bank Corp’s seemingly successful prioritization of small and micro-sized firms. According to its latest earning report, Minsheng netted RMB 37.56 billion in profits, a 34.5% increase from



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Alberto Forchielli
Managing Director,
Mandarin Capital Partners

2011, and it did it on the back of small enterprises. *China Daily* reported 62% of Minsheng’s micro-lending were non-mortgage loans geared toward small businesses. The bank’s chairman, Dong Wenbiao, termed the sector a “deep blue sea”.

Another key development for Minsheng in 2011 was its partnership with FICO, a risk assessment and analytics service provider, to bring its risk management system up to speed with its active lending portfolio. The new system uses IT to quantify, and to some degree automate, the application risk grading process. The impact that such an update will have on its portfolio and lending activity hasn’t crystallized yet, but it does somewhat alleviate the issue of risk management officers having to defer, in many instances unwisely, to the will of managers and loan officers who are swimming in as many political directives as commercial interests.

Christopher Whalen, co-founder and Managing Director of Institutional Risk Analytics, noted in his 2007 editorial for the Global Association of Risk Professionals that credit risk is often bulldozed in Chinese lending institutions.

“If you take a senior risk management position at a Chinese bank, you had better be prepared to be ‘flexible’”, he wrote, going on to explain that ‘flexible’ means approving loans to the politically well-connected with slim to zero hope of seeing it paid back.

A data-based and relatively computerized system like that of the newly minted system at Minsheng could relieve the pressure of such ‘flexibility’.

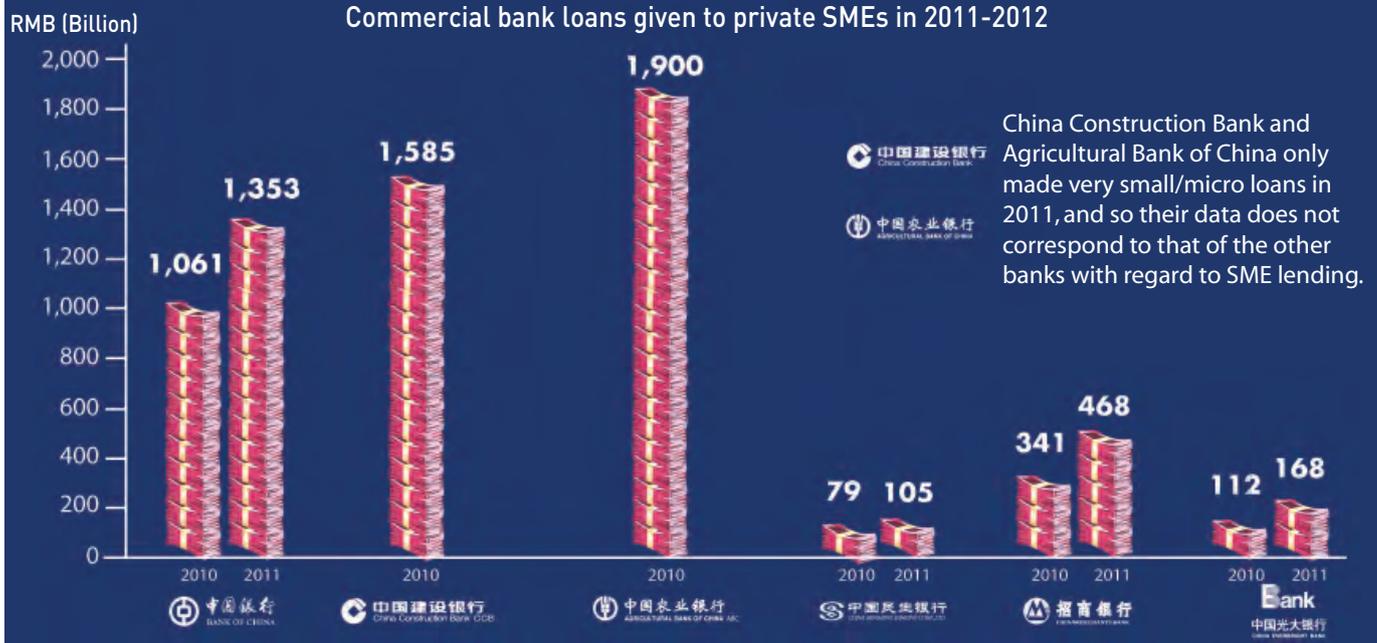
Another way to extricate good lending practices from political motivation is to legitimize private lending institutions, as we’ve seen in experimental form in the city of Wenzhou. But the reality of the legal implications of loan defaults have cast a shadow on the potential nationalization of Wenzhou reforms, which could result in leading entrepreneurs to even more alternative lending.

They Haven’t Said ‘No’ Yet

In March of 2012, China National Radio reported that more than 2,000 peer-to-peer

The Who's Who in SME Lending

Commercial bank loans given to private SMEs in 2011-2012



Source: Bank of China, finance.com, fjsen.com, hexun.com

*The numbers represent the balance of loans given to SMEs at year's end, and is inclusive of the previous year's data

(P2P) lending websites had been set up nationwide since 2007, with the value of their loans increasing 300-fold, reaching RMB 6 billion as of mid-2011.

The official response to the boom has been one of warnings rather than outlawing.

Such was the basis for the go-ahead attitude of Ppdai.com's founders, who were featured in a *Bloomberg* report in January.

"We went ahead because we couldn't find any regulation that specifically bans it," Zhang Jun said of his founding one of the nation's largest P2P financing sites, in the report.

The CBRC's warning statement from September of 2012, asserted that the bad-debt ratio of these lending sites was "significantly higher" than that of banks, but an exact figure was not released.

P2P lending being outside of jurisdiction evokes inherent risks, such as lack of enforcement when a borrower defaults, but the same could be said of the shadow-banking sector, which has yet inspired great self-censorship from borrower or lender.

With Ppdai, borrowers give basic information and a proposal of their loan requests, investors review it and lend if they meet the criteria. Loan amounts start at RMB 3,000 and reach up to RMB 500,000 with interest rates supposedly not exceeding the legal 23%.

But a Ppdai representative tells *CKGSB Magazine* that one of their members recently raised only RMB 2,400 in three days on loans with an interest rate of 24%. Such figures represent micro-loans geared more toward self-starters than businesses with any real overhead expenses, plus, the complete lack of regulation is a red flag. The same representative says that if a borrower defaults on repayment, then their information and identity card will be posted on the site, a small comfort to the lender.

The Lending Ceiling

Whether lending pocket money online or bank capital, it all boils down to risk management, and with that, there is much banks can do themselves before hitting a wall.

According to Edward Tse, Chairman of Booz and Co. China, a global management consulting firm, scientific and quantitative approaches to credit rating and risk management are positive steps in the direction of a healthy private SME lending environment. But he also notes that as long as political influences impact loan officers, there is only so far any bottom-up reform will go.

"In a way there's only so much you can do if you're trying to drive this from a more internal management standpoint, banks have really been trying to improve their discipline and better their credit management systems, but really ultimately it's the loan officers, not only in the bank, but also those out there in the provinces, making the decisions," Tse says.

Liu Jing of CKGSB also complements the Minsheng approach, but adds a caveat.

"We need to reform the financial sector toward private enterprise to sustain China's economic growth, but without reforming the ownership structure of the banks, that becomes very difficult," Liu says. ■

Kickstarters

China's incubators set entrepreneurial spirit in motion

By Matthew Fulco





Stephen Bell has high hopes for Chinese student entrepreneurs. The American venture capitalist invests in seed-stage start-ups across China, betting that the next Mark Zuckerberg will emerge from the world's second-largest economy.

Bell's Beijing-based venture-capital firm Trilogy VC runs the ChinaStars incubator program at the country's top universities. Participants have 90 days to build an original consumer Internet, mobile, game, or new media product. The product Bell judges to be best at the end of the three-month period receives two years of funding from Trilogy Ventures.

"There's a myth in this business that experience matters," Bell says. He believes the unconstrained imaginations of young entrepreneurs often convert the best ideas to winning products—"when they don't know they can't do it".

If China's overall private sector remains "in retreat", reaping scant benefits from mercantilist economic policies that favor state-owned giants, then technology start-ups buck the trend for now, their success buoyed by low capital requirements and China's surplus of programming and engineering graduates. A vibrant scene has sprung up in Beijing's Zhongguancun—"the Silicon Valley of China".

According to 17Startup, a website that collects data on Chinese start-ups, nearly 3,600 start-ups were founded in China in 2012, and more than half were e-commerce or mobile Internet companies. Among them were the Changba mobile karaoke and Papa photo-sharing applications, the former which boasts user numbers in the millions. Mobile and e-commerce firms secured more than 50% of the total investment in start-ups. Still, overall, less than 5% of the start-ups received investment.

Incubators can help fill that void by injecting capital into cash-starved young companies. At the same time, with Chinese start-up culture still in infancy, incubators have the potential to play a larger role in shaping the industry landscape than in the West, helping to build an enduring start-up ecosystem made in China.

Although China's conservative soci-

ety still largely frowns on start-ups, viewing them as inferior to a stable job with a major company, things are changing fast thanks to the work of ambitious incubators, says Kevin Lee, Chief Operating Officer of China Youthology, a Beijing-based market-research firm that tracks trends in Chinese youth culture. "Incubators are making market-based entrepreneurialism mainstream and accepted here," he says. "They give young entrepreneurs who are not well-connected or wealthy the chance to transform an idea into a working product and business model and then they help them launch it."

Lee believes incubators can help fill a void created by the Chinese education system, providing a platform to develop the cross-functional skill sets essential to the success of entrepreneurs in the West. "In China, you have to sacrifice everything else to have great tech skills, but bringing a product to market is not just about how well you can program," he says.

Incubators in China provide far more

resources to start-ups than their counterparts in the US, says Kevin Der Arslanian, an analyst with China Market Research Group, a Shanghai-based consultancy. "It is much more of an accompaniment process in China," he says, important in his view because Chinese law requires companies show three years of profitability before they can list. The heralded Innovation Works incubator, founded by ex-China Google chief Kai-Fu Lee, provides start-ups with in-house designers, office space and legal consultants in addition to capital. With a nine-month incubation period, start-ups in Innovation Works also have three times as long as their Silicon Valley counterparts to bring a product to market. When they do, they can use the Innovation Works name to gain wider brand recognition in the market.

But not all China-based incubators have long incubation periods. Stephen Bell's ChinaStars and Dalian-based Chinaaccelerator both graduate start-ups in 90 days like the typical Silicon Valley model.



Looking for the next big thing: Wuxi Software Park, an incubator for hi-tech start-ups.

Start-ups in the Jue.io incubator, which manufactures technology accessories like iPhone cases and specialized key chains, have access to Jue.io's trusted distribution network and production facilities, streamlining the manufacturing process.

Mentorship forms another cornerstone of the capabilities of China's incubators. The Dalian-based Chinaccelerator incubator, which bills itself as "the first mentorship-driven seed-funding program in China", has more than 60 mentors available to assist its start-ups, among them Brad Higgins, former Chief Financial Officer of the US Department of State, James Tan, Founder and Managing Director of the leading Chinese venture-capital firm Quest VC, as well as Stephen Bell. Chinaccelerator is a network partner of the US-based TechStars incubator, which was founded in 2006.

"Powerful mentors are rare in China," says Josh Ong, tech-industry watcher for *The Next Web* site. "Guidance and insight to aid a start-up in overcoming challenges are some of the most important services an incubator can provide. It helps start-ups understand the value they can bring to the ecosystem." Having world-class mentors onboard also boosts the incubator's prestige, helping it to build its own products and brand, Ong adds.

Incu-greater?

High-profile China incubators typically begin by borrowing a page from the Silicon Valley handbook. Lee of China Youthology describes a trajectory of "fast ideas, fast iteration, fast testing and fast scaling." Bell's ChinaStars and Chinaccelerator graduate start-ups within three months of incubation. Ex-Google China chief Kai-Fu Lee's Innovation Works, the biggest China-based incubator, initially followed a similar model, although it now focuses on later-stage incubation.

Der Arslanian of China Market Research Group, believes Kai-Fu Lee established the incubator model as credible in China. In his view, Lee, having previously served in executive roles at Apple and Microsoft, used his IT industry prowess to establish a viable model for China-based



Could China produce the next Mark Zuckerberg? The odds are high based on population

Josh Ong
Tech Industry Watcher,
The Next Web

incubators and made them mainstream. "Before Innovation Works, incubators did not enjoy the same reputation," Der Arslanian says.

According to the *TechinAsia* website, as of last September, Innovation Works had incubated 50 start-ups since its inception in September 2009, with a total investment exceeding RMB 3.9 billion (more than \$615 million). Innovation Works selected those 50 start-ups from a pool of more than 5,000 applicants. The greatest success story thus far is Wandoujia, or SnapPea in English, a third-party Android sync management app and app store that helps users to manage their smartphones and tablets from their computers. Billed as "Android's best friend," Wandoujia software had exceeded 30 million installations in China as of June 2012, about 50% of the nation's Android users. It went global the following month.

But SnapPea's success overseas is far

from guaranteed, says Der Arslanian. He adds: "It is an application that is very specific to the Chinese market."

Of the 37 start-ups Stephen Bell's Trilogy has funded in the past few years, eight are profitable. Droidhen, an Android game developer, is present on half of China's Android phones. JiaThis, which lets users share information over Chinese social networks, also has strong prospects.

The most recent product to emerge successfully from the ChinaStars incubator is Weidanci, or Wikiword in English, which Bell describes as "a Chinese Wikipedia for dictionaries". Available in web and Android versions, Weidanci allows users to add their own definitions of words in Chinese and English. It has become popular with students, who have added sections pertaining to different tests they take. The team of Beijing University Science and Technology graduate students that created Weidanci received two years of funding from Bell, Nearly RMB 1 million, which he says will last them for two years.

The Next Zuckerberg

Bell believes the next revolutionary tech start-up will emerge from China. "The pace of change is faster here than anywhere in the world," he says, adding that young Chinese entrepreneurs are "incredibly creative". In Bell's view, Facebook revolutionized social networking because "it was the latest and best way for people to keep in touch with their friends". Similar to Apple, Google and Microsoft before, Facebook "was 100% focused on turning out a great product," he adds.

"Could China produce the next Mark Zuckerberg? The odds are high based on population," says Ong of *The Next Web*. Bell's challenge, Ong believes, lies in the Chinese education system, which "is not designed to cultivate innovation".

Culture matters enormously, in the view of Howard Yu, a professor of management at the Switzerland-based business school IMD. American popular culture has long enjoyed popularity overseas, he says, which helped Facebook quickly gain a global following. Chinese culture, which

remains esoteric to much of the world outside of Asia, could constrain the potential of a Chinese Facebook to catch on with the international market, he said.

For his part, Kai-Fu Lee remains skeptical about a Chinese Zuckerberg. Differences between the Chinese and American educational systems, Internet markets and general societies mean that Chinese venture capitalists favor a more mature, execution-oriented entrepreneur. This Chinese entrepreneur aims for success, but may think more in the mainstream, Lee said, in remarks to the audience at the Boao Asia Forum held in Hainan last April.

The Price of Freedom

Despite the extensive resources incubators provide, the majority of Chinese startups still choose to go it alone. This was certainly the case with star performers of 2012 like Changba, the red-hot mobile karaoke app launched by the Beijing startup Zuitao, founded by serial entrepreneur Chen Hua. Chen also co-founded the travel portal Kuxun which TripAdvisor acquired in 2009. Changba provides a licensed se-



They copied the Silicon Valley incubator model first, and innovated later

Kevin Lee
Chief Operating Officer,
China Youthology

lection of 2,000 songs along with a virtual stage and audience for smartphones. Us-

ers can sing a song into the phone, save it, add a photo slideshow, and share it with the Changba community or their friends. Changba now reports more than 10 million users.

Papa, the photo-sharing application launched last year that allows users to record voice narrations to accompany their images, also has risen to success without the aid of an incubator. But according to Steven Millward, an Asia tech-industry watcher for the TechinAsia site, Kai-Fu Lee himself is a Papa user. Lee could potentially take Papa onboard if he believes the app has sufficient potential. Papa has already received an angel investment from Xu Zhaojun, whose Diandian startup—known as “the Tumblr clone of China”—has the backing of Innovation Works.

While a good incubator “is a win for everybody”, when start-ups join, they do forfeit freedom and equity, says Ong of *The Next Web*.

Some incubators exist only in name, says Der Arsalanian of China Market Research Group, adding that “a company just renting office space to a start-up or taking

Shades of Difference

Comparing the incubation models of the US with those of China

		
Tenant Entry/Exit Criteria	Clearly stated and adhered to mostly	Rather hazy and not adhered to in many cases. Government mandate takes precedence over efficiency criteria
Incubator Success Criteria	Incubators not run entrepreneurially with clear performance measures	Not clear. Incubator operations heavily subsidized by government, negating the need for self-sustainability
Incubator Management Capability	Strong	Weak
Role of Government	Low. Supportive, but not dictatorial	High. Visible hand
Role of Universities	Active	Passive, yet responsive and innovative
Role of Industry	Active	Passive
Institutional Environment	Strong institutions of capitalism	Weak, but developing, institutions
Culture	Risk taking	Risk averse
Source: International Journal of Entrepreneurship, 2009, 13: 67-86		

Tech Forever

Growth of China's tech start-ups via incubators

	2007	2008	2009	2010	2011
Number of incubators	614	670	772	894	1,034
Incubation space for tenants (10,000 square meters)	2,270	2,316	2,901	3,044	3,472
Number of tenants	44,750	44,346	50,511	56,382	60,936
Number of employees in tenants	93	93	101	118	126
Accumulated number of graduated tenants	23,394	31,764	32,301	36,485	39,562

Source: www.chinatorch.gov.cn

a large amount of its stock is not an incubator”.

According to Charlie Custer, founder of ChinaGeeks.org, the benefits of joining an incubator may not outweigh the costs. Many start-ups have sufficient funding and office space, and would prefer not to give away substantial equity to join an incubator, he wrote on TechnAsia.

Beyond tech

In the years ahead, industry watchers expect China's start-ups to further expand beyond the tech field, which will necessitate incubators adapt their business models. “I find it exciting to look beyond tech,” said Lee of China Youthology. “Already, *fuerdai* [China's wealthy second generation] kids are pooling their parents' money together and investing it in things like NGOs, especially in the south of China.”

Lee believes these affluent young entrepreneurs, facing pressure from their social circles, are concerned largely with the prestige of their endeavors. “If there were a tech opportunity high on reputational impact, then *fuerdai* would be interested, but those kind of opportunities are rare,” he adds.

Kai-Fu Lee's Innovation Works has already changed its business model con-

siderably, analysts say, evolving from a Western-style incubator focused on early seed-stage investment to an organization specializing in late-stage incubation. For that reason, a startup like the Papa photo-sharing app that has already achieved a certain level of market penetration would be a contender to join. Innovation Works today has become more institutionalized, said Lee of China Youthology, with the addition of finance, marketing and organizational experts. “They copied the Silicon Valley incubator model first, and innovated later,” he said.

Professor Howard Yu of IMD predicts China's strengthening of the rule of law will benefit incubators. As IP protection and the general arbitration environment improve, it will provide fertile ground for more sophisticated innovation, he says, adding that “a lot more business incubators will be popping up in the future”.

The market is maturing, Ong of *The Next Web* believes. In his view, Chinese companies, once notorious for cloning, are quickly becoming innovators in their own right.

In the meantime, while Chinese start-ups have achieved widespread success domestically, their international footprint remains negligible. At the OpenWebAsia 2012 awards held in December, which

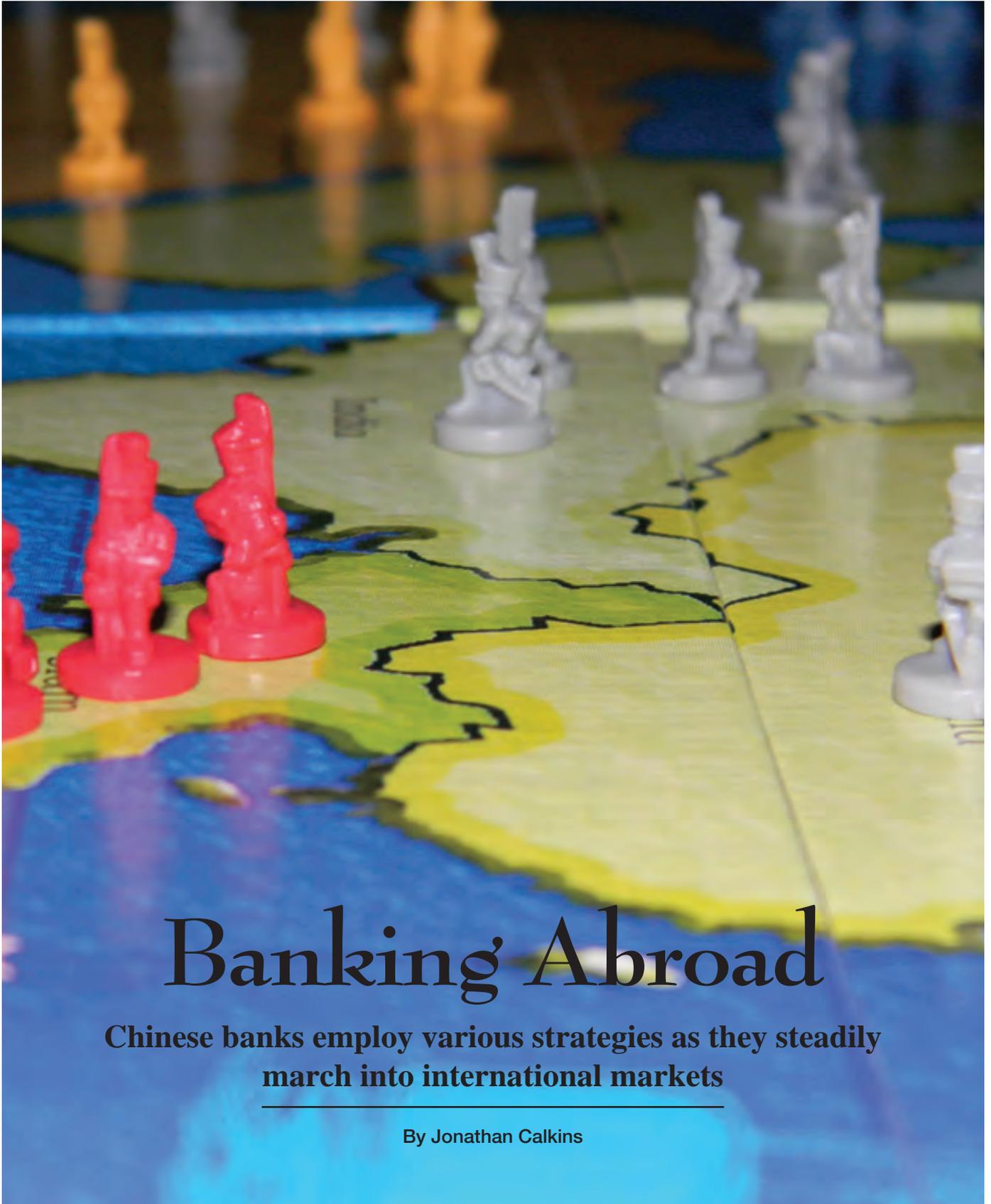
recognized the top 10 start-ups of the year in the region, not one of the companies awarded hailed from mainland China. The closest was Hong Kong. The rest of the winners were from Japan, Korea, Malaysia and Singapore. Ironically, the event itself was held in Hainan Province.

What works in China may not work overseas, says Der Arslanian of China Market Research Group, adding that Chinese start-ups have little experience adapting hit products at home to foreign tastes.

In the view of Ong of *The Next Web*, that's not a large problem, since Chinese start-ups remain in a nascent stage. It resembles the first Internet boom in the US, “a frontier in many respects, bursting with entrepreneurial energy,” he says. Ong believes incubators not only help start-ups get a product to market faster, but also foster a wider community-driven culture supportive of entrepreneurs.

Lee of China Youthology agrees. “The cultural impact is huge,” he said. “Incubators are making start-ups more acceptable in Chinese society.”

Yet ultimately, incubators' ability to help cash-starved start-ups secure funding will determine the scale of China's start-up culture, believes Der Arslanian. “At the end of the day, cash is king,” he says. ■



Banking Abroad

Chinese banks employ various strategies as they steadily march into international markets

By Jonathan Calkins

On July 6th 2012, Industrial and Commercial Bank of China (ICBC), the world's largest bank by market value, became a controlling shareholder in The Bank of East Asia's US subsidiary after receiving final approval from American regulators to purchase 80% of the bank's equity. This marked a milestone for the Chinese banking industry, and ICBC became the first Chinese financial institution to assume control of any US bank.

The deal was agreed upon more than two years ago, and despite its small size in dollar terms, the Chinese bank had to clear a lengthy 18-month approval process.

The ICBC acquisition, along with similar purchases and investments made by Chinese banks into offshore financial markets in recent years, represents the latest push in China's 'going global' strategy. Chinese businesses have been successful in expanding into underdeveloped markets, in large part due to reduced competition from Western brands and a higher growth potential. Chinese businesses, especially those engaged in petroleum and construction engineering industries, are in great multitude overseas and require enormous credit lines to finance day-to-day operations.

In practice, Chinese banks provide a financial support network for Chinese businesses as they move into overseas markets, such as the Middle East, Africa and Latin America. Therefore, many Chinese lenders are, for the time being, primarily focused on commercial banking, and are not yet prepared to offer asset management and investment banking services.

"We look to target regions that have a significant number of Chinese businesses in operation already, which allows us to play the critical role of financial intermediary," Chief Executive of ICBC Middle East Tian Zhiping told the *Financial Times* in December 2012.

The expansion of Chinese banks into offshore markets represents a twofold triumph for Beijing officials. The first—and more obvious—meaning is that China's central bank will have more influence on the global stage. As more countries begin using the renminbi to settle international payments, the yuan's role in offshore fi-



State-owned enterprises are looking to invest abroad because the domestic market is over-invested

Zhou Shaojie
Associate Professor,
Tsinghua University

ancial markets will create additional leverage for the Chinese government in dealing with the World Trade Organization (WTO) and International Monetary Fund (IMF).

The second, and arguably more important inference, is that the expansion of Chinese businesses into international waters has reached critical mass. Chinese businesses have been investing heavily into R&D, management and branding capabilities. A recent Millward Brown analysis highlighted the growing success of Chinese businesses in foreign markets, and in 2012 Lenovo became the largest PC maker by volume, with overseas revenues accounting for 58% of total company revenue. These businesses want a streamlined financial system that allows an easy transfer of money between the mainland and offshore, and Chinese banks are better equipped to provide this service.

Chinese banks are extending their services in a variety of ways by taking advantage of their relative isolation from financial mayhem in the West. Acquisitions and equity investments by Chinese banks in major overseas financial institutions come at a time when mature US and European banks are struggling to manage risk and rebuild portfolios in the lingering aftermath of the 2008 financial crisis and Eurozone debt crisis. Declining bankruptcy and asset prices for offshore financial institutions are providing more choices for M&A deals by Chinese banks, and many countries are lowering market entry barriers to encourage financial investment.

For example, ICBC upped its original 20% stake in Standard Chartered Bank by \$600 million in 2011 to acquire retail branches in Argentina after a meeting in Buenos Aires, according to a *Wall Street Journal* report. In a related move, the Bank of Portugal approved the opening of Bank of China's (BoC) first Portugal branch, set for March, in January 2010, according to the Portugal Economy Probe, a non-profit economic news monitor.

"China has a huge volume of foreign currency reserves, and many Chinese businesses were not negatively affected by the financial crisis. State-owned enterprises are looking to invest abroad because the domestic market is over-invested, and Chinese banks help them do this," says Zhou Shaojie, Associate Professor at Tsinghua University School of Public Policy and Management. "China needs to enhance its financial service offerings in offshore markets such as the United States."

China's need to expand in the US is obvious in its impressive increase in direct investment in the country. According to the Heritage Foundation's research on China's global investment activity, investment in the US jumped up by more than 41% year-on-year, reaching \$54.2 billion in 2012, and soon to follow suit was ICBC, China's largest bank, with its US bank acquisition.

China's 'Big Four' state-owned banks are being encouraged to expand their overseas financial profiles in order to provide financial services for major Chinese busi-

The Worldly Banks of China

China's top five banks by global branches, 2011



ness interests operating in foreign markets.

China's top four lenders remain dependent on domestic financial operations for a majority of their annual revenue. Current overseas operations by major Chinese banks account for less than 10% of their total assets, according to a 2012 Standard & Poor's report.

Despite a heavy reliance on domestic financial services, Chinese banks completed a total of 38 overseas M&A deals between 2002 and 2011, for a total value of \$20.24 billion, according to financial services firm Deloitte.

"While banks will benefit from greater geographic diversity, rapid overseas expansion could test their operation and risk management capacity," said Standard & Poor's credit analyst Ryan Tsang in a July 2012 press release.

Strategic Overseas Expansion

ICBC has proven to be the most aggressive Chinese bank in overseas markets, setting up 239 subsidiaries and branch offices in 31 different countries and regions worldwide, according the company's web-

site. ICBC's first majority equity purchase of an overseas bank was of Indonesia's Bank of Halim in 2006. The Chinese bank would then go on to purchase majority and minority interests in seven foreign financial institutions between 2007 and 2012. In addition, the board of directors of ICBC announced in November 2012 that the bank had received regulatory approval to open branches in the Middle Eastern markets of Kuwait and Saudi Arabia, the Arab world's largest economy and primary source of oil for Asia.

ICBC is not alone in its expansion. Agricultural Bank of China has opened branch offices in New York, Hong Kong, Seoul and Singapore.

By the end of 2010, Bank of China had overseas assets totaling \$351.6 billion, according to internal bank records. Xiao Gang, chairman of the board of directors of Bank of China, published a letter to shareholders in July 2012, explaining why the bank must go global:

"There is good reason to believe that the Chinese economy has reached a point where its status as the biggest country

will lead it to become the biggest in outbound direct investment. This new model not only requires Chinese enterprises to expand their global businesses, but also China's banking sector to accelerate its internationalization," Xiao wrote.

Although many Chinese bank executives are optimistic about entering new markets, others urge caution. During his final news conference as Chairman of China Construction Bank in 2011, Guo Shuqing, China's new securities chief, called for due diligence in examining cross-border M&A. "It might seem a good deal. But it wouldn't necessarily suit our development strategy," he said. That strategy was set aside as ICBC acquired the Bank of East Asia, US branch, departing from a formula of serving Chinese clients in underdeveloped markets. China Construction Bank has taken part in some pretty weighty M&A deals in the past seven years. In 2006, the bank purchased 100% equity of the wholly owned Asia subsidiary of Bank of America, and then took over AIG affiliate AIG Finance (Hong Kong) in 2009.

Go Global, Serve Local

Generally speaking, the international arms of Chinese banks and financial institutions lag behind the operational and managerial capacities of more established multinational banks, and often lack the prerequisite language skills and knowledge of local culture and regulations necessary to compete for local clients.

“Chinese banks find it very hard to do business with local [non-Chinese] customers. They dream of serving local clients but are forced to follow preexisting clients as they move into international markets,” says Liu Jing, Associate Dean at the Cheung Kong Graduate School of Business.

Liu’s comments touch on why Chinese businesses abroad remain the focus of Chinese banks. Beijing is active in financing infrastructure projects across the developing world, where Western financial institutions control a smaller share of the market and the potential for growth is higher.

Over the long term, Chinese banks active in markets such as the Middle East up the volume of RMB cross-border payments. RMB-based transactions are a key part of the central government’s agenda for internationalizing the RMB and strengthening the central bank, but it will have to meet the IMF’s requirements first.

RMB and the IMF

In 2009, People’s Bank of China, the country’s central bank, began loosening currency controls by passing “Administrative Measures for Pilot Implementation for RMB Settlement in Cross-border Trade”. This allowed companies on the Chinese mainland to use the RMB in cross-border transactions. By 2011, cross-border RMB transactions were recorded in 181 countries and regions, and cross-border RMB settlements reached RMB 2.5 trillion, a growth rate of 394% over the same period in 2010, based on Deloitte data. According to financial consultancy Swift, more than 900 financial institutions in over 70 countries are already doing business in RMB.

Previous Chinese president Hu Jintao described the current US dollar-led currency system as “a product of the past,”



You only
have one real
international
currency, and
that’s the US
dollar

Yukon Huang
Senior Associate
Carnegie Asia Program

and summarized China’s recent moves at “internationalizing” the renminbi in a written interview with the *Washington Post* and *Wall Street Journal* in 2011. But it is unlikely that the RMB will supplant the US dollar as the world’s reserve currency.

“You only have one real international currency, and that’s the US dollar. The United States has what I call ‘the ability to print out money and have everyone take it.’ This financial benefit makes it very desirable to have an international currency,” says Yukon Huang, a Senior Associate in the Carnegie Asia Program and World Bank’s former Country Director for China.

There are numerous benefits to having an international reserve currency. Domestic exporters have lower transaction costs in overseas markets, higher levels of business for financial institutions, seignorage and political power.

Beijing will likely adopt a more pragmatic approach by lobbying the IMF to support the use of the renminbi, rather than push for an international alternative

to the dollar or euro.

“Beijing wants the RMB to grow to become part of a ‘basket of currencies’ held by the IMF during the next five to 10 years,” says Eswar Prasad, a senior fellow at the Peterson Institute for International Economics.

The Special Drawing Right (SDR) currency basket held by the IMF is an international reserve asset used by the fund to act as a potential claim on IMF member currencies, and does not function as a currency itself. The current SDR basket is made up of four currencies—the euro, yen, dollar and pound—but Beijing officials have indicated that the renminbi should be included in the basket.

Current regulations require that SDR basket currencies have to be issued by a major export country, and the currency must be considered “freely usable.” A currency is generally considered “freely usable” once it is used as a unit of account, such as corporate invoices, as a medium of exchange, as in settling cross-border transactions, and as a store of value, including deposits and reserve currency. However, China does not predict the renminbi will reach this threshold before 2015, despite having US support to introduce the renminbi into the IMF basket.

The RMB ranked 21 in world currencies as of June 2011, with only a 0.24% share in total payments, compared to China’s share in global exports at 10.4% in 2011, according to World Trade Organization statistics. China’s currency can’t go into the IMF basket until the renminbi’s share in total international payments approaches its portion of global exports.

Chinese banks will continue to pair with Chinese businesses as they expand into new offshore markets. This will promote payments in RMB and increase the level of RMB currency reserves held by foreign countries. Western banks likely won’t compete directly with Chinese financial institutions as they begin to explore less developed regions and the Middle East. To maintain expansion, Chinese banks will have to begin offering more sophisticated financial products as they adapt to local clients’ needs and expectations. ■

The Web Wise-Up

搜索

手气不错

Increasingly sophisticated online consumers are pushing China's cyber retailers to the next level

By Engen Tham



Just as clever marketers have whittled the meaning of Christmas down to the goods that are gifted on the 25th of December, festive days in China are quickly following suit. Singles Day—a celebration of bachelorhood on the 11th of November—seems to have been hijacked by online retailers and molded into a shopping extravaganza. A short eight hours after price cuts began at midnight on the 11th of November, 2012, one of China's leading online shopping platforms, Tmall, made record sales, hitting \$800 million.

But retail highs quickly fell to frustrating lows. Online shoppers complained of slow delivery, fraudulent promotions and false advertising. More than half of the 8,160 complaints about online vendors submitted to the China Electronic Commerce Association in November related to Single's Day.

Aware of an increasingly vociferous constituency, vendors have made attempts to serve their needs. Taobao, for example, introduced the 'supplier alert page', a system that allows consumers to prominently publicize poor quality service by vendors, in 2009. At first, it seemed the addition of this feature showed how responsive even a mega-company like Taobao could be in the face of growing consumer demands. But in November 2012, Taobao ceased to update the list, and in its stead Taobao shoppers created their own 'Bad Suppliers' thread on Alibaba.com

Vigilant consumers are driving the evolution of online retailers and the e-commerce regulatory landscape by sharing knowledge through social media, and showing little restraint when voicing criticisms. The new generation of online retailers will be those that listen and evolve.

Hints of Sophistication

According to the Ministry of Commerce, China will become the world's largest online retail market in 2013, following years of rapid expansion. The nation had 194 million online shoppers and \$123.72 billion in online retail trade at the end of 2011, marking a 53.7% rise year-on-year. Boston Consulting Group projects a threefold increase of the current e-commerce sales vol-



Taobao changed the way Chinese consumers thought about e-commerce

Ben Weldon
Director, Thread Design

ume by 2015 to reach \$360 billion.

Online consumers are not only growing in numbers, but are also growing in sophistication. Chinese consumers are often suspicious of official news sources and advertising, preferring instead to get retail wisdom from online reviewers and social networks, according to a McKinsey report released in April 2012.

Those who frequent social media sites do so regularly: 91% of the 5,700 respondents polled by McKinsey had used online social media in the last six months, compared to 67% in the US and 30% in Japan, and spend 46 minutes per day on social media sites, in contrast to 37 minutes in the US and seven minutes in Japan.

More than 40% of online consumers in China post product reviews on the web, double the percentage of online shoppers in the US, according to the Boston Consulting Group. An increasingly common channel for consumers to comment, or complain, about products they have bought is Sina Weibo—China's Twitter-like site.

The result is a vast, comprehensive network of user comments on various types of goods online, which serves as an invaluable source of retail knowledge for the consumer. The reliance consum-

ers place on objective online opinion is greater in China than anywhere else in the world, says the McKinsey survey.

The network of highly wired-in online buyers forms a de facto union of consumers, with the confidence to raise a racket if expectations are not met. The use of retailer complaint platforms among Chinese online consumers has also increased. Complaints submitted to the Consumer Protection Bureau more than doubled in 2011, to 90,000 from 36,000 in 2010.

Dissatisfied and Proud

Consumer vitriol for online retailers has garnered government attention and spurred changes in vendor behavior. Online price wars in August last year between 360buy.com, Suning Appliance and Gome Electrical Appliances Holdings, resulted in numerous searing customer complaints when shoppers found the sites were hiking prices before cutting to exaggerate the savings in their promotions.

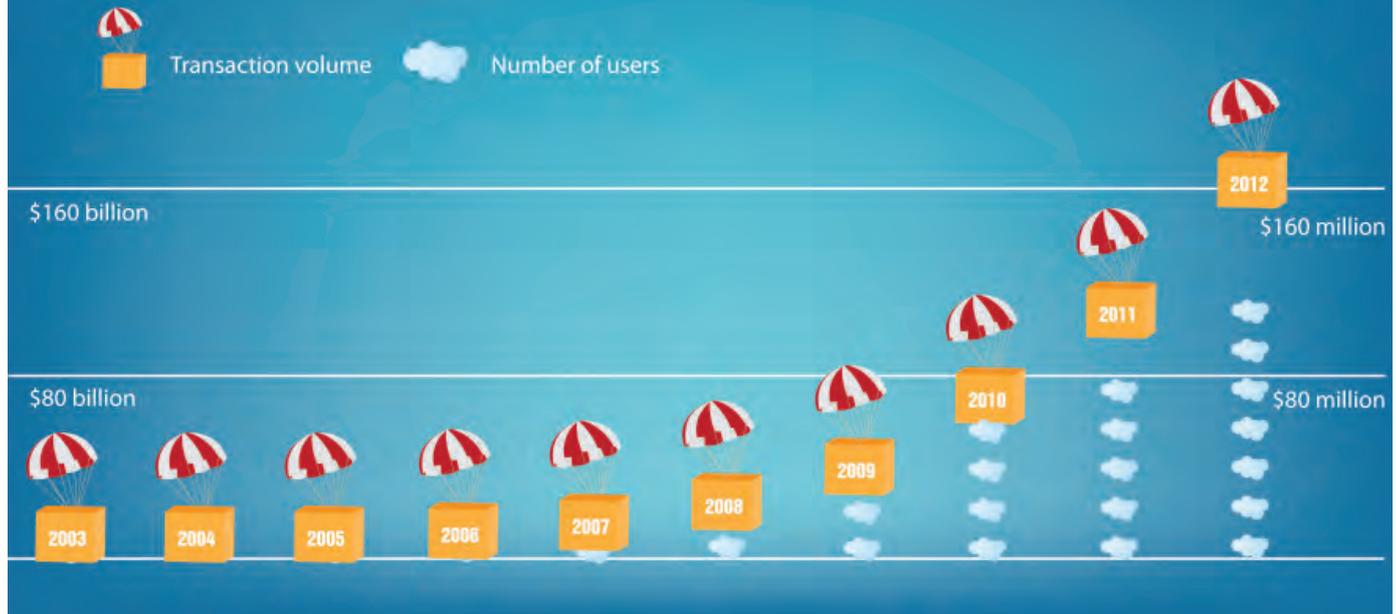
The clamor was so loud that the Ministry of Commerce responded to charges of misrepresentation with Shen Danyang, the ministry's spokesman, publicly stating that e-commerce companies should obey laws and regulations safeguarding fair competition. In September the National Development and Reform Commission launched an investigation into the price wars, and the Ministry of Commerce issued guidelines to regulate the conduct of over 40 e-commerce stores in China.

Suning responded to the 11th of November complaints this year by pledging not to engage in price wars in December when seasonal cuts are expected.

In grander display, Chinese courts held Taobao liable for failing to suspend the account of a counterfeiter, also held liable, and charge a penalty in accordance with its rules. The ruling departs from previous judgments and shows the nation is taking steps to formalize an increasingly important portal of trade. While this case highlights IP rights as much as best consumer-driven practices, it stands to show that a platform as large as Taobao is not above scrutiny, and can suffer recourse when engaging in destructive e-retail practices.

The E-commerce Takeoff

Taobao and Tmall's annual sales (transaction volume)



Source: TechnAsia

Upping Their Game

Taobao, with its low price incentives, laid the foundation for many online Chinese to experiment with cyber-retail. “Taobao changed the way Chinese consumers thought about e-commerce. They got used to Taobao, and now are happy to go into other e-commerce sites,” says Ben Weldon, director of Thread Design, a company that assists Taobao retailers establish themselves on the Taobao platform.

Recent advances in online shopping technology have also brought more consumers to web-stores. “There were huge obstacles to selling online which have in the last 24 months, really crumbled and the floodgates have opened,” says Weldon.

Alipay, the world’s largest third-party online payment platform, enacted a system last year that allows consumers to first confirm they’re satisfied before releasing money to the vendor. The platform works with over 100 financial institutions, such as UnionPay and Visa, making it accessible to the vast majority of Chinese account holders.

Yihaodian.com, one of China’s largest



If consumers are buying for convenience, then you want to ship within 24 hours

Jillian Xin
Founder, Xinlelu.com

online stores, reacted to customer complaints on the 11th of November in 2011 by guiding customer expectations downwards and reviewing delivery procedures this year.

“We lowered our promises. For example, in the past we promised next day delivery, but during those days we said we would deliver in two days or three days, we also added more resources, more staff to digest orders,” says Yu Gang, Co-founder and Chairman of Yihaodian. The company has also responded by creating a complaints system. A complaints manager provides daily reports on complaints received, and employees are rated and compensated on the basis of the customer feedback.

Survival of the Biggest

Traditionally, Chinese need a price incentive to go online and buy, whereas Western buyers are motivated by convenience. As Chinese consumers increasingly start looking to online retail for convenience, vendors will have to take this into account, which include delivery times. “If consum-

Making and Breaking Company Fortunes

Chinese e-consumers discuss their reactions to new products on Sina Weibo

The screenshot shows three Weibo posts. The first post is from user '陈雨童 candy' sharing a photo of a product, with the text '这货是小米3? 这设计太棒了吧~~~' and an English translation 'Is this the new Xiaomi? What an awesome design!'. The second post is from user '李果' with the text '把手机行业比作一个班的话, 那索尼一定是班花。接下去' and an English translation 'If the smartphone industry is a class in school, Sony must be the class hottie!'. The third post is from user '大黃媽煩厭厭' with the text '倩碧的黄油果然是夏天用极油秋天用极干的护肤品, 是谁叫我买的' and an English translation 'I want to spit it out. That Clinique lotion will oil up your face in the summer and dry your face in the fall. Who suggested I buy this? I will check the chat logs and request compensation'.

ers are buying for convenience, then you want to ship within 24 hours," says Jilian Xin, founder of online fashion retailer Xinlelu.com.

Other future shifts in online behavior include a more holistic approach to the consumer e-retail experience. For the platforms, this will mean adapting the design of their interface to keep up with changing tastes. "Users are beginning to appreciate a more stylized, minimalistic layout, something that's not too messy," says Xin. Chinese sites often have as many links as possible on their homepage but Xin believes that this is changing. Evidence of increasing aesthetic sophistication is apparent on the cleaner and more stylized look of Taobao and Vancl, whose homepages were initially more link-cluttered.

Tech advances, quickly adopted by the online Chinese consumer, are also ringing in web retail changes. Increasing smartphone use will spur vendors to adapt their home pages to be handset friendly. A third of urban residents in China currently use smartphones and the numbers are rising. "You'll see a major share of your transactions coming from a smartphone in the fu-

ture," says Xin. In the US more than 50% of online orders are done through mobile devices, and Chinese are trending that way, said Patrick Deloy from e-commerce consultant Bluecomgroup.

Continued price sensitivity will fuel consolidation in the industry, favoring mega-sites few in number. Size will be everything in certain sectors. "It's going to be just a size game, the bigger you are, the more likely you are to survive in this, because scale is a powerful thing in China. So many of these websites compete on price, the bigger the scale you have, the larger the bargaining power you have with your suppliers, the more you can drive costs down and win this game. Also, these bigger players can work on economies of scale with their logistics and their backend operations," says Xin.

The epoch of consolidation is already underway as vendors increasingly overlap with each other. Dang Dang originally sold only books, but now sells multimedia and other IT items, encroaching into the market of electronics retailers. Vancl and Mombasa both started as fashion websites, but now sell accessories as well. As web-

sites start to offer largely similar goods, the ones that falter in the price wars will fall away, leaving the strongest standing.

As consumers become increasingly experienced web-shoppers, they will move to purchase goods they wouldn't traditionally purchase online. "People are exploring new categories like food and fresh fruit," says Xin.

The post-mortem of Singles Day has most importantly led to an awareness among retailers that the e-consumer cannot be taken for a ride. Vendors now know that attracting consumers will mean a principled approach to retail and better discipline when it comes to quality control. Chinese consumers will be watching closely during the next celebration of bachelorhood, harboring hopes that there will be less retail heartache and thwarted shopping dreams. And if there are. They will complain.

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(Also read 'Social Commerce in China goes Beyond Sharing' on CKGSB Knowledge: <http://knowledge.ckgsb.edu.cn/2013/01/28/technology/social-commerce-in-china-goes-beyond-sharing/>)

EXIT



Digital Promised Land

**Can Western retail brands
make it big in China's e-market?**

By Daniel Garst

In September 2012, The Home Depot announced that it was closing all seven of its megastores in China. After eight years of consumer research and a \$100-million 12-store acquisition, The Home Depot called it quits in China after realizing that China isn't a sure return on investment. Speaking at the 2012 Reuters Retail and Consumer Summit in New York, the company's Chief Financial Officer Carol Tome said that its brick-and-mortar retailing model "wasn't meeting the needs of Chinese consumers". Even while it was making this move, the beleaguered home furnishings retailer had already started selling goods on China's 360buy.com—one of China's leading business-to-consumer e-commerce sites. It also announced it was trying to partner with other Chinese e-commerce platforms.

The Home Depot is one among several foreign retailers now seeking to deal with setbacks in their Chinese brick-and-mortar ventures by capitalizing on the explosive growth of e-commerce in China, albeit one step behind their Chinese competitors.

The foreign big box retailer game in China hasn't been as straightforward as hoped, and e-commerce offers a quick reach and requires significantly less capital.

Electronics retailer Best Buy also closed all of its megastores in China last year after dismal sales, opting to set up a space on Alibaba's Taobao Mall (Tmall.com), China's biggest e-retail platform. Retail giant Walmart, in the face of rising competition from foreign supermarket retailers, and declines in store visitors, acquired a 51% stake in the online supermarket Yihaodian in October 2012.

While companies like The Home Depot and Best Buy turned to e-commerce only after their brick-and-mortar stores all but failed in the Chinese market, others such as fashion retailer Zara, which has tasted success in China, are simply trying to capitalize on the online retail boom. And there are yet others, like US retailer Macy's, which do not have a physical presence in China yet and are tapping the market via e-tail. One benefit of e-commerce in China is that both flops and successes

skirt the increasing costs of real estate and the political tango it can involve.

The efficacy of the various e-retail strategies adopted by Western companies is still being weighed, but some have greater risks and execution challenges than others.

The Broad Shoulders of Tmall

E-commerce is becoming an indispensable part of any company's China-business model, and with good reason. According to the Boston Consulting Group, e-retail sales should triple over the next three years, rising from \$120 to \$360 billion by 2015, when e-commerce will account for nearly 10% of all China retail sales.

There are three discernable strategies currently at play among multinational companies vying for e-retail action in China; partnering via equity purchase, piggybacking via Tmall, or going it alone by establishing a dedicated website.

One, and perhaps the fastest, strategy common among well-known Western MNC retailers breaking into e-commerce in China is reserving space on China's biggest web platform, Tmall. In addition to Best Buy, others including British retailer Marks & Spencer, The North Face, GStar, and Ralph Lauren, have set up shop on this virtual mall.

Getting on Tmall has some clear attractions for big-name Western retail brands. With RMB 200 billion (\$32.1 billion) in sales in 2012, it is China's biggest B2C online platform, and market research firm Euromonitor predicts it will soon displace Amazon.com as the world's number one e-commerce site. The Alipay system, which surpassed the US' Paypal in 2010 as the world's largest third-party payment platform, is another feature of Tmall attractive to Western companies (Alipay was created by Alibaba, Taobao's parent company). Lastly, the site has also been investing heavily in upgrading its supply chain and distribution system, so as to match 360buy.com's same-day delivery guarantee. Quick delivery has become increasingly important in e-consumer motivation to shop online.

But Tmall has genuine risks. In 2011

retailers on the site protested after customers complained about receiving counterfeit products purchased at premium prices, and received support from the Ministry of Commerce. In reaction, Alibaba founder Jack Ma sharply ratcheted up service fees to drive out marginal vendors and improve Tmall's image.

Even if this move succeeds—the presence of an upmarket-clothing brand like Marks & Spencer on Tmall might deal a blow to its brand equity, as the platform features stores of all sizes selling everything from sportswear to groceries. In China, the equity of foreign fashion brands stems from the idea that Western brands are of superior quality. This is especially true for the affluent Chinese consumers Marks & Spencer is targeting.

Take Fang Jie, a 40-something chief account manager at New Alliance Chinese Global Communications firm. She says, "I don't buy anything local, only foreign brands, as Chinese brands are cheap and shoddy."

Awareness of brand delicacy may be a contributing factor to Marks & Spencer's two-pronged approach. In addition to its space on Tmall, the clothing store incorporated a dedicated Chinese website into its China e-tail strategy, which it launched in January.

Going it Alone

Even successful foreign retailers like Zara, which has 127 stores in China (not including sister stores like Zara Kids) according to parent company Inditex, have set up their own dedicated Chinese web stores to assume control over style and image projection. Toy retailer Toys 'R' Us has also implemented its own China site.

The Zara and Marks & Spencer e-retailing approach of going it alone forgoes the task of finding the right local partner, but the standalone approach presumes that Chinese shoppers will not just stick to familiar sites when buying online, but also venture new online shopping experiences.

China-specific online sales figures for Zara and Marks & Spencer haven't been released yet, but the experience of other foreign retailers with new and unique spe-

cialty offerings speak of a positive outlook for online newcomers. Ernie Diaz, the founder of Web Presence in China, which helps foreign companies build their own e-retail sites, explains that the somewhat surprising ease of setting up a website and payment system opens the doors to an array of companies offering niche specialty items.

“For a few thousand dollars, companies can set up an e-commerce account with a Hong Kong bank and then their customers can pay for goods with Alipay or 99pay,” says Diaz, dispelling the notion that Chinese online payment behaviors are difficult to crack, such as a lack of credit card ownership among e-shoppers in lower-tier cities.

Diaz further notes that Chinese banks are “promising in the next year to provide the ‘mobile wallet’ payment solution that exists in Japan for shoppers”. This new payment solution, which has been gaining ground in several developed markets, will enable online buyers to use their mobile phones to do the bank transfers required for online purchases. One certainty about the future of Chinese e-retailing is that payment logistics will soon become much simpler, which is good news for Western MNCs trying to crack open China’s digital sales market.

By developing one’s own platform, the task of finding the right Chinese partner is alleviated and company brand and aesthetic are maintained. But there are image-conscious Western retailers that are seemingly getting the best of both worlds.

Web Synergy

Macy’s, which has no physical presence in China, may have made the right move by partnering with VIPStore to get on Omei.com, a recently established online retailer that bills itself as the first choice for retailers in the US and Europe, even though it reaches far fewer consumers (2.5 million) than Tmall.

J. Crew similarly opted for a style-conscious online partnership with Lanecrawford.com, a retailer of upmarket clothes and home furnishings, which helped it make Hong Kong one of its top five mar-

kets in 2011. The Macy’s and J. Crew approach underscore the importance of this web synergy for high-end brands, should they go the way of partnership.

But it’s not only high-end brands that are investing in their partnerships, but also high-spending companies, such as Walmart.

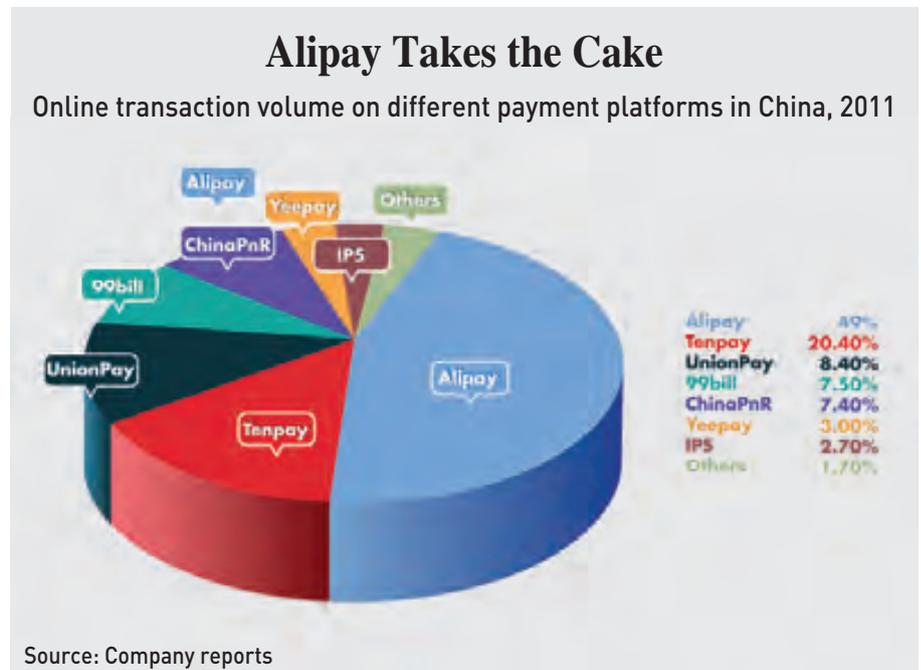
Walmart continues to post double-digit sales growth in China, but the number of store visitors is down 7.1% between 2011 and 2012, according to China Market Research Group. The slip reflects rising competition from other big-box retailers. Despite having over 350 stores in 140 Chinese cities, Walmart is not achieving the level of same-store visits as competitors RT Mart and Carrefour. After last year’s pork mislabeling scandal in Chongqing, Walmart favored a more centralized top-down approach to management, which counters the point of RT Mart’s success precisely because it cedes control to store managers. There is also a problem between Walmart’s brand in the West versus its capacity in China. It won’t be the cheapest option for everyday goods for the China consumer, as it claims to be in its home country, so it may need to focus on the quality of living aspect of its brand to

really hit China’s upwardly mobile.

Walmart recently acquired a majority stake in Chinese e-retailer Yihaodian. While the financial details of the deal have not been disclosed, it is being seen as a key pivot in both its branding mission and logistical operations.

Yihaodian, which was launched in 2008 and mainly sells fast-moving consumer goods, including groceries, is an attractive digital partner for the US retailing giant for a number of reasons. The online store now claims 24 million registered users and its sales have soared from \$6 million in 2009 to \$420 million in 2011. The retailer has invested heavily in technology and supply chain management, enabling it to provide same-day and next day delivery service. Twenty-three-year-old Liu Xue, employee of Chinese PR firm Evison, says that she prefers Yihaodian over shopping herself. “I’m really busy and don’t have time to shop, so Yihaodian is very convenient, plus the quality of their food is quite good,” she says.

But there are questions surrounding Yihaodian. First, its supply chain is most developed in the Yangtze Delta, which accounts for 70% of its orders. With the big growth in e-retail set to occur in





Acquiring Yihaodian is a smart move by Walmart that will give it a good presence in Chinese e-retailing

Wei Jiang
Professor of Economics,
Shanghai Jiaotong University

Western China's tier-three and tier-four cities, Yihaodian will have to make further heavy investments in its supply chain and sales management system to follow the growth.

More worrisome, despite its skyrocketing sales, Yihaodian has yet to break even, much less make a profit. The company estimates it will break even when its revenues hit \$1.6 billion in two or three years.

When Yihaodian begins making money, Walmart will face legal constraints on its new partnership. Concerned over its impact in generating excessive market power for Walmart, the Chinese Ministry of Commerce stipulated that the Yihaodian acquisition be confined to the online retailer's direct sales segment.

But according to Professor Wei Jiang

of Shanghai Jiaotong University's Antai School of Economics and Management, Walmart made the right decision.

"Acquiring Yihaodian is a smart move by Walmart that will give it a good presence in Chinese e-retailing," he says. "Yihaodian is unique in China, there are no other online stores selling a wide variety of merchandise, the other e-retailers are either platforms, like Tmall, or have a narrow range of offerings, like Suning and Gome."

In aligning with Yihaodian, Walmart has not just partnered with a smaller Chinese e-retail version of itself, but has also rendered competitors, such as Tesco, unable to compete using a similar strategy.

A Digital Oasis?

"I am not sure how e-retail will solve the basic issues of variations in merchandising and pricing needs in various markets. However, what it can do is reduce the burden of minimum scale and associated costs to enter a market. It can also allow the foreign retailers to avoid having to deal with the local real estate market, which is often not very transparent and fraught with political and economic challenges," says Krishna G. Palepu, Ross Graham Walker Professor of Business Administration at the Harvard Business School, and co-author of *Winning in Emerging Markets*.

Examples of the challenges of variations in merchandising and pricing needs are manifest in The Home Depot and Best Buy, which are now heavily damaged brands in China.

Media reports have postured that China lacks the project-oriented customer that The Home Depot has targeted elsewhere. Julie Harris, Global Managing Director of research and forecasting firm WGSN, forcefully echoed this verdict in webzine *Mashable*. "People don't have homes to invest in in China; homes are small, not spaces to invite your friends and display your wealth." Selling online is not going to change these unfavorable demand patterns for The Home Depot.

For Best Buy, on the other hand, the problem is not lack of demand, but fierce local competition, especially from heavy-

weights Gome and Suning. The latter has been consistently able to undercharge Best Buy. More problematic for Best Buy's turn to e-commerce, their big Chinese rivals already boast strong e-retailing capabilities. As a Johnny-Come-Lately to the Chinese e-retail game, the time for Best Buy to gain substantial online market share may have past.

The situation is quite different for big-name Western fashion retail brands. Jiaotong's Wei sums up the contrast.

"In consumer electronics, Chinese consumers are more price- and less brand-conscious, and will purchase cheaper local offerings; however, in fashion they want the real Western deal, and, unlike most electronic gadgets, acceptable local brands don't exist," Wei says.

Over the next decade, many of these consumers will be living in Western Chinese lower tier cities, where land-use issues make building new mega-malls difficult. This offers a huge new opportunity for Marks & Spencer, but exploiting it requires adopting an e-commerce strategy that maintains the brand's integrity. In this regard, the British retailer may be better off focusing on selling through its dedicated Chinese site.

In Walmart's case, it is well positioned to cash in on China's e-commerce gold rush. But while it has beaten other MNC general merchandise retailers to the punch in partnering with Yihaodian, Walmart will find the digital 'Shangri La' a very crowded place. As Diaz noted, China e-commerce entry barriers for smaller, specialty product retailers are becoming less of an issue. These companies can now sell directly to consumers in China without having a physical presence in the country, as Macy's has done.

MNC retail brands, even those facing setbacks, can make good on their China investments by shifting their focus to online selling. But in the fast-changing and hyper-competitive world of Chinese e-commerce, these firms are unlikely to achieve the same brick-and-mortar presence as in their home markets. Still, a small slice of China's \$120-billion e-commerce pie is better than none at all. ■

Colonel Sanders' Recipe Gone Wrong

Have Chinese consumers lost their appetite for Yum! Brands?

By Angela Doland



The KFC in the food court at Shanghai's New World Department store has seen better days. The yellow stuffing of a dingy vinyl booth has broken free of its casing, and someone has patched it with tape. A stool is minus its seat, and faded promotional stickers peel from the backs of chairs.

Customers to this Shanghai shopping center have their pick of almost every major local and foreign food chain, all competing for the Chinese market with new products and trendy store designs. It's hard to see what might lure them to this shabby outpost of KFC, aside from its reputation as China's most successful restaurant chain—albeit one whose sales have faltered lately amid questions over the quality of its chicken supply.

Thanks to KFC's breathtaking expansion in China, a Louisville, Kentucky-based corporation has improbably become China's largest restaurant company, inspiring case studies in business schools and accolades in books on how to conquer the Chinese market. KFC parent Yum! Brands, a PepsiCo. spin-out that groups KFC with Pizza Hut and Chinese food outlet East Dawning, (which opened 889 new Chinese locations in 2012) and earned 51% of its profits in China, reaching \$6.9 billion.

Now KFC is shifting its focus to lower-tier cities, where it says restaurant margins and investment returns are higher. That suggests a de-emphasis of more established cities like Shanghai and Beijing, which is one explanation for the worn appearance of some of its first-tier restaurants. Nonetheless, the sad display projects the image of a company whose best years are behind it—or possibly, of a chain so confident of its success that it is no longer trying so hard to please.

No successful Western company, even one as well-established as Yum!, can ever be too sure of its footing in such a fast-changing, complex market. That lesson became clear in February, when Yum! reported a 6% dip in fourth-quarter same-store sales in China and worse in the first quarter of 2013: a 20% drop.

What exactly went wrong? While a

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KFC is moving down, while Chinese consumers are moving up

Yifeng Mao
Founder, Goldpebble

recent scandal over KFC's chicken supply is the main culprit, new questions are being raised about Yum!, from its strategy to its growing competition in China. Is Yum!'s heady growth in China about to slow down?

Days of Glory

In 2004, 1,000 Yum! employees posed for a photo at the Great Wall to mark the opening of the 1,000th restaurant in China. Clad in puffy red jackets, they raised their arms, transforming their bodies into “Y’s” for Yum! Or possibly a “V” for victory.

The company had opened its first KFC just 17 years before, in 1987, near Tiananmen Square. Soon, grandfatherly brand mascot Colonel Sanders had one of the most recognizable faces in China, alongside that of Chairman Mao.

Warren K. Liu, former VP of Business Development for Yum! predecessor Tricon, and executive accredited with building KFC in China from 1997 to 2001, believes the chain was a natural fit for the Chinese market because people here prefer chicken to the standard US fast food fare of hamburgers.

Beyond that, Liu wrote in *KFC in China: Secret Recipe for Success*, the

company recruited executives from Taiwan—dubbed the “Taiwan Gang”—who understood Chinese sensibilities, resulting in dishes tailored for local tastes, such as Chinese porridge and dough fritters. When KFC entered China it brought a “sweeping revolution,” Liu wrote, noting that both fast food and restaurant chains were new ideas in China.

Yum! now accounts for four out of 10 fast-food restaurants in China, according to a 2012 Euromonitor International report.

China is home to Yum!'s 4,260 KFCs (easily its main cash cow), 826 Pizza Huts (recast as an upscale casual dining spot in China) and more than 450 branches of Little Sheep, a Chinese hotpot restaurant Yum! Brands purchased in 2011. There are also several dozen outlets of East Dawning, a Chinese fast food chain. While small and facing heavy competition from local chains, it may be Yum!'s ultimate mark of self-confidence—a Kentucky-based company selling Chinese food to Chinese people, in China.

No Longer Upwardly Mobile

Back at the New World Department Store's KFC, four sisters in their 50s and 60s whiled away an afternoon, getting their money's worth in a promotional deal: Spend RMB 10 and get a free drink or ice cream.

But they didn't actually eat at KFC. They ate noodles elsewhere, then came to KFC for coffee.

“Even if you don't buy anything at all at KFC, they still let you sit here,” says Xiaomei Hu, a 65-year-old retired office worker wearing red sneakers and carrying a faux Louis Vuitton handbag.

People are at ease at KFC, to judge from the number of customers napping with their heads down after lunch. But it is no longer an aspirational brand for upwardly mobile Chinese in first-tier cities, says Yifeng Mao, founder of Goldpebble Research, an independent research firm with a focus on China.

“KFC is moving down, while Chinese consumers are moving up,” says Mao, referring to consumers' increasing wealth and sophistication. Two chains that are aiming to target those increasingly savvy

consumers with spending power are Starbucks and Yum!’s Pizza Hut.

Starbucks, which has more than 700 stores here and predicts that China will be its second-biggest market outside the US by 2014, serves espresso and green tea to urban professionals taking time for afternoon chats (takeaway business at Starbucks in China is smaller than in the US, and afternoons, not mornings, are the peak hours).

Yum!’s Pizza Hut, meanwhile, has marketed itself as a stylish place for families and groups to eat standard Western food—not only pizza, which is too cheesy to appeal to some Chinese who avoid dairy—but also easily shared dishes like chicken wings and fried squid. Yum! also has a second Pizza Hut concept in China, a delivery service.

The company is putting a new focus on Pizza Hut openings, since those outlets bring higher margins at a time of rising rents and labor costs. That’s part of the backdrop of Yum!’s recent difficulties, along with higher prices for ingredients, a general slowing of China’s economy, and intensified competition.

China’s Fast-Food Wars

At the McDonald’s next to the worn New World Department store KFC, cheery messages in English plaster freshly painted walls: “Enjoy!” Burger King, meanwhile, has flat-screen TVs and trendy graffiti art scrawled on black walls.

KFC is “stalling out in terms of growth in first-tier markets, so from their point of view it may be thinking, ‘it may not matter if we do as good a job as we did at maintaining the stores we already have,’” says Ben Cavender, Associate Principal of China Market Research Group. “It does send a bad message, because consumers notice.”

Fresh store design is one area where McDonald’s has been aggressive. It has also launched McCafes, stylish coffee stands, another tactic to keep the brand up-to-date. McDonald’s still has a long way to go to catch up with KFC: It’s the second-biggest fast food brand in China, with a 15.6% share of the market, compared to KFC’s 38.9%, according to Euromonitor. Burger King is still tiny, at 0.4%.

Appearances aren’t everything, of course. KFC “isn’t stylish, but at least it’s

clean,” says Hu Ziyi, a 28-year-old Shanghai soda salesman who stopped there recently for a quick chicken burger. Yet the battle over store design is one area in which KFC seems to be resting on its laurels while other Western eateries raise their game to compete not only with each other, but also with growing Chinese brands.

Both KFC and Burger King have lost about 2 percentage points of market share since 2008, according to Euromonitor, while some Chinese brands have made small gains. Chinese fast food chains didn’t exist when KFC entered China, but local entrepreneurs have successfully emulated the Western model, offering fare specifically suited to the Chinese palate.

Real Kung Fu, recognizable for its spunky Bruce Lee logo, is an example. The set menus of its 400-plus stores (up from 300 in 2009) feature steamed meats and vegetables, a healthy alternative to KFC’s fried fare. Japan’s Ajisen noodle shop, Taiwanese fried chicken chain Dicos, which has 1,200 stores after 15 years of operation, and China’s Country Style Cooking Restaurant Chain, a KFC imitator, are also making gains.

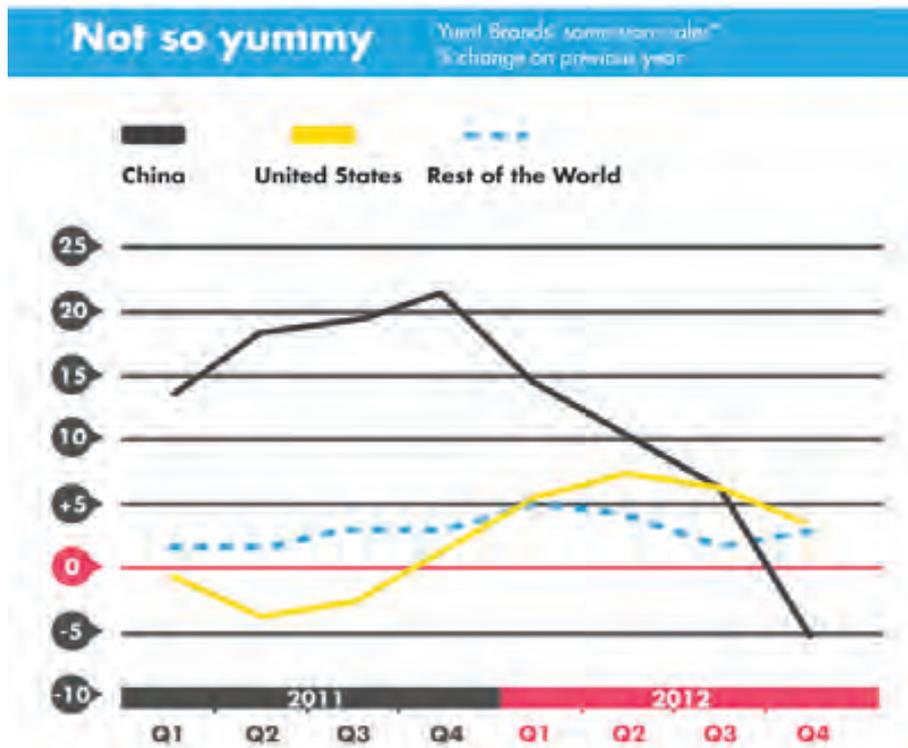
Finally, competition for KFC outlets comes from KFC itself, as new stores poach business from existing ones, says Jing Bing, Associate Professor of Marketing at Cheung Kong Graduate School of Business. In the fourth quarter of 2012, same-store sales dropped, though new outlets opened.

“This is a sign that the increase in the outlets may cannibalize each other,” he says. “The total demand is there, but as you increase the number of stores in an area, the per-store sales decrease.”

That’s a big reason for KFC’s push into other Chinese cities where it still has room to grow.

Crisis Mis-management

China Economic Net reported in November 2012 that some chicken sent to KFC was laced with chemicals. The public was horrified by the science fiction-esque reports of chickens treated to grow to maturity in just 45 days—though KFC retorted that 45 days was an industry norm, and



Source: Company reports *Same-store sales shows sales in outlets open for at least 1 year

Strength in Numbers?

Number of outlets in China, 2012



4,260



1,730



596

Real Kung Fu is a local Chinese chain that is slowly grabbing marketshare from global fast food chains

Source: Company records

that only 1% of its chicken came from the supplier at the center of the issue.

Since November 2012, when Chinese media accused a KFC supplier of treating its chicken with antiviral drugs to make them grow faster, jokes targeting KFC have popped up on Weibo's microblogging service.

User Bingtuan Tianshan wrote: "Some people ask: Will eating a chicken burger cure the common cold?"

After more reports and a probe by Shanghai's food safety watchdog, Yum! China Chairman and Chief Executive, Sam Su, posted an apology on Weibo, saying the company failed to address the issues quickly enough. But his mea culpa came seven weeks after the first report—an agonizingly slow response in a country on edge about food safety after scandals ranging from deadly baby formula to cooking oil that was collected from gutters and recycled.

The official Chinese news agency, Xinhua, issued a scathing editorial, calling the apology "understated", accusing the company of "arrogance" and pointing out that Chinese consumers believe foreign brands are "safer and of higher quality than domestic brands," indicating an abuse of trust. The Shanghai food safety agency declined to bring a case against Yum! but suggested ways to improve its poultry supply chain, which Yum! said it would implement. The company also says it will no longer do business with suppliers that get their chicken from small farms that are hard to keep tabs on. Wu Heng, who runs

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They said that KFC has more respect for its American customers

Wu Heng
Blogger

Throw it out the Window, a widely viewed food safety blog, thinks KFC suffered more than its fair share of blame and still believes it offers the safest chicken option in its price range. But Chinese consumers felt they had been slighted, he says.

"They said that KFC in the US would never have allowed this accident," says Wu. "They said that KFC has more respect for its American customers."

KFC has had food safety issues in China before and overcame them. In 2005, it pulled some products amidst a scare over a banned dye. In 2004, it speedily battled

fears over bird flu with a Q&A released to journalists and TV commercials emphasizing its high-temperature, germ-killing cooking style.

This time, KFC decided to wait until after Chinese New Year to launch a marketing campaign. Yum! says it believes that waiting out a scandal is the best approach.

"We could be wasting a lot of money right now doing marketing," CEO David Novak told analysts in early February. "We need to give it time."

Can Yum! Get Its Groove Back?

As questions over KFC's chicken brewed on social media, Yum!'s stock price dropped about 14% from November 29th 2012 profit warning to its February 4th 2013 quarterly earnings announcement.

While Goldman Sachs downgraded Yum! from "buy" to "neutral" in February, some say Yum!'s current problems and depressed share price provide an opportunity. Janney Capital Markets analyst Mark Kalinowski still has a "buy" rating on Yum!, for example, though he trimmed his fair value estimate by \$7 to \$68.

Yum! says it can't predict when the fallout will subside, though it says it is staying the course in China. There is still room for growth: There are 3.5 Yum! restaurants in China for every one million people, compared to 58 in the US, as Goldpebble Research's Mao points out.

But can Yum! continue to grow as fast as in the past? Mao thinks not.

The company plans to open 700 restaurants in China in 2013, down from more than 800 in 2012, he notes. Mao believes future quality issues are inevitable in China. Online shopping is also reducing the foot traffic to malls where many restaurants are located, he says.

And KFC, Yum!'s star brand, has simply lost some magic.

Mao recalls going to KFC at Shanghai's People's Square more than 20 years ago and waiting in line for an hour. Back then, KFC's fried chicken was a delicacy to be savored, "not to consume like fast food."

"As people get richer," Mao says, "as they move up along the curve, they will notice—it's just fried chicken." ■

Cleaner China?

After record smog and a leadership change, what's in store for energy policy and green investment in China?

By Angela Doland



In China's major cities, you can use an app to check the level of smog, or you can just step outside to see, smell and taste it. A *Bloomberg* news headline put the problem in sharp relief: Living in Beijing, it said, is as unhealthy as taking up residence in an airport smoking lounge. Air pollution broke records in January in Beijing, reaching a level nearly 40 times what the World Health Organization considers safe—a particulate air matter score between 20 and 30. China, the world's biggest energy consumer and carbon polluter, gets two-thirds of its power from coal-fired plants. The statistics go on and on.

With numbers like those, it can be hard to see anything but gray skies ahead for China and its energy policy. And yet the picture is more nuanced. Despite the reliance on coal to power economic growth, the government's 12th Five-Year Plan sets ambitious targets for saving energy and using greener power.

CKGSB asked the experts: What difference will China's efforts make? What's in store for China's energy policy after Xi Jinping takes over China's presidency? And despite rough times for green investment, are there still opportunities in the sector?

Q. How will China's leadership transition affect energy policy? And what is China's central government doing to ensure local officials meet their environmental targets, since they have an incentive to encourage the kind of speedy development that often brings skyrocketing pollution along with new wealth?

A. China's 12th Five-Year Plan spans 2011-2015, during which China plans to invest RMB 2.37 trillion in projects to save energy. In the same period, it plans to reduce its carbon emissions per GDP unit by 17%, and general energy consumption per GDP unit by 16%. It also plans to expand wind and solar power so that non-fossil fuels account for 11.4% of primary energy use by the close of 2015.

Melanie Hart, a Policy Analyst on Chi-

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This is an effort to recognize that local officials have an incentive to pass up statistics that make their regions look great

Melanie Hart
Policy Analyst,
Center for American Progress

na energy and climate policy at the Center for American Progress, says the new administration is unlikely to make major changes, since the Five-Year Plan “is designed to provide continuity from 2011 to 2015, which very neatly provides a policy bridge between Hu Jintao and Xi Jinping.”

Hart also points out that the China National Environmental Monitoring Center is setting up stations around the country to double-check air and water at a local level. “This is an effort to recognize that local officials have an incentive to pass up statistics that make their regions look great,” Hart says, noting that stations are equipped with video cameras to prevent tampering. “So it's not just local officials passing up

statistics that Beijing takes at face value. They're doing a lot of triangulation [term used for vetting statistics]... As someone who engages with China on a daily basis, I recognize the problems with data, but I also recognize that the Chinese government appears to be doing everything it can do to get really accurate numbers.”

Q. From 1981 to 2011, China's energy consumption rose 5.82% every year, according to a white paper released last year by China's Cabinet. With consumption constantly swelling and with coal central to national energy security, can China's green energy push really make a difference?

A. A 2012 Economist Intelligence Unit report praised Beijing for “taking aggressive measures to steer the country towards lower-carbon energy use, with some notable successes”. But that progress is hampered by rising energy consumption in general.

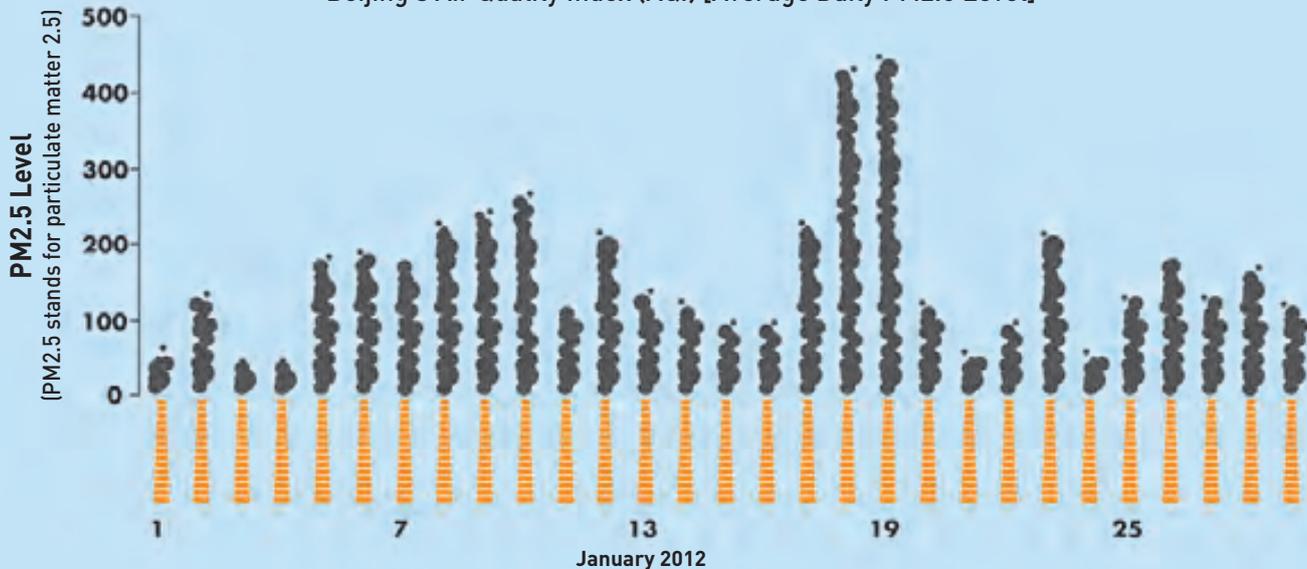
The report says, “35% more coal will be burnt in 2020 than in 2010. Together with strong demand for other fossil fuels, this means that carbon emitted from burning fuel will rise by over 40% by 2020. Although China will grow greener in relative terms, judged purely on how much carbon it emits, the opposite will be true,” says the summary of the 2012 report, titled “A Greener Shade of Grey.”

Q. More recently, China has indicated it is planning a tax on carbon dioxide emissions, the state-owned Xinhua news agency reported. The February report provided few details but noted that in the past, government experts had suggested a small, RMB 10 per-ton tax on carbon in 2012 that would rise to RMB 50 a ton by 2020. How important would such a move be?

A. Anthony Liu, a Visiting Assistant Professor of Economics at Cheung Kong Graduate School of Business, says a carbon tax is a great idea for tackling air and water pollution in coal-dependent China, partly because carbon taxes are believed to be “the lowest-cost way of accomplishing a given

Huffing and Puffing in Beijing

Beijing's Air Quality Index (AQI) [Average Daily PM2.5 Level]



Source: US Embassy

WHO considers a particulate air matter score between 20 and 30 safe

amount of carbon dioxide reductions”.

“I’m glad that China is talking about regulating emissions via a carbon tax, rather than by using cap-and-trade as the European Union does,” Liu says. “Compared to cap-and-trade, a carbon tax has many advantages for business, such as price clarity and cost certainty. A carbon tax also has significant advantages for government, such as ease of administration and the ability to minimize tax evasion.”

Liu notes that there are still many unknowns. “Among the most important issues in conversation in the research community are, who will be taxed?” he says. “Where will the tax be collected? Upstream at coal mines, or downstream at households?” Most importantly, he asks, “where will the tax revenue go?”

Q. China’s solar industry is in difficulty, with supply far outpacing demand, and the industry is stuck with a massive stock of photovoltaic panels. Furthermore, the US slapped anti-dumping and anti-subsidy tariffs on solar panel imports from China, and the European



Among the most important issues in conversation in the research community are, who will be taxed

Anthony Liu

Visiting Assistant Professor of Economics, CKGSB

Union also launched an anti-dumping case. What’s in store for China’s solar sector?

A. Traditionally, China’s solar manufacturers exported more than 90% of modules to the US and Europe, with only 10% going to the Chinese market, says Junda Lin, Senior Research Analyst with the China Greentech Initiative, a grouping of mostly Western companies and organizations.

As the weakening global economy and trade pressures caused turbulence for the local solar industry, China developed the domestic market, he says. “Even with that, still the overcapacity is a big challenge for the industry,” he says. “As of 2011 there were around 600 module producers in China—you may expect more than half to go out of business.”

Q. Shale gas in the US has been a game-changer, while in China, there are significant reserves that have not yet been exploited. The country has set a target of 80 billion cubic meters by 2020. Is that realistic?

A. Junda Lin of the China Greentech Initiative says that target appears “very aggressive”.

“China has to partner with US companies or license import technologies, and there are also water pollution issues, since it would potentially pollute underground water,” Lin says. “If we combine both the technology and pollution challenges, as well as the monopoly gas market that does not support private investment and innovation, I don’t expect there will be meaningful commercial production in the next 10 years.”

Q. Green tech investors have taken a beating in the last few years, especially in the wind and solar power sectors. Take Suntech, the Wuxi-based manufacturer of photovoltaic panels. Its stock peaked at over \$85 in late 2007, but lately has traded around \$1.50. Are there still ways to make money in China through environmentally friendly investments?

A. Liu of CKGSB says that though in-

vestors in clean energy have been “badly burned all over the world”, there are still opportunities. Liu says one idea is to “look to the government for guidance on where they are directing large amounts of capital.” The next opportunity in that domain, he says, may be electric cars, once batteries become more stable and have longer lives.

He also suggests looking at what the next generation of needs will be. “A third of wind capacity in China is idle—it could be producing power, but it’s not because it’s not connected to the power grid. That’s a good place to find very cheap power. You could set up something next to it that would benefit from very cheap, intermittent daytime power, such as office buildings.”

Finally, Liu says, investors can take advantage of overcapacity. “The auto industry in China is operating at 60% capacity—40% of its capacity is lying idle. That’s a good place to take advantage of opportunities, if you think of something else to be developed by that capacity, perhaps trucks, tractors or other kinds of moving equipment.”

Q. Thinking creatively and looking ahead, what are some potential models for green investment in China?

A. Peggy Liu, a former venture capitalist who co-founded the influential non-profit group JUCCCE to encourage the greening of China, believes that public-private partnerships will carry green tech forward. One idea JUCCCE has been pushing is the introduction of green municipal bonds.

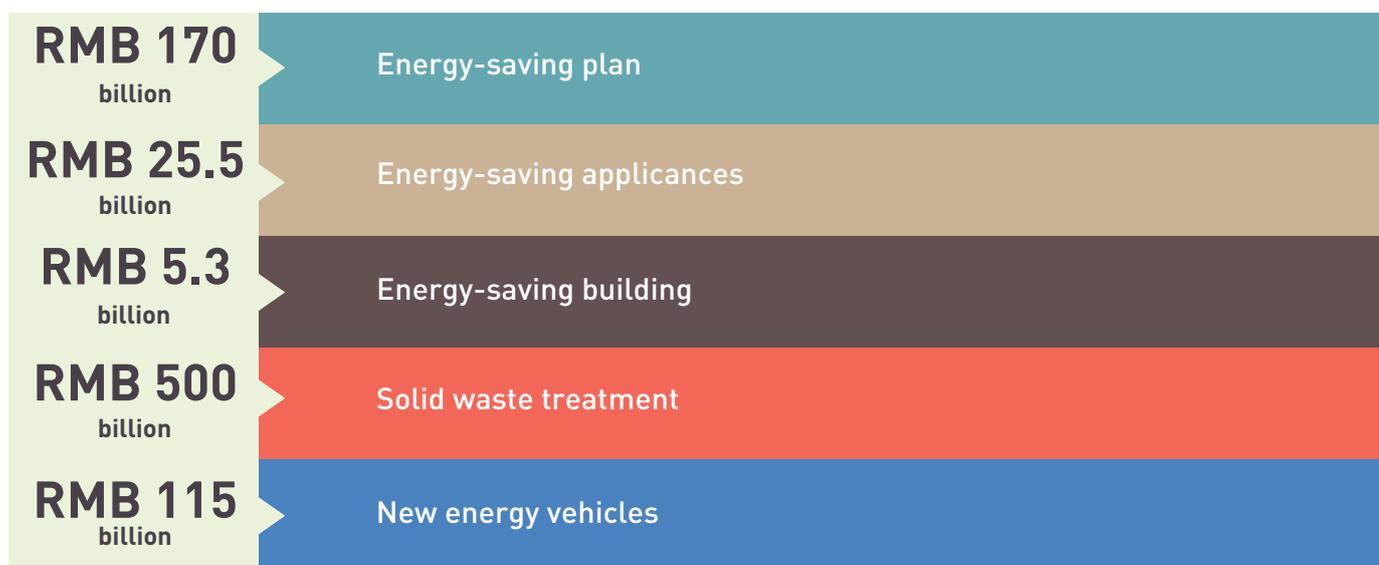
China launched four pilot municipal bonds in 2011, and Liu believes the country should build on that model to finance green projects.

“Right now China doesn’t have municipal bonds, generally speaking, because the central government carries debt for state-owned enterprises and municipalities,” Liu says. “I think what would make a lot more sense is to allow cities like Shanghai to offer green bonds for very specific projects”, such as wind or solar farms.

Ultimately, until emissions represent a real bottom-line cost to local officials, reform in the green sector won’t extend beyond the good intentions of Beijing. ■

Putting Your Green Money Where your Mouth Is

Central investments in green industries, 2011



Source: Ministry of Finance

US SEC vs. China Accounting Firms



Qi Daqing

Associate Dean, Professor of Accounting at CKGSB

The SEC believes that it ultimately has to do its own work to safeguard the interest of the shareholders

CKGSB Professor Qi Daqing and Peiking University Professor Paul Gillis share their views on the regulatory battle between the US Securities and Exchange Commission and the China branches of five international accounting firms over access to work documents

The SEC is doing what it must to protect the interests of US market shareholders.

On the surface, the regulatory dispute between the US Securities and Exchange Commission (SEC) and the China arms of the major international accounting firms is a technical issue. In truth, these firms are trapped between conflicting domestic regulations of two powerful states.

This intrinsic conflict would have to be rectified first to resolve the audit-related headache faced by Chinese companies listed in the US. In registering with the Public Company Accounting and Oversight Board (PCAOB) under the SEC, the China-registered entities of these international accounting firms have to agree to accept the oversights from the SEC and PCAOB, but Chinese domestic laws regard certain information as state secrets and do not permit access by foreign regulatory bodies to detailed documents such as audit work papers.

While the Chinese side may reasonably feel that its own regulatory standards should be sufficient for US listings, the

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In truth, these firms are trapped between conflicting domestic regulations of two powerful states

SEC believes that it ultimately has to do its own work to safeguard the interest of the shareholders. The SEC believes that it has reasonable basis for requesting closer examination of some of the Chinese companies listed in the US, especially in the context of recent history whereas some US-listed Chinese companies were found to be fraudulent.

A company listed in the US must be audited by an accounting firm registered with the PCAOB. Should the dispute drag on, the uncertainty will negatively impact the value of the Chinese companies which have already been, or are planning to be, listed in US markets. Their options for auditors will be severely limited, possibly ruling out a US listing all together.

The SEC has to balance between the interests of the listed companies and the interests of the shareholders, but the shareholder interests are definitely foremost between the two.

The dispute has one year to reach resolution under US law, which will likely arise from a middle ground, as opposed to one side fully conceding to the other. If no resolution is reached, companies which have a mind toward the US markets may have to turn to Hong Kong as an alternative, though for some companies no real substitute for the US markets may exist.

As of now, there is no real strategic move that either these Chinese companies listed in the US or the audit firms can make. They simply have to wait and see, until the two states work things out. ■

Battle for Access to Information

Paul Gillis

Visiting Professor of Accounting at Peking University



There are two problems at play here: national sovereignty and state secrets

Both the American and Chinese positions on this issue make sense, and that is the problem.

The Public Company Oversight Board (PCAOB) in the US has been negotiating with the Ministry of Finance and the China Securities Regulatory Commission for many years so that that PCAOB can come to China to inspect accounting firms that audit US-listed companies. China thinks that allowing foreign regulators to enforce foreign laws against Chinese people and firms on Chinese soil impinges on China's national sovereignty.

If the issues between the US and Chinese regulators are not worked out soon, the SEC and PCAOB may have no choice but to ban the Chinese accounting firms from auditing US-listed companies. While that would be bad for the accounting firms, it may be worse for their clients, who may get kicked off the US stock exchanges.

There are two problems at play here: national sovereignty and state secrets.

China has forbidden the PCAOB from performing inspections on its soil because it would violate China's national sovereignty, to which China is particularly sensitive.

Chinese regulators have declined the PCAOB's offer to conduct inspections alongside local regulators as it does with that of several other countries. Without access, the PCAOB has forgone its own requirements to complete the initial round of foreign inspections required under its rules by the deadline for the end of 2012.

China's State Secrets Law prohibits the transfer of information related to the

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China has the right to decide what goes on within its borders

country's national security and interests outside of China's borders without approval. But China has an expansive view of what might constitute a state secret. While most countries have such laws, China's definition of a state secret often includes information related to transactions with SOEs. China's Archives Law also restricts the transfer of information outside the country's borders.

China wants US regulators to rely on China's own robust regulation of accounting firms. But China does not regulate most of the audits conducted for US-listed Chinese companies because most of these companies have incorporated outside of China, typically in the Cayman Islands, to avoid Chinese regulation. Consequently, these companies fall into a regulatory hole lacking regulation from either nation. In my opinion, this hole encourages fraud.

Not only is it law, but the PCAOB and

the SEC help to protect investors by requiring complete and accurate disclosure of financial activities. Removing this investor protection on Chinese stocks listed in the U.S won't do. If Chinese companies and their auditors can't follow US laws, then they should not be listed in the US.

Conversely, China has the right to decide what goes on within its borders. China is perfectly within its rights to keep working papers from leaving China and to ban foreign regulators from coming to China to enforce foreign laws. But, it is also within China's rights to cooperate with foreign regulators if it chooses to.

The decision is up to China. China may decide that cooperation with the SEC and PCAOB is too much of an impingement on China's national sovereignty and risks national secrets. The consequence of taking that position is Chinese companies getting kicked off of US stock exchanges.

So the real risk of not finding a deal is for China. China's own markets are not ready to handle the \$100 billion in private equity money currently tied up in Chinese firms looking for an IPO exit. If US markets are closed to China's entrepreneurs, there is a risk that indigenous innovation will suffer.

In the political short-term, China wins by standing up to "American hegemony". The US wins by showing that it "will not allow China to cheat".

But ultimately, this is a case of two superpowers working out their relationship for the 21st century. The US is used to making the rules and expecting other to follow them. That is going to change. ■



CKGSB Knowledge

Knowledge.ckgsb.edu.cn provides Information, analysis, and interviews about the Chinese economy and doing business in China, from the people who know it best.

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Conversations

"Maximizing rationality means pursuing your interests (and) doing the best you can to further your goals."



56

Robert J. Aumann

Nobel Prize winner

58



Jeffrey Pfeffer

The Thomas D. Dee II Professor of Organizational Behavior at Stanford-GSB

"To the extent that employees are being 'used up', both physically and psychologically, that does not strike me as a very sustainable practice."

"We want to be here for the Chinese users, but we want to serve global users as well."



62

Jennifer Li

CFO, Baidu

65



Sir Tom Hunter

Noted entrepreneur and philanthropist

"You quickly understand that it isn't the money that's important, it's what you actually do with it."

The ROBERT AUMANN Interview

In conversation with CKGSB Professor Mei Jianping, the Nobel Prize winner talks about game theory and the lessons of history

In late 2012, Israeli-American mathematician Robert J. Aumann, the 2005 Nobel Laureate in Economics, came to CKGSB where he gave a fascinating talk drawing links between the Talmud and phenomenon from Economics. Aumann is best known for his contributions to game theory. He pioneered the idea of correlated equilibrium within the concept of non-cooperative games, among other things. He won the 2005 Nobel Prize along with Thomas Schelling for his work on conflict and cooperation through game theory analysis. Unlike several mathematicians whose

research has little to do with the real world, Aumann's work has practical implications.

After his talk, Aumann, who is now Professor at the Center for the Study of Rationality in the Hebrew University of Jerusalem, sat down with Mei Jianping, Professor of Finance at CKGSB, for a discussion spanning topics such as rationality and game theory; forgiveness and revenge; and war, peace and unrequited gestures. Read on.

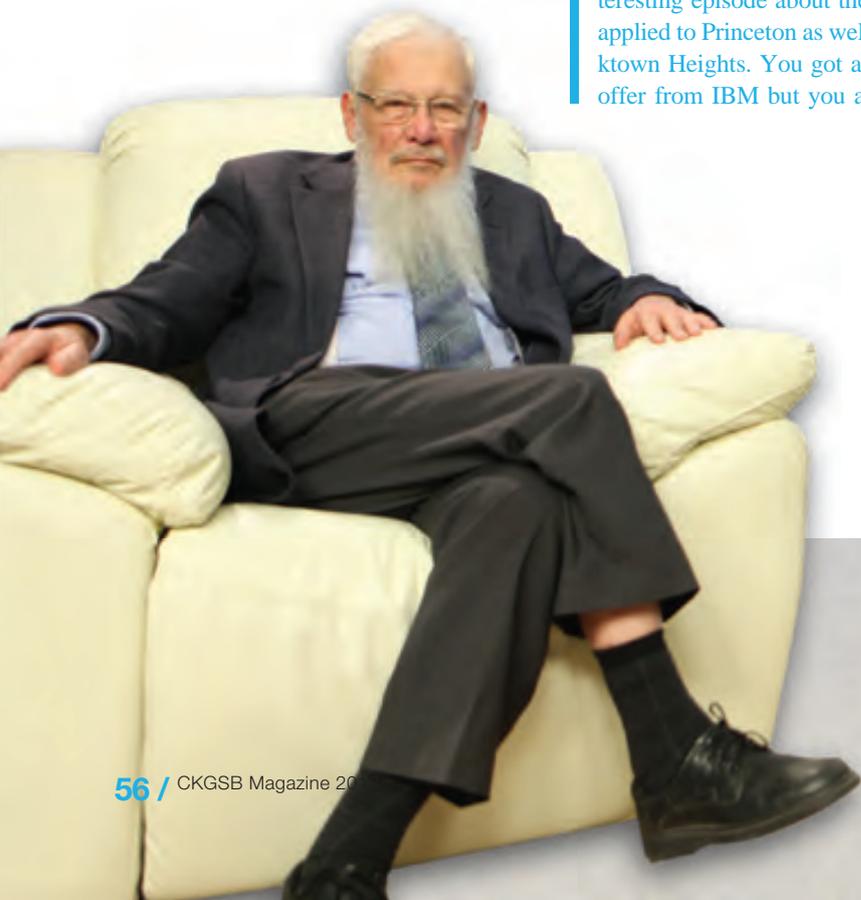
Mei Jianping: In the biography you sent to the Nobel Committee you mention an interesting episode about the time when you applied to Princeton as well as to IBM Yorktown Heights. You got a better monetary offer from IBM but you actually accepted

the offer from Princeton. My question is, do you think there are actually different levels of rationality or rationality from different perspectives? Because at that time in terms of monetary value, it appears you didn't make a rational decision.

Robert Aumann: I went to Princeton for \$7,000 a year instead of going to IBM where I had an offer of \$14,000, so twice as much. Now the decision was not irrational because rationality does not mean maximizing monetary returns. Economic rationality means promoting your interest in view of your information. It doesn't mean making the most money.

MJ: Yes, that's the point I'd like to get at.

RA: In fact, this wager turned out very well indeed because it was at Princeton that I came across Lloyd Shapley and John Milnor's paper titled 'Oceanic Games'. Later in the year there was a conference at Princeton in which Herbert Scarf gave a lecture on the core and competitive prices. I put two and two together and I realized that the model of Shapley and Milnor had to be the right way to deal with that matter of the core, which Scarf had very good ideas on, but the model was unwieldy. That was my first big hit.



So that turned out very well. Even in monetary terms. The reason I went to Princeton—although Yorktown Heights was extremely challenging intellectually—I was convinced that Princeton would be more challenging. Maximizing rationality does not at all mean maximizing your income. It means pursuing your interests (and) doing the best you can to further your goals.

MJ: A related question in the study of game theory is this concept of forgiveness versus revenge. If you look at the relationship between France and Germany—and I think they somehow reconciled after World War II—the question is when should you forgive and when you should not?

RA: (About) France and Germany, I don't think it's an issue of forgiveness. It's an issue of somehow saying this is not going to further our interests to pursue this matter further, so let's just get on with our lives. I actually did some research with Sylvain Sorin on 'bounded recall', or optimality and bounded recall. It's easier to reach an optimal solution if your recall, repeated gain, is bounded. If you don't remember too much, it's easier to reach an optimal solution.

MJ: Talking about limited recall, there is a quote by Hegel which basically means that we actually forget the lessons learned by people before us, and so we're bound to repeat the same mistakes again and again. As someone who has observed human behavior for (a) very long (time), in your observation, do you think human beings have evolved? In other words, (do we) tend to make more rational decisions?

RA: I don't see any evidence of that (laughs). I think the 20th century was easily the bloodiest century in history. I don't see any evidence for thinking that people don't repeat the mistakes that they made in the past. One can always read history in different ways. It's very difficult to see

clearly things that are happening now. In hindsight, it's very easy to identify the mistakes. I do what I can to try to promote rationality. Let me give you an example. People try to promote world peace. And what they do for example is say, 'Okay, to promote world peace we have to disarm, we have to try to make concessions to the other side'. But that doesn't work because one-sided concessions, gestures, this is interpreted by the other side often as a sign of weakness and then it actually encourages war.

An example of that is the Second World War which was perhaps the bloodiest in history. It's common to think Hitler brought it about but he didn't. It was (then British Prime Minister) Neville Chamberlain. Chamberlain came back after making one-sided concessions in Munich. He came back to Parliament and said, 'Ladies and gentlemen, I've brought with me peace in our time.' But actually what he brought was war, not peace. When Hitler invaded Poland on the 1st of September 1939, it took England two days to respond and then they declared war on Germany. They asked their ambassador in Berlin to notify Joachim von Ribbentrop, the foreign minister in Germany. They did so and Ribbentrop immediately notified Hitler. Hitler was furious. He didn't expect it. He was furious because Chamberlain had cheated him. He had sent him a clear signal that he was not going to respond to any outrage and, in fact, he was right, because Chamberlain did not want to

go to war even then, and the British cabinet forced him to. They said, 'Mr. Chamberlain, either we go to war or you're not prime minister and then we go to war.' And he stayed on until May, he stayed on another six months. So it was Chamberlain who brought war, by shouting, 'Peace, peace, peace in our time!' This is not only game theory, it's also history. You're talking about people repeating the same mistakes again and again. The greatest champions in the history of peace are the Romans. The Pax Romana lasted 238 years. The Roman Peace. And the Romans were not nice people. I don't like them at all, but they knew how to make peace, and how they made it was, '*Si vis pacem, para bellum*' (If you wish for peace, prepare for war). It sounds upside down, paradoxical but that's how you make peace. So unrequited gestures do not bring about peace, treaties may, agreements, explicit agreement, that may bring peace. Unrequited gestures bring war not peace, so that's an example of not learning from history. ■

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 To watch the video, please go to the following link:
<http://knowledge.ckgsb.edu.cn/2012/12/12/videos/robert-aumann-interview/>





The Human Factor

**Organization behavior expert and Stanford Professor Jeffrey Pfeffer
on the poor state of human sustainability in organizations**

By Neelima Mahajan

In a career spanning more than four decades, there is one thing that Jeffrey Pfeffer has never done—mince words and sugarcoat advice. Pfeffer, the Thomas D. Dee II Professor of Organizational Behavior at the Stanford Graduate School of Business, is one of the most influential authorities in the field of organizational behavior today.

Over the years, through more than a dozen books written with his trademark candor and biting wit, he has helped many individuals confront and come to terms with uncomfortable truths about the organizational and business environment. Among his most successful books are *The Knowing-Doing Gap* (with his Stanford colleague Robert Sutton), *Hard Facts: Dangerous Half-Truths & Total Nonsense* (with Sutton again), and the more recent *Power: Why Some People Have it and Others Don't*. While *Hard Facts* ruffled many feathers because it put the spotlight on evidence-based management and warned against fads masquerading as the “next big management idea”, his 2010 book *Power* dismissed the notion of the hierarchy-less office as pure bunkum. It went on to advise employees that to succeed in their careers, they must actively seek power for themselves.

More recently, Pfeffer has started focusing on an idea he likes to call ‘human sustainability’. In an *Academy of Management Perspectives* article, he rued the fact that while more and more organizations are focusing on their environmental impact, they pay little attention to the affect they have on their human and social environment. He focused in particular on the impact on employees—ranging from ill health and stress, to mortality. “...(T)his emphasis on the natural environment raises an interesting question: Why are polar bears or even milk jugs more important than people, not only in terms of research attention, but also as a focus of company initiatives?” he asked.

In this interview, Pfeffer elaborates on the idea of human sustainability, also the subject of his next book. Excerpts:

Q. By putting the spotlight on employees and the kind of conditions and environ-

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Are you
engaging in work
practices that
do not disrupt,
in this case, the
social or human
environment,
and which do
not basically kill
people?”

.....
ment they have to cope in, you've brought to the fore an issue that has long been ignored. What really prompted you to look at this direction? And how does it tie in with your past work?

A. It began when I wrote *Competitive Advantage through People* (1996) and then *The Human Equation* (1998). I have also given a lot of talks, read a lot of the literature on high-performance or high-commitment work practices and served for several years on the Human Capital Leadership Council for Hewitt (now Aon Hewitt), one of the big HR consulting firms. What struck me (was that) if you look at consulting firm research or academic research, there has been for decades a recognition that organizational performance would be enhanced if companies basically reorganized their

management practices to engage the workforce and reduce work-family conflict—basically do things that would permit people to make decisions and exercise their gifts and skills, and provide training. After decades of research, and lots of reports coming out of the HR consulting firms, I did not see that any of this work was being implemented, very much, or in very many places. So if profits did not motivate companies to do the right thing, I began to think if there was some other way in which we might get companies' attention. It occurred to me that maybe some of the management practices that would increase organizational performance might also be related to employee health. That's what got me on this thing, kind of trying to think of a hook, or a lever, or some way of getting companies' attention on this issue.

Q. We usually hear of sustainability in the context of the environment and you have put a human dimension on it. How do you define 'human sustainability'?

A. I would define human sustainability, in a way, analogous to environmental sustainability, (which is really about whether) you are engaging in economic activities in a way that disrupts to the least extent possible the natural world. It's exactly the same for human sustainability. When companies—and you can see this in China and certainly in the US—do not care about employees and the employees' work environment, you have higher incidences of cardiovascular disease, health problems, workplace-related stress, psychiatric problems and workplace violence. To the extent that employees are being ‘used up’, both physically and psychologically, that does not strike me as a very sustainable practice. It's more sustainable in a country that has more than a billion people like China, but it's still not very sustainable, because China has a one-child policy so sooner or later they'll run out of people too. Sustainability means just what it implies: are you engaging in work practices that do not disrupt, in this case, the social or human environment, and which do not basically kill people.

Q. Now that we have human sustainability in the picture, how do we need to rethink a concept like the triple bottomline that every company is talking about now?

A. We need measures of employee well-being. I have a dear friend who's just been promoted to chairman of the board of a non-profit modeled after the Financial Accounting Standards Board (FASB), called the Sustainability Accountability Standards Board (SASB). If you look at the measures that they want companies to adopt, this goes back to the quality movement, and everybody in management will tell you, that what you inspect, you get. As soon as I begin measuring and inspecting, my carbon footprint and the size of that footprint, now I will pay attention to it. Companies, for the most part, do not measure employee well-being. They may do an annual survey of employee engagement which most of them don't pay much attention to, but they are not measuring employees' physical and mental health, and particularly, they are not tying those measurements to what they are doing inside their organizations. Look at the discussion in the US about healthcare—it's always done in terms of cost. Look at companies, and they are for the most part, talking only about dollars. To the extent that they are talking about anything else, it's, you know, a carbon thing or something (like that). We need to have measures and attention to human well-being. To use the words of a friend of mine who teaches at IESE in Barcelona, 'Why should we care more about polar bears than we do about human beings?' We need to measure human well-being. We need to have standards for that, and we need to compare organizations to each other and to themselves over time and we should see if companies are doing things to make their employees healthier as oppose to less healthy.

Q. What are the different dimensions of human sustainability and how would you measure and quantify them?

A. Interestingly enough, since I'm doing a lot of work on this I can tell you this: there is a single-item question. It's called Self-Reported Health Status (SRHS). It basi-



Companies, for the most part, do not measure employee well-being

ally asks people how healthy they are. (It turns out to be in some studies more correlated with their prospective subsequent mortality than even physiological measures. So it's actually quite easy to measure. You ask people basically, 'How are you doing?' or 'Is your work-related stress interfering with your health? Is it interfering with your ability to live your life?' You ask them about their physical health, psychological health, and how much stress they're experiencing.

The problem with many companies' wellness programs is they assume that your individual decisions about smoking, drinking, overeating and substance abuse or any other individual issues that you have, that this is somehow your individual responsibility. While they will provide you perhaps with some incentives, or dietary and nutrition counseling, or a once-a-year cholesterol measure, what companies have failed to recognize is that a lot of the individually unhealthful behaviors such as overeating, not exercising, drinking and smoking are directly related to workplace stress, and the stress that comes from economic insecurity, including the threats of layoffs and relatively high unemployment rates. While it is true that individuals have some responsibility for their own choices, those choices are not made in a vacuum. There is actually a very large epidemiological literature that suggests that people

who are laid off, or who face the threat of unemployment, or who have been unemployed are much more likely to engage in individually unhealthful behaviors, controlling for everything else, than people who have not faced those kinds of stresses.

Q. Has the situation with regard to human sustainability worsened in recent years?

A. There's an article in *Health Affairs* which talks about the fact that at least for the less educated groups in the US, mortality is up and life expectancy is down, so they are clearly worse off. Overall, I think it's a mixed thing, but the US has now more uninsured people than ever before, this is prior of course to the passage of the Affordable Care Act. This is from the Kaiser Foundation's studies—a smaller percentage of employers are offering healthcare coverage than before, and healthcare coverage is related to health and mortality and morbidity. Certainly the levels of job satisfaction according to the Conference Board are lower, and if you go to virtually any of the major human capital consulting firms' websites, you will see that the levels of employee engagement are pretty low and are probably not as good as they used to be. To the extent that there are indirect indicators, they suggest that things at least in the US are probably worse than they were. I think this is less true in places like Northern Europe, which have, I think, very humane policies mandated by the government towards the workforce. There was an article in *The New York Times*, which spoke about all the suicides occurring in Greece because of the severe economic stresses that that country is under. Economic insecurity and economic turmoil lead to a variety of forms of unhealthy individual behaviors and bad health outcomes. So yes, I think things are probably worse.

Q. We are all well aware of the dangers of ignoring human sustainability issues, but most of it is really from the perspective of the individual. What are the dangers of ignoring these issues from the organizational perspective?

A. At the moment, at least in the US, and

I suspect this is probably true in China as well, from the individual organization's point of view there actually are no dangers, because as long as there is a reserve army of the unemployed, as long as there is an adequate workforce, as long as I can replace my workforce, as long as there is sufficiently high unemployment rate and a sufficiently large number of people with the skills I need available in the workforce, there is no real cost. The costs are really paid by society. In the US, when people become unhealthy, they either die, which of course costs nobody anything, or they leave the workforce, and once they leave the workforce, they become the responsibility of the state. Forty years ago, if I polluted either the air or the water, what was the cost to me? Nothing. Those costs were externalized, to use an economics term. Other people had to clean up the water, other people suffered from the air pollution and I, as a company, paid no price. So one of the things that physical environmental regulation did, was it said that if you were going to pollute the physical environment, either that was going to be proscribed or else the cost would be borne at least partly by you, which would give you an incentive to figure out how to engage in less air, water and other forms of pollution. Basically cut it off at the source. Prevention is always cheaper than remedy. It's the same thing for human sustainability and human health as well. Until companies have to pay for the social costs they're incurring or imposing on people in terms of their physical and mental health, there's really no reason for companies to change their behavior.

Q. Is there a tradeoff between achieving the typical organizational goals of, say, efficiency, quality, low-cost, scale, etc., and employee well-being? Is it an 'either or' or can the two be achieved together?

A. Literature suggest that healthier employees, of course, are more productive, which wouldn't surprise you. But many of the practices that cause economic insecurity and stress are not actually economically efficient either. I think this is a win-win situation not an 'either or'.

Q. Have you actually seen anyone do that? Typically the companies that are successful, like Walmart for instance, are probably the worst offenders on this account.

A. It is (one of the worst offenders). Walmart is definitely one of them. Companies which are on rankings like the Great Places to Work list and the Fortune Best Places to Work list, I think do a pretty good job at this, places like the SAS Institute, Patagonia and Google. The SAS Institute has had onsite healthcare for decades, and has offered generous health insurance and family-friendly work policies. So there are companies that have done this, but there aren't, unfortunately, very many of them.

Q. What are the possible solutions to this problem?

A. If the organizations want to address this problem, it's actually quite simple. If you have a problem with your production quality or with sales, you basically do the same thing: first of all, you have measurements which permit you to see if the problem exists, and then you try to use, to the best of your ability, those measurements to figure out the source of the problem and how to fix it.

Q. One of the things you also talk about is rethinking job design in this context.

A. You certainly should offer more autonomy and flexibility and there've been lots of studies that suggest that that's a

good thing to do. One of the biggest predictors of health problems is absence of control over your work environment. So you have people changing your deadlines all the time, making capricious demands on you,... you don't understand what you need to do in order to be successful because it changes all the time. To the extent you give people clarity about what they need to do, why they need to do it, and you offer them a predictable and controllable environment, they will be better off and the company will be better off as well.

Q. On a lighter note, we live in a world of quick-fixes. Is there a 'Pfeffer Formula' for dealing with human sustainability problems?

A. There is a very simple formula: to the extent that people actually take this seriously, they will address it. One of the things that distresses me is that we have all these discussions, and human well-being is never a part of the calculation. There's lots of discussion about should we expand or contract Medicare and Medicaid in the US, and that is a discussion talked about only in dollar terms, even though there is enormous amounts of research that shows how access to those specific programs affect people's lifespans. So yes, I have a quick-fix, and the quick-fix is that when you discuss any issue of performance, you add human well-being to the dollars. ■



What is your company's human sustainability score?



Growth Engine

Baidu CFO, Jennifer Li, on how her company is navigating a rapidly evolving market

By Neelima Mahajan

In a little over a decade since it came into being, China's first homegrown search engine, Baidu, has become a formidable internet giant. Today Baidu commands over 85% of the Chinese search market, and in terms of marketshare, it is counted among the top three search engines globally. It has also started to create a global footprint.

While web search is Baidu's proven business model, it accounts for only about one-third of the overall traffic. The majority of traffic now comes from other ancillary products, like vertical search or community knowledge-based products such as Baidu Knows (Baidu Zhidao, an interactive knowledge-sharing platform), Baidu Encyclopedia (Baiké Baidu, a collaborative encyclopedia) and PostBar (Baidu Tieba, an online community to share views and experiences).

Jennifer Li joined Baidu as Chief Financial Officer in early 2008 after successful stints at GMAC and General Motors in various capacities and across geographies. Li, who is often referred to as the 'Sheryl Sandberg of China', is counted among the most influential businesswomen in Asia according to *Forbes*, *The Wall Street Journal* and *Financial Times*.

In this interview, Li reflects on Baidu's strategy so far, opportunities for the future and the allegations of Baidu being a Google clone. Excerpts:

Q. In the last decade or so, from the time of Baidu's inception, how has your strategy evolved?

A. The first change was the shift from an enterprise service to an independent, general search engine. At the time, the majority of Baidu's income was coming from

our business associates, the B2B kind of business. (Baidu CEO) Robin (Li) sensed the explosion of internet usage and what a search engine can offer. So he pulled the plug on the B2B business. [Editor's note: Baidu already had 85% of the market at that point already so there wasn't much room to scale from there.]

Q. In some sense, that was also a painful decision.

A. Yes, it took a lot of guts to do it, because you are basically trying to reinvent yourself. You make that critical decision and challenge yourself, and only then you re-emerge and become something that you never thought you could be. There were many other things that happened along the way, like PostBar which was launched in 2003. The company is very innovative and creative. (Back then) there was not a lot of information online and to create more activities online and generate content, they came up with these products. So Baidu Knows and Baidu PostBar are about user-generated content. By creating a product like that, users engage more with the internet and they are offering much more quality content that can be used by search engines. People look for something that can actually produce

results for them. We're not only a web search waiting to use our spider to grab everything that is available out there, but we also think about ways to create more activities and content online.

Another point is about competition with Google (in China). We had internet users who were not very active and we wanted to stimulate their activity, but at the same time we had competition—many of them very strong, powerful and resourceful as competitors. Because the internet content was growing fast, one of the things we did was expand our index size like crazy. Google set a pace to enlarge their index size, but they underestimated how fast the Chinese market was exploding. With more content indexed, of course, your search results are better because you have more things that you can choose from. That was one reason why our search results are so much more relevant than Google's. Users learn fast. If they experiment on different search engines and they get to see what they like and not so much in another search engine, that forms a habit. That was very critical in the way Baidu grew. Many things that the company did was about the right decision executed well at the right time.

Q. The dominant perception outside of China is that Baidu is just a clone of Google. How do you deal with such perceptions?

A. If you look around today there are only a number of search engines available. Google is obviously the most powerful one. Then you have Yandex in Russia and NHN Naver in Korea. The funny thing is that while everybody knows Google, when Yandex went public in 2011, in their IPO brochure they said, 'We are the Baidu of Russia'. So there's difference in the search service that Baidu does versus Google's. Yandex knows that because they face similar issues. Still a lot of people think that Baidu is the Google of China.

I would also go back to the very beginning. I would always challenge (the notion) that we were purely derivative by pointing out that Robin was one of the leading luminaries in search. The core idea at the heart of all market search engines,

Hyperlink Analysis, is something he both applied and received a patent for prior to (Google co-founder) Larry Page for Page Rank. In fact, Robin's work is cited in Larry Page's. We started doing what Google was doing at around the same time. And really if there is anyone to be credited, I think we were both looking to the same company for business model inspiration—GoTo, which later became Overture.

Google is now taking a page from our playbook, and looking at delivering information structure data, content—by which I mean digitally consumable content—and applications directly to the search engine results page.

Q. China's internet market is exploding. How is Baidu gearing up for the opportunity ahead?

A. (Internet) users in China are a little over 500 million—that's less than 40% of the population. Search is a great function that provides very convenient access for people to find information. If there are more people coming online, search is inevitably the gateway that directs whatever the right information is that people should be looking at. Going forward, there will continue to be a lot of momentum on the user side. That offers much more opportunity in the use of search that gives us the market base for us to operate on. What comes with a search

Baidu's Globalization

Some time back, Baidu CEO Robin Li declared that he wanted Baidu to be a household name in 50% of the world's markets. The company has already started taking baby steps to realize this goal. According to Kaiser Kuo, Director of International Communications at Baidu, "Today we are the number two search engine in the world. The core technology for searches in a way can be applied (elsewhere), so there's some scale that you can leverage from existing platforms." To go global, Baidu is looking at emerging markets which are underserved by the dominant players. These markets are still evolving from an internet user perspective.

Baidu believes that having roots in China will help as it globalizes. "In China we really are in two markets at the same time," says Kuo. "We have the developed world market in these first-tier cities and we are very much in the mainstream of technological developments globally. We also serve very much a developing world market already with a relatively unsophisticated user base with relatively unsophisticated consumers. So we've gotten really good at developing technologies and products that are appropriate for those sorts of markets."

So far Baidu has chosen to dip its

toes in Japan, Egypt, Vietnam, Thailand and Brazil (and has plans for other markets as well). So Baidu went in with a Japanese language search in Japan, it took a Portuguese language version of Hao123 (a directory of weblinks) to Brazil (and a similar local-language version of the same site in Thailand), and an Arabic version of Baidu Knows in Egypt. "These products were chosen in part because of their ability to help us understand the terrain and to connect us with other players," says Kuo.

The choice of countries is somewhat surprising. Take Egypt for instance, which doesn't rate very high on many companies' globalization plans. But Baidu has thought this through. "Egyptian Arabic has now become sort of standard all the way from the Maghreb all the way through to Iraq, and Egypt is the culturally dominant country in the Middle East. It has the highest output of literature, film and so forth. There's a huge group of very well trained engineers in Egypt," says Kuo. "It makes the most sense from a lot of perspectives."

Baidu's strategy is simple: go where English is not the dominant language, build capabilities in that market—and then expand. ■

service is a beautiful business model. The beautiful thing is at the time we are servicing users, there's a tremendous commercial opportunity for us and for our customers.

Q. Online advertising is also growing in China, as are internet players. How are you developing that space?

A. Our business model is based on bidding for advertising-based service to our customers. Already online advertising is becoming a bigger piece of the overall ad market. Within online advertising, search is growing faster and taking more share: in the 30-something percent range. Search engine (advertising) is very unique as it's very targeted and performance-based. So if you don't click, you don't have to pay. That's very affordable for many small companies. Not only can we serve the large advertisers, but we also opened up a new market potential: these small- and medium-sized enterprises (SMEs) never had that kind of channel to promote their products and services. Because of search engine advertising, they can have very little budget and start from wherever they are and advertise. In China there are 40-50 million SMEs. (Currently) we service only around a couple of hundred thousand—484,000 was the number in 2011. We can continue to service these customers and grow the customer base.

Q. What about the local developers' ecosystem?

A. In 2009 we launched the open data platform; in 2010 we launched the open application platform and in 2011 we launched the personalised homepage. So step-by-step our platform has become very open, it gives access to many developers and innovators. Because we are the gateway, we connect these innovations with a vast user base, and give opportunities for young entrepreneurs to showcase their products and help the whole ecosystem to build up.

We have made terrific progress. We have the largest developer community in the country as an open platform. That's been our focus over the past few years: to develop an ecosystem, to nurture a platform which encourages innovation and accumulates many excellent developers and

uses their skills and manpower to together serve the users. All this is influencing the search results very positively.

Q. A recent report by China Internet Network Information Centre said that the use of mobile internet has surpassed desktops. How is Baidu looking at this opportunity?

A. More people accessing the internet through mobile adds another dimension of users that access information online, and (for us) the opportunity to service them as well.

Everybody sees mobile as this technology that we build on a solid foundation for us to move forward. Having a very powerful cloud service or back-end technology that houses many other developers' data points, information and apps that drive the information or service to your end device (is very important). That's one thing that's hard to replicate. We have been building on it over these past years. Whatever the end device is, the cloud can drive the service.

The Chinese marketplace is very exciting. (There is) much ahead of us in technology innovation, mobile opportunities, user behavior and how that will migrate and evolve, and how the business model will emerge in the mobile space. A lot of those are unknown issues, but we will work it out along the way.

Q. In recent years, Baidu has started expanding globally. Given that a lot of what Baidu does is very unique to China, what is the thinking behind the global strategy?

A. Obviously (China) is a massive market and we serve many people. But those kinds of services can also be offered elsewhere, where the country environment is in a similar state. Unlike those very developed markets, the users' behavior, the environment can be very different. We can leverage what we have operated and experienced here and expand that beyond the border. Longer-term if you look at all the successful businesses in the world in business history, no successful companies are only domiciled in one place. They are global companies. On one hand, we are proud of our products and services and on the other hand, this is a young and ambitious company. So we want to be here for the Chinese users, but

we want to serve the global users as well.

We have to offer a differentiated value proposition. Because we have gained tremendous experience in this market, all the different kinds of products that we offer here are very unique. On how the country has evolved from an internet development stage perspective, we have much experience there. So it makes sense for us to establish presence in some of the developing countries. (It is) still early stages for the global efforts, and (there are) a lot of challenges for Chinese companies to go beyond their borders—cultural, managerial, familiarity with the local markets—but it's worth experimenting.

Q. Japan was really your first big international foray and it hasn't worked out as you expected. What are some of the lessons that you have learned from that experiment?

A. Baidu made that decision to go to Japan in the 2006-2007 timeframe. We thought we could leverage the language similarities, the geographic co-proximity and maybe the communications cost not being too high. Yahoo! was the main player in Japan and there was Google and some others. We went in there to do search, in a very mature market. If you compete head-on with the same service, it is very difficult. Search by nature has an element of a virtuous circle that leads to a winner-takes-all phenomenon. We have good people, good technology, but in a very mature market there is very little (room) you can get in to establish yourself. Over time with Google actually doing the search service for Yahoo!, they eventually got 90% of the market. So the market situation shifted. There is something to be learned about the approach you take to get into a market.

We still think there is something special about the Japanese market, it is not totally like the Western developed markets. It is developed but it has Eastern features and there is something that Baidu can probably still leverage, but not directly through search.

(For the full interview, please log on to CKGSB Knowledge: <http://knowledge.ckgsb.edu.cn/?p=2002>)



VENTURE PHILANTHROPIST

Noted entrepreneur and philanthropist Sir Tom Hunter elaborates on his model of philanthropy

By Neelima Mahajan

Sir Tom Hunter's story is an inspiring one. The son of a grocer in a small mining village in Scotland, he started a business selling sneakers from the back of a van. From humble beginnings, he went on to create sportswear retail giant Sports Division. Over the years, his business empire grew to 250 stores. He eventually sold off Sports Division to JJB Sports and he gained £252 million from the transaction. It was perfect. He could have retired with his riches, and lived the rich life. But a meeting with Vartan Gregorian, head of the Carnegie Foundation in New York, changed things, and Sir Tom decided to put his riches to a good cause. And so in 1998, he set up the Hunter Foundation to fund projects in education and poverty alleviation.

Sir Tom's model of philanthropy is different from conventional charity—something he calls 'venture philanthropy'. In this interview, he elaborates on his unique journey from an entrepreneur to philanthropist, and his model of philanthropy:

Sir Tom Hunter is the founder of sportswear retail chain Sports Division and West Coast Capital, a private equity partnership. He is a trustee of the Hunter Foundation. Sir Tom is also a member of CKGSB's European Advisory Board.

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Q. You've had a rather interesting journey as an entrepreneur. What are some of the lessons that you learned from your early life and how have they shaped you and guided your journey as a businessman?

A. (I was) brought up in a small village in Scotland—which had less than 5,000 people. My father was the local grocer, so hard work was very much part of my education. But also my father taught me that we were working in a local community where we were taking money from the community and, therefore, we had to put

something back into that community if we were going to survive. So hard work and sense of community were parts of (my) education. In Scotland not many are born with a silver spoon frankly.

Q. When you visited CKGSB some months ago you gave a talk, and one of the most telling statements you made that day, and one that has stayed with me ever since is: 'I did not want to be the richest man in the grave.' What triggered that thought?

A. My journey has been a pretty incredible (one) in terms of starting from nothing and then selling the first business at a relatively young age of 37. Therefore, once I had sold the business, which was the only thing I had ever done, I had plenty of money in the bank, but nothing really to do. So I had to take time to educate myself to try and work out what was the purpose of it all and what I was gonna do. Life wasn't over then—it was only really beginning. I began to seek out people around the world who

maybe had had a similar journey, trying to learn from others' experience. One of the most influential persons I met was Vartan Gregorian, president of the Carnegie Corporation of New York. Andrew Carnegie had become of real interest to me. He was a fellow Scot who left Scotland penniless, went to America and became the richest guy in the world. But he decided that he was going to put his great wealth to a purpose. Vartan Gregorian challenged me to say that this wasn't really my money, I was a custodian of this money.

This is quite a challenging thing to be told when you've worked so hard for it. But I just decided I wanted to put the money to work while I was still alive. I think quite a few people leave legacies, but I am having too much fun investing for the common good, so being the richest man in the grave seems a waste.

We came to a couple of decisions coming out of that education: one, we wanted to continue to make wealth, but two, that the wealth was going to be invested through our foundation and we weren't gonna leave great wealth to our children either. I think Warren Buffet summed it up, 'Leave your kids enough that they do something, but not too much that they do nothing.'

Q. How does one really change from becoming a successful businessman whose life is all about making money, to a successful philanthropist whose life is about spreading goodwill and cheer?

A. I can only tell you my personal experience. Once when I was growing up, I set myself goals, and the goals were frankly quite material goals. I wanted a certain type of car, a certain type of house and then a certain type of boat, but once you fulfill yourself with these things, you've got to have a purpose. You quickly understand that it isn't the money that's important, it's what you actually do with it. Can money buy you happiness? It can, if you give it away.

Q. So did this challenge your existing mental models?

A. When you're a first generation wealth creator, you're driven by the insecurity of

not having anything, so you're worried, 'Oh, could it all disappear? Could something happen?' Your first instinct is to hang onto it, but you know, as I educated myself, I understood that there was something better to do with it.

Q. Some of it did disappear. How did you view that failure?

A. You learn more from failure than you do (from) success. The financial crisis that hit us in Europe, yeah, I lost a great deal of wealth through it, but that wasn't the important thing. The important thing was what did we learn and what lessons are we putting into practice now to make sure that we make the most of that learning? It also made us look back at the foundation and double our efforts to make sure we were getting value for money.

Q. You call your work 'venture philanthropy'. What does that really mean and what are you trying to achieve?

A. I don't really like the word charity. The people that we're working with and are trying to help, they don't really want handouts, they want and need 'hand-ups', so we're a kind of catalyst to help people help themselves. What we're trying to do is to help people with sustainable economic development. In countries like Rwanda, we're helping build a food oil processing plant. We're investing not for profit, but we have for-profit investors alongside us because profit makes it sustainable. Therefore we mix not-for-profit and for-profit investors and it's something which hopefully is going to be very successful. The for-profit investor gets out of it what he wants, which is profit, and (what) we get out of it is that we're helping people help themselves out of poverty. So it's a win-win.

Q. Does this intersect in some ways with social entrepreneurship, an idea that is very popular nowadays?

A. I guess you could say our investment is through social entrepreneurship, but we don't mind mixing it with other entrepreneurs. The difference lies in what we do with the profit. The for-profit investor takes his profit out and he can do whatever

he wants with it, which is fine. We decide to invest (our profit) back in the country.

Q. One of the things you really stress upon is measuring the success or failure of such projects, which is something that not a lot of people in philanthropy do. Is there a good way of measuring impact in philanthropy?

A. It's like any other investment, and we do see it as an investment. We agree upfront what success looks like. Success for us in the food-oil processing plant is one, that's got to be sustainable, and two, is how many lives it touches positively. Those are easily measurable key performance indicators. .

Q. A lot of people who get into charity do it because it makes them feel good about themselves and it isn't necessarily changing lives as it should. How do you go about bringing in that discipline or rigor into this field?

A. I'm not gonna preach why people should get involved with philanthropy. I'm very much a pragmatist and if people want to do it for whatever reason, that's okay with me.

Q. A lot of the philanthropic work being done in Africa often comes under criticism. A lot of people say that these are really 'first world solutions' to 'third world problems', and the best solutions lie in something that's homegrown, that people buy into. How do you kind of get around this unique challenge in Africa?

A So when we work in the likes of Rwanda, we're very aware of that, and we're very aware that we're helping the people in the country help themselves. We're not imposing our beliefs or what we think is best. It's very much done in conjunction with the people, not to the people, and that's a really important distinction for us. But having partners like President Clinton helps us in our education to get these things right. ■

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 (To watch the video, please log on to CKGSB Knowledge: <http://knowledge.ckgsb.edu.cn/?p=1829>)



Business on the Battlefield

Sun Tzu's *The Art of War* is the gift that keeps on giving in the world of business strategy

By Don Weinland

The Wisdom of Sun Tzu

“In the practical art of war, the best thing of all is to take the enemy’s country whole and intact; to shatter and destroy it is not so good”

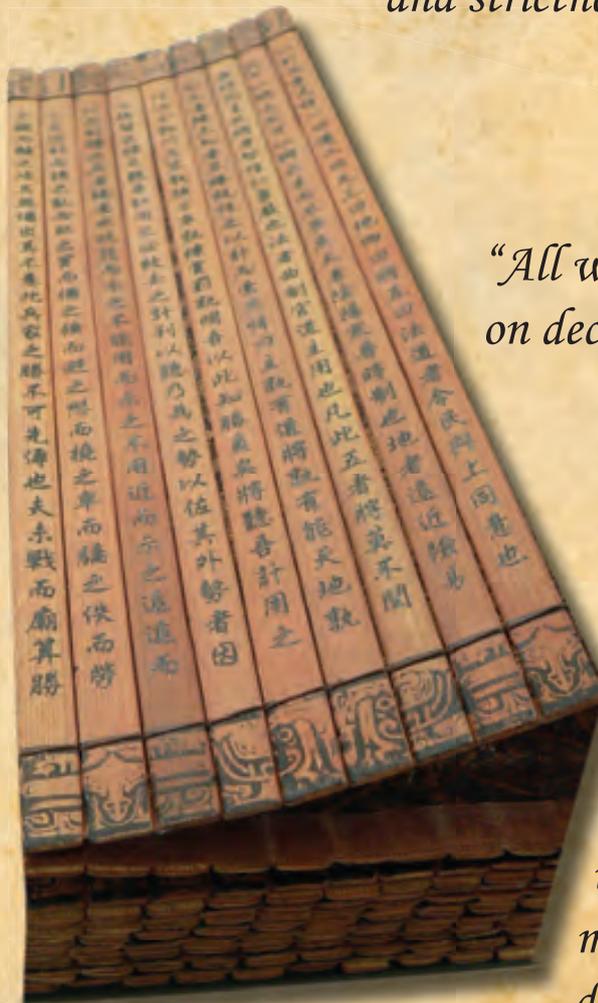
“The Commander stands for the virtues of wisdom, sincerity, benevolence, courage and strictness”

“Let your rapidity be that of the wind, your compactness that of the forest”

“All warfare is based on deception”

“Ponder and deliberate before you make a move”

“Maneuvering with an army is advantageous; with an undisciplined multitude, most dangerous”



As the great general Sun Tzu led soldiers from the State of Qi into combat more than 2,400 years ago, never could the famed general have known how far his tactical wisdom would spread beyond the battlefields of what is now China's Shandong province.

The Art of War, Sun Tzu's only recorded work, has traversed not only oceans and continents, but also disciplines and industries. It has been a favored reference in the publishing and film industries, drawing on what has been called the world's the most comprehensive yet concise military strategy text. Stacks of titles analyzing and quoting from it claim to give Oriental insight on everything from creativity and spirituality to Formula One racing.

The concept has been extended to cover all sorts of other life issues involving tactics. There is an 'art of war' crafted just for women. Lonely men might pick up *The Art of War for Dating: Master Sun Tzu's Tactics to Win Over Women* for a little ancient wisdom on romance.

The Art of War has served as the hyper-aggressive business leaders' credo ever since the infamous character of Gordon Gecko quoted the book in the 1987 financial drama *Wall Street*.

"I don't throw darts at a board. I bet on sure things. Read Sun Tzu, *The Art of War*. Every battle is won before it is ever fought," Gordon Gecko, the cutthroat Wall Street trader that Michael Douglas plays, declares. Book orders reportedly spiked after the movie came out.

Author and business consultant Gerald Michaelson notes in the introduction to his 2010 book, *The Art of War for Managers* that Sun Tzu's work was required reading in venture capitalist Asher Edelman's entrepreneurship courses at Columbia University in the late 1980s. The class was called 'Corporate Raiding: The Art of War'.

The HBO TV series *The Sopranos* also led to a jump in sales after mob boss Tony Soprano told his therapist that he'd been reading the book.

Beyond Hollywood and the hype, business professors today generally agree that *The Art of War* is far more than a gimmick.



The Chinese are so taken by Western knowledge that they have been blinded to their own history

Shalom Saada Saar
Professor of Managerial Practice,
CKGSB

The wisdom of Sun Tzu, predating the teachings of the New Testament by nearly 500 years, has never been more apposite in the business classroom. But the primary language of instruction these days for Sun Tzu is not Chinese, but English. Students at Harvard are far more likely to hear an excerpt from one of the 13 chapters of the short book than those at Peking University.

Acclaimed leadership expert Shalom Saada Saar, Professor of Managerial Practice at Cheung Kong Graduate School of Business, says that one of his recent lectures on *The Art of War* struck an instant chord with an EMBA student, also the chief executive at a major Chinese company.

"He said that the best partner that he had brought into the business had left for the competitor," Saar recalls. "He said, 'I've been listening to your lecture for the past few days and now I realize that I didn't give him time. Now it's too late.'"

Saar had been lecturing on patience, one of several fundamental qualities that Sun Tzu says constitutes an effective leader. On the battlefield, an antsy general will send his soldiers scrambling—like ants, as the ancient master puts it. One-third of them will perish "without taking the city". In the office, impatient managers and executives will not drive their employees and partners toward better earnings or successful deals, Saar says. Only leaders who demonstrate composure and resilience will retain the confidence of their staff—or armor-laden warriors, depending on the era.

Patience is essential, but it is only one of a list of characteristics that balance a leader. Finding an equilibrium between the two sides of the brain is a fundamental aspect of Sun Tzu, Saar says, as well as highly foretelling.

"He understood the importance of the left brain and right brain," Saar says. "He talks about wisdom, he doesn't say intelligence. Wisdom is EQ [emotional quotient]. Here is a man who thought about EQ thousands of years ago."

Sun Tzu's insights on battle strategy first became available to the West in the 18th century. The treatise first appeared in the West in French with a work translated by a Jesuit missionary being published in 1772, says author Mark McNeilly in his book, *Sun Tzu and the Art of Business*.

Surprisingly, as the treatise caught on in the West, its importance waned in China. Sun Tzu today is not a popular subject in Chinese business schools. Western strategy and business thinking has largely supplanted indigenous wisdom. The trend, Saar says, is an unfortunate development in one of the longest traditions of intellectualism and learning.

"The Chinese are so taken by Western knowledge that they have been blinded to their own history. The Chinese don't know how inventive and innovative this society has been," Saar says. "The biggest challenge for China in my view is that China is looking toward the West for answers and framework and know-how. I do believe they have it right here, but they're not looking." ■

Reaching the World One Book at a Time

WPP's Scott Spirit on his active reading life and what he deems as 'must-reads' for those in the China marketing business



When it comes to understanding different markets and my company's role in those markets, I very much rely on reading books to inform my approach.

I tend to read about areas and pick my non-fiction books geographically. Reading helps me get to know places that I wouldn't know about as a tourist. I've been drawn to literature on Japan, India and Africa.

Africa really fascinates me, both personally and on a more work-related level as I've been doing quite a bit of business travel there recently, and my reading on the region is very much relevant to serving our China clients who are expanding into the continent. I recommend *China Safari: On the Trail of Beijing's Expansion in Africa* by Serge Michel and Michel Beuret. It really explores the Chinese soft-power approach in Africa in aiding infrastructure development and working alongside governments and local companies. There were a few chapters on China's entrance into a particular market there that we are also trying to access, and that bit has spurred my own thoughts on how to communicate

with the Chinese clients in that location.

Another great China strategy read I've been digesting recently is *What Chinese Want: Culture, Communism and the Modern Chinese Consumer* by Tom Doctoroff. It's a combination of Doctoroff's *Huffington Post* articles and new material, and it gives excellent insight into the Chinese consumer mindset. From the perspective of our business, this is obviously quite important.

As a communications professional, David Ogilvy's *Confessions of an Advertising Man* is not only required reading, but also fantastically entertaining and inspiring reading. It is amazingly relevant considering it was written 50 years ago. For anyone who is remotely interested in our industry, there is no better way of getting inspired or gaining knowledge than reading what David wrote.

Before making the move from Europe to China, I certainly tried to ingest some of the comprehensive historical literature available, but much of it was so dry that I found them difficult to get through. But that was not true of Jung Chang's *Wild Swans* and *Mao: The Unknown Story*. Both of these works put rich historical context into the place I was going to call home.

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Scott Spirit has lived in Shanghai for eight years and serves as the China Strategy Director for global communications strategy firm WPP.

Business Bestsellers in the US

- No. 1 **To Sell Is Human**
by Daniel H. Pink

- No. 2 **Francona**
by Terry Francona and Dan Shaughnessy

- No. 3 **Ninja Innovation**
by Gary Shapiro

- No. 4 **The Power of Habit**
by Charles Duhigg

- No. 5 **Antifragile**
by Nassim Nicholas Taleb

- No. 6 **Total Money Makeover**
by Dave Ramsey

- No. 7 **Great by Choice**
by Jim Collins and Morten T. Hansen

- No. 8 **Thinking, Fast and Slow**
by Daniel Kahneman

- No. 9 **Strengths-Based Leadership**
by Tom Rath and Barry Conchie

- No. 10 **Steve Jobs**
by Walter Isaacson

Source: The New York Times

Business Bestsellers in China

- No. 1 **Influence**
by Robert B. Cialdini

- No. 2 **Big Data: A Revolution That will Transform How We Live, Work, and Think**
by Viktor Mayer-Schonberger

- No. 3 **Will Huawei be the Next One that Falls?**
by Tian Tao and Wu Chunbo

- No. 4 **Getting More**
by Stuart Diamond

- No. 5 **The Effective Executive**
by Peter F. Drucker

- No. 6 **Please Give Me the Results**
by Jiang Ruxiang

- No. 7 **Positioning**
by Al Ries and Jack Trout

- No. 8 **Hai Di Lao: It Can't Be Taught**
by Huang Tieying

- No. 9 **The Big Data Revolution**
by Tu Zipei

- No. 10 **The Way of Doing**
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