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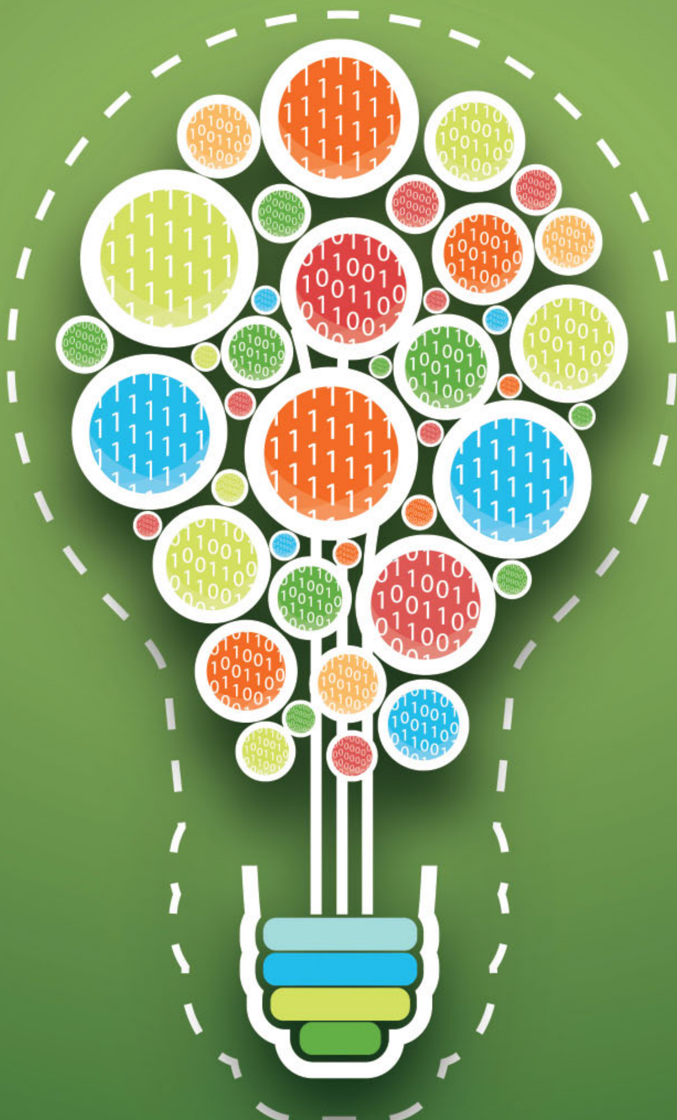

One Billion Data Points

Big Data has arrived in China—will it bring a revolution with it?

- Penny Pritzker, US Secretary of Commerce, discusses the US-China trade relationship
- Caught between economic and political shifts, the RMB looks set for a wild ride
- At times controversial, just how does China's Anti-Monopoly Law work?

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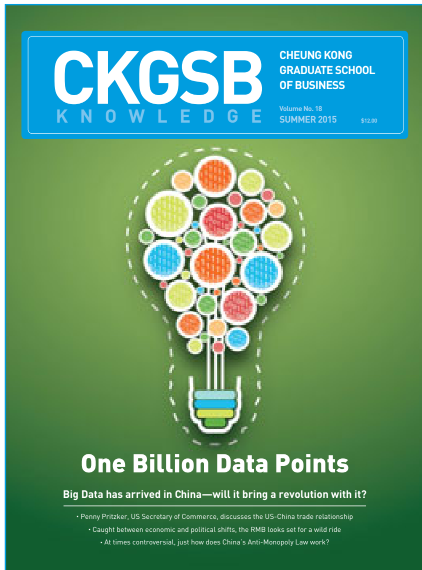
China Takes to Big Data

Big data has become a buzzword in China as in many other parts of the world. When everyone talks about big data (BD), in some cases it becomes a tool of BD (business development). Many IT companies claim their leadership, knowledge and experience in this hot—and emerging—field. In our cover story 'The Power of Data' on page 20, we help you understand the potential of big data in China (soon to be a billion dollar a year market), the companies that are leading the charge and the challenges that are coming up along the way. As you will read, it's a mixed picture, and for the sector to grow to its true potential companies need to understand—and tackle—the challenges that come with big data.



In February this year, the two biggest taxi hailing apps in China—Didi Dache and Kuaidi Dache—merged to create an entity that controls roughly 90% of the Chinese taxi app market. This development—along with heightened government scrutiny of multinational entities like Microsoft, Daimler and Mercedes-Benz—have brought into sharp focus China's anti-monopoly laws and regulations. In our story on page 36 we take a look at what China's Anti-Monopoly Law entails and the three government bodies that regulate anti-trust issues. We examine, in particular, the contentious issue of foreign companies being increasingly scrutinized for monopolistic behavior in China. Readers whose companies do business in China may feel that the playing field has been leveled for both Chinese and foreign companies. Now they just need to work harder than they did in those years when the multinational companies had more privileges because the country needed foreign investment.

Elsewhere in this issue we turn the spotlight on to China's empty malls. The shopping malls built in Chinese cities such as Shanghai, Shenzhen, Chengdu, Chongqing and Guangzhou topped the world in terms of shopping center development globally. Their challenges don't come from the cooling of the real estate market, or the hard landing (at least not yet as so many economists in the West had anticipated), but from the rapid development of e-commerce in China. Already, a lot of the mall development in China is reeling due to the growth of e-commerce and the impact of 'showrooming'. Further muddling the situation are issues of bad mall planning and design. But all is not lost—malls can still succeed in this country. They only need to know how. That's one of the questions we address in our article titled 'China's Ghost Malls' (page 15).

On page 61, we bring you an exclusive interview with Penny Pritzker, the current US Secretary of Commerce. As our readers, particularly those in the US, would know, the US and China share a good business relationship irrespective of how the politics play out, and China is a major source of investment for the US. Despite that, Chinese companies wanting to invest in the US still encounter some major challenges along the way. In the conversation with our writer, Pritzker explains what the US Department of Commerce is doing to help Chinese companies invest in the US, where the big opportunities lie and the challenges confronting US companies doing business in China.

I hope you enjoy reading this issue of our magazine. As always, please feel free to email us at *ckgsb.knowledge@ckgsb.edu.cn* if you have any suggestions and comments. We will publish them in our future issues.

Yours Sincerely,

Zhou Li
Assistant Dean, CKGSB

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

China Data

The stats you need to know

Social Capital

$206 bn

Tencent's market capitalization surpassed $200 billion for the first time in April, with its shares having grown 52% from the start of the year. The company's valuation is now higher than Amazon and IBM's.

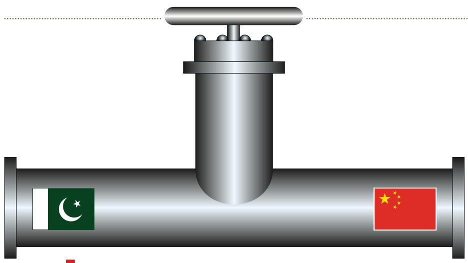
Source: Business Insider

Cleaning Up

Drop in carbon emissions last year

Last year China saw the first drop in its carbon emissions since 2001. China has poured money into clean energy and is working to diversify its energy mix.

Source: Bloomberg



$46 billion

Best of Friends

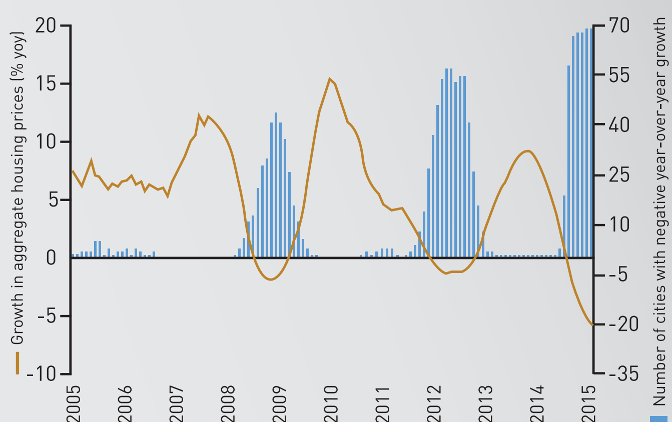
In April, China and Pakistan unveiled a plan for energy and infrastructure projects in the latter country worth $46 billion after a visit by China's President Xi Jinping. The projects are to help establish a China-Pakistan economic corridor between Xinjiang province and the port of Gwadar on the Arabian Sea.

Source: Reuters

Sharp Correction

Aggregate housing price index vs. number of cities recording housing price declines

China's property market continues to witness a significant correction—69 out of 70 cities in an index published by the National Bureau of Statistics showed negative growth. In March, the People's Bank of China announced an easing of mortgage requirements.



Source: Petersen Institute of International Economics

The Sprawl

A new report from the OECD has put the number of megacities in China at 15, over double the UN estimate of 6. Cities in China have grown rapidly as the country urbanizes.

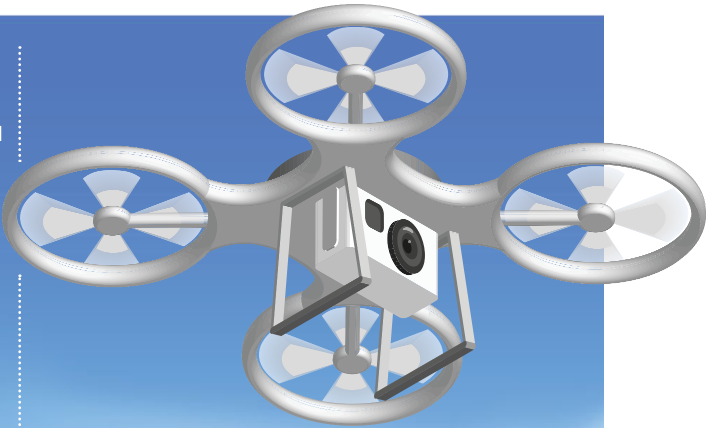
Source: Bloomberg

Clubbing Together

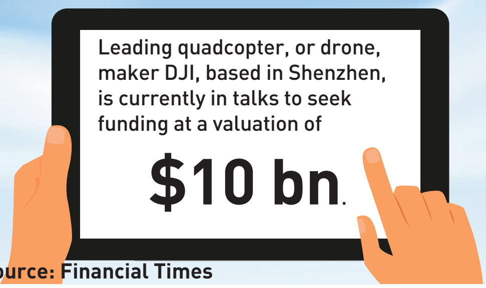
57 countries have been approved as founding members of the China-led Asian Infrastructure Investment Bank (AIIB), with the UK, Brazil, Germany, South Korea and Malaysia among the members. The bank will have an initial capitalization of

$50 billion.

Source: South China Morning Post



Taking Off



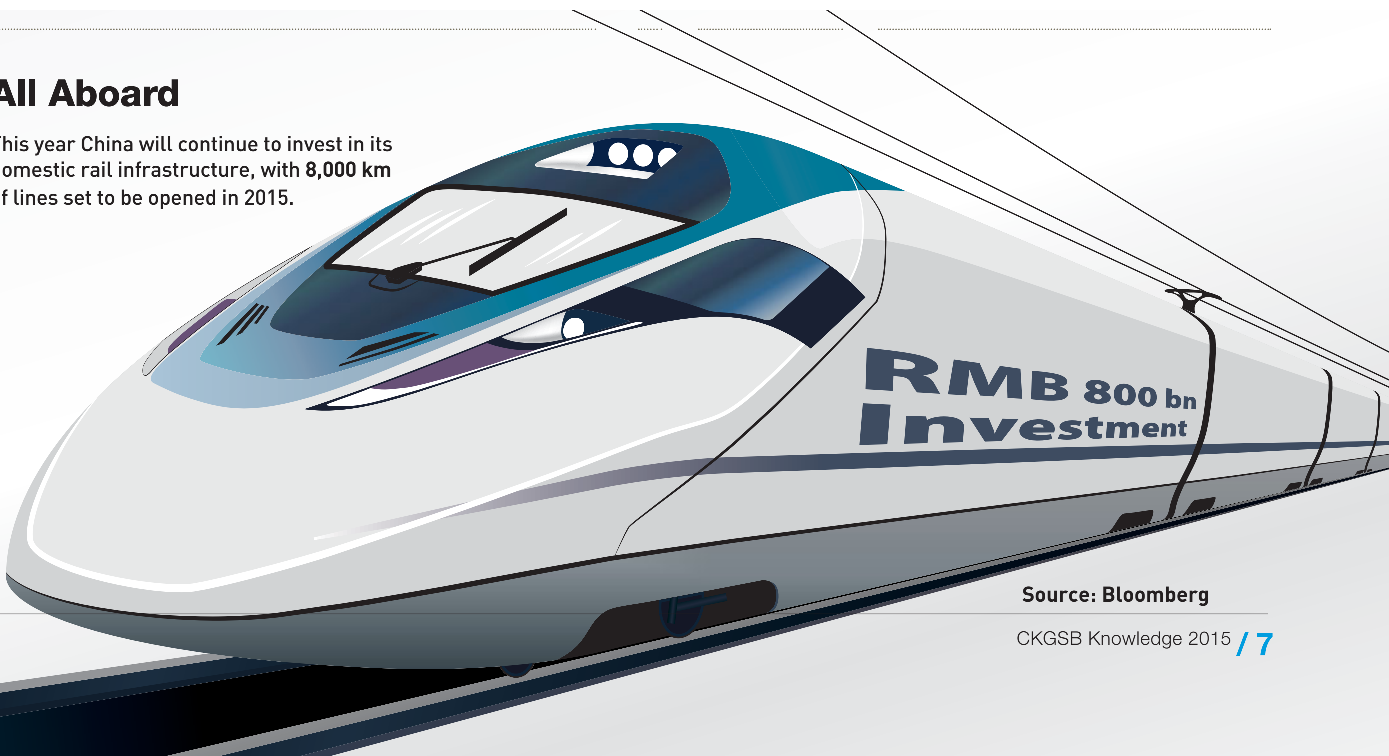
Leading quadcopter, or drone, maker DJI, based in Shenzhen, is currently in talks to seek funding at a valuation of

$10 bn.

Source: Financial Times

All Aboard

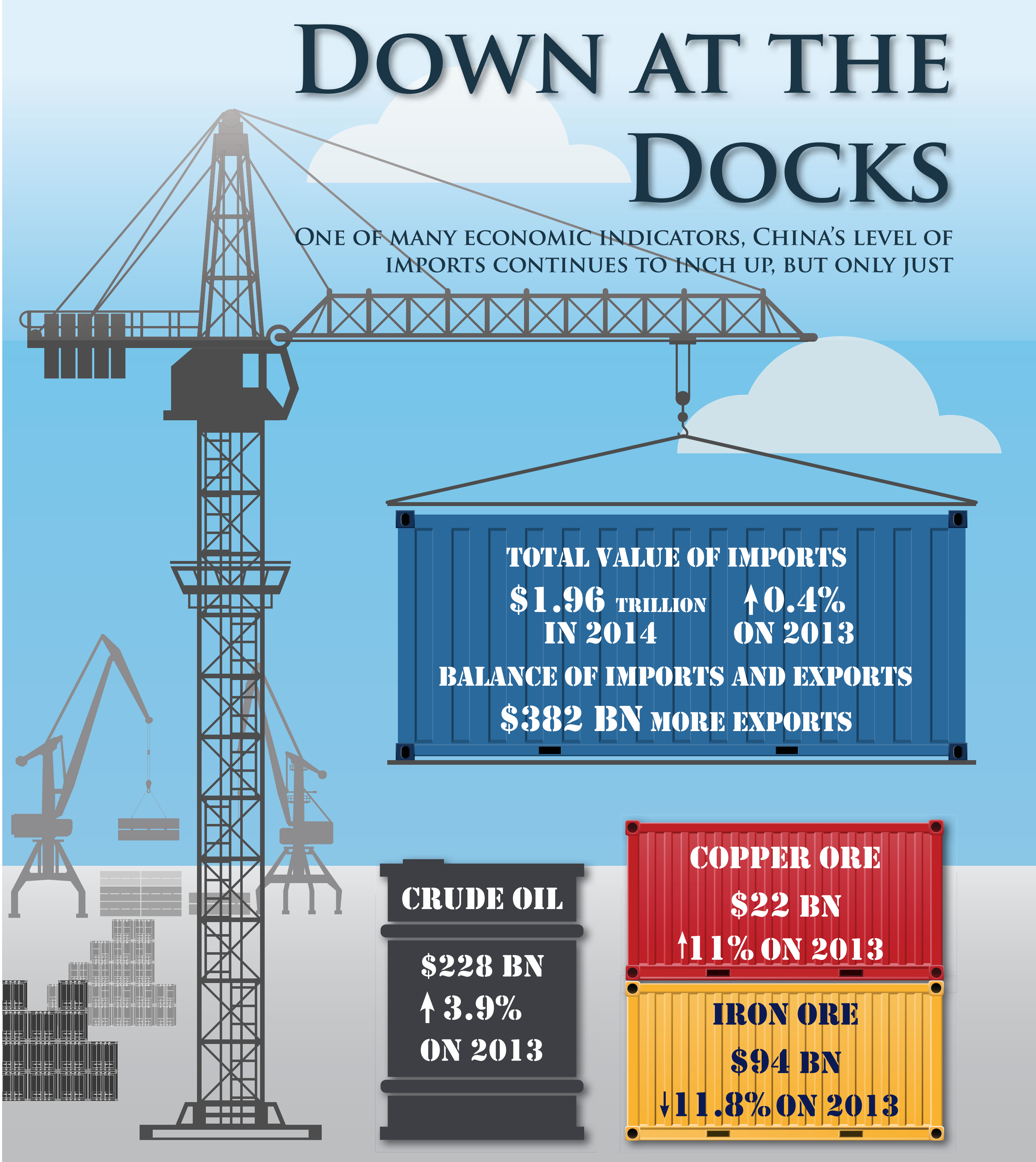
This year China will continue to invest in its domestic rail infrastructure, with **8,000 km** of lines set to be opened in 2015.



Source: Bloomberg

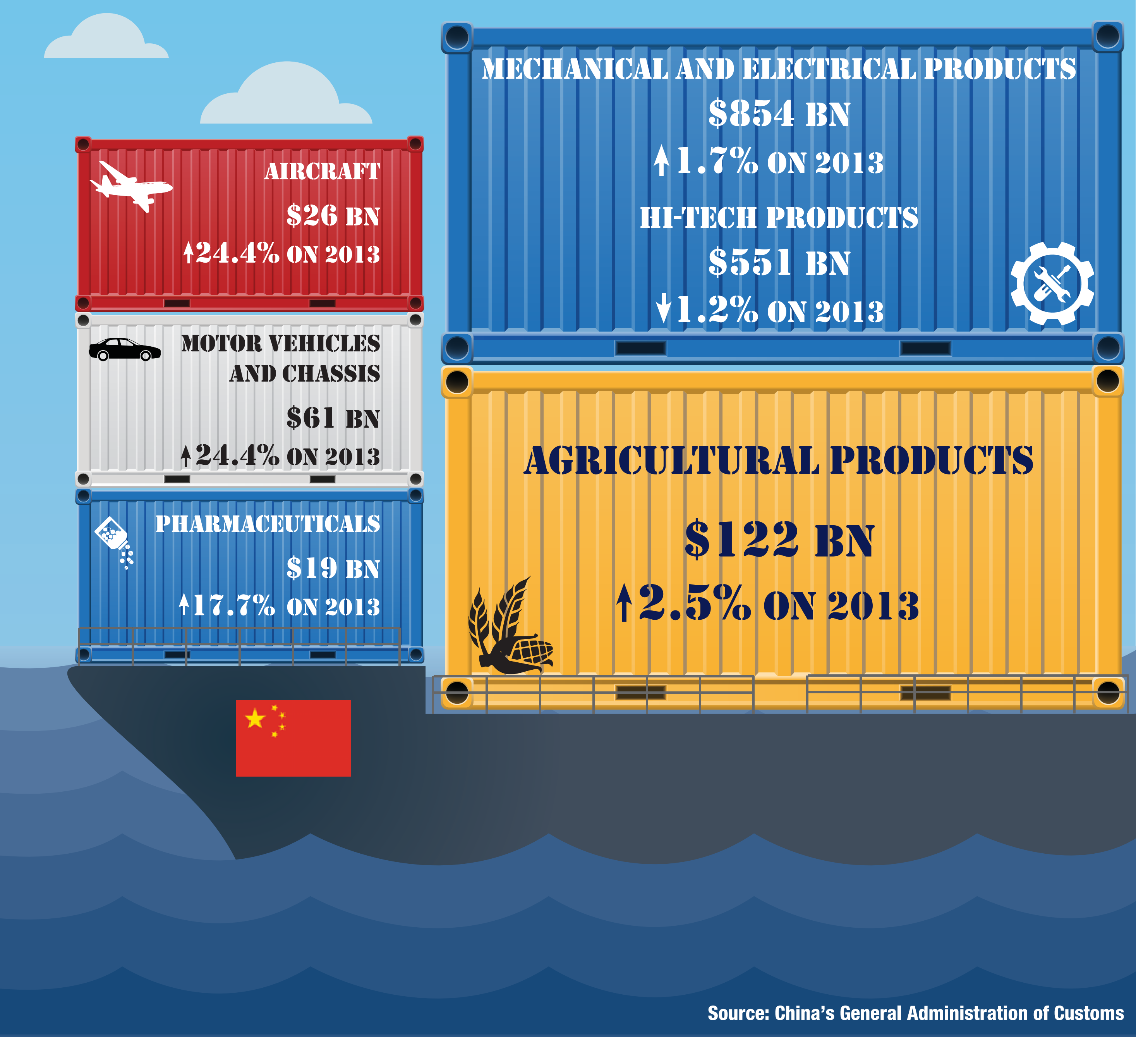
Down at the Docks

One of many economic indicators, China's level of imports continues to inch up, but only just



(Changes in total value: 2013-2014)

As China enters the so-called “new normal”, analysts continue to to try to gauge where the economy is heading. Imports are one such guide, with the data reflecting domestic demand within an economy, and also giving useful insight into its industrial trends. Chinese imports growth slowed last year, with Ministry of Commerce figures showing only 0.4% growth, implying a slowing demand for foreign goods. Despite the freefalling prices of crude oil, China’s customs administration reports only a small rise on 2013, with other imports, notably vehicles, growing much faster.



Source: China’s General Administration of Customs

China's Ticking Time Bomb

Does China's growing mountain of debt threaten to take the show off the road?

By Chris Russell

For years, China's economic growth has surged ahead even as that of more advanced economies has stuttered in the wake of the financial crisis, spellbinding pundits and economists around the world. But this period of prodigious growth has also seen the emergence of an issue that also bedevils developed countries—debt.

Since 2007, China's total level of debt—encompassing that held by the government, households, financial institutions and non-financial corporates—has quadrupled and now represents 282% of GDP, a higher percentage than that of Germany or the US, according to a McKinsey Global Institute (MGI) report released in February.

In the eyes of some economists, China may be approaching an inflection point. Now, as growth slows and people are being encouraged to come to terms with a so-called "new normal", there is a sense that in addition to the ongoing and difficult process of systemic reform, the country's debt issue may soon come to a head. Should Beijing continue to pile on the credit in the hopes of sustaining growth with the risk that it is simply creating a greater reckoning later on? Or should it cut back and face the potentially deleterious consequences?

Turning on the Taps

As with many contemporary economic tales, the latest chapter of China's debt story has roots in the aftermath of the financial crisis. As countries around the world reeled from its impact, particularly those that were key export markets for China, the central government was forced to unleash a massive stimulus, lest the external tumult create a crisis in China too.

But there were earlier entries in the narrative of debt build-up as well. The first was the changes to local government finance rules in 1995 that constrained their ability to raise funds. As a result, the wave of China's infrastructure projects that formed a large part of the 2008-09 stimulus package had to be financed by local government through debt. The second plot line came from China's long-building property boom throughout the last decade, which saw developers take on increasing amounts of debt.

Nonetheless, it was from 2007 that the real build up in credit began. From then until mid-2014, China added $20.8 trillion to its debt, more than one-third of global debt growth, according to MGI. In that time, only Greece, Portugal, Ireland and Singapore saw a greater increase in their debt-to-GDP ratio. If China's debt were to continue to increase at the same rate as it did in that time period, China's debt-to-GDP ratio would be the same as Spain's, 400%, by 2018.

> The property sector is [a] sector where we worry [about a default]
>
> Li-Gang Liu
> Chief China Economist
> ANZ

Although its ratings are currently stable amongst the big three credit ratings agencies, in April 2013 Fitch downgraded China to A+ from AA-, where it currently remains, citing "underlying structural weaknesses" and concerns that rising debt would require a bailout. Fitch had previously issued a downgrade warning in 2011, but this was the first downgrade of China by a major international agency since 1999.

What Lies Beneath

Much of China's debt is, directly or indirectly, linked to real estate—MGI puts the figure at 40-45% of all loans, or equivalent to $8.5-9.5 trillion. These loans encompass homeowner mortgages, property developer debt, lending to related industries and debt raised by local governments for the purpose of property development.

Moreover, many loans come from the shadow banking sector, with credit coming from informal loans, wealth management products, entrusted loans between companies and other sources. By its very nature the shadow banking sector lacks transparency. Nonetheless, such loans are estimated by MGI to be worth $6.5 trillion, or 30% of China's debt when excluding the financial sector, and they grew 36% per year from 2007 to mid-2014.

Demand for these loans is primarily driven by small companies that otherwise find it hard to access funding and by investors looking elsewhere for high-yield investments as a result of low bank deposit rates.

Of government debt, much is held by local governments. They possess little taxation authority and much of what they do raise flows to the central government. In addition, from 1993 up until last year local governments had been banned from borrowing directly. As a result, many were forced to turn to so-called local government financing vehicles (LGFVs) in order to pay for the vast infrastructure projects that have proliferated around China. Local governments are also heavily exposed to the property sector due to their reliance on land sales as a way of raising cash.

The numbers, however, aren't necessarily straightforward, both in general terms and specifically for local government debt. It is hard to get a complete and accurate picture, and Jianguang Shen, Chief Economist at Mizuho Securities Asia, notes how local government debt is often packaged as corporate debt instead. "Sometimes they classify LGFVs as [the corporate sector]. They have to because Chinese law does not allow local government entities to borrow."

As such, the true extent of government debt has for many years been unclear, and only now is some transparency being introduced through government audits. These concerns are why the Chinese government actually conducted two big surveys in 2010 and 2013, says Shen. "In 2013 they found out the total local government debt actually amounted to RMB 18 trillion ($2.86 trillion)," he says.

Dragged Down?

The nature of this debt is problematic for several reasons. One is its strong connection to the property market, which after years of growth showed signs of overheating early in 2014. Since then the market has begun to witness a correction as a result of government policy, lagging sales, excess inventory and slowing price rises. In the event of a severe downturn in the market many companies would default, with potentially serious knock-on effects. And even without a serious downturn, some developers will still be at risk.

"The property sector is [a] sector where we worry [about a default]," says Li-Gang Liu, Chief Economist for Greater China at ANZ. "In addition to high leverage, this anti-corruption campaign will also push certain privately run property developers into default."

The opacity and lack of regulation in the shadow banking sector is another area of concern. Despite lacking the complexity of the pre-financial crisis financial products that nearly brought down the banking system in the US, there are questions over the risk assessment capabilities of lenders, as many are forced to invest in speculative real estate and high risk borrowers in order to achieve the high yields that investors are looking for.

But thankfully, there has been a slowdown in shadow banking activity. "The shift in credit flows back to the regulated banking system should enhance transparency and reduce financial risks, but it could also create pressure on some borrowers, such as small and medium-sized enterprises and small property developers who are reliant on the shadow banking sector," Michael Taylor, Moody's Chief Credit Officer for Asia-Pacific, said in a press release from the agency.

Of greater concern to some economists is local government debt. "I think the biggest risk definitely is the LGFV debt," says Shen.

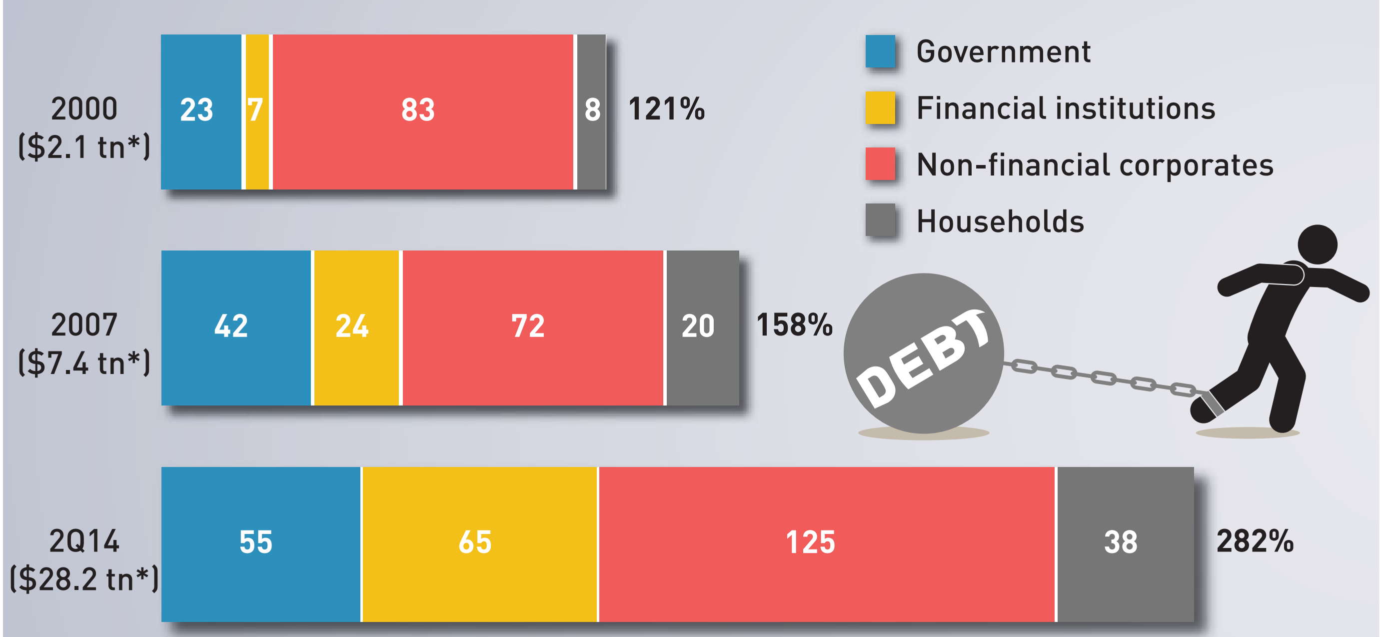
The strain that some local governments are under was indicated in March when the government of the southern city of Haikou revealed it was unable to make its debt repayments and needed financial assistance. Despite that claim, the provincial government, Hainan, and Finance Minister Lou Jiwei were both quoted at the Boao Forum (a high-level annual forum in China modeled after the World Economic Forum) as saying that local governments were not at risk of defaulting.

The slowdown in the property market feeds heavily into these difficulties. Many local governments are reliant on land sales in order to make loan payments, but as the market has cooled, these are no longer lucrative or reliable sources of income. Just how serious this has become was brought into sharp relief in January after the *Financial Times* reported on the farcical situation of local governments in some provinces, such as Jiangsu, buying their own land in order to push up prices.

The risk posed by local government debt also stems from the fact that defaults would be felt throughout the banking sector—the China Development Bank and

Piling Up

China's debt by sector as a percentage of GDP



*Total Debt

Source: McKinsey Global Institute

the Big Four banks (Bank of China, ICBC, China Construction Bank and Agricultural Bank of China) all have significant exposure, according to MGI. A November 2014 Standard & Poor's report stated half of China's provincial governments would be below investment grade if rated.

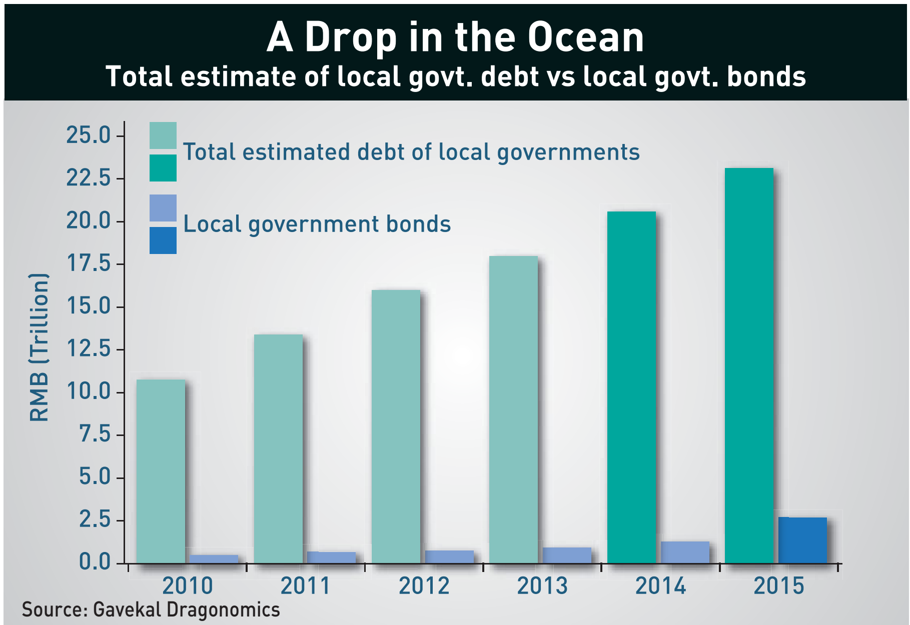
Wider economic factors play a role in determining the threat posed by China's debt, too. The country is witnessing slowing inflation, which in turns exacerbates debt levels as the debt is no longer depreciating as quickly. The slowing economic growth further constrains the ability of firms to pay back loans, particularly if growth in debt remains strong, and increases the risk of defaults as companies struggle with China's current economic transition.

In addition, China's debt service ratio—principal and interest payments as a share of income—is very high. According to the Bank of International Settlements (BIS), it is now 9.5 percentage points above its long-run average, and BIS has specifically identified this as presenting a risk since a greater share of income is being required to pay off debt, and so the economy is less able to handle extra credit. A 2012 BIS report found that debt service ratios can provide an accurate warning of future bank crises.

Going to the Wall

For years there has been a perception that the government would guarantee loans, creating a moral hazard whereby investors feel they will be bailed out should a default occur. That has only served to encourage risky lending. Nonetheless, the government has committed to allowing the market to play more of a role in this area, for instance at the Third Plenum, where it was announced that market forces would play a "decisive" role in the economy. But their willingness to do this is already being tested.

In March 2014, Chaori Solar, a solar equipment producer, became the first mainland company to default in China's domestic corporate bond market. In the end, investors were bailed out through a debt restructuring plan in October, with the government being heavily involved through the Great Wall Asset Management Corporation, indicating the limits of the government's rhetoric, and also their desire for stability.



Since then, other companies have joined the ignominious list of defaulters. In April, Cloud Live became the first company to default on its principal, and later that month the property developer Kaisa defaulted on interested payments on its offshore debt after lengthy attempts to restructure and a 30-day grace period. Rounding off the list of companies with credit woes that month was Baoding Tianwei Group, the first state-owned company to default on an onshore bond.

"This is probably a good thing for China's corporate bond market," says Liu. "The government will break down the moral hazard so that investors will have to be careful in investing in those corporate debts. I think perhaps more such defaults will be seen, but the government will also very careful not to cause a systemic risk for the Chinese financial system." He also points out that significance to the local economy and employment will be important factors in the government's thinking as well, and this may explain the attitude towards letting Baoding Tianwei default.

Shen agrees that such defaults will be closely managed. "I think the [Baoding Tianwei default] will be quite isolated," he says. "I don't see a chance of massive bankruptcies by state-owned enterprises (SOEs)."

So Serious?

But for all the scale in China's debt situation, two facts weigh heavily in its favor: manageable amounts of household and central government debt. "Although local government and firms are overly in debt, the Chinese central government and households are very limited in debt, and this is a very positive picture," says Liu.

Not only does the government have vast foreign currency reserves at its disposal—although it would be reluctant to tap into them—MGI puts the amount of central government debt at 27% of GDP, giving it ample room for borrowing. For those reasons, the government is well positioned to handle a bailout, should the need arise—even with a default rate reaching 50% for property-related loans, such a bailout would still be viable.

"The central government's direct debt is only 15% of GDP, so that's why there is huge room for the central government to absorb and actually help local governments," says Shen.

Moreover, government control of the financial system gives the government much scope for action. "China still has a mainly state-owned financial system… the government, the central bank, the People's Bank of China (PBOC) and other regulators can jump in quickly," says Liu.

But complications remain.

Changing Vehicles

The central government still faces the onerous task of converting local government debt into something more sustainable, transparent and manageable. To that end, LGFVs were outlawed in October by the State Council, China's top decision-making body, although they later backtracked in May for cases involving ongoing projects. Still, a prior change to the budget law in August 2014 had finally allowed for local government bonds.

"People actually expect something like municipal government bonds, but in the end I don't think it's real government municipal bonds," says Shen. "Still it'll have to be under tight control by the state, by central government. So actually they need to approve these bonds, and also it's more or less guaranteed by the central government… the major issue for me is the central government is using its balance sheet to borrow more to pay for the LGFV debt."

In order to deal with maturing debt, in March the Finance Ministry announced that local governments would be allowed to issue RMB 1 trillion in long-term, low-interest bonds to pay off maturing loans. According to the ministry, these bonds are equivalent to 53.8% of municipal loans that need to be repaid in 2015, and Finance Minister Lou has indicated that the program will likely be expanded.

Questions have been raised about who will buy these bonds, although others remain confident there is a market for them. "The special debt replacement bonds will likely be bought by banks and other institutions," wrote Tao Wang, Chief China Economist at UBS, in an April report. "Given the general abundance of domestic saving and controls on bank lending, there should be sufficient domestic liquidity and demand for local government bonds, and there is no need for the central bank to purchase them."

But, apart from the big four state-owned banks, uptake has not been as strong as expected, and some provinces have delayed issuing bonds. But in response to the reluctance on the part of commercial banks to buy the bonds due to their low yields, the PBOC will let banks use the bonds as collateral for key lending facilities in order to make the bonds more attractive.

> "Even if [SOEs] have a problem paying, the government will always step in and ask the bank to lend them money
>
> Jianguang Shen
> Chief Economist
> Mizuho Securities Asia

Overall, though, many analysts are optimistic about the bonds' prospects, and expect the program to be expanded. "Fitch expects the extension of the municipal bond issuance program to allow [local and regional governments] to smooth out revenue volatility and improve their liquidity during this period of slower economic growth and weakness in the property market," the agency wrote in March.

Further Action

Government support for the beleaguered property sector is also on hand. Although prices and sales continued to decline in the first few months of 2015 in many cities, market sentiment has shown signs of improving, in part because of government measures to stabilize the market. In March, regulators moved to lower requirements for down payments on second homes from 60% to 40%, and reduced the number of years homeowners are required to hold a piece of property before they can gain exemption from a sales tax.

There are also wider steps the government can take in order to control the level of debt in the country. One of these is reform of SOEs and Shen feels that this is also an area ripe for government action when it comes to scaling down China's debt.

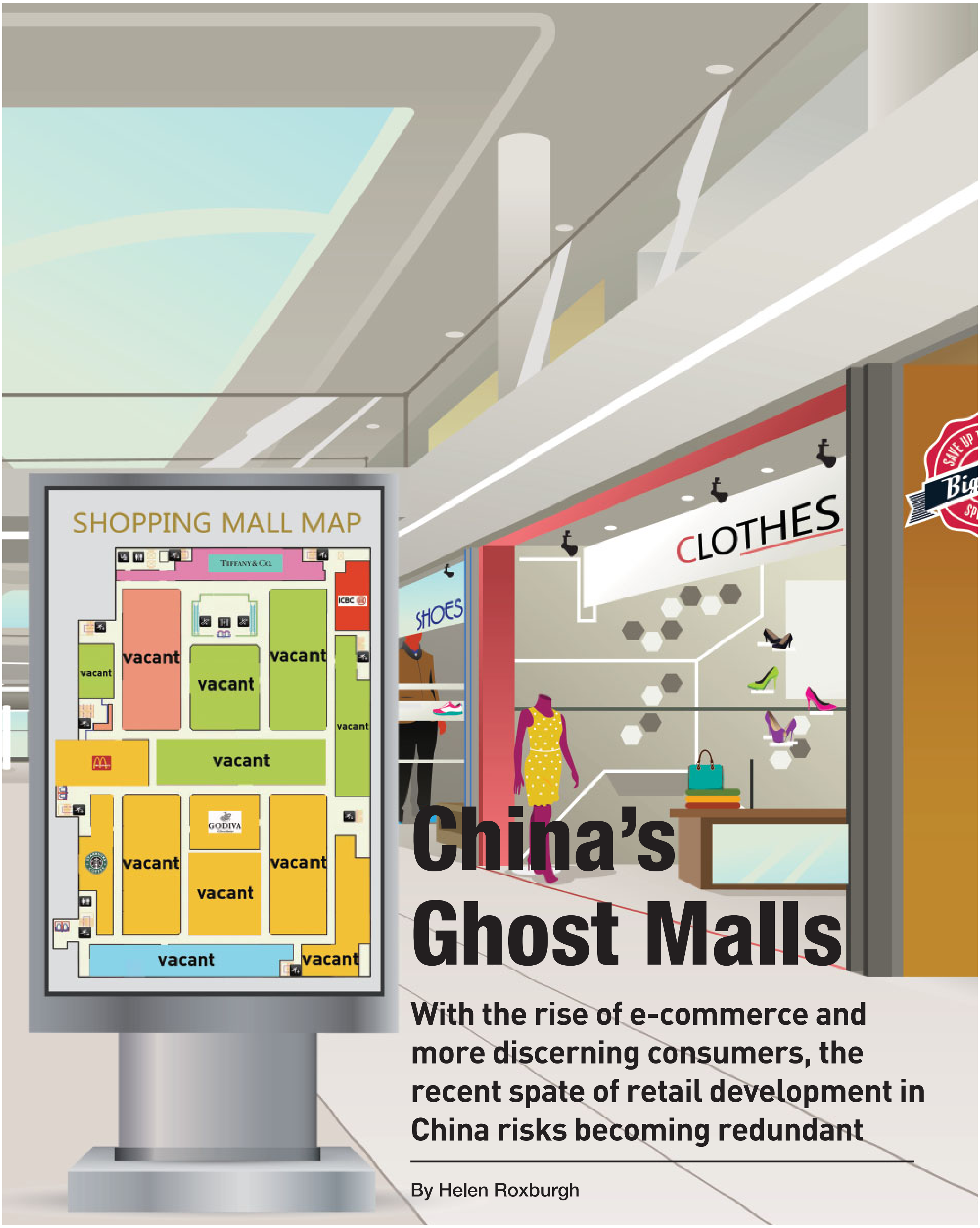
"A private company, if you're losing money, then mostly they'll be closed down, so there is a limit to how much they can borrow, and also for most private companies bank lending is very difficult to get" he says. "The issue is mainly the SOEs… they borrow a lot of money, but even if they have a problem paying, the government will always step in and ask the bank to lend them money. So that's rolling over and getting more and more debts."

Shen says that SOE reform had been expected in order to introduce transparency in this area, but that this has been "postponed".

Instead, he identifies the stock market, which in Shanghai has witnessed an extraordinary rally in recent months, as playing an important role in addressing the issue of SOE debt. "We think the new government strategy is to boost the stock market," says Shen. "It can reduce the debt burden of the corporate sector. So the SOEs, they don't need to borrow from the banks, they can issue equity."

In the final tally, China is unlikely to face a Lehman-style crisis as a result of its growing debt, largely due to the government's firm grip on the financial system and its own relative lack of debt.

But the build-up of this debt in China will provide a test of the government's willingness to embrace the market and to push ahead with reform, particularly in areas it has hitherto treated with a light touch, such as with SOEs. As things shake out, some firms will no doubt suffer, as the likes of Kaisa have already begun to discover.



China's Ghost Malls

With the rise of e-commerce and more discerning consumers, the recent spate of retail development in China risks becoming redundant

By Helen Roxburgh

On the third floor of the Huan Long shopping center in Shanghai, all is quiet. The mall, adjacent to one of the city's major railway stations, has long rows of empty stores, grubby windows covered with fading posters and shop doors chained shut with padlocks. Many areas seem abandoned except for a few lone traders and their children, who sit eating instant noodles, playing card games in dusty corridors and fixated on smartphones with no business to distract them. Even with the draw of the nearby transport links, the mall is inconsistent, grubby and rundown.

"Business has been getting worse year by year," sighs Chen Weicheng, who has been selling photographic film in his small store for the last 10 years. "Now everyone just buys things online." But the situation is not straightforward—a cheap glasses market on the third floor attracts some crowds, and the lower floors stock China's ubiquitous smartphones, cases and covers. Yet the Huan Long center, now over 20 years old, is in no way unique or noteworthy in a city saturated with shopping malls.

An unprecedented amount of retail development and spending has swept into China over the last decade, driven by the country's rising spending power and a shift to consumerism, and the building frenzy shows little sign of abating—figures from property agency CBRE suggest half of the world's current retail development is in China. But at the same time, China's e-commerce market is booming and putting pressure on the need for retail space as a result. Is the country's retail sector facing massive oversupply?

Shopping Mall Nation

Annual disposable personal income among urban citizens reached RMB 28,844 in China by 2014, up from a figure of just RMB 343 in 1978, government figures show. As people grew richer and spending was encouraged, China's retail sector was ill equipped to deal with the opportunity. According to the National Retail Federation, while the top 100 retailers had a 57% share of overall retail sales in the US in 2012, in China at the same time the figure was only 9%. Retail was loosely organized and inefficient, and most cities lacked adequate shopping space.

Retailers flooded into the country as demand outstripped supply. Growth in sales was in double digits between 2009 and 2013, while official government figures show retail sales rocketing to RMB 26.24 trillion in 2014.

According to the International Council of Shopping Centers, in 2009 there were 2,293 shopping malls in China. By 2013 this had reached 3,450, and by some estimates there will be almost 5,000 by the end of 2015. This development was encouraged by enthusiastic local government land sales, and these bodies were also keen for the regular tax income and employment opportunities that retail development offers. A newly-urbanized population quickly adopted going shopping as a national hobby.

With few experienced retail developers before the boom, the sector remains extremely diverse. According to figures from property agency Jones Lang LaSalle, only about 15 developers in China have built more than 10 malls, with the majority building only one or two.

And the development drive continues. China is set to become the world's largest retail market by 2018, according to figures from PwC and the Economist Intelligence Unit. That is being driven by the country's ever-increasing riches—McKinsey estimates that 75% of the mainland's residents will be classified as middle class by 2022, compared with just 4% in 2012.

New retail supply in Shanghai and Chengdu to be completed this year and next is expected to reach 3.3 million m^2 and 3.2 million m^2, respectively, and eight of the 10 most active cities for shopping center construction globally are in China, according to CBRE. According to their research, less than a fifth is being built in prime retail areas by experienced mall developers.

"Most of the real estate developers have looked at the mall as something to be sold," says Melanie Alshab, Managing Director of Kensington Asset Management. "When you build something to sell it, you're not interested in making an investment to reduce your operating costs, you just want to see it finished and get a return… nobody stopped to look at the fundamentals of retailer demand or shopper demand."

Shopping Capital of the World

Top 5 cities globally for shopping center space development (2014)

Shanghai: 4,101,449 m^2
Shenzhen: 3,425,050 m^2
Chengdu: 3,029,967 m^2
Chongqing: 2,645,063 m^2
Guangzhou: 1,986,205 m^2

Source: CBRE

Cyber-Spaces & Other Places

While shopping malls grew in record numbers, China has also been setting records as the world's largest online market, surpassing the US in 2013. Chinese shoppers spent $440 billion online in 2014, according to research group Forrester. This figure is forecast to rise to $1 trillion by 2019. Online retailers have found a market ripe for innovation, particularly in lower-tier cities with few retail options.

According to research from Bain & Company, online retail in China will grow three times faster than overall retail, with half of total online sales coming from third tier cities and below by 2018.

Inevitably, this is being felt in physical retail. Some retailers, such as British fashion brand Topshop, have chosen to make their China debut via an online platform; others are reducing their store portfolios in the country. In March, Marks & Spencer announced it was closing five stores in and around Shanghai, instead serving these secondary cities through its partnership with Alibaba site Tmall.

Stores are also facing challenges around 'showrooming', where consumers look at products in-store and then buy online. In shopping malls where many rental agreements were based on a percentage of sales, falling in-store purchases can have serious knock-on effects for landlords reliant on turnover.

Shoppers also don't distinguish between online and offline shopping. As Bain puts it: "Increasingly, the transactions themselves are becoming just a single step in an online consumer journey enabled by digital capabilities. That journey begins when a customer goes online to discover and research products. It continues when the customer decides to purchase and makes the transaction. Then, in surprisingly large numbers, China's shoppers go back online after a purchase to share their experiences."

Developers around the world have to adapt to the new pressures in retail. Challenges of online commerce are by no means China-only phenomena, but in China the risks are exaggerated because it coincides with a huge amount of space coming to market.

> There is a real demand to create a destination away from home, a place where you can relax, explore, be inspired
>
> Trevor Vivian
> Director
> Benoy

Wanting More

It's not just e-commerce that is changing expectations among China's consumers. Shoppers in China are increasingly global, and consequently expectations at home are changing. This is not just on price, but also around service. One luxury outlet mall in Shanghai, the Florentia Village in Pudong, offers free training for tenants' staff to bring service up to European expectations.

Moreover, consumers are increasingly attracted not just by retail, but by the overall experience. The K11 'art malls' are a key example of this, hosting a Monet exhibition in its shopping mall in Shanghai in 2014, pumping out a distinct scent so the mall always smells fresh, along with setting up a dedicated team to manage the K11 art shows.

Increasingly, malls are home to cinemas, ice-skating rinks, bowling alleys, medical services and language schools. Haichang Holdings, a China-based theme park developer, has ambitions of creating small marine parks in retail centers. The IFC Mall in Shanghai hosted a year-long exhibition of miniature collections, which it says generated a 13% increase in traffic and achieved $4.5 million in revenue during the campaign's run. Chengdu IFS turned historic relics discovered during construction into an "antiquity plaza".

"Retail malls have had to evolve to adapt to the changing marketplace," says Trevor Vivian, director at architectural firm Benoy. "In China, there is a real demand to create a destination away from home, a place where you can relax, explore, be inspired, dine, socialize, be entertained, and of course still shop. It is now the diversity and mix of uses that is appealing to the public… the market is becoming more aware of designing for a location and not duplicating models city to city."

Adapt or Die

As malls allocate more space to non-retail uses such as cinemas, the overall size needs to increase to make sure the landlord's turnover is not damaged. Consequently, China is home to swathes of 'mega-malls'.

The average new mall in China from 2005 and 2014 was 86,000 m^2 in gross floor area—although most modern malls are between 100,000 m^2 and 200,000 m^2—and a study from financial services group BNP Paribas found that developers such as Dalian Wanda allocate as much as 50% to leisure.

These larger malls require more tenants, and are more vulnerable as the landlord has to allocate consistently high levels of management across all floors and areas. The New South China Mall in Guangdong, more than twice the size of the biggest mall in the US, was classified a "dead mall" by one study in 2013; eight years after opening only a smattering of the 2,350 stores are occupied; largely due to a misunderstanding that few residents in the industrial region have spare money for the type of attractions the mall offers.

But landlords are gradually developing these previously neglected skills of mall management as developers tend towards building a center not to sell, but to run as a business.

For a long time, tenant mix has been led by the tenants themselves (for instance by going bust, or by rearranging their portfolios), but now resourceful and proactive landlords are experimenting with the placement of tenants, including pop-up stores, markets and flexible retail space, to keep the retail environment varied and engaging. And the concept of attracting a mall anchor, typically a department store given their size, is now focused on securing brands like Apple or iMAX, which landlords know will draw crowds.

"The ability for developers to create unique differences between malls to some extent depends on how smart the landlord is, and how smart the asset manager is in terms of thinking outside the box," says James MacDonald from property consultancy Savills.

Retail developers are also testing driving sales from online-to-offline (O2O), such as 'click and collect' services where shoppers buy online and collect in-store. Other examples of O2O include augmented reality supermarkets in malls, already experimented with in China, where shoppers can position themselves in a specific location and digitally purchase an item seen on their smartphone screen. Other concepts involve a customer making a purchase in-store where the item goes back on the shelf after payment and the product is delivered to the consumer's home.

This also plays into the trend of 'reverse showrooming', where customers go online to research products but head to a physical store to complete the purchase. Burberry is seen as one of the market leaders in the area of "bringing online in-store" by transforming the in-store experience with a live connection to the brand's website, digital mirrors and touch points that can be shared through social media.

> Mall design will have to evolve in China as landlords realize they have to be more flexible in terms of retail layout
>
> Melanie Alshab
> Managing Director
> Kensington Asset Management

O2O retail in China has taken hold more easily because it lacks established consumption patterns and loyalties, plus consumers have easily and rapidly adopted mobile e-commerce. Mobile payments in China have seen massive growth, reaching $965.1 billion in 2014, according to consultancy iResearch; 391% growth on 2013.

"It's not just what technology we have at the moment, but also making sure your mall is flexible enough with the IT infrastructure in place to adopt new technologies which haven't even been created yet," says MacDonald.

Developers are also increasingly aware of which brands are most vulnerable to forces of e-commerce. Bain research suggests consumer electronics registered a 20% online retail penetration rate, and the penetration rate for apparel rose to 18% in 2014.

"As this phase of experimentation produces winners and losers, the onus will be on mall owners in China to pick brands for their malls that are managing the transition to multichannel strategies successfully," explains Steven McCord, lead China retail analyst at property consultants Jones Lang LaSalle.

Landlords are largely being led by both shoppers and retailers in the area of O2O retail. One of China's biggest store chains Suning is an example of a Chinese brand repositioning itself as a multichannel retailer. The chain had more than 1,500 stores and a solid reputation for home appliances through big-box retail outlets before it started to be impacted by e-commerce. In 2013, it rebranded itself as an online to offline retailer—store and online payments, supplies, inventory and deliveries were integrated, free Wi-Fi was introduced and staff were given targets to sign customers up to social networks and register online.

Leading retailers already understand the balance between offline and online, multi-channel retailing and how consumers often come to inspect products in-store, says Trevor Vivian. "It's this balance that mall operators need to embrace; with the introduction of entertainment, leisure, education and events to drive traffic to these developments, how can consumers interact both online and offline?"

Where retail innovation in other markets has been largely powered by retailers and developers, in China much of the innovation is driven by the country's e-commerce giants. A tie-up in August 2014 between Dalian Wanda, search engine Baidu and social media giant Tencent agreed to build a massive e-commerce platform specifically focused on how to "integrate offline with online", melding Baidu's search capabilities, Tencent's popular WeChat messaging network and Wanda's bricks-and-mortar infrastructure.

"Mall design will have to evolve in China as landlords realize they have to be more flexible in terms of retail layout," says Alshab. "Good mall developers have always done this, but now they really have to be flexible in terms of the way stores are laid out. It might be that one brand wants multi-storey stores in the future, or wider stores in the future, or to use flexible space outside its shop—all kinds of things that the landlord needs to adapt to."

Matthew Smith, Global Head of Market Development for the Internet of Things at Cisco, also points out that there can be efficiencies for mall landlords who start to "think hi-tech". "Currently, operators in most large malls do not have direct relationships with customers—the growing use of apps and wireless connectivity will allow this to change," he says. Operators will be able to provide data on footfalls and the flow of people, and promotions can be sent to handheld devices at the right time.

Closing Time

Many of these concepts are still at a very early stage in China, and there will still be malls that fail to adapt, especially in lower-tier cities.

The PwC/Urban Land Institute report *Emerging Trends in Real Estate Asia Pacific* makes a particularly downbeat assessment, warning "although second- and third-tier cities have successfully built up their local economies, real estate prospects have deteriorated rapidly after local governments sold too much land too quickly, resulting in oversupply in almost all sectors." China's second-tier cities have now fallen to 22nd in the report's attractiveness rating.

"The way I see it is that downtown areas in every city can probably support a few innovative 'cool' malls, which makes sense because going to the city should be about seeing something special," concludes McCord. "The difficult question is what to do about the classic suburban mega mall, which is big, certainly not tourist-oriented, and needs to fulfill people's more regular needs and frequent trips."

There are few alternative uses for shopping malls—some can be converted into other uses such as arenas, but their size, bulk and lack of windows often makes repositioning difficult. Property experts expect to see a significant number of malls come to market in the near future, with opportunity for consolidation, repurposing or redevelopment for the more able developers.

The retail market is settling after a mad rush from consumers and inexperienced developers over the last decade, while being buffeted by the new forces of digital retail. But what the next few years promise is an increasingly wide gap between successful malls and failing ones.

"To be successful in the future, retail will become one part of an overall experience within a destination," concludes Benoy's Vivian.

There's no doubt that the concept of syncing offline shops and online activity will dominate retail innovation this decade, with China's digital giants positioned to lead the way. Malls in strong locations that offer strong combination of shops, a good environment, a good retail experience and a strong location can prosper. Those who fail to keep up are likely to be left behind.

Shanghai's K11 Art Mall shows how malls can adapt to a new era in retail

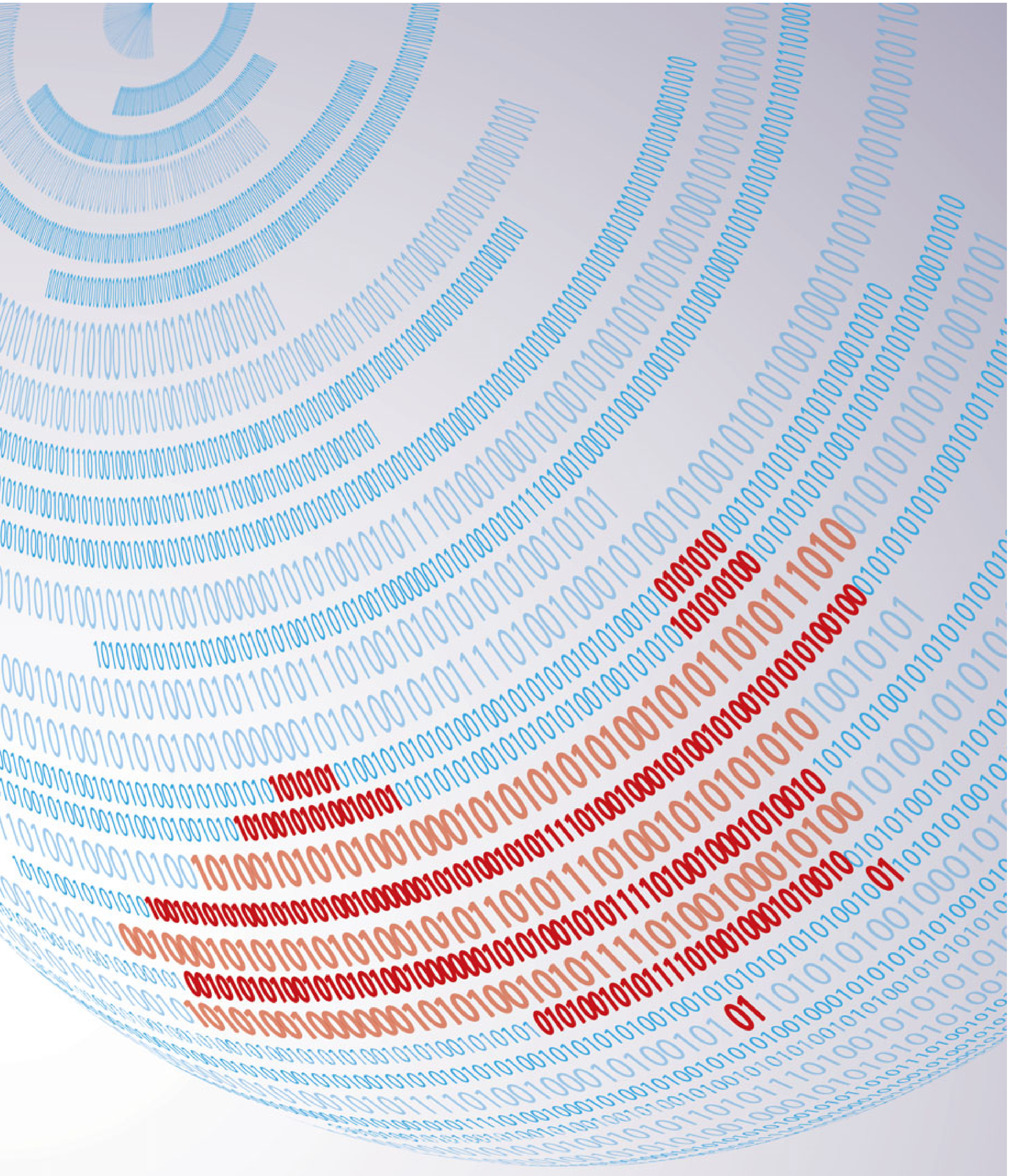
THE POWER OF DATA

Big data promises to revolutionize the work of business and government, and China's largest internet companies are leading the way

By Ana Swanson

One of China's biggest box office surprises in recent years was *Tiny Times*, a 2013 film which took in $11.9 million in the box office on its first day alone and spawned a series of sequels. Yet this movie was as much a result of market research and data analysis as it was artistry. The filmmakers tapped into Chinese social media networks to help determine the stars, director and marketing campaign that would most appeal to China's younger generation. And the payout for this research was substantial.

This is one original example of the use of 'big data', an often vague term that means harnessing the huge amount of information that is created through online activities and transactions to discover trends and make predictions. Big data is too big, too fast or too diverse to be analyzed with traditional databases and software—instead, data scientists use advanced techniques and computing to build models that can process a huge amount of information.



"We can deal with hundreds of billions or trillions of data [points]," says Zhang Tong, the head of the Big Data Lab at Baidu, China's largest search engine. "This potential is very large, so for billions of dimensions, we can build very big models." Big data technologies are often used alongside other high-tech innovations like cloud computing and artificial intelligence.

Though big data has blossomed only in the last five years, it is already being used in China in fascinating new ways. For example, Baidu is using big data to track and project patterns in disease, which can help hospital administrators make vaccines or schedule staff. Tencent, the tech giant that runs China's largest mobile chat network, WeChat, is using social data to identify the trendsetters among groups of friends, and target marketing spending on those people. Alibaba, China's largest e-commerce company, is using a wealth of financial information from its Taobao and Alipay programs to figure out which small businesses are worthy of a loan.

Some critics say big data is over-hyped, and that may be true. Li Yang, Assistant Professor of Marketing at the Cheung Kong Graduate School of Business, says companies in China today are more into using big data to attract media and investors. "This industry is full of bubbles, and there's hot money flowing around. People are trying to get money and get funded and move to the next round and then IPO… The question is whether this data is different from something we had five years ago, before we had big data. I don't think so. I think it's just bigger volume data."

Many companies are eager to harness big data, but don't know how to do it. Some companies appear to be collecting tons of data with no specific plan of how to use it, while others are letting valuable data slip between their fingers. But while some Chinese data projects are bound to fail, overall the industry promises to disrupt the way companies do business—starting with the tech sector, then rippling out to traditional industries more slowly. The government has pledged its support, laying out in March an Internet Plus strategy to integrate mobile internet, cloud computing, big data and the Internet of Things with manufacturing.

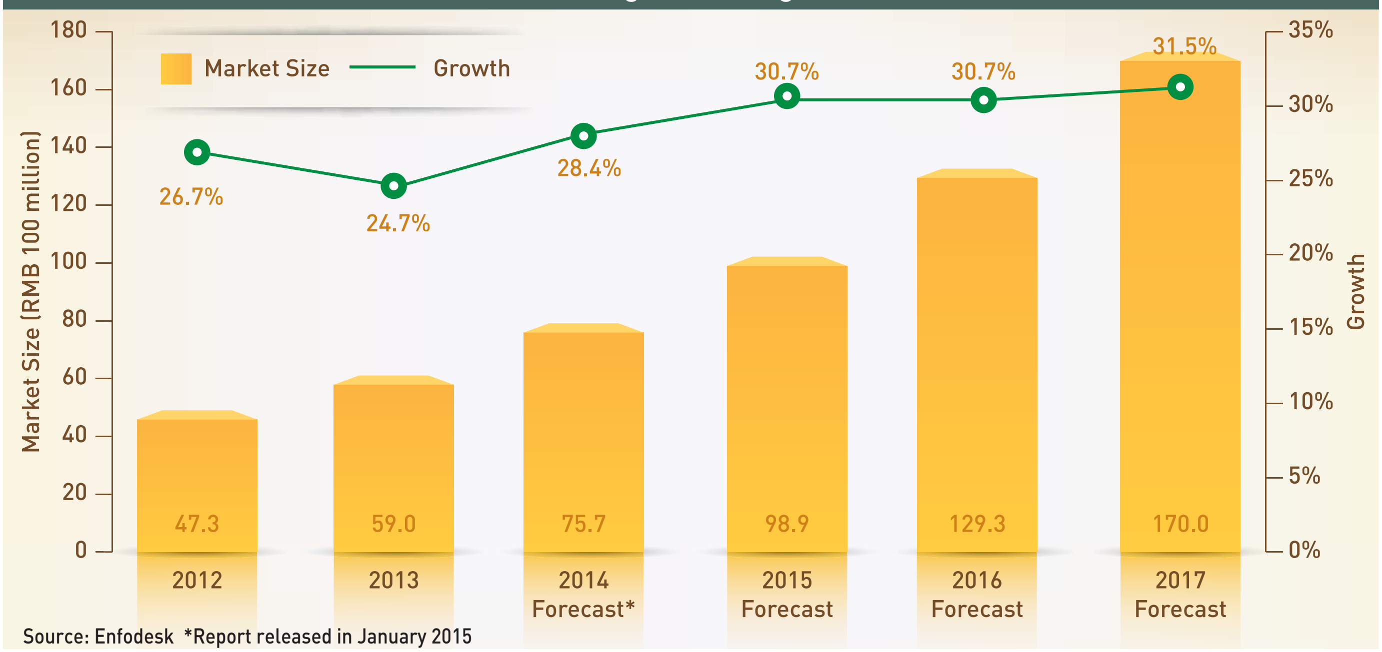
"In the big picture, I would say big data and all of what that entails is being massively embraced by China, by the Chinese government, by the internet companies," says David Sullivan, an analyst at Alliance Development Group (ADG), which assists technology companies expanding in China. "They were and probably are a little behind Google and Amazon, but they started a little bit later. Right now, they're starting to establish more R&D centers, they're putting more dollars behind it."

Alibaba, Baidu and Tencent, China's three internet giants, are unquestionably the largest players in the big data field. Their wildly successful internet services give them a wealth of data to analyze and plenty of customers to try out the results on. While these three companies compete across a range of sectors, they each tend to have their own specialty—Baidu in search, Alibaba in e-commerce and Tencent in social media—though all three are partnering with other companies in an effort to fill in any gaps.

These internet giants are roughly on par with Western technology companies in their ability to use big data, says Zhang of Baidu, though China's other industries lag farther behind. Industries like telecom, banks, the government and medical institutions have yet to harness big data, but there is a huge potential.

Even Bigger

Market size and growth of big data in China



Source: Enfodesk *Report released in January 2015

Big Data for a Big Country

China is one of the most exciting markets in the world for new technologies, and big data is no exception. China has 1.3 billion customers, who are seeing their disposable incomes rapidly increase, and high rates of penetration for mobile internet. According to the China Internet Network Information Center, the country had 649 million internet users by the end of 2014, more than 557 million of whom used mobile phones to go online. And companies, the government and research institutions all have a keen interest in harnessing and analyzing the massive amounts of data that internet users are producing as a result.

Big data began in China much as it did in the West: as an effort to use the information that websites were gathering about customers to sell more products. Advertising and e-commerce are still the largest uses for big data. One of the earliest examples was Baidu's use of big data in its search engine. "Search engines have been doing what is now called big data since the very beginning," says Baidu spokesperson Kaiser Kuo. "In order to have a good search engine, what you're doing is massive data management."

In addition to providing search results, Baidu made its money by selling ads alongside them. Baidu would monitor what its users were searching for, and then charge companies for ads that were tailored to that activity. And, as the company's big data capacities improved, it found it could tailor advertisements further. Says Kuo, "You can use that massive set of data and analyze it and figure out what advertisements are likely to be clicked on more. If we display more of those, the click through rate will go up and our revenues will reflect that."

Since then, Baidu has expanded its big data efforts into other areas, including opening a Beijing Big Data lab under its Baidu Research arm. To demonstrate its big data capabilities, Baidu has developed predictive programs for monitoring diseases like hepatitis, Lunar New Year travel, earthquakes, FIFA World Cup victories and movie box office successes. The company also has an open platform that allows developers to use Baidu's algorithms to make predictions.

> "Big data and all of what that entails is being massively embraced by China
>
> David Sullivan
> Analyst
> Alliance Development Group

Zhang and Kuo argue that Baidu is the leader in big data in China because of its massive amount of data and its strength in technology. There are even some aspects in which Baidu's big data efforts are more advanced than US companies, like building large sophisticated models and infrastructure, says Zhang.

But while Baidu is perhaps the original big data company, Alibaba occupies a valuable niche in the big data market. Given its position as China's largest e-commerce company, Alibaba has a wealth of data on consumer spending and business income that it gathers from buyer and seller accounts. The company provides data to sellers to help them understand the industry and target new customers. It also uses data to personalize search results and shopping recommendations for customers.

For example, Alibaba's data management platform recently helped Mercedes-Benz launch a targeted online-to-offline promotion for its new compact car brand, Alibaba spokesperson Beckie Wang says. In addition, the company uses data intelligence and deep learning to improve its marketplace design, search, logistics, location-based services and financial services.

Compared with Baidu and Alibaba, Tencent is sometimes seen as lagging behind in technology, with it focused more on spinning out new products than on cutting-edge research. However, ADG's Sullivan says that Tencent could have the most valuable big data resources of all three companies because of its massive WeChat social networking app—resources that Alibaba and Baidu lack. WeChat gives Tencent extensive data on people's personal connections and allows the company to chart who the "influencers" are in each social group, he says. That can help advertisers maximize their market spending by targeting those individuals.

"It's possible in many cases Baidu is not going to know who the user is… and without that, it's a lot less value to the advertisers. If you look at Alibaba and Tencent, they've got so much more understanding of who you are because you're signed into your account. With WeChat, they know who your friends are," Sullivan says.

While each company has their unique traditional specialty—Baidu in search, Alibaba in e-commerce, and Tencent in social networking—all three companies are aggressively trying to expand into each others' turf to ensure their long-run viability. To do so, the three internet giants are making investments, acquisitions and partnerships with smaller companies. For example, Tencent has partnered with JD.com, China's second-largest e-commerce site, to integrate e-commerce into the Tencent WeChat app. That allows Tencent to know what a user is buying and looking at in JD.com and send them coupons in real time.

Steps Beyond

Beyond sales and marketing, big data has an important role to play in operations. New big data technologies are helping companies more efficiently analyze and coordinate their warehousing, supply chain management and delivery, which is essential as Chinese e-commerce companies fiercely compete to shorten delivery times.

Another use is monitoring massive amounts of content online. Social networking and video sites, such as Sina Weibo, WeChat and Baidu video site iQiyi, use big data technologies to sort through and delete posts or videos that involve pornography, are politically controversial or infringe copyrights. A similar use is sniffing out fraud—tech companies can use big data to find and eliminate counterfeit products, or advertising clients that commit click fraud.

Still another use going forward will be transportation. Like Google, Baidu is looking into self-driving cars, a technology that requires a lot of data from maps, cameras, tracking devices and other real-time data analytics.

Another promising area for tech companies is using big data to offer financial services. China still lacks a strong credit monitoring system, and its state-owned banks have been slow to evolve. So Alibaba, Tencent, Baidu, and even online-to-offline retailers such as Guomei have stepped into the gap, offering easy-to-use mobile financial and investment services.

Alibaba is probably the most advanced player in this area due to its wealth of data on sales and payments. Alibaba's Open Data Processing Service, for example, allows it to analyze millions of transactions on its e-commerce sites and payment tool, and extend loans to small online businesses at a cheaper rate than traditional banks.

In the future, big data will also be useful and disruptive for companies outside of the tech sector. Banks can use big data to analyze consumer creditworthiness, while insurance companies can use it to find more secure investments for their funds. Brokers can analyze how the stock market responds to social media activity and news reports. Automotive manufacturers can use big data to manage supply chains, ensuring they produce the right number of components and ship cars to the right markets.

Outside of industry, there are many potential uses for big data in government. For example, Beijing is working with IBM to model and manage the city's smog problem. The system provides warnings about pollution up to three days in advance, giving the city government time to regulate traffic volume. Scientific institutions can use the advanced computational ability to undertake previously unimaginable projects, like genome sequencing. Chinese companies BGI Shenzhen and BioMed Central have launched an online public database with life science resources—such as the entire genomes of various plants and animals.

> When it comes to data analytics, modeling, mining, I think few Chinese companies can do it well
>
> Li Yang
> Assistant Professor of Marketing
> CKGSB

Muyueh Lee, a programmer in Taipei, worked with the China Standard Medical Information Research Center to develop one-such big data program. Lee helped to build an interactive platform analyzing 30 million medical datasets from 750 hospitals in China. The project allows China's national medical service to analyze the prevalence of diseases, costs, average days in the hospital and mortality rate among men or women, and urban or rural residents.

Lee's explanation of the work shows just how much time big data shaves off traditional practices. "Previously, the research center had to turn the different requests into database queries, spending up to two to three weeks in the process. With the new system, users can conduct interactive analysis on a dataset of 5 GB with a response time of less than one second," he says.

The potential for big data outside of the tech industry is huge. But despite this opportunity, so far traditional industries lag behind. Most traditional industries tend to be more cautious than Chinese tech companies and lack the infrastructure and human resources necessary to carry out big data projects. "There are a lot of places that have data but not all of them are using it well," says Zhang of Baidu.

CKGSB's Li says that Chinese companies are competent in data acquisition and data management and integration, which he describes as the bottom two levels of a big data pyramid. But when it comes to discovering the useful information behind the data and using that to improve their businesses, Chinese companies are still falling short. "When it comes to data analytics, modeling, mining, I think few Chinese companies can do it well," he says.

In the near future, Baidu, Alibaba and Tencent will likely maintain a pivotal role in China's big data market. That's partly because these companies are already investing big in the necessary infrastructure and human capital, but it's also because of their entrepreneurial culture—China's privately owned tech companies are far more experimental and willing to wade into a new and unpredictable sector.

Sitting on a Data Goldmine?

The big data industry has benefited from generous government support. Next-generation information was named as one of the seven strategic "emerging industries" in the current Five-Year Plan, and the government is trying to develop the infrastructure necessary for the industry.

In a Work Report in March, Premier Li Keqiang introduced China's Internet Plus strategy, which aims to integrate advanced IT into traditional industry. "We

Baidu used its big data capabilities to create an interactive tool illustrating the journeys made over the Chinese New Year period

will develop the Internet Plus action plan to integrate the mobile internet, cloud computing, big data, and the Internet of Things with modern manufacturing, to encourage the healthy development of e-commerce, industrial networks and internet banking, and to guide internet-based companies to increase their presence in the international market," Li said.

Zhang of Baidu says the government has provided significant support, including drafting supportive policies, providing research grants and opening up government data.

China also fares well in terms of human resources for big data. The country lacks experts at the executive level, but it has a huge supply of low-level engineers that could do big data analysis with some on-the-job training. Beijing in particular has become a hub for the industry due to strong universities, an educated workforce and a preponderance of internet start-ups.

Yet the big data industry in China also faces some major obstacles. Security and privacy are major concerns. As in the US, data storehouses remain vulnerable to hacking, which could cause a loss in consumer confidence in the future.

In addition, the government's strict state secrets law places some restrictions on the kind of data that can be gathered and sold, says Sullivan of ADG. China tends to demand that data from companies operating in China is stored in a cloud in China. It also requires companies to give authorities surveillance access and prohibits banks from storing personal financial information offshore. In a report in April, the American Chamber of Commerce urged China to loosen these tough restrictions, saying the measures hurt foreign companies and the Chinese economy.

But the biggest challenge in China is sharing best practices for big data with traditional industries. Some traditional companies still aren't storing their data, and others that are storing some may not be focusing on the right metrics. Other companies have a lot of data, but don't effectively use it.

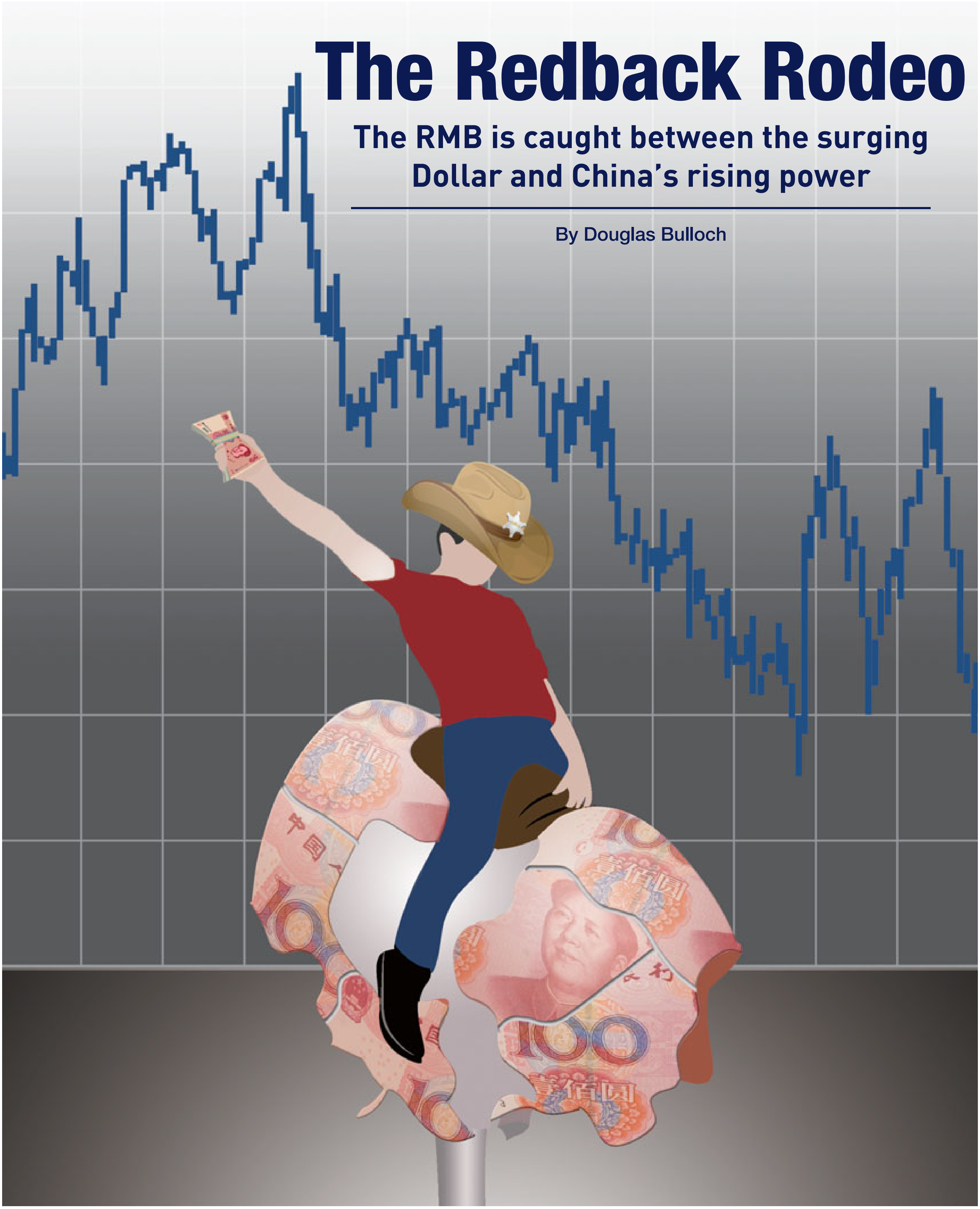
And experts say some of what is considered big data in China today is hype, rather than real development. Li notes how a CCTV broadcast spoke of an average they had calculated using their "big data technology". "This is a very trendy topic, and no one wants to be left behind," he says. "Can you really call this big data?"

China's big data industry remains behind the US for now, and companies, especially outside the tech industry, have a lot of learning to do about collecting data and making it valuable. Despite this, and the presence of some unfortunate hype, Chinese consumers are already embracing mobile internet and e-commerce faster than their counterparts in the West. And that creates huge opportunities for a big data revolution.

The Redback Rodeo

The RMB is caught between the surging Dollar and China's rising power

By Douglas Bulloch



In the world of foreign exchange, the relationship between the RMB and the US Dollar is easily one of the most important, its every movement fervently scrutinized by analysts and traders.

But while the RMB has broadly tracked the US Dollar for 20 years, its exchange rate also has a history of defying expectations. Following slow but steady appreciation through much of 2014, starting in October the RMB once again began depreciating much like it had prior to March of that year, when the People's Bank of China (PBOC) intervened heavily to push it down just before widening its daily trading band—the limits within which the currency is permitted to trade in the offshore markets—to 2%.

About a year after that widening on the 3rd of March this year the RMB reached its lowest rate against the dollar since October 2012. It has since recovered somewhat, but the long-run assumption of a steadily appreciating exchange rate is looking less and less credible, not least because while the PBOC has traditionally intervened in the forex markets to hold down the currency's value from the top of its range, of late it appears to have intervened to hold the value up to avoid it hitting bottom.

When discussing China's economy, it is easy to lose sight of its sheer scale, and macroeconomic indicators and decisions can often take on an abstract and distant quality, yet ultimately their effects on businesses are very real. And nowhere is this more true than with the country's RMB exchange rate—as one of the world's most important trading nations, its effects ripple outward across the vast hinterland of large and small companies worldwide, ultimately influencing the lowest level of investment and employment decisions.

As Steve Martin, CEO of Shanghai Ying Jie International Trading Co., says, "People at the top understand the macroeconomic policy, but down at the coal-face, standing in an industrial park... where there are thousands of commercial enterprises, all of them end up being affected by their decisions."

Converting Expectations

Despite this recent depreciation, in April's installment of its semi-annual Report to Congress on International Economic and Exchange Rate Policies, the US Treasury repeated its long-held view that the "RMB exchange rate remains significantly undervalued".

Yet there is almost no market sentiment that supports this view any longer. Adam Posen, former member of the Monetary Policy Committee of the Bank of England and current President of the Peterson Institute for International Economics, was quoted by *Xinhua* as saying that this was "not justified", even adding that it "doesn't make any sense". Even the mighty International Monetary Fund (IMF) concedes that China's currency is heading towards equilibrium, giving sway to growing speculation that if the RMB is going anywhere, it is going down.

Unfortunately, the lack of full convertibility ensures that the market only plays a limited role in finding the value of the RMB. If the currency was fully convertible and traded freely, its value would rise and fall entirely at the mercy of prevailing global trading patterns and market sentiments, and while there remains a longstanding commitment to full convertibility, fulfillment is still years away.

Power in Reserve

The manner in which the PBOC now manages the exchange rate is still fairly blunt. China's capital account—which funnels

True Value?

Since 2013, the value of the Dollar against the RMB has varied significantly

cross-border capital transactions, acquisitions, investments, etc.—remains closed and under close regulatory supervision, while the current account—the conduit for trade in goods and services—is more open. But given that both capital and current accounts have long both been flush with surplus, the PBOC balances these surpluses out by using the reserve account in which it holds an estimated $4 trillion, an amount that dwarfs the daily traded volume of RMB.

To simplify: China maintains an expanding offshore market in its currency as an exercise in price discovery, but keeps enough firepower in the reserve account to determine the value of the RMB through the threat of massive potential intervention. Real price discovery—or something closer to it—is therefore a question of macroeconomic analysis, estimating what would happen if the controls were lifted and watching what the PBOC does when the RMB strays too close to its daily trading limits.

However, the last year has seen significant changes to this pattern of large surpluses. Indeed, weakening growth and the emergence of China as a capital exporter both mark milestones along the RMB's route to reserve currency status, for they potentially allow the current and capital accounts to balance off against each other directly, therefore mitigating the need for PBOC intervention through the reserve account. Having said that, if the PBOC steps back from its assumed role of exchange rate guarantor, there would inevitably be greater fluctuation in the RMB, highlighting once again the tricky question of its 'real value'.

Capital Movements

In contrast to the US Treasury, Michelle Lam, an Economist at Lombard Street Research in London views the RMB as significantly overvalued. "We continue in our medium-term view that the currency is around 30% higher than its competitive price," she says.

Lam concentrates her analysis mostly on current account and trade factors, including OECD estimates of labor costs, falling producer prices, falling export prices and continued price cutting by exporters in search of market share, suggesting that

> "All [the] arrows are pointing to a currency that is too strong
>
> Michelle Lam
> Economist
> Lombard Street Research

"all these arrows are pointing to a currency that is too strong".

Song Gao, Managing Partner at PRC Macro Advisors in Beijing is not quite so adamant, but concedes that "in the long run… the current valuation of the RMB cannot be justified. It should go through some kind of gradual depreciation." Although he widens his scope to include both current and capital account factors, Song nevertheless holds that "China's current account surplus will continue to decline, which is a reflection of both soft growth from Chinese manufacturing eroding Chinese competitiveness in the export sector, and also because of the capital offload".

The aggregated figure for capital offload includes a wide range of private transactions as well as 'hot money' movements—the flow of investor funds between financial markets in order to profit from short-term interest rates—which are often the source of regulatory concern.

However, Song thinks the dangers of hot money outflows are overblown. "Bad capital is speculative money betting on the idea that the RMB will always appreciate against the US dollar. So if the depreciation of the RMB encourages bad capital going out of the country, that's actually a good thing." He adds that in the past, bad capital inflow has significantly distorted trade data.

Nevertheless, unpredictable hot money aside, the Ministry of Commerce announced in January that China became a capital exporter in 2014 and the trend looks set to continue due to the emergence of the New Silk Road initiative with its associated Silk Road Fund and the Asian Infrastructure Investment Bank (AIIB), both of which establish an institutional framework designed to funnel large amounts of capital abroad.

Political Imperatives

China's near term aspirations are broader than simply institutionalizing capital outflow and extend to ensuring that the RMB is included in the IMF Special Drawing Rights (SDR) basket of reserve currencies, an important symbolic step on the course toward currency internationalization. Patrick Bennett, Executive Director of Macro Strategy Asia at the Canadian Imperial Bank of Commerce (CIBC), sees this undercutting any expectation of a depreciation in the RMB.

"The big thing that has changed [in the last year] is the push towards internationalization. They've been quite specific with that, including with the meeting about that at the Boao Forum with [Christine] Lagarde [Managing Director of the IMF] on the panel, saying they are pushing for inclusion in the IMF's SDR in October," he says. (The Boao Forum is a World Economic Forum-style conference in China's Hainan province.)

But, Bennett warns, "the idea to push for internationalization, to expand internationalization, to introduce more swap lines with other central banks, to encourage traders, merchants and investors to hold more currency is counter-intuitive to the idea that they might weaken the currency." He goes on: "I don't think it's going to happen."

Song posits a similar set of priorities informing Chinese policy makers, adding that uncertainties generated by unorthodox monetary policies will add to the attractiveness of the RMB as a regional reserve. "Since mid-March we have begun to see some kind of stabilization of the RMB against the Dollar—there was a sudden RMB appreciation after mid-March—

which reflects the progress of the AIIB and China's anxiety to have the RMB included into the IMF Special Drawing Rights and the promotion of the RMB as a more viable option to the US Dollar."

However, Song adds a further consideration in China's regional political aspiration for "the RMB to become an anchor currency in the region especially while external conditions and global central banks create turmoil in the financial markets".

From Greenback to Red

Behind all this lies the fact that the RMB has for long been measured only against the US Dollar, rising and falling in tandem in the global currency markets. Until 2005, the PBOC maintained a formal 'peg' against the Dollar as a key part of its development strategy. However, in 2005 the 'peg' was abandoned and since then the phrase 'Dollar peg' has merely referred to the policy of reserve account management that prevented the RMB rising too quickly and consequently choking off growth. In other words, it was not strictly speaking a 'peg' so much as a drag on the long-term expectation of an appreciating RMB.

But recent monetary activism in the form of central bank purchases of government securities—also known as quantitative easing—on the part of both the Bank of Japan and the European Central Bank has made this dollar tracking hard to sustain.

Setting aside other market fluctuations, the reduction in interest rates and increase in the money supply implied by the process of central bank monetary purchases puts downward pressure on the currency's exchange rate. So compared to the Euro and the Yen, the RMB has been rising recently, making key Chinese exports less competitive against European and Japanese manufacturers.

Which reveals that, of course, the real outlier in the international currency markets at the moment is not the RMB but the Dollar, following the stronger than expected recent macro-economic performance of the US economy and in keeping with the expectation that the Federal Reserve will raise interest rates in the coming months.

For just as monetary easing by the Federal Reserve from 2008 brought down the Dollar, so the prospect of tapering monetary support pushes it back up again. And while the PBOC was happy for the RMB to track the Dollar downwards against the Yen and the Euro between 2008 and 2012, now the pressure is reversing.

> "The PBOC has effectively de-pegged the Dollar
>
> Song Gao
> Managing Partner
> PRC Macro Advisors

At the same time, China is easing monetary conditions both by dropping the benchmark lending rate by 25 basis points on 1st March, and more recently by cutting the Reserve Requirement Ratio for all banks effective 20th April. While these moves are not surprising in themselves, they point towards an obvious scenario in which China's 'Dollar peg' becomes increasingly unsustainable.

Regime Change

In February, the *Financial Times* published a guest post written by Guonan Ma, Non-Resident Fellow at the European think tank Bruegel and formerly Senior Asia Pacific economist at the Bank of International Settlements, titled 'Time to ditch the renminbi-US dollar peg'. This article echoed other market rumors at the time and set out three scenarios in which the PBOC could either cling on to a policy of defending the peg, effectively abandon it, or let it loosen gradually. What was missing from the article was what some market watchers have begun to see since November last year; that to all intents and purposes the 'Dollar peg' is already a thing of the past.

The reason this has gone largely unnoticed is simply that analysts have understood the need to second-guess the PBOC's reasoning behind moving the daily fix according to market fundamentals. To be clear, "the PBOC has effectively de-pegged the Dollar, and has begun to target a basket of currencies," says Song Gao, going on to estimate the proportions of the basket at approximately 10% Japanese Yen, 10% Pound Sterling and 10-20% Euros, with the remainder of the basket continuing to be comprised of US Dollars.

Patrick Bennett concurs, although he has for some time estimated the real value of the RMB on a trade-weighted basis, which similarly accounts for the fluctuations of the RMB against the Dollar. "A trade-weighted approach is much more important. All central bankers use a trade weighted value."

However, Song believes this change to be a formal policy shift at the PBOC rather than simply the validation of longstanding market assumptions. "Before November last year, there is no correlation between the Euro and Dollar exchange rate and the RMB/Dollar parity rate. But if you plot a chart after November between RMB Dollar and Euro Dollar… there is an almost perfect correlation," adding, "we think the RMB has reached a very significant regime change".

Opportunity Costs

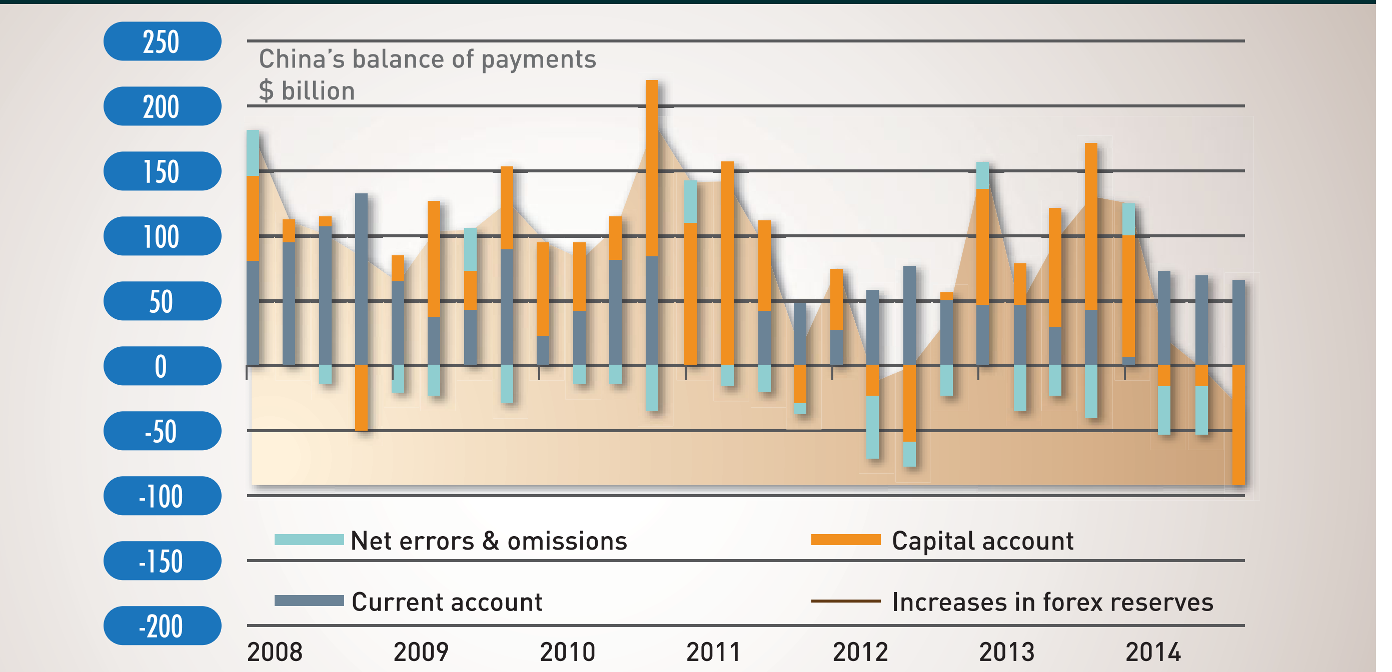
All this leaves the RMB exchange rate trying to find a price between not one but two macroeconomic divergences. On the one hand, the obvious market divergence between the rising Dollar, linked to a recovering US economy, and the relative weakening of the RMB reflecting a slowing Chinese economy on the other, for with less economic activity comes less demand for the currency.

However, within China itself there is considerable tension between a long-standing policy of prioritizing growth, exports and development, and the newly assertive geopolitical imperative of realizing China's regional and international aspirations.

These policies do not necessarily conflict, but they affect the exchange rate in op-

Capital Deficit

China's balance of payments shows a recent, persistent decline in the country's capital account



Source: Societe Generale

posing ways, which leaves small businesses struggling in between. For companies long used to dealing with a stable exchange rate, the prospect of greater fluctuation brings problems.

"Generally for Chinese companies the exchange rate issue in the current economic climate is just another complexity," says Steve Martin, adding that "I really liked the original policy. We always knew what the RMB was worth, but international politics came into play and now they're going to float it." From now on, Martin concludes, "I can't see it stabilizing, I can only see it going up and down," and, somewhat portentously, this "makes me nervous".

But Bennett is sanguine about China's prospects. "The export numbers that came out a couple of days ago with the headlines screaming how weak they were, well that's nonsense. Exports in Q1 were up 5% on exports in Q1 last year. So if you were to talk about exports being down 14% in March, they were up 48% in February.… With Chinese numbers you need to look at the moving average… it depends how close you stand to the screen."

Song sees some political uncertainties—which he describes as 'tail risks' in these growing tensions: "Export numbers for March have been very bad, growth has been negative 14% in March. Of course there are some seasonalities, but just broadly that reflects a loss of China's competitiveness for the export sector. That probably will make for some serious reconsideration for the PBOC's exchange rate strategy this year because they will be forced to tilt towards growth, therefore a weakening currency will become a more important option."

He stresses that he thinks this is unlikely, but cannot be ruled out, indicating that the most recent economic data coming out of the US raises questions concerning the real strength of their recovery, which would rein-in upwards pressure on the RMB relative to other currencies. This suggests that "everyone is not so sure that the Federal Reserve will hike interest rates" after all.

Stability vs. Volatility?

The big uncertainty over China's near term forex rate concerns whether the economic imperatives drive the currency downwards, or if the political imperatives keep it stable until October, when the decision on SDR status will likely be made. Either way, most market watchers—in contrast to the US Treasury—think the long term will show a depreciation.

For many years, China's economic trajectory was the big story, but as China has begun to cash in some of that success, conflicting political aspirations have emerged.

Along with the 'New Normal' of lower growth rates, China now faces the other normal of political and economic trade-offs—trade-offs whose contrasting effects will leave their trace on the forex market, adding currency risks to China trade.

As Lam puts it, "they are trying to achieve a lot of things—they have to pursue reform, they have to manage a slowing economy and they have to embark on ambitious foreign policy like establishing the AIIB, so I guess there is no simple forex target they can stick with."

Which, if true, indicates that when the RMB eventually reaches a market-determined level, the Redback rodeo might have only just begun.

Thrills and Spills

Theme parks are taking off in China once again, but could some be heading for a big drop?

By Hudson Lockett

When the gates of Disneyland Shanghai open in 2016, visitors will be treated to the tallest towers of its largest and most interactive castle. It is to be located in the biggest theme park Disney has ever built, with park grounds sprawling over 30,000 acres, or 3,000 more than Florida's own Disney World. As of April 2014, Disney and Shanghai Shendi Group had committed to pouring approximately $5.5 billion in total into the park. But Disney's will be far from the first such castle to market on the mainland.

For a decade and a half, the unfinished, skeletal ruins of a strangely familiar fantastical fortress peeked out over the horizon northwest of Beijing. There, in 1998, all activity at the Wonderland Amusement Park suddenly died (along with investors' hopes) when a dispute between landowners and developers halted construction. The increasingly infamous remains were finally razed in 2013, the same year China's central government also lifted a nationwide ban on new theme parks.

Since then, with numerous parks opening, or being slated to open, across the country, concerns have arisen over whether the industry was headed toward another bubble like that seen in the previous decade, or the decade before, when many purported parks proved nothing more than copycat knock-offs at best and backdoor real estate deals at worst. But Chris Yoshii, Global Director in Asia for AECOM Technology, says that interest in China's park sector remained substantial thanks to real market demand from a growing, cash-flush middle class.

"I think in the future we're going to see a big increase in investment in this area," Yoshii says. "I'm hopeful most of it will have a positive outcome, but I'm sure there's going to be a few that are just… you'll kind of wonder what they were thinking."

From Anaheim to Shenzhen

The modern theme park industry began in America with the 1955 opening of Disneyland in Anaheim, California. But it would be over three decades before the first theme park launched in mainland China. In 1989 Overseas Chinese Town Group (OCT) finished construction in Shenzhen of Splendid China, a park featuring miniature replicas of many famous Chinese landmarks.

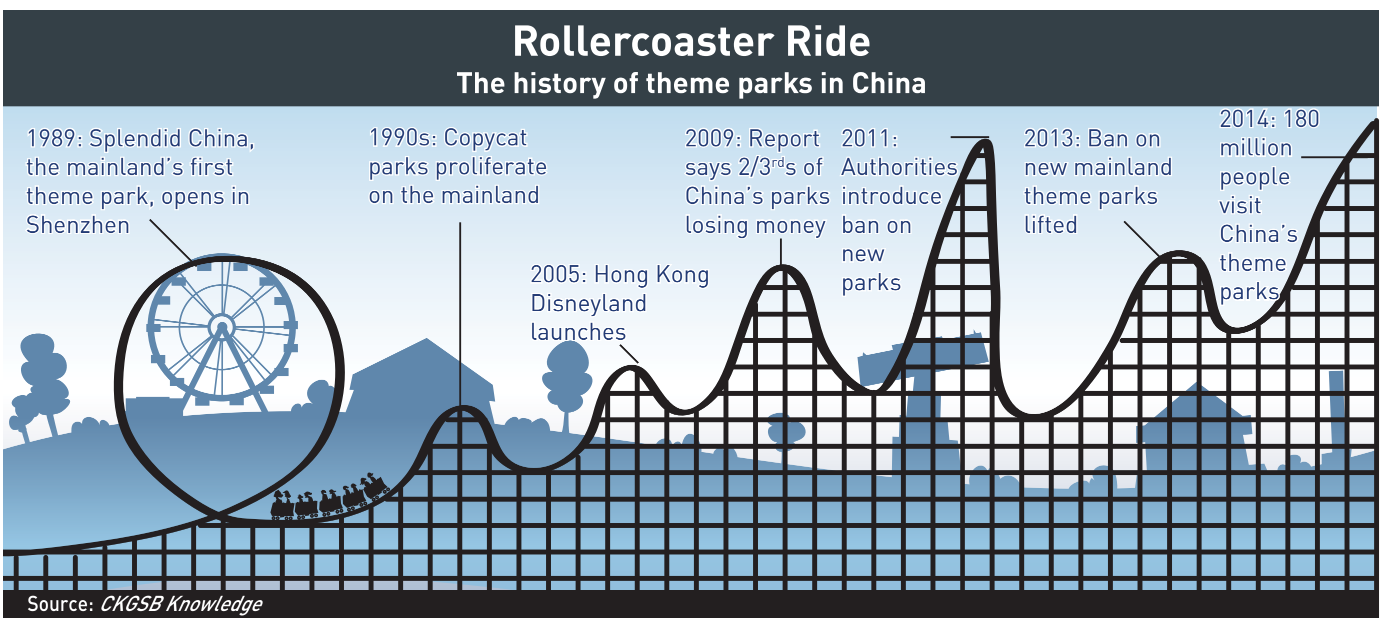
Splendid China was a roaring success, and from the late 1980s to 2005 saw 50 million visitors, took in RMB 2.6 billion in revenue and generated RMB 1 billion in gross profit, according to one academic study of the company's performance. Some parks that launched nearby soon after Splendid China's debut also became wildly popular.

In 2011 *Winshang News* cited Zhao Huanyan, Chief Intelligence Expert at Huamei, as having said that China had more RMB 150 billion ($24 billion) tied up in more than 2,500 theme parks, of which 70% were lossmaking, 20% were breaking even and the rest turning a profit. By contrast, statistics from the International Association of Amusement Parks and Attractions (IAAPA) state that the US has over 400 theme parks.

But the early successes in Shenzhen built up false expectations among adventurous entrepreneurs elsewhere, who concluded that all they had to do to achieve similar profits was throw up a few rides outside of town. As parks proliferated around the country, many found themselves unable to attract repeat visitors and were soon shuttered. According to the Themed Entertainment Association/AECOM report for 2009, two-thirds of China's theme parks were losing money, with billions of yuan either already lost or at risk.

Markus Schuckert, an assistant professor at Hong Kong Polytechnic University's School of Hotel & Tourism Management who teaches and has written extensively about theme parks in Asia, says that originality was and still is a challenge even now for many Chinese parks.

"It's still the theming, it's the branding, it's the storyline," Schuckert says. He explains that Chinese parks can come off as less aggressive than their western counterparts because they focus less on thrilling, high-G-force rides, which exert pressure on riders. Instead they've opted to emphasize a more multimedia-based experience with



soft rides that an entire family can enjoy. But that doesn't make a signature brand and intellectual property any less important: Asian parks also tend to rely more heavily than other regions on merchandise, which Chinese consumers consider both highly collectible proof of their experience and souvenirs to bring back for friends and family.

That helps explain the widespread failure of China's theme parks in the first decade of the millennium, though it was by no means the only culprit. Most parks were also far outside of town, which minimized property costs but made many parks nigh-impossible to reach. When visitors finally arrived, they found parks that were nothing more than copies of those in Shenzhen. Bad management and corruption further undermined park quality and visitor experience.

These troubling practices all came to a head in 2010 on the Space Journey ride at the Ecoventure Valley park when the ride malfunctioned, killing six people and injuring 10 more. Compensation and an apology from the chairman of OCT wasn't enough to undo the damage done to the industry's reputation. It had lost what Schuckert considers the other two prerequisites to the sector's success: consumer satisfaction and a feeling of safety and security.

Lessons Learned

Even Disney's performance in greater China hasn't been flawless. When Hong Kong Disneyland launched in 2005, it was really almost half a park—a lack of attractions made the grounds look empty, and more had to be added post launch. The Hong Kong outfit only began turning a profit in 2012, when Disney was already working to seal the deal on a Shanghai park.

Shanghai's park makes it clear that Disney learned from its mistakes in Hong Kong and won't rush things—earlier this year Bob Iger, CEO of Walt Disney, told investors it would launch in spring 2016, likely so it will open during warmer weather. The grounds—now entering the final stretch of construction—are huge, but fully outfitted with plenty of rides, and are located in-between Pudong International Airport and the Shanghai city center. Disney is betting on big crowds from people seeking something special, and locals seemed set to oblige.

> “They all want to put their city on the map, and they tend to often fail
>
> Michael Cole
> Head of Real Estate Intelligence
> Mingtiandi

"Most parks are quite alike in China," said a woman, surnamed Zhu, voicing a common complaint among those surveyed. While she hoped Shanghai's park would charge less than those abroad, others didn't mind if it meant less of a crowd.

One Mr. Li suggested better service from less sullen staff would go a long way, and most said they were glad for a park that could guarantee safety after an accident the previous month in Henan, where a rocking boat attraction had flung 19 visitors free of their seats and clear of the ride. And that was before a ride in Wenzhou killed two at the Zhejiang Pingyang Amusement Park in early May.

As Disney's opus takes shape and restrictions on park approval have eased, attention has been drawn to a variety of other parks on the mainland that run the gamut from savvy to unsettling. The theme park concept fits nicely into the future of a consumer- and services-driven economy envisioned by China's top officials. And China's massive population, as elsewhere, makes the potential profits all the more alluring.

About 180 million people visited China's theme parks in 2015 according to estimates from the IAAPA, and Yoshii says AECOM expects the theme park market to double over the next five years. Little wonder, then, that Disney isn't the only one looking to set up shop on the mainland.

Foreign-planned mainland parks include the $2.4 billion Dreamworks Center in Shanghai, a $3.3 billion Universal Studios park outside of Beijing and a Six Flags park in Tianjin. These projects, backed by experienced Western theme park firms and well-situated within or near top-tier cities where discretionary spending is typically higher, all look relatively safe.

Local Adventures

Local developers run a wider gamut, and it's easy to laugh at some of the more eyebrow-raising concepts on display and in the works. One widely-cited online review of a Hello Kitty-themed park in Zhejiang complained of ho-hum rides and wretched food. The chief executive of the main investment firm behind a planned Titanic theme park—replete with simulated iceberg collision—told *Reuters* that "[w]e will let people experience water coming in by using sound and light effects… They will think: 'The water will drown me; I must escape with my life'."

Not all the drama is hypothetical. Real estate conglomerate Dalian Wanda grabbed headlines with the debut of the nationalist-themed Han Show performance at its new Wanda Movie Park in Wuhan, and Chairman Wang Jianlin has plans to invest RMB 200 billion ($32 billion) in 12 theme parks around China—including in Guangzhou and Shanghai, where he hopes to take a bite out of visitor rates at the Disney parks nearby in Hong Kong and Shanghai. Michael Cole, Shanghai-based head of real estate intelligence site Mingtiandi, is less certain of Wanda's plans for amusement park domination.

"That looks fairly challenging to me," Cole says. "Part of what's attractive about these places is the branded experience. Wanda's trying to create their own brand, which is something they haven't really done before [except with malls]."

Schuckert, too, is skeptical of Wang's publicly stated ambition to use a dozen

Wanda parks to cannibalize the target demographic of Disneyland and other foreign-backed ventures, particularly when compared to more established domestic players in the sector who have successfully crafted enjoyable, well-branded parks that offer visitors a unique experience.

"If Disney would have opened Disneyland in the US in four or five different corners [of the country], would it be so amazing to go to California or Orlando?" Schuckert asks. He points instead to newcomer Chimelong Ocean Kingdom in Guangdong province—the most-visited water park in the world in 2013, with visitors up 7.5% year-over-year, according to AECOM—as a paragon of park planning.

Other major Chinese theme park outfits include OCT Parks China, whose attendance in the same year was up 12.7% to 26.3 million visitors; Fantawild Group, which hit 13.1 million visitors, up 42.7%; and Haichang Group, which saw 10 million visitors, an increase of 7.4%. These three firms ranked 4th, 9th and 10th, respectively on AECOM's latest list of top 10 theme park groups worldwide.

Fantawild in particular appears to have beaten Wanda to the punch in many mainland locales. While the firm is a heavyweight in the domestic parks industry, none of Fantawild's attractions are located in first-tier cities. But the total profits from its many second and third-tier parks were enough to vault it into the ranks of global industry leaders for the first time in 2013.

Other headline-making plans from the past year are still amorphous at best. These include collaborations between local and foreign companies, such as vague plans from DMG and Valiant to build superhero-themed parks. Citic and Village Roadshow recently announced plans to jointly develop a panda-themed park in Chengdu, with five more locations around China being mulled.

If You Build It...?

Much like the first success stories out of Shenzhen, impending profits generated by big-name park groups' China ventures have planted copycat dreams in the brains of many local government officials around the country. That's not to say demand isn't increasing; today there is a growing middle-class cohort willing and able to pay RMB 200-400 ($32-64) for a memorable theme park experience. That kind of consumption, says AECOM's Yoshii, was unthinkable even just five years ago. But he cautions that the latest flurry of activity isn't solely a matter of market fundamentals.

The Wonderland Amusement Park shows not all theme parks live happily ever after

"There's also the political push, that different cities want to promote themselves and they see theme parks as one of the things on their list. If they want to be an international city or a first-tier city, they've gotta have one," Yoshii says. Local governments and developers aren't necessarily aware that a good theme park is a capital-heavy, long-term investment that can take close to a decade to start paying off, he says. Cole of Mingtiandi agreed, and pointed to a similar bubble in America, long since popped.

"They did that in the US a bit too. Everyone thinks it's a great idea to have an attraction that pulls people to their city and they all want to put their city on the map, and they tend to often fail," he says.

There is also the issue of developers using theme park development as a backdoor for official endorsement of other endeavors. Schuckert says that when development projects in China are large enough, developers are required to provide value-enhancing elements, such as shopping complexes, together with another feature of either cultural or entertainment value. That is where theme parks often come in—as a box to be ticked on the road to approval.

"The primary goal is not to make revenue, it's just to tick the box in terms of a long list of requirements," Schuckert said. "This a part of the development game. So yes, there is still potential for a bubble." That potential may have been heightened by the recent go-ahead from the central government to allow theme park projects valued at less than RMB 5 billion ($800 million) to be approved. This policy change may set the stage for another rash of unprofitable and quickly shuttered theme parks.

That stands in contrast to the proven and profitable park models already on offer from firms both local and global. With these juggernauts eyeing further expansion, the market for theme parks looks to soon be saturated. Big names like Disney and Universal, or Fantawild and Chimelong, will likely thrive due to their backing and experience, while theme parks without a strong concept and marketing will dissolve as quickly as they were thought up.

China's theme park industry will almost certainly thrive in the course of the next decade. But observers can expect to spot plenty more spectral half-finished park grounds popping up along the way.

Monopoly Games

At times controversial, China's Anti-Monopoly Law is playing an increasingly important role in the country

By Colin Shek

In Beijing's bustling suburb of Wangjing, the China headquarters of Microsoft and Daimler sit side by side in identical office towers. They have been neighbors in the capital for nearly the past five years, after Microsoft arrived in late 2009 and the German automaker moved in a little more than a year later.

They share something else in common besides an address—both have been scrutinized by the government agencies tasked with enforcing China's seven-year-old Anti-Monopoly Law (AML). It was a hot, hazy day last summer when almost a hundred government investigators swooped in on Microsoft's building in a surprise show of force. A week later, anti-monopoly agents from a different authority visited Daimler's office for Mercedes-Benz in Shanghai.

More multinational corporations have since bumped up against the AML. Powerful state government departments have investigated dozens of foreign firms over alleged "anti-competitive behavior", adding to broader fears that the business environment has turned chilly for outsiders.

But Chinese firms long used to a local advantage against their foreign rivals are also bumping up against anti-trust law. China's top two taxi-hailing apps Didi Dache and Kuadi Dache announced a union worth $6 billion on Valentine's Day that drew whispers of a potential monopoly. Days later, reports emerged that the government was pondering a merger of the country's top two national oil companies, which raised questions over the wisdom of consolidating the current duopoly into a new monopolistic giant.

Both megadeals could be subject to China's newfound anti-trust activism. Such probes have fallen under the scope of the AML, which was passed by the top state legislature in 2007 and came into effect on 1st of August 2008. "This was the first comprehensive competition or anti-monopoly law," says Zhou Zhaofeng, a partner at the law firm Bird & Bird's competition group in Beijing.

Laying Down the Law

First proposed in 1994, the AML went through 13 years of drafting, deliberation and consultation before being passed in 2007. Heavy lobbying by foreign governments occurred during the lengthy legislative and development process, reflected in the final text being reminiscent of foreign models such as the European Union, United States and Japan. Forums and workshops were held for other countries to air their views—particularly between EU and US officials, and their Chinese counterparts—before the text was settled.

> "
> The competition law was viewed as a very useful tool at Beijing's disposal
>
> Martyn Huckerby
> Partner
> King & Wood Mallesons

But you don't need to read far to spot quirks in China's AML. Article 1 says one aim of the law is to "promote the healthy development of the socialist market economy". Then there are the specific requirements that enforcement agencies must take into account industrial policy considerations. These "interesting elements" suggest the AML is not solely a competition law, according to Natalie Yeung, a Hong Kong-based partner at Slaughter and May.

The AML is built on anti-trust-relevant rules scattered across different regulations, as well as two key pieces of older competition legislation—the 1997 Price Law and the 1993 Anti-Unfair Competition Law. Enforcement of the rules and laws, however, was generally patchy and they also lacked the heavy penalties typically found in competition law regimes around the world. That created the need for a broader, cross-sector anti-monopoly law with principles based on international best practices, according to Martyn Huckerby, a Shanghai-based competition partner at King & Wood Mallesons.

Encouragement and pressure from foreign governments and overseas regulators also played a part in persuading China to come up with a definitive anti-trust law. "There was perhaps a sense that it tied into China's World Trade Organization obligations," says Huckerby.

China's export-oriented, investment-driven economy hummed along during 2007, having expanded by 12.7% the year before. But there were early signs back then that China was pondering industry overhauls to some extent. "China wanted to encourage reform in a number of sectors. The competition law was viewed as a very useful tool at Beijing's disposal to be able to bring about some of the changes they were looking to introduce," says Huckerby.

An expanding private sector also hastened the need for a full and robust competition law, something that was arguably not needed when the state sector and government interests dominated the Chinese economy. The shift toward to a market economy lifted the perception that appropriate tools would be needed to regulate it. The AML fit into China's overarching approach to market liberalization, which to date has been to allow more market freedoms while retaining the ability to intervene or step in.

"Competition law is common for a market economy," says Zhou. "You need an anti-monopoly law to deal with anti-competitive behavior. China is in the process of having a market economy, so it's actually something they have to have anyway." Huckerby sounds a similar view: "As the economy has got larger, there was probably a greater perceived need for more regulating behavior in markets."

Three's a Crowd

The AML looks to protect consumers in three categories. The Ministry of Commerce (MOFCOM) is charged exclusively with reviewing mergers and acquisitions. Merger control, as it is known, "only happens when you have an acquisitive merger or establishment of a joint venture," says Zhou. Companies must notify MOFCOM if the merger meets certain thresholds, such as all parties in the deal having combined global revenue exceeding RMB 10 billion or more than RMB 2 billion of turnover in China.

The National Development and Reform Commission (NDRC) handles the pricing of everything from gasoline and natural gas to drugs and electricity. It primarily looks at instances of cartels and abuse of dominance involving price-fixing.

The State Administration for Industry and Commerce (SAIC) is the third anti-trust enforcer, and responsible for the raid on Microsoft's offices last summer. Like the NDRC, it also tackles cartels and abuse of dominance but only those unrelated to pricing.

"These three categories are identical to other competition jurisdictions. There's nothing strange about them," says Zhou. What is unusual, however, is that China has three anti-trust enforcers. Most countries or jurisdictions only have a single enforcement authority, like the EU and Japan, though the US has two—the Department of Justice's Antitrust Division and the Federal Trade Commission—due to historical developments.

Existing turfs explains why China has three anti-trust bodies that handle different forms of anti-competitive conduct. MOFCOM, the NDRC and the SAIC were previously responsible for enforcing laws and regulations that overlapped with or were similar to the provisions of the AML—and so they made a grab to retain their turfs when it came to deciding who should enforce the AML.

The presence of three agencies has been questioned inside China, with an ongoing debate over whether to have a single unified and independent body responsible for the AML. "When you have more than one regulator, the consistency of judgments will be varied," says Zhou. The other argument for consolidation was that potentially over-

> "How the law has been enforced is questionable... It's not always guaranteed that enforcement will be consistent
>
> Zhou Zhaofeng
> Partner
> Bird & Bird

lapping jurisdictions between regulators could see businesses get hit with probes from different regulators, wasting time and resources on both sides.

Those concerns have not yet materialized for the most part, thanks to a fair degree of coordination between the agencies. There are also benefits to having multiple agencies, with advocates arguing that the status quo is helpful because it fosters internal competition and learning by shared experience—thereby raising the overall quality of enforcement. But perhaps the biggest barrier to spinning off anti-monopoly duties into a single agency is inertia. Bringing about change is likely to be fraught with difficulties, as lawyers say the regulators are unlikely to cede responsibility unless it is enforced from higher up in the state government.

Each watchdog has a slightly different style. MOFCOM gets the thumbs-up from lawyers who tend to regard the ministry as the most professional enforcer, open to engagement and dialogue, and more consistent in its application of the law. "I am impressed with MOFCOM," says Yeung. "They are most used to dealing with foreign companies because that was a big part of their role before the competition law came into force in China."

If MOFCOM is the good cop, then the NDRC would be the bad cop. The commission has drawn attention with its aggressiveness and intimidation tactics used to strong-arm companies into confessions of guilt. "The NDRC is notorious for being keen to wrap things up very quickly, usually by getting the companies to admit their wrongdoing, pay a fine and promise to reduce prices," says Yeung.

Zhou attributes the cultural disparity between MOFCOM and the NDRC to their remits under the AML. "It's probably because they're dealing with different types of anti-competitive behavior. The commerce ministry only deals with mergers so it can afford to be a little bit gentler, whereas the NDRC needs to be a bit tougher in dealing with anti-trust investigations and cases." That has raised concerns about the way the NDRC carries out investigations into firms in its crosshairs.

The SAIC is seen as the weakest watchdog. It has the smallest team of investigators, the fewest resources, and in general terms wields far less clout than its peers. That has shaped the administration's approach to investigations. "They are very open compared with the NDRC," says Zhou. While it may be under-resourced, the SAIC has adapted deftly by only focusing on a few investigations at a time to build up a watertight case—with the ensuing confidence another reason for its softer approach.

Lawyers say that all three agencies are still on a learning curve. But while they may be young, they are also extremely powerful. As arms of China's sprawling government, they have the ability to impose significant penalties and demand changes to business behavior. Some claim their influence is undue, but others argue that in an economy buttressed by huge state-imposed monopolies, China needs regulators strong enough to stand up to corporate giants.

Confident Start

Application of the AML got off to a brisk start, with MOFCOM especially busy with M&A transactions. In November 2008, the commerce ministry endorsed a merger between two brewers, Anheuser-Busch from the US and Belgium's InBev, on the condition that the combined firm freeze its existing interest in several Chinese breweries—including Tsingtao, China's biggest beer exporter. That marked China's first announced merger control decision under the AML.

It was not until March 2009 that China's competition law made global headlines. In the six months beforehand, Coca-Cola had been trying to coax a $2.4 billion acquisition of Huiyuan Juice, the country's largest juice brand, past regulators.

It would have been a landmark deal—the biggest foreign takeover of a Chinese company—but MOFCOM blocked it on the grounds that Coca-Cola might have used its "dominant status" in the carbonated soft drinks industry to push up prices and limit choice for consumers in the juice beverages sector. Lawyers and experts lined up to criticize the decision, and it sparked an ongoing debate over Beijing's motives for adopting the AML.

Yet China has continued to up the ante on anti-monopoly actions. Its regulators have intervened in global mergers. Last year, MOFCOM blocked a proposed alliance between Danish shipping group A.P. Moller-Maersk, Mediterranean Shipping Company and France's CMA CGM. That rejection, on grounds that it was not in the interest of Chinese consumers, was the first time the regulator had blocked a tie-up that involved no company from China.

The NDRC joined the fray a few months later, slapping fines totaling RMB 1.24 billion ($200 million) on a group of 10 Japanese auto-parts manufacturers. That was the largest anti-monopoly penalty imposed in China until American chipmaker Qualcomm was hit with a $975 million fine in February.

Unequal Before the Law?

The growing list of foreign companies hit by anti-trust probes has prompted complaints that China is deploying the AML for nationalist or protectionist purposes, rather than to foster genuine free market competition. After European auto brands such as Audi, BMW and Mercedes-Benz were accused of anti-competitive behavior, the European Union Chamber of Commerce in China—with more than 1,800 members—asked whether "foreign companies are being disproportionately targeted".

"How the law has been enforced is questionable," says Zhou. He notes that while the AML itself does not discriminate between different nationalities, the structure of anti-trust enforcement can result in uneven decisions. "It's not always guaranteed that enforcement will be consistent when you have three authorities and so many officials from different backgrounds," he says.

The foreign community's grievances go beyond the alleged targeting to the regulators' heavy-handed conduct. "There is a concern about procedure, about how the AML has been administered," says Huckerby. "Even if you've done the wrong thing, has China gone about investigating the case in a fair manner? Have they carried out due process when they've investigated companies?"

Many targets often only learn they are under investigation when investigators

The Power of Three
China's anti-monopoly regulators

Regulator	Ministry of Commerce	National Development and Reform Commission	State Administration for Industry and Commerce
Responsibility	Merger control	Price-related matters and abuse of market dominance	Prevents monopolistic behavior that restricts competition in non-price related matters
Notable cases	Prevented Maersk, MSC and CMA GGM merger; forced Gencore to sell mine; scrutinizing BG Group and Royal Dutch Shell merger	Fined Qualcomm; fined 10 Japanese auto parts manufacturers; fined Mead Johnson Nutrition and Danone	Raid on Microsoft; ongoing investigation into Tetra Pak
Reputation	Highly regarded, professional and open, experienced with foreign companies	Aggressive, toughest of the three regulators, keen to wrap up investigations quickly	Fewer resources and less powerful, more measured and transparent, longer investigations

Source: *CKGSB Knowledge*

Both Microsoft and Daimler have had their offices raided by anti-monopoly officials

from an authority show up. Lawyers say that when agents search a target's offices in popular "dawn raids", they tend to seize more evidence than regulators would in other countries. In some cases, companies in China have succumbed on the basis of evidence that authorities elsewhere would not have been able to collect.

"In China, it's pretty much the case that they can do what they want. One of my clients had the experience of being forced to sign something that wasn't true," says Yeung.

The regulators deny they are targeting outsiders and insist they are only creating an equal playing field for domestic and foreign companies. They point to probes of Chinese companies as evidence of their even-handedness.

In 2013, the NDRC fined local distillers Kweichow Moutai and Wuliangye Yibin RMB 247 million ($39.5 million) and RMB 202 million ($32.3 million), respectively, for resale price maintenance. Politically-connected state telecom giants China Unicom and China Telecom, along with domestic financial institutions, have also been penalized for anti-trust practices.

Indeed, the next headline-grabbing anti-monopoly case in China could involve two local firms. The high-profile merger between Didi Dache and Kuaidi Dache will leave more than 99% of China's nascent mobile taxi-booking business in their hands. Experts are divided over whether the mega-merger violates the AML. "If it doesn't constitute a monopoly, then I don't know what would," says one M&A lawyer in Shanghai who declined to be named.

Not necessarily, say other experts. Much will hinge on which markets are deemed relevant by authorities. Yeung says that if the principal market affected is mobile taxi-hailing apps, then the regulators are likely to view the merged company as dominant. But Didi Dache and Kuaidi Dache may try to argue that their market is much wider, encompassing the overall transport space. Their union in that case would not restrict competition, as there are many other ways to commute.

Competition Copycat

Some experts argue that Beijing is not alone in targeting some of the foreign companies it has scrutinized. Qualcomm, for instance, is also under investigation in Europe and the US.

Yeung also notes that outsiders may be falling under the spotlight more simply because China's regulators are following in the footsteps of their peers abroad—a number of probes were prompted by Chinese authorities looking overseas to see which cases their peers had initiated and concluded in other jurisdictions. "If that's their method of looking for cases, then the natural result is they will involve foreign companies," says Yeung. "If you're looking overseas, then investigations are likely to involve multinationals."

In some cases, foreign corporates are getting caught because authorities are no longer turning a blind eye to business practices that were illegal, but tolerated nonetheless. In a country not known for the strength of its rule of law, a desire to enforce regulations ought to be applauded.

But it is also what landed the European auto brands in trouble last summer, according to Huckerby. "In the early years after the AML came into force, a lot of the participants in the automobile sector held the view that their practices were in line with the general accepted behavior in the industry, so therefore it seemed to be of low risk. Obviously it was just a matter of time until the authorities decided to target the sector and impose fines."

At the same time, multinationals—particularly those with global compliance programs—tend to blow the whistle on their infractions in return for leniency, whereas Chinese companies have less awareness of leniency and are more willing to sweep violations under the carpet.

That attitude potentially offers a silver lining for international businesses now nervously looking over their shoulder. China's anti-monopoly mania shows no sign of dissipating soon, but it could prove favorable for foreigners in the long run. Multinational firms are experienced in dealing with compliance issues around the world, and transplanting that knowledge to China will require little effort.

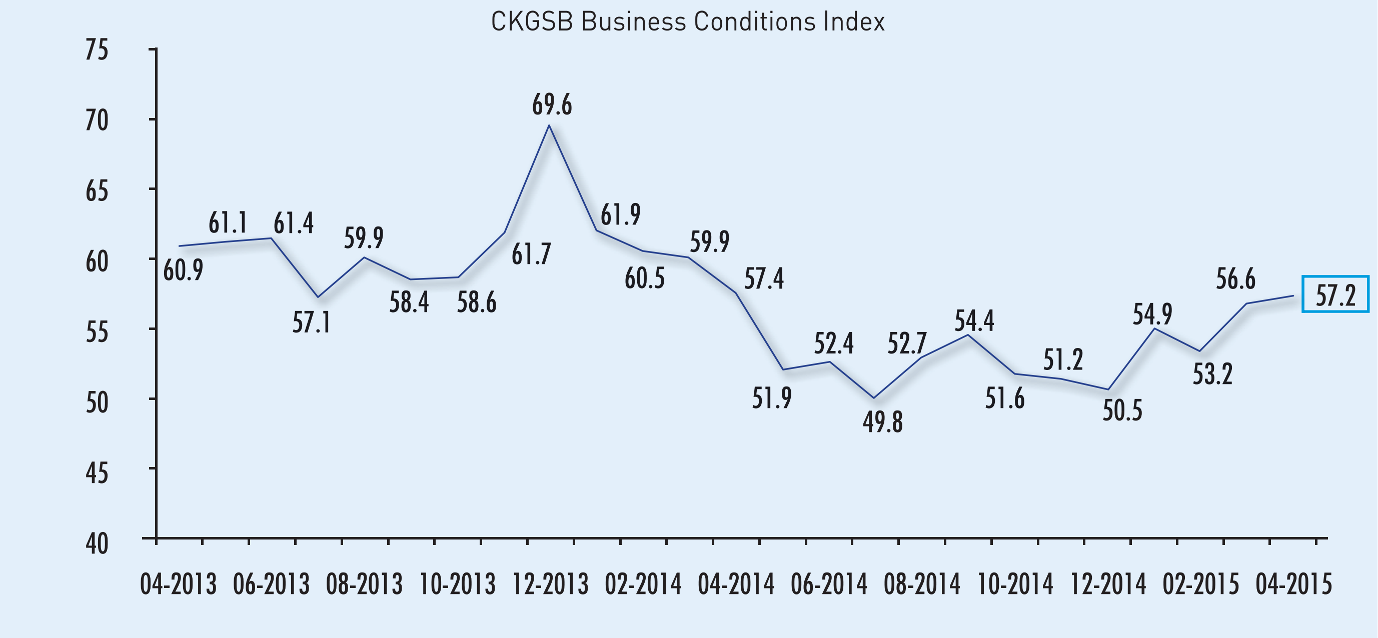
Their Chinese competitors, however, are only just starting to get acquainted with these thorny issues, and will need to invest significant time and money to ensure they don't run afoul of the law. Outsiders may complain now that Beijing unfairly holds them to a higher standard, but in years to come, they could look back on such a double standard as a blessing in disguise.

Defying the Downturn

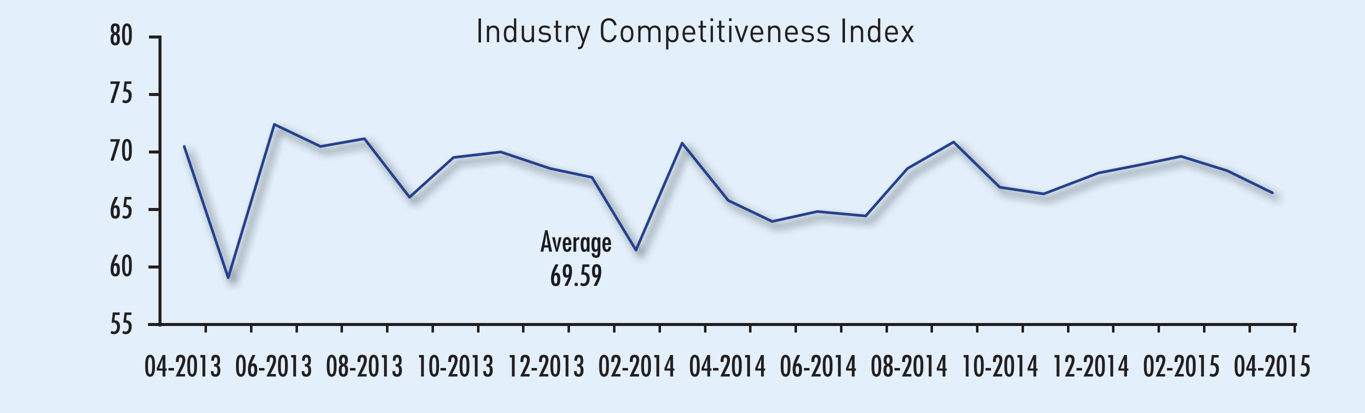
Business confidence continues to see improvements, but risks of a downturn remain

In April 2015, the CKGSB Business Conditions Index (BCI) registered 57.2, up slightly on March's index of 56.6, and above the confidence threshold of 50. Although the index has seen a small improvement in the past two months, looking at the overall situation gives us reason to believe risks of an economic downturn still exist. Price deflation, falling labor investment and inventory backlogs are key concerns. Firms should stay alert to the potential impact of these risks on their operations. The BCI, directed by Li Wei, Professor of Economics and Emerging Markets Finance at Cheung Kong Graduate School of Business, asks respondents to indicate whether their firm is more, the same, or less, competitive than the industry average (50), and from this we derive a sample competitiveness index (see Industry Competitiveness Index). As our sample firms are in a relatively strong competitive position in their respective industries, the CKGSB BCI indices are higher than government and industry PMI indices. Users of the CKGSB BCI index may therefore focus on data changes over time to forecast trends in the Chinese economy.

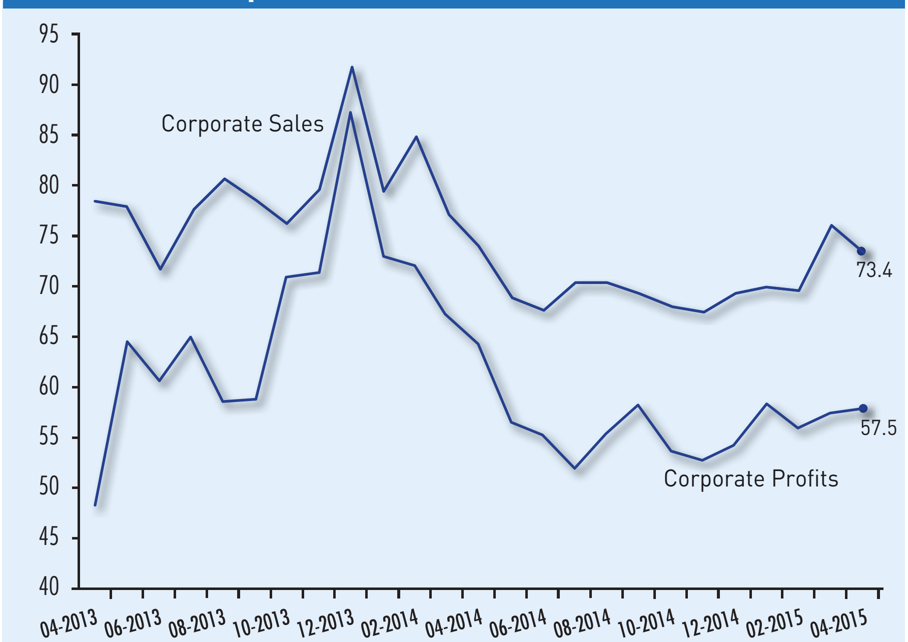
Confidence continues to edge upwards...



...even as competitiveness dips downwards

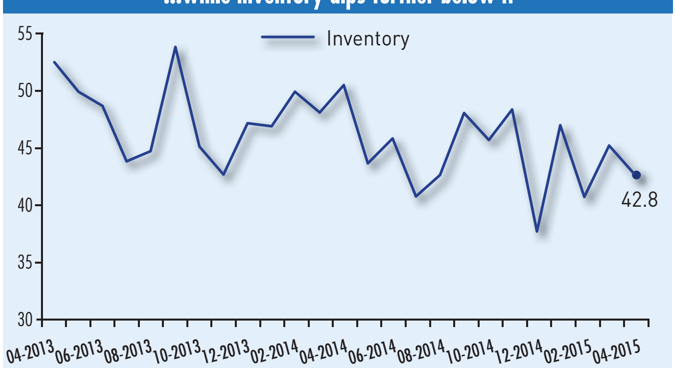


Sales and profits remain above the confidence threshold

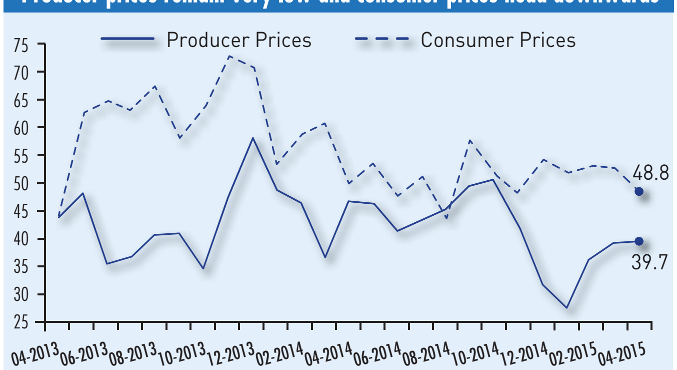


The corporate sales index registered 73.4 in April, lower than last month. The profit index registered 57.5, up on last month and higher than the confidence threshold of 50. These indices show that most companies have a positive outlook on sales and profit in the next six months. The inventory levels index registered 42.8 in April, a fall on 45.1 in March, so inventory pressures will remain serious. The consumer prices index registered 48.8, down on March's index of 52.7—these existing deflationary pressures need continued attention. The producer price index has increased over the past three months, but remains very low at 39.7. Conditions for the industrial sector remain depressed. Overall, the April BCI shows a positive outlook for business in China. But given the run of low indices that began in 2014, macroeconomic risks clearly remain.

...while inventory dips further below it



Producer prices remain very low and consumer prices head downwards



Rules of the Game

A proposed change to China's foreign investment law could have big implications for foreign investors

By Chris Russell

Additional research by Georgie Barber

On the 19th of January, a seemingly normal Monday much like any other, the Ministry of Commerce (MOFCOM) heralded a possible new era for foreign investment into China when it issued a new draft law for comments from the public. A speech by a ministry spokesperson accompanying the release of the draft may have been thick with high-flying rhetoric, but it made immediately clear that the draft was more than a mere repackaging of existing laws; instead, it would change the fundamental rules for foreign firms in the country, both relaxing and tightening government oversight. And media coverage quickly homed in on the hypothetical impact of the draft on variable-interest entities (VIEs), a controversial foreign investment legal structure used by mainland tech firms and some major multinationals.

Exactly how those changes shake out for foreign firms, despite some of the grave predictions that have been made since January, is still shrouded in at least some uncertainty. But given China's status as the world's top destination for foreign direct investment—last year it overtook the US, according to figures from the United Nations Conference of Trade and Development—any developments in this area will be felt around the world and will be of particular interest to the many major multinationals who have pumped funds into China over the last few decades.

The Rule Book

Current rules on foreign investment in China are a complicated web of laws and regulations that have evolved since the 1990s as the economy opened up and became more market-oriented, as well as in response to China's preparations for accession to the World Trade Organization. These include foreign-investment-specific laws, such as those on the various company structures that can be used by foreign investors, as well as more general rules like company and contract laws.

Of particular note to foreign investors is China's investment catalog, which has been in use since 1995 and is updated roughly every three years. The catalog serves to guide investment into and away from certain areas by dividing different sectors into those that are 'encouraged', 'restricted' and 'prohibited'—while those not specifically listed are considered permitted.

> "They've made it clear… that VIEs are illegal under Chinese law
>
> Steve Dickinson
> Partner
> Harris & Moure

The catalog was most recently updated in April, following a draft version circulated in November last year. That draft was arguably less restrictive, but the European Union Chamber of Commerce nonetheless said in a press release that, although a "positive and incremental development", it "falls short of the European Chamber's expectations—and, in fact, is only a small step for the Chinese Government's own stated ambitions of giving full play to the market". The chamber argued that moves should be made instead towards a so-called negative list, as was used initially in the Shanghai free-trade zone (FTZ) and which has since expanded to the other FTZs that have emerged across China.

Existing regulations have also given rise to VIEs, which are used to circumvent restrictions on certain sectors, most notably technology. Employed by Alibaba for its listing on the New York Stock Exchange, and also used by companies such as Baidu and Tencent, a VIE allows for foreign investment through a chain of overseas-listed companies, onshore foreign-owned subsidiaries and service contracts with domestic firms wholly owned by Chinese citizens.

But with the new draft foreign investment law, all this may soon change.

Rolling the Dice

The age of these regulations and their need for consolidation and updating has made a new law a more pressing concern. "The current foreign investment laws were published quite a while ago… and the government feels it's an appropriate time to do a general overhaul," says Terence Foo, a partner at Clifford Chance. Kenneth Zhou, a partner at WilmerHale, notes that the draft law would represent China's first unified foreign investment law.

Steve Dickinson, a partner at Harris & Moure, also feels that current rules are well overdue for an update. "[Existing regulations are] completely out of touch with the reality of foreign business operations in China now," he says. "They've really become completely dysfunctional, and so a change is certainly needed."

To that end, the draft law first and foremost streamlines existing regulations, specifically those concerning the formation and operation of foreign-owned enterprises. Dickinson points out that the draft is actually better understood as a companies law. "It's not about foreign investment, it's about the vehicles, the corporate and business vehicles used for foreign investment," he says. "Really it's the foreign companies law, the foreign-owned companies law."

At the moment, the rules for foreign-owned companies and domestic companies are unequal, and another key point of the draft is to put both on a more equal footing. "The current status quo is that there are two sets of regulations that apply to two types of companies, so there's one set of regulations that apply to foreign investment enterprises and one set of regulations that apply to domestic companies," says Foo. "Another reason driving this is the wish to harmonize the regulatory framework."

Presently, formation of a company can be a lengthy, laborious process. Dickinson notes that currently this can take at least four to five months—even for the simplest form of foreign-owned enterprise—and costs significant sums of money, whereas domestic companies not operating in a sensitive area can finish forming within two weeks.

"When you do a company formation in China that's got a foreign ownership element, you're not just simply being approved to set up the company," Dickinson says. "Your entire investment project is being reviewed and approved." He adds that this is not an area where government officials have expertise, and that decisions are made with reference to the investment catalog—whether the investment is desired or not.

Now, at last, the call of the European Union Chamber of Commerce is being heeded, with the negative list pioneered in the Shanghai FTZ incorporated into the draft law. With this in place, company formation would be reduced to a simple filing procedure in cases where the company's sector was not specifically listed, a "radical departure" in the words of Foo.

Another important development relates to China's national security review, an equivalent to the Committee on Foreign Investment in the US. This was introduced by MOFCOM in 2011 and scrutinizes investments that may have implications for national security. The draft suggests that the review will be applied more broadly to foreign investments that "would have or possibly have national security concerns", although it does not specify what industries it would apply to. Moreover, national security review decisions would not be subject to any administrative or judicial review.

"The fact that this draft, the new draft law [has] an entire section on this national security review, I would expect that China is going to be more active in the future in terms of actually enforcing the national security review legal regime," says Kenneth Zhou. So far there have been no notable cases since the rules were introduced, he points out.

Game Over?

But perhaps the most contentious change in the draft law relates to VIEs, even though no specific mention is made of them in the draft. Nonetheless, Zhou says some clauses have the potential to impact VIEs, while a consultation note accompanying and explaining the draft raised the issue of VIEs along with proposals of how to deal with them. Dickinson is much more blunt in his view on the aims of the law and what it means for VIEs: "Just by floating the law, they've made it clear… that VIEs are illegal under Chinese law and have to be stopped," he says.

In the Firing Line

VIEs that could be threatened by the foreign investment law

Source: *Wall Street Journal*

The implications for VIEs result from how the draft interprets control of a company. VIEs have always served to facilitate foreign investment in restricted areas, as the domestic company in play was fully Chinese-owned and thus able to obtain the necessary licenses. The new draft now defines domestic enterprises as foreign enterprises if the latter can be said to control the former. The same idea is also applied in reverse, and a foreign company can be considered to be a Chinese company if it can be demonstrated to be controlled by Chinese investors.

"The definition of control is quite broad," says Foo. "It's not just owning 50% of the shares or having the right to appoint the majority of the board… it [includes] the ability to influence the decisions of the board or the shareholders meeting, or the ability to exercise decisive influence over a company through contractual arrangements."

In the case of public (as opposed to private) VIEs like those used by Alibaba and Baidu, the influence of shareholders puts the parties involved in a tricky position. "Every VIE by law is controlled by foreign individuals because every VIE is a public company and foreigners are the shareholders, and by law foreigners are the actual control force in any public company," says Dickinson.

As a result, Dickinson describes the arrangement as "good on paper", but "completely unworkable in practice", even with attempts to allow for Chinese control of foreign companies. Such a condition is seemingly meant to allow for a situation where the Chinese executives of a company could point to a covenant where the shareholders agree to forego their rights to influence the company, but such an arrangement would be unacceptable to many as this would go against standard practice.

Moreover, Dickinson points out that the government has no expertise in determining who controls a company, and Foo notes that the situation is further complicated by Chinese people who have taken overseas citizenship since it is unclear how they would be regarded.

Although those in unrestricted sectors will not be affected, what the draft law means for VIEs in sensitive sectors like tech or communications is not yet clear. For one thing, Foo says the draft doesn't contemplate an automatic grandfathering system (meaning the new rules would not apply, at least in some instances, to existing cases)—instead, the explanatory note proposes three possible approaches whereby a VIE company would report that it is controlled by Chinese investors, apply for certification of that control or apply for foreign investment approval.

Given the sensitivities involved, it is unlikely any rash action will be taken. "I think the Chinese authorities also will probably take a practical view considering how widely used the VIE structure is, so the question mark is to what extent and how they will grandfather existing structures," says Foo.

The authorities themselves may be uncertain how to proceed. "From MOFCOM's press release and the explanation on the background of the law, you can tell they have not yet made up their mind," says Zhou. He also points out the practical difficulties involved in cracking down on existing VIEs, not only on account of their prevalence and the influence of the companies that use them, but also because the VIE is a set of contractual arrangements that are not subject to approval by or filing with MOFCOM or other government authorities. Many are still implementing the VIE structure, he says, despite recognizing that the outlook isn't entirely clear.

Questions remain then as to how VIEs will be dealt with, but what is clear is that authorities are well aware of them and they will face growing scrutiny going forward.

Back Three Spaces

Aside from VIE questions, foreign firms consider the draft law a positive development, not least because of how the negative list streamlines and unifies many regulations. That said, other concerns remain.

"It does appear to impose more onerous information reporting requirements on foreign-invested enterprises, which are not the same as domestic enterprises," says Foo. "On the one hand [the government] is opening up and relaxing the approval requirements for foreign investment generally across the board, particularly in areas that are not considered sensitive, but on the other hand they are strengthening their ability to intervene, for example through the national security review, where foreign investment is made in certain sensitive areas."

> "China is going to be more active... in enforcing the national security review
>
> Kenneth Zhou
> Partner
> WilmerHale

Concerns center on how that intervention might be used. "I would say the national security review is one of the key things the Chinese government can use in terms of enforcing its industrial policies," says Zhou, who is also General Counsel of the American Chamber of Commerce in China. He likens the review to the authorities' recent use of the Anti-Monopoly Law.

There may also be some technical difficulties with the law. "Some of the clauses are not likely to be able to be enforced because they create unnecessary difficulties in terms of provision of information, in terms of information disclosure—it's just difficult to actually be implemented," says Zhou. He also points out that the "devil is in the details," many of which are still waiting in the wings. "There will be detailed implementing regulations after the law is promulgated, that's always the case… [the law] is not going to be the end of the story."

Square One

For all the positive and negative implications of the draft, the law-making process in China is often a lengthy one, and it may still be some time before a finalized foreign investment law comes into being. As has happened with other drafts, it could also be subject to radical changes along the way as different government bodies have their say. Dickinson notes that China's tort law took several years to pass, and "the document that was adopted was nothing like any of the drafts that were published."

Zhou is more certain there won't be substantial revisions, saying, "I would think the main structure of the draft is not going to be changed, so all the key stuff is still going to be there."

In terms of timeframe, the draft still needs to go to the State Council, China's top decision making body; the National People's Congress (NPC), the country's legislature; and various regulatory bodies. The NPC's yearly legislative plan does not give the law first priority, nor has the State Council prioritized the law. But some experts think that the law is more likely to be passed in 2017.

Further indications of when the law might finally be promulgated will likely come later in the year. "If this law has any hope at all, then there will be another draft out in August" ready for the political meetings in the fall, says Dickinson.

But whenever it is finally passed and implemented, the proposed foreign investment law—at least as it currently stands—looks set to be a mostly welcome and overdue update consolidating and clarifying China's many fragmented and uneven regulations. Provided the draft's main thrust remains in its final form, foreign investors will likely welcome its implementation, in spite of some potential headaches it may cause.

Round the World Trip

Leading Chinese online travel company Ctrip now faces the dual challenges of overseas expansion and stronger competitors

By Nicole Sy

Nancy Zhou, 23, and Amy Fang, 22, giggle over pictures they had taken during their time in Paris this Spring. Nancy was studying in Europe for a semester when Amy came from Beijing to visit, before heading to Sweden for a first-hand look at one of the graduate schools she applied to. Both girls are recent graduates of Beijing Foreign Studies University's International Relations course, a program with a reputation for churning out globetrotters.

Their first stop when booking tickets? "Ctrip," answers Nancy. Although perhaps unfamiliar to many outside China, the Nasdaq-listed firm has used its first-mover advantage in the country to dominate the online travel space, becoming China's largest online travel agent (OTA) in the process and capturing 55.9% of the OTA market in Q3 2014. But China's tourism industry is a dynamic one, and Ctrip's status, competition and expansion plans provide a window into the state of the market.

Now the world's third-largest by market capitalization after Priceline and Expedia, Ctrip plans to expand internationally to serve the ever growing numbers of outbound Chinese travelers like Nancy and Amy. To that end, in a deal that culminated in January this year, Ctrip purchased a majority stake in London-based travel content aggregator TravelFusion for a reported $160 million, allowing Ctrip's customers to search for and book a greater number of international flights, trains and hotels, as well as enhancing Ctrip IT systems.

Bolstering Ctrip's position in China's international travel market was the stated aim of the investment, and it looks to be just the start. "Starting with TravelFusion, Ctrip will invest in totally foreign companies," CEO Jianzhang Liang said in an interview with the *South China Morning Post* in February.

But the company can't take its eye of the domestic scene. Although Liang predicts there will be "blowout" growth in China's online tourism market, Ctrip's largest competitor remains offline travel agencies, still the preferred choice of most Chinese travelers, and the years since Ctrip's founding have seen the emergence of more online competitors such as Qunar, meaning Ctrip will continue to face challenges at home, even as it ventures abroad.

Taking Off

As with many sectors in China, tourism has witnessed prodigious growth in recent years. In 2014 the industry's revenue reached RMB 3.38 trillion ($551 billion), growing 14.7%, according to a *Xinhua* report quoting Du Jiang, Deputy Director of the National Tourism Administration.

As tourism grows, the nature of the market is also changing, says Feifei Xu, Brand Strategy Director for brand consultancy Labbrand. "When GDP reaches $5,000 per capita, the tourism market will mature," she says. "In leisure travel, they will have a lot more needs that weren't there before, like adventure tourism, travel[ing] to relax." In 2013, China stood at $6,807 per capita, according to the World Bank.

That increased wealth will be felt more and more in the tourism market. Enfodesk, a market research company, reported that the online tourism market is set to reach a value of RMB 352 billion ($56.7 billion) in China this year, and is expected to reach nearly RMB 500 billion ($80.6 billion) in 2017.

Such growth is also being witnessed in the area of travel reservation apps, and 2014 was a landmark year for them according to a China Internet Network Information Center (CNNIC) report released in February. They beat out every other category of mobile apps with an annual user growth of 194.6% year-on-year. Moreover, 53% of Chinese international travelers book online or via mobile apps—especially for independent travelers under the age of 25—overtaking traditional travel agencies.

"In the future, there will be 70% of Chinese travelers using the internet, which is the biggest proportion of all countries in the Asia-Pacific region," says Zhen Lu, Associate Professor at the Ted Rogers School of Hospitality and Tourism Management at Ryerson University.

Charlie Li, China expert analyst of travel research company Phocuswright, says such adoption has beaten expectations. "The travelers are actually shifting to the mobile side very quickly… much more quickly than what most of the industry experts expected before."

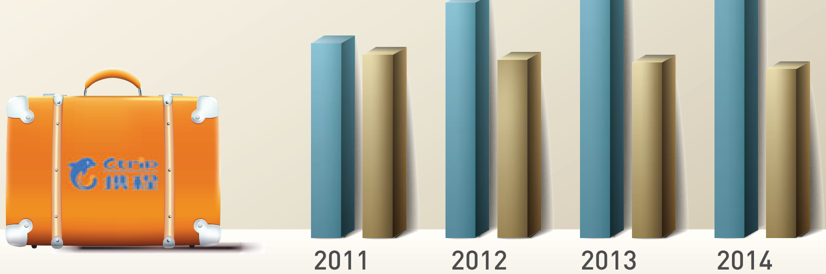
Ctrip has been quick to capitalize on that shift, pushing its own mobile app, with the company's 2014 earnings report noting that cumulative downloads reached nearly 600 million by the end of that year, growing over 70% from the previous quarter. In addition, over 70% of transactions were made through mobile platforms during the Chinese New Year holiday.

"Ctrip has built itself as a very dominant player in the online market. They also made some very strategic investments, especially last year," says Li. "They are investing very

Less from More

Ctrip's annual revenue and gross margin

Year	Revenue	Gross Margin
2011	RMB 3.5 bn	77%
2012	RMB 4.2 bn	75%
2013	RMB 5.4 bn	74%
2014	RMB 7.3 bn	71%



Source: Ctrip

aggressively in new technology development on mobile, and big data."

Set for Expansion

As China's consumers have gotten richer, they've increasingly ventured abroad, both for business and leisure, and it makes sense for Ctrip to tackle this growing market. Chinese outbound travelers spent RMB 1.3 trillion ($498 billion) in 2014, according to China Confidential, the *Financial Times*' research service. And that year was a big one for the company in terms of strategic partnerships they formed to reach a larger audience. "They are trying to attract the outbound Chinese consumer with more choices and more options," says Li.

Their biggest partnership culminated in August 2014, when Priceline, the world's largest OTA, purchased a 10% stake in Ctrip for $500 million, allowing both websites access to each other's portfolio of products. In addition, Ctrip also partnered with Madrid-based Amadeus to provide "all air content for points of sale outside of mainland China", and has partnerships with cruise companies, Chinese car rental and services providers, and minority stakes in local hotel operators.

In making these partnerships, Ctrip is extending its ability to be a one-stop shop for consumers. "Their international expansion aims to offer Chinese outbound travelers or foreign companies in China an extension of their value-chain platform of tourism," says Xu.

"We are currently trying to build up brand awareness in overseas markets through our public relations and social media efforts," writes William George, Ctrip's Marketing Communications Manager, in an email. "Currently our biggest markets are outbound Chinese travelers and domestic travel."

But it hasn't been all smooth sailing. Expansion comes with problems familiar to all companies going beyond their original borders. "Some difficulties they might encounter are cultural differences, different management styles with their international partners," Xu says. "They are just like any company expanding internationally."

Moreover, operating margins continued to slide from their heavy investment in 2014—2% compared to 16% in 2013. Product development expenses for 2014 increased 86% from 2013, according to their earnings report. Sales and marketing expenses and general and administrative expenses also increased.

> Once you have the Ctrip app… you probably think it's not necessary for you to get another
>
> Charlie Li
> Market Analyst, China
> Phocuswright

Their heavy focus on customer services (Ctrip has run award-winning call centers throughout its history) also comes at a premium, with the strategy paying off for some segments of the market, but not all. "For business travelers, Ctrip is their first choice because they are not as price-sensitive. The higher-end travelers appreciate the services," Xu says. "But personal travelers are more price-sensitive, and there are more personal travelers than business travelers." That is where Ctrip generates much of its revenue, with corporate travel only accounting for 4.8% in 2014.

In addition, there has been a dramatic drop in high-end and government travel, according to Lu, compounding the situation. And the composition of China's tourism market is also changing. "Millennials have become a major force… They have very distinct travel consumer behaviors," he says. Appealing to that market remains an ongoing challenge, although one helped by the company's increased emphasis on mobile.

Heating Up

In addition to the traditional offline travel agencies that it has always faced, some of Ctrip's biggest competitors now come in the form of other OTAs who have been able to strengthen their positions. These include eLong and LY.com, who had 9.7% and 6.3% of the market, respectively, in Q3 2014. And then there is Qunar, a metasearch site rather than a strict OTA.

Although Ctrip is still in the lead as China's largest OTA, competition has intensified a great deal since its establishment in 1999, not least because its rivals are also backed by the country's and the world's largest tech companies. eLong and Qunar have received investment from the Chinese internet giants Tencent and Baidu, respectively, with eLong also being a subsidiary of the world's number two OTA, Expedia.

Although Ctrip was a first-mover and pioneer in the field of online travel, its market share, although still dominant, has fluctuated with the rise of its competitors. Statistics from iResearch show that in 2012 Ctrip's market share stood at 45%, while eLong's hit a high of 16%. But the following year Ctrip rebounded to 50%, with eLong's falling to 10%.

"Qunar is one big competitor, but they offer different services. They are a search site and offer software services to travel agencies, for them to put the agencies' lowest price offerings on their platform," explains Xu. It offers a wide range of search results from airlines, hotels and other agencies, including Ctrip. Meanwhile, eLong focuses on hotel offerings.

While Ctrip, eLong and other smaller competitors mainly work much like a traditional travel agency, Qunar uses a different model. Instead, Qunar earns by pays per click or per successful transaction and the user buys from the travel agency they've been directed to. That means agencies must still compete with each other, resulting in price wars.

Price-cutting is the primary source of Ctrip's relatively tighter finances because it whittles down margins, according to Li. "They are competing head to head with their competitors like Qunar, eLong and Alitrip, so the price-cutting is becoming much more aggressive than before," he says.

In a speech in Shenzhen, Zhang Weining, Assistant Professor of Accounting at CKGSB, noted that using standard measures of gross profit margin, Qunar's has been higher than Ctrip's in recent years, but when marketing costs are properly factored in (the adjusted gross profit rate in Zhang's terminology), Ctrip's is in fact higher, and the company is much more effective at attracting users. That said, Qunar's adjusted gross profit rate is actually increasing year by year.

That helps explain the highly competitive relationship between the two companies. This manifested itself in September last year, when Ctrip cried foul over Qunar's search results—they removed their hotel offerings from Qunar, saying it was no longer a neutral travel search platform. Then in December Ctrip announced they were putting aside a RMB 1 billion fund in order to engage in a price war and offer zero-profit tourism products. Price wars and zero-profit products are unsustainable in the long run, but Ctrip clearly hopes it will help them achieve an unassailable position first.

But despite the intensity of the battle they are waging with other OTAs, these aren't even Ctrip's biggest competition—that would be offline travel agencies, who are generally preferred by middle-aged and older travelers. The online travel market represented only 10% of the entire travel market in 2013, although it is set to double by 2017, according to CNIT-Research.

That is in spite of the offline sector being hit by the country's first national tourism law, which came into effect in October 2013 and banned hidden traveler costs such as compulsory shopping excursions. Tour agencies could previously offer low rates to customers, only to make up the difference with commissions from shopping trips.

But Lu is optimistic about the online travel industry. "Tourism products are one of the most suitable products for online sales. OTAs, one day, will probably eliminate the traditional travel agencies," he says. "Traditional offline travel agencies, tour operations are only the providers of tourist products (such as tours, tourist attractions tickets, etc.) for OTAs."

Moreover, the line between online and offline in the travel market is blurring, with the latter investing in online, and vice versa. "Ctrip has been moving to the offline [market] by investing in some big travel agencies," says Li. That includes offering group-organized tours and products from offline tour operators on their own platform, he says.

In March, the OTA Tuniu acquired majority stakes in two offline travel agencies with licenses to offer and operate tours in Taiwan, expanding the company's reach outside mainland China. Qunar has likewise invested in an offline tour agency based in the city of Chongqing in southwest China, and offline tour operator UTour from Shanghai has dipped its fingers in investments online.

Big Fish Eats Small Fish

The market appears to be consolidating with a string of purchases and investments from larger OTAs. Ctrip acquired Tours4Fun, a vacation package site targeting Chinese traveling abroad, in January 2014 reportedly for more than $100 million. In addition, Ctrip and JD.com, who relaunched their own travel site JD Travel in June 2014, invested $15 million and $50 million in Tuniu, respectively. JD.com followed this up with an investment of $350 million in May.

Surprisingly, at one point the trend of consolidation looked set to include bitter rivals Ctrip and Qunar. Rumors of merger talks between the two companies swirled in April 2014, though eventually nothing came of it. "There were talks about the merger, but it ultimately didn't push through because both the CEOs of Ctrip and Qunar have strong personalities," Xu says. "But they have most of the same investors, so they want them both to succeed."

Problems with Qunar's financial performance may have also been a factor. "Qunar recorded some big losses last year, about RMB 1.8 billion. Their controlling shareholder, Baidu, is not satisfied with their performance… I think Baidu is pushing for this deal at this moment," says Li. "It's good for the investors of these companies. But it's not good for the consumer because less companies means less offers and less choice."

While that particular union might not have come to pass, Li thinks this trend of consolidation will nonetheless continue. "I think… the online market will have less fragmentation. Like in the US and Europe, right now there are only two major players, Expedia and Priceline," he says. "I think a similar thing will happen in China."

Acquiring new customers is also becoming harder, presenting a large barrier for new players, especially if mobile is the new face of the industry, as these platforms can serve to tie consumers in with one OTA. "Once you have the Ctrip app on your mobile, you probably think it's not necessary for you to get another app," says Li. He notes that consumers are becoming more impatient and they want the convenience of being able to rely on one app, which makes it harder for newer and smaller players.

But while the market is becoming saturated, Xu is confident of the industry's growth. "For this industry, I'm optimistic because the tourism boom is ongoing and it will develop very quickly in the future."

Ctrip has reason to be too—for proof, look no further than their positive Q4 2014 earnings report, which stated that 2014 net revenues were up 36%, and profits reached RMB 5.2 billion ($845 million), up 23% year-on-year.

The company's investments have started to pay off, and project further growth for the year ahead. Ctrip's guidance suggests net revenue growth of approximately 40-50% for Q1 2015, though they admitted that the Chinese online travel market environment is becoming aggressively competitive. It is planning for strong bottom line growth by the year 2020, with high operating margins between 20-30%.

If that comes to pass, Ctrip looks set to maintain its position at the head of a significant, albeit reduced, group of online travel companies.

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Foot to the Floor

Karsten Engel, President and CEO of BMW Group China, on the company's run in what is now its largest market globally

By Neelima Mahajan

Three German automakers—BMW, Audi and Mercedes-Benz—rule China's luxury car market. BMW entered China in 1994, a time when car imports weren't really permitted unless you had a special license. In its first year in China, BMW sold 800 cars. Ten years later it sold 20,000. A joint venture agreement signed with Brilliance China in 2003 gave BMW the ability to produce cars locally, which contributed to its spectacular rise in the Chinese auto market—the company sold 450,000 cars last year, a number that is still growing.

The year 2013 marked a significant turning point in BMW's China journey: China became its biggest market in the world. In this interview, Karsten Engel, President and CEO of BMW Group China, talks about what it takes to succeed here, adjusting to the "new normal" and marketing to the Chinese consumer.

Q. As someone sitting at the helm of the company and watching this market change, what does it take to quickly adapt and grow in China?

A. The key of our strategy is that we are in China with Chinese people, for China. Knowing that [China] will become a very big market, we always had a team here consisting of mainly excellent Chinese people, and expats only in those positions where we needed them, to train our Chinese colleagues. This has proven to be a very successful [strategy] as it helps us integrate the four legal companies we have here in China: our import company, our joint venture, our financial company and our purchasing company. With this strategy we think we are well suited for all the challenges [of] the future.

Q. In some ways you had a bit of a late start in China in 1994, Audi was already here and pretty well entrenched in this market when you entered. How did that impact your entry strategy?

A. We saw that there will be a premium market in China. The car market had started in the mid-1980s, and there were, of course, people still on bicycles. The first cars were very simple. In 1994 we saw the emergence of the premium segment. So it was not a delayed start, it was perfect timing to coincide with the emergence of the premium market. It proved to be very efficient as we were able to build the knowledge and the network before we took the big step of going into the joint venture. We had a good understanding, and this also helped us to find the most suitable partner for production.

Q. In some ways China was also a risky bet back then: what if the premium market did not take off as expected?

A. We saw this development in many countries. First of all, individual mobility seems to be a desire of the people—they want to have a car. Once they have a car they want their next car to be better. So there is a normal way upwards in the direction of the premium. The growth of the overall car market in China is similar to the GDP growth of the country, but the premium car market is always growing stronger, faster than the normal passenger vehicle market. So we saw positive development over the past 20 years—premium developed much stronger, and we also expect the premium segment to develop faster than the passenger car market in the next 5-6 years.

Q. Despite the slowdown and the clampdown on luxury purchases?

A. This is independent. Our customers are people who have a bit more money than others. To enter the premium segment, you should [have] more than $80,000 net household income per year, and there are currently about 15 million households in China in this bracket, and we expect this to triple to 45 million in the next 10 years. These are potential customers. The GDP growth, of course, helps the emergence of the middle class. There is already quite a lot of accumulation of wealth in China. Of course there are topics like anti-corruption, anti-monopoly, which will also stabilize the political and economic base of this country, so it's all in the right direction.

Q. What are you doing to tap smaller cities and also the western region in China which are obviously very different from Beijing and Shanghai?

A. The growth in China of the overall market will come more from the western regions and from the smaller cities, and we were the first to concentrate on building dealerships there. We still have the largest number of dealers in tier 3, 4 and 5 cities and are concentrating on developing more cities in the future. In a lot of cities we are the first premium car dealer, so this helps the brand, because we can establish the brand before competition, but also there are special challenges. A BMW [dealership] in a smaller city is one thing, but having the right people, being able to do the job in the best possible way and to a high level of customer satisfaction [is another]. So we are running the biggest training program in the world—about 50% of all the training days we are conducting worldwide are being done in China; more than 250,000 man training days. Nobody has done this before. We get younger people [and] train them. Those people are relatively stable so the attrition rate is not too high in the dealership, not as high as elsewhere. And we can build our brand. We need new concepts for our dealerships in those cities—they must be smaller, concentrating on service and providing customer satisfaction.

The growth in China of the overall market will come more from the western regions and from the smaller cities

Q. In China you need to market in very innovative ways, and one of the tools you deployed was the BMW Lifestyle shop which carries BMW-branded merchandise, such as super expensive bicycles. Maybe you were targeting consumers at a very perceptual level. Can you explain the thinking behind it?

A. We have more than 20 of these Lifestyle Shops in China, and we decided [on] this concept more than 10 years ago as we did not have many dealers at that time. It's only in China, but as we now have a lot of dealers who are selling lifestyle, we don't need these shops any more in tier 1 cities. We still have some at airports, and [in] tier 2 or 3 cities, but all the others are slowly disappearing. The concept is not necessary now for this, but we have concepts here, where the dealerships are more outside Beijing, so we need fast lane service, where customers can drop their cars off in the morning and pick them up in the evening, and we take care of the service somewhere. These are China-specific projects which are developed here. After a couple of years they will probably disappear.

These Lifestyle Shops were there to create brand awareness. They were profitable. We had them in excellent locations where we would not normally have a BMW dealership, and at that time many people did not know what BMW stood for, so they saw our logo and they got in contact with our brand at an early stage, and they probably saw the BMW advertisement later and said, "I probably can't afford the car now, but at least I'll take a T-shirt or a hat or a bicycle!" Everything helps to build up brand awareness—you have 1.3 billion people living in China and you couldn't do enough advertisement in the print media or television at that time to get close to all of them. Today it's easy, with smartphones [and] new channels to approach new customer groups, to approach younger people and to get in dialogue with them.

Q. What are some of your new marketing concepts?

A. The most important is our experimental marketing. Car drivers are young, they are born post-80, and soon post-90. The concept of premium has not been fully developed as in other mature countries, so the best way to make people feel the innovation and the class of BMW is to let them drive. So we are doing extensive experimental marketing—going to cities, inviting people to [test] drive the car, to do drivers training… Especially now in the smaller cities—we are not doing it in the bigger cities any more, they are mature enough—that's the approach to enter. The new concepts of cars—like the 2 Series Active Tourer—are for people who do a lot of outdoor activities, or small families who want a premium car. They are also the main target group in smaller cities, and probably this car will be the first premium car those customers will buy. Once you have them, it's up to the dealer and our normal marketing to keep those customers loyal.

Q. And where does e-commerce fit into all of this?

A. It is getting more important by the day. In the normal communication via print or TV, you create awareness. There's a new product for your brand, so people aspire to your brand, they probably aspire to your product. But there are so many products. You can't communicate them all via print or TV. So e-commerce, or 'e-communication', is becoming the most important way to communicate. For some of the cars we are only in that area—we are not going in print or TV.

Q. So this depends on the segment?

A. You can target much better your target customers than in the past. E-commerce, then selling via smartphones, this has not really started. The consumer today is very well informed via smartphones—actually 70% of the post-80s [generation] only use smartphones for their communication. They are extremely well-informed. They go to the dealership and say, "I want this car, and by the way, this is the price of the car [that] I can get, can we talk about this?". A car is still a high-touch, high-feel product—you want to see it, look at the color and the leather, sit in it and do a test drive. And you would anyway need a very close link to the dealer for insurance and maintenance. The actual sale is in the dealership, and afterwards the dealing [with the customer] is between the dealer and the consumer directly in the dealership.

We have several [tie-ups with] all these verticals—Autohome, Tmall is the latest one.... We started with [selling the] Mini [on Tmall] and now with BMW. It works well. It's more a marketing tool in this way, it's not really our intention to sell a lot of cars via this [approach].

Q. How do you view the electric vehicle opportunity?

A. It's a big one all around the world, and China will become the largest market for new energy vehicles worldwide. The government is determined to make it successful, for good reason—there are so many cars on the road, [and they] influence air pollution. The energy for new energy vehicles is being produced somewhere, then it comes to the car via the wall box. We are in very close contact with the Chinese government in helping them build this industry. We are also installing wall boxes for all our customers, so you can't buy an electric car from us without a wall box. And only if your landlord permits you to install a wall box or a socket or whatever, will we sell you the cars.

The target of the government, 1 million cars in 2020, is achievable. It is not a lot actually in a market that will sell about 25 million cars in 2020, it is still only 4%. We are developing along with our joint venture cars in China, for China. The 530LE is the first premium plug-in hybrid car developed in China, and produced in China, and only sold in China, and there will be more cars coming.

> [E-commerce] is more a marketing tool… it's not really our intention to sell a lot of cars via this [approach]

Q. Do you see a lot of competition within this segment? There's obviously Tesla, which is very expensive, and then there are all these Chinese cars which are at the low-end.

A. The car industry is probably one of the most competitive industries worldwide. This specific industry, new energy, is just emerging, so there is no real competition yet, there are not many products yet available. There are some coming in the lowest segment, but in the [high-end] segment, everybody is trying to develop the cars and figure out in which direction it will go. The numbers we are selling are still very small—the main reason is the lack of recharging infrastructure, but this will come, and the government programs are very extensive here. This market will come, also supported by government regulations. Here in Beijing we have now 150,000 car licenses [a year]. It used to be 10% and now it's 20% of these cars have to be new energy vehicles. The government is steering it actively in that direction.

Q. What does "the new normal" in China look like from the automobile sector's point of view?

A. We have to be happy that the growth rates of the past are past and gone—30-40% growth rate a year is not sustainable for the country and the company because you can't build the knowledge, network, quality [and] customer satisfaction with those rates. So if you have rates of 6%, 7%, 8%, it's still a huge growth, as the base is now very large in China—it's the largest car market in the world—so with such growth numbers, on a normal level, it's much better and more efficient to live with, than with a higher number of the past.

We do expect further growth, but it's also going in other areas of the business—in the past our dealers sold the car and made profits, and in March we had the 2 millionth car on the road in China. Aspects like after sales [service] are much more important now. Additionally, used car business and financial services are growing. Operational lease is not yet here in China but will come. Once we have all these areas we have a very mature market, with all aspects of the business involved, which we did not have in the past. So then it's normal for us.

Everybody Has a Slice of Genius

Linda Hill, author of *Collective Genius*, believes leaders should create a context in which people are willing and able to innovate

By Neelima Mahajan

Remember Sully, the lovable blue and purple monster in the movies *Monsters, Inc*. and *Monsters University*, who spent much of his time trying to learn how to scare human children? His antics have made audiences across the world—and perhaps you—laugh. But did you know how much effort went into making Sully's blue fur? *A lot*. And this is not just counting the approximately 5.4 million hairs in Sully's fur in *Monsters University*. A lot went into portraying the fur realistically: moving strands of hair as Sully walked, getting shadows of the hair to look right. The Sully you got to see and love was not the result of one man's efforts—but the 'collective genius' of several animators at Pixar, as Harvard Business School professor Linda Hill would probably put it.

In a recent book titled *Collective Genius* (co-authored with Greg Brandeau, Emily Truelove and Kent Lineback), Hill, a renowned leadership expert, demolishes the myth of the 'solo genius' who has an 'aha moment' leading to breakthrough innovation. Instead, she argues, innovation is a collaborative effort, featuring many individuals' contributions, several missteps, false starts and combinations of several ideas.

In this interview she explains the role leaders should play in the innovation process.

Q. You say that innovation is not about solo genius, but it's about collective genius. This flies in the face of a lot of management thinking.

A. I began to realize that the research on innovation was very separate from the research on leadership. So even though we knew about how to innovate, we didn't talk about what do you as a leader need to do so that your organization can do these things.

When I began to explore that connection, and talk to leaders who led organizations that were very innovative, one of them said, "I don't read books on leadership because when I read them I begin to feel bad, because the book says on page 1 if you're a really good leader, you better have a vision of where you're going. But if you're trying to do something that's breakthrough, you don't have a vision, you don't necessarily even know how you're going to get there. So I decided that these books weren't relevant to my experience." That was very unsettling because I did a lot of teaching about vision and visionary leadership. When I began to see the lack of connection plus these very innovative leaders [who] didn't identify with that, I thought I better study this.

All the people that I studied were, in fact, visionaries. They just don't define their leadership role as being visionary. They're really in the place where visionary leadership is very much about leading change, as John Kotter and Warren Bennis have thought of.

Q. Is the idea of the visionary leader overrated?

A. It's not overrated when it comes to change. Since we need to innovate, which is a different process, we need to do things that are breakthrough. I don't think I'd say it was overrated because many, many companies need to be transformed and need change agents. We can't hope that, as someone writes, lightning is going to strike twice. There are geniuses out there like Steve Jobs, who can create businesses. But I study Pixar, Steve Jobs' other company [apart from Apple], and they are deep believers in collective genius, so I think also the image of what he believes about leadership is not accurate. Because, you look at this other company that he created and that operated [differently].

The evidence is that millennials are different. This new generation does not want to follow. As one of the leaders said, "If I said, I'm the visionary, you follow me, they won't follow me." They don't want to follow you to the future; they want to co-create the future with you. The idea of collective genius is just to capture the imagination of a lot of young people, because they want to be able to co-create, [and] not be a follower, in the traditional sense.

Most innovation is the result of collaborative work, of diverse individuals with different points of view and different expertise

Q. One of the most telling lines in some of the talks you've given, is that leaders set the stage, but they don't perform on it. What is the role of the leader in the innovation process?

A. So this is the challenge. All of these leaders can perform. And you would want them to perform, because they are so good and they are visionaries in some ways. But they understand that if they perform all the time, first, they're going to take up all the space from other people who have their own talent that they can bring to the table.

If you believe that everybody has a slice of genius, everybody in your organization has something to offer, your role as a leader is to create the context in which people will be willing and able to do innovative problem solving. Look at the research on solo geniuses, who have supposedly 'aha' moments.... Howard Gardner (a famous developmental psychologist), who looks a lot at the creativity of artists like Picasso, said to me, "I don't know that I emphasized as much as I could have the social context that was required for that artist to be effective and how much that artist actually interacted with other artists to make his or her work so excellent." So we actually have always known on some level that there is this social process that happens, you need to have that stage setting, even for the genius to get it done.

If you believe you have diverse slices of genius in your organization, you have to bring those slices together to do a process of innovative problem solving. And there are three things that we've known for a long time about innovation. Most innovation is the result of collaborative work, of diverse individuals with different points of view and different expertise. The second thing is that most innovation is the result of discoveries from learning. You don't plan your way to an innovation, you act your way. It's not surprising that so many individuals try to learn how to do design thinking, because that's about discovery driven learning: you work with your customer, prototype, learn rapidly, fail fast, etc. Almost all innovations [have] lots of missteps, false starts, mistakes. And then the final thing we know is that most innovations are not completely new: using the combination of old ideas, [or] a reconfiguration of some old ideas, to solve a new problem or address a new opportunity. So you have to have a way of decision making that you actually end up being able to combine ideas, as opposed to having one side win and one side lose. Those are Roger Martin's ideas about opposable thinking. All these pieces of the puzzle have been written about. Because we were on the ground watching people do stuff, we were able to combine it in a more integrated way. So we've always known that's true about innovation, yet there's this myth of this solo genius having these 'aha' moments: there's no research that supports that.

Q. Can you give me an example of a company that does this really well?

A. My favorite example is Pixar because founder Ed Catmull is one of the finest leaders I've ever met. He also was very involved in the turnaround of Disney Animation. He knows how to build from scratch and also transform. [At] Pixar, they say it's like everybody has a slice of genius, and the art of leadership is to create a world to which people want to belong. So they understand the importance, the power of a culture you build, and the capabilities that will allow those people to really share, use, refine and learn their own slice of genius, so they can contribute to an organization whose purpose they really care about. In our work on winning talent and emerging markets, we found that talented, passionate people want a couple of things: they want the opportunity to learn with people that they respect and enjoy, so they can contribute, they can actually have an impact on an organization whose purpose they care about. On any dimension you'd have to say that Pixar is one of the most successful studios ever, financially, in terms of artistic achievement, technical achievement… They understand the importance of community. A lot of the people at Pixar who are at the heart of it have been together for over 20 years. It actually took them 20 years to create the first full-length computer generated movie. We often forget how hard breakthrough innovation truly is. They continued to build on that. They've done 15 movies, and they're iconic, most of them. They've changed how children and families are entertained, and they've changed the whole industry.

Creating collective genius is not about abdicating responsibility or being passive

Q. Good leaders need to create communities with a sense of shared purpose. How can everyone, with differing personalities and ways of thinking, be aligned around the shared purpose and be made to believe in it?

A. That is one of the hardest pieces of the puzzle, and one of the reasons why I have the deepest respect for Ed is because Pixar has gone through a lot. It's been acquired by Disney, the company has scaled, so it's not like he's just had to deal with it in one context… As you get larger and more diverse, it is harder to build that collective sense of identity. That is one of the deep challenges that large global companies have. I was very impressed when one of the foremost CEOs of IBM understood, as he put it, "I can't provide a vision for this company that will really align us because we're too big and too diverse, so any vision I come up with will not really guide you. I'd rather make sure we can clarify our values, that we all agree on what we value, fundamentally who we are." A number of years ago, he asked one of the most prestigious groups at IBM to create a way for 200,000-300,000 people to have a real-time live conversation with each other. They had what they called a values jam. The CEO said, "These are the values of IBM, this is why this company was founded. Are they still relevant today? If so, describe examples, or what doesn't work." After they finished the values jam, they all agreed, and the CEO weighed in as well. In the end he said, "Okay, we've had this conversation, we've heard all of this, and now here are the values of IBM. If you don't agree with these values, leave, you don't belong here, you're not going to be happy, we're not going to be able to trust and respect you."

Q. Different kinds of people make up an organization: some can be called doers, others thinkers; some lead, others simply follow. How should leaders really step in and use these different kinds of people, or as you say, in some cases minimize differences, or amplify them, and why?

A. Relatively speaking, in most organizations where you see a lot of innovations or teams, they do hire carefully. A leader describes that she hired more for attitude and values, than competencies. Frankly the world is changing so much you don't really know what skills and competencies you're going to need in the long haul. So one of [the things] she was looking for was the people [who] wanted to learn, expand, [be] curious… We all have different strengths and passions. What you're trying to do in the ideal world is allow people to be authentic and play out who they want to be. So you as a leader need to at first be open to recognizing what the talents and passions of people are and let them let you know what those are. That means providing enough psychological safety that people aren't worried about job security, that people aren't going to not speak the truth to you about what they like to do and how they like to do it. When you build these kinds of cultures, people will tell you what they don't know. Once you have people you can trust, who are open to telling you what they don't know, and on the other hand, are looking for opportunities to be stretched..., then your job as a leader… is stage-setting—creating the right culture and those capabilities. A part of stage-setting is helping those people identify what they are good at and what they should do. You want to encourage people to be able to play out as much as possible what they are good at, what they want to do, help them understand why it's worth broadening themselves, because they actually have that curiosity to do that, and provide them with the experiences they need to do that. In those roles sometimes you as a leader are going to be very top-down. Vineet Nayar (former CEO of HCL) says, "Sometimes I use just plain brute force to get done what needs to get done." So creating collective genius is not about abdicating responsibility or being passive: they're very actively in the game, shaping the context, working with the people: they're all pretty hands on. But they understand that balance between when you need to intervene and step in, and when you need to step out. In the book we talk about these paradoxes that are at the heart of innovation, and what we're always doing on a daily basis is calibrating, or recalibrating: has it been going on long enough, is it too chaotic, do we need a little bit more urgency, do I need to step in to make sure that we actually harness our slices of genius and make them into something that's collective? There's … [a] paradox: one side [is about] how you unleash people's talents, thoughts and passions, and the other side is about how you harness them. As a leader, an innovation has to be both new and useful: if it's just new, it's creative, but it's not an innovation because it's not useful. As a leader what you see is interactions are constantly calibrating between is it time to unleash; is it time to pull them together?

Q. You've studied a number of fairly global companies which have people from different countries working together. Some of them might be coming from collectivist cultures; others from more individualist cultures. Does this cause a dissonance in the idea of collective genius?

A. All the research on different cultures and different countries is based on averages. The average leader from the US is more individualistic than the average leader from Japan. You can see it in individualistic cultures, people are much more resistant to these ideas. Millennials, to some extent, are more accepting of the argument. I met a group of young entrepreneurs. Some were very worried about what I was saying because they wanted to be visionary leaders [like] Steve Jobs. They were thinking, "Well, wait a minute, I have a vision". I think when you're being an entrepreneur, it's almost closer to leading change, to creating something new, [so] obviously there is some visionary leadership required. I said, "How long do you want your company to exist?" A lot of them don't care: they're building it and selling it. But I said, "If you want to build a sustained company, what's it going to take? Is it going to be all about you? No! Think about it, what does it take to build sustainability? The right culture, the right capabilities, that's all I'm saying, so focus on those matters as well, because that is going to determine whether you can do it time and again, and if you're not just a one-trick pony." I find… other cultures [are much more comfortable with] collective ideas… and are very relieved that I'm talking that way. But when you have people who come from the two different cultures there can be these clashes. As a very senior country manager from India said to me: "It's so tiring because you do all the work and in some ways you don't get the credit, others end up shining." When he was the star producer, he was the star. And now, when he's the leader, he's the manager, not the star, and that's what is really admired in his company. I said, "Yeah, that's one of the things about leadership, learning that you're more of a stage-setter than a performer. If you're performing all the time, chances are you haven't set the right stage for everybody else, and you know your time and attention is not taken up by all the right things." Accepting that changing role is going to be one of the things that keeps some people from not being able to build innovative organizations.

The other one that's going to be hard for people is trying to build an organization where you believe everybody has a slice of genius. That is not to mean that everybody has equal slices: some people have much bigger slices than others. It's very hard to lead the way I've described unless you fundamentally have a positive or an optimistic view about human nature and people's capabilities. One of the things that people say about these leaders is that they're described as being the most demanding boss a person has ever had, but also the most generous boss.

Q. A lot of companies from certain countries—China for instance— are very hierarchical, people are very respectful of authority, they don't speak up to bosses, they don't disagree. This would obviously have a bearing on the idea of collective genius. How should a leader really work around these issues?

A. In many of those cultures actually you can have this combination of hierarchy but also more collaborative approaches. We collected data from seven different countries, and some of them are very hierarchical. We did see common patterns in how the leaders thought about what their role was, but it was about creating the culture and the capabilities that I've described. But the actual tactics that they used varied. One leader [in Singapore] said, "People will not even sit down: they will stand when I'm in the room because of the hierarchy. If I want to have a very serious conversation with an executive, I start the conversation when we're on an airplane where we have to sit next to each other!" A Chinese executive that we studied never moved into his own office. He has a big corner office, but he still works outside the office in a very big cubicle. He said symbolically it's very important that he's never really moved into that office. But it would have been too unsettling to people if he didn't have an office. These interesting tactics, a symbolic action often, send signals to people that it's okay to be different towards me than you're used to, or that your culture would tell you to be.

Back and Forth

Penny Pritzker, US Secretary of Commerce, discusses the shape of the US-China trade relationship

By Ana Swanson

While tensions can sometimes run high between the world's two largest economies, business ties between China and the US are stronger than ever. Beyond the huge presence of US companies in China, China has also become a major source of investment in the US, accounting for $12 billion of deals in 2014, up from $10 billion the previous year. The number of Chinese mergers and acquisitions in the US reached an all-time high in 2014 and looks likely to continue to rise in 2015.

In the past, only China's well-connected state-owned firms were given the necessary approvals and financing to make acquisitions overseas. But now the floodgates appear to be opening to meet the growing demand from private Chinese firms for markets, assets and technologies. Because the US economy is so large and diverse, Chinese companies come to the US seeking a wide variety of things. Some come for the high-value consumer market, while others want to acquire advanced technologies, operating expertise, safe agricultural products, natural resources or diversified investments.

China is working to clear the way for its private companies to make more investments abroad, including loosening registration requirements for investments and providing some of its ample foreign currency reserves to them to make overseas acquisitions. And despite some occasional domestic opposition, for example over national security concerns, the US government is determined to welcome as much of this investment as possible to help maintain momentum in American economic growth and provide high-paying jobs.

As relatively new entrants to the US market, Chinese companies face some significant obstacles. They are still learning how to properly value and negotiate with American companies, where best to locate their investments, and how to navigate the dramatically different institutional and media environment. But the US Department of Commerce is working to help Chinese investors overcome these common obstacles, says US Secretary of

In order for [an investment treaty] to really come to fruition there are a number of market access challenges [China] needs to address

Commerce Penny Pritzker, who in April co-led a trade mission to China.

Pritzker spoke with *CKGSB Knowledge* on the sidelines of SelectUSA, an investment-focused forum that the US government hosted in late March. The forum welcomed delegations from around the world, including a substantial delegation from China. We spoke with Pritzker about the biggest opportunities and challenges in the US-China business relationship, and how the US can help Chinese companies make successful investments in America.

Q. I know from my conversations with Chinese and American companies that there are still some barriers to investment for Chinese companies in terms of finding the right investment target and understanding the investment and legal climate in the US. How would you describe the challenges that still exist, and what are the major initiatives that the US is undertaking to facilitate that investment?

A. Well, first of all, this is not just Chinese companies. A lot of companies say, "How do I start in the United States?" So one of the things we've done is we've created the SelectUSA boot camp where we teach companies here's how you begin, here's how you meet people, here's the landscape. We've also created a custom mapping tool, so if you're a company, and you're coming here to the United States, and you want to understand where is a certain kind of supply chain, what kind of infrastructure exists, where is the skilled workforce, we have this cluster mapping tool, and we're continuing to evolve that.

So how to start is one issue, the second issue is visas. So… in November (2014), President Obama and President Xi announced that we're expanding the visa with China to 10 years for travel and business, and the student visa to five years. So that makes just the whole process of doing business easier with China. Also, we've announced at the summit the expansion of the L1B visa.

This is not just China [specific], but many companies have said to us, look we have technical experts, we're investing here in the US, [and] we want to make sure our technical experts can come. An L1B visa is the visa you need to bring for a temporary period of time an expert to help your business. Most of the businesses investing here, a predominant number of their employees are American, which is why we're encouraging foreign direct investment. And one of the things we're doing is clarifying the rules to be able to get an L1B visa, so it's more efficient for companies to get that. Because there's no cap on the L1B visa, we just want to make the process more efficient for companies. So these are the kinds of things we're doing to attract not just Chinese businesses.

I met with several CEOs of Chinese companies who are really pleased with their experience here in the United States. That's not unusual—I have a number of companies that come see me throughout the year from China and they're really pleased with not just the help they're getting through SelectUSA but their experience here in the US.

Q. What are the major trends that you're seeing in Chinese investment in the US? What industries do you see as particularly promising for US-China partnership?

A. They span a number of sectors, everything from real estate to manufacturing to auto parts. So I haven't seen a particular focus, what I've seen is a real growth in interest. We have a large Chinese delegation, but we also have a large delegation from Japan, Taiwan, Canada, Italy, Germany and India. And that's one of the exciting things… about what we're doing here at SelectUSA, the real interest and the fact that it's broad, not just from one country.

Q. I want to ask specifically about China's growing purchases and reliance on US agricultural products. Do you see that as an area that could be particularly promising?

A. I know from my experience at the US-China Joint Commission on Commerce and Trade (JCCT, an annual bilateral trade dialogue) that there is real interest by our US agricultural industry to sell more of our products in China. Particularly we'd love to have a greater access to sell beef and other products like that. That has been a challenge for our agricultural industry to get that kind of access. I think there is a need and demand, but not always the market access that we need.

Q. In the last few years, surveys by the US-China Business Council have suggested that the atmosphere for US companies doing business in China may be getting more challenging. What are your biggest concerns for US businesses operating in China, and what is the best way to level the playing field?

A. What I would say is that we've been through the JCCT process working closely with the Chinese government and Vice Premier Wang Yang on market access challenges, and of course the use of the anti-monopoly law seems to be a challenge that's being faced. The Chinese are very interested in having a bilateral investment treaty with the US, but in order for that to really come to fruition there are a number of market access challenges they need to address. I think that we're working with the Chinese on this, they're desirous of more trade, but there are a number of issues that stand in the way.

> Getting these free trade agreements done is about our economic growth, it's about job growth, it's American competitiveness

Q. You've argued that foreign direct investment is key to US growth. But sometimes we see more of a negative or competitive attitude between the US and China, whether at a government or popular level. Are you concerned about those types of frictions in the US-China relationship?

A. No, what I see is, these are not Chinese specific data, but for example, we have 1,000 firms here at SelectUSA from over 70 countries. One hundred seventy of those firms made investments in the US [of] about $13 billion and employing about 32,500 Americans. That's good for America. And we know that the jobs of American subsidiaries of foreign companies pay $79,000 on average. These are good jobs. So it's good to have foreign investment in the US. And that's why SelectUSA is an initiative that is really becoming part of the fabric of the Department of Commerce.

Q. What has the conversation been about the Trans-Pacific Partnership, the upcoming trade deal, so far over the last few days?

A. The conversation is encouraging, because companies want to see both Trade Promotion Authority and the Trans-Pacific Partnership get done. The reason is, and I've seen this both here and in the travels I've done over the last six weeks, traveling around the United States, talking to companies about trade. What's really interesting is, small, medium-sized and large companies want to see trade agreements. Since I've come into this position, I've met with over 1,600 business leaders, and they want to see more trade agreements. Why, you may ask. First of all, there are many companies where their exports are growing, it's the fastest growing part of their business. They want to be able to access the 95% of consumers that are outside of the US. And what they're seeing is, if we don't have a free trade agreement, sometimes their ability to access that market, both the tariff barriers and the non-tariff barriers prevent them from being able to sell their goods.

So whether it's Electric Mirror that I met with outside of Seattle, they're a company that manufactures, they sell into the hospitality industry, and they said, "Look, we're following our customers that are growing all over the world, and some of the markets we're going into the tariffs are so high, we're not competitive, and our customers are asking us to move our production to other parts of the world where there are trade agreements." So getting these free trade agreements done is about our economic growth, it's about job growth, it's American competitiveness, and it's about national security. It's really important that we get these things done. And whether I'm talking to small, medium-sized or large businesses, I hear uniform support for that.

Cultural Immersion

Michael Zakkour, co-author of *China's Super Consumers*, tells us what makes Chinese shoppers tick

By Chris Russell

China's consumer revolution shouldn't be news to anyone, but the knowledge of what makes it tick, and how to profit from it, is much rarer. From Best Buy to Groupon, there are plenty of foreign companies who learned the hard way that this understanding doesn't come easily. But for intrepid executives, thankfully trial by fire is no longer the only way to glean the necessary insights, and now there is a whole series of literature where they can consult the China business wisdom of others.

One such guide is *China's Super Consumers: What 1 Billion Customers Want and How to Sell it to Them*, co-authored by Michael Zakkour and Savio Chan. It tells the story of how China's consumer market has developed from the start of reform period, as well as setting out its ever-increasing maturity, giving readers the inside track on how to ride the Chinese consumer wave, the effects of which are not only felt in China, but also globally.

In this interview, Michael Zakkour, a consultant with more than 18 years of experience, much of it in China, discusses some of the crucial points of the book and tells us why culture is key.

Q. In China's latest phase in consumption, what are the things that distinguish Chinese consumers from consumers in other countries?

A. When talking about how Chinese consumers differ from consumers around the world, the real differentiation isn't so much in what they buy, but why they buy it. So in the book actually almost half of [it] is really a study in [the] culture, history, philosophy, language that creates the mindset of the modern Chinese consumer, which ultimately leads to the purchase decision. The truth is, buying the same products [as a Western consumer] is not the same as why they buy those products. It's very much about face, a lot of it has been showing off. But we've seen a lot of morphing in that, so a lot of spending now is turning… to a much bigger focus on the self and well being and the home and experiential spending.

Q. How should companies vary their approach when targeting different demographics?

A. We look at now the McKinsey model of China having 22 distinct market clusters, and a lot of the old thinking about tier 1, tier 2, tier 3 cities and the consumers who lived in them doesn't really apply anymore. So the first step is to look at China as these market clusters and determine how to appeal to the consumers within each cluster—where there are commonalities of development, wealth, industry, politics, culture, food, climate, etc. The other is to start thinking about Chinese consumers as global consumers—it's no longer just about going to China and setting up shop and doing your marketing and selling products here. It's about how do I address the Chinese consumer in China, in my home market and in my third-party countries around the world, and harmonize my messaging, my pricing.

Q. What's the best way to reach out to and connect with these Chinese consumers?

A. Social media and digital marketing, and especially with a focus on mobile. So you know in the West, especially the US, there's still a debate about whether social media really can sell products—it may help with your brand image, your brand awareness. In China, there's absolutely no doubt that social media and digital marketing sell products. And that has a great deal to do with peer recommendation and group acceptance being much more important in China than it is in the West.

It's a matter of still being on the ground with the Chinese consumers to let them touch and feel and engage with your product and your brand, but having a more interactive relationship with your brand and the consumer, and really focusing on mobile, e-commerce, social media and digital.

Q. What are the things they need to be aware of when they're thinking of e-commerce in China?

A. The first thing they have to take into consideration is their relationship with Alibaba. It's estimated that roughly 70% of all e-commerce transactions in China somehow touch an Alibaba property, so whether it's Alipay, whether it's Tmall, whether it's Taobao, that's your first consideration—how do I engage with, understand and build relationships through the Alibaba network.

The second is to really spend the time on segmentation and defining the consumer so you can take the right combination of steps for your e-commerce. So, is a Tmall store right for you? Are you better off starting on JD.com? Are you better off selling through a retail e-commerce platform? Those are really important to get down right.

And then you really have to consider everything in the supply chain too. I mean it's great to set up a shop and sell your product, but if you don't have the product available and you can't deliver it quickly and efficiently, you're gonna have a problem and you can lose Chinese e-commerce consumers very quickly by failing to deliver.

> The real differentiation isn't so much in what [Chinese consumers] buy, but why

Q. How brand loyal are Chinese consumers and what can companies do to drive that loyalty?

A. Chinese consumers are very brand aware, but they're not particularly brand loyal. So there's kind of a paradox where brand is everything—the brand history, the brand story, what it says about you because you've engaged that brand, providing legitimacy for the product, knowing that it's a safe product. [But] it doesn't take much for them to move to a competitor brand in the same category if you don't keep up that constant dialogue and engagement.

The other part of it is the Chinese consumer is very price aware, but isn't always necessarily price sensitive. So it's that area where you're saying, I could charge more than I am now and actually increase sales.

I think the other most important thing to do is to really build a scale for yourself and say, on one end of the scale I need to change very little to nothing about my brand, my business model and my operations to succeed in China, and on the other end of the scale I need to change almost everything to succeed in China. So on one end of the scale, I think if you look at Starbucks and their success here, there's very little they had to change. I think the reason for that is Starbucks tapped into something that already existed in Chinese culture. When they wanted to go to China, people told them they were crazy because there was a tea drinking culture. But what they understood was that along with tea drinking, there was tea house culture. And so Starbucks' whole value premise is we're your third place [in addition to your home and you office]. What they really did was they brought the tea house back to life in a modern sense.

On the other hand, if you look at what happened with Pizza Hut and Domino's here, Pizza Hut were successful almost immediately and until recently they had almost a 20-year run of uninterrupted success here. [Domino's came in and more or less failed] and the reason was they didn't understand that it wasn't about the pizza—it was the first Western dining experience so to speak, it was the menu, it was the atmosphere. Domino's came in and tried to make it about the pizza and about delivery.

Q. How can foreign companies and executives best familiarize themselves with Chinese culture and history?

A. What I've been encouraging my clients to do for a long time is really take seriously the need to understand the culture, history, language, mindset first. And that's usually achieved through some combination of bring some knowledgeable people in house and, not to be self-serving here, but to really bring in experts to do this every day all day all year to help you with that assessment. And so we encourage the business to start with a cultural analysis and then a market analysis, a consumer analysis, and really start with a "Is there even a go, no go here where we fit in?"

Q. What can foreign companies learn from local brands when it comes to selling to Chinese consumers?

A. We think there's as much if not more to learn from their success than what foreign companies have done. One example we gave in the book was a company called octmami (a maternity wear retailer). Where did they come up with a name like octmami? A pregnancy in China is viewed as 10 months. October is the tenth month of the year, [so] you have octmami, which is something that immediately has resonance here, but a foreign brand might never have approached it that way when naming.

What they've done is they've gone roughly 15 years from one small shop in Hangzhou to being the largest maternity wear line in China with I think 2,000 retail touch points across the country. And a lot of their success was due to their [being] very forward thinking about marketing and branding and using technology and digital media to create that interactive experience for the consumer.

We talk about Lenovo in the book and I think a great lesson for companies around the world, and for Chinese companies, is viewing it as an opportunity to engage with 700 million consumers. On the one hand [Lenovo's] harmonized their China marketing to appeal to everybody… but when it actually comes to merchandizing and marketing their products, they really do it differently in the different market clusters. When they were approaching the rural, undeveloped market… what they did was they actually produced [an old-fashioned] PC for the rural market that was specifically aimed at people buying it as a wedding gift. And they packaged it appropriately in red and gold. They had the local insight that said there's going to be a lot of face for the givers and the receivers of this PC. So everything they did from the packaging, to the pricing, to the size, it was a runaway success—they sold, I think, 2 or 3 million units. They didn't dismiss 500 million rural residents and say, "Well they're not our technology customers", they found a way to make them their customers.

Q. Just how strong is the competition from local brands now? You've touched on a few like Lenovo, and obviously Xiaomi has a lot of buzz about it, so with the rise of these brands, how much more difficult is it for foreign companies?

A. The competition in general is fiercer than it's ever been. As a foreign company [you're] coming into China and having to compete with other foreign companies in your category as well as competing with local Chinese companies. Xiaomi is doing very well, but it's not necessarily because they've branded well, it's because they're basically saying we can give you an iPhone 4 for a third of the price, so they're really competing on price, which segues to the bigger story, which is for foreign brands, don't come here and compete on price and don't come here to compete in the mass market—your appeal lies in being foreign and whether you're a luxury company, or what we call affordable luxury. Now you're talking about, look how well Coach and Michael Kors and Kate Spade, GNC Vitamins [have done]... so companies like those. The question about competing is more about what the category is, but you need to differentiate based in a large part on your foreign appeal.

In China, there's absolutely no question that social media and digital marketing sell products

Q. The luxury sector has been a key area for foreign brands—how do you see the prospects of that market? Obviously the anti-corruption crackdown has affected it somewhat.

A. Even with the anti-corruption crackdown and the reported slowdown in the Chinese luxury market… the fact remains that still right now as we have this conversation about 30% of every luxury purchase made globally is made by a Chinese consumer.

What I think has changed, and you hear this in some other places but I don't know if everybody really understands, about 60% of those purchases are being made outside of the mainland of China… [you need to be] integrating your products, your services, your offerings, your messaging, your experience and your pricing on a more global level.

But there are real effects. [I recently did a talk about] the Macau luxury watch and accessory show that got cancelled. And to me, the only surprise in that was that they even attempted to put it on—I mean, Macau has been a ghost town for the last three years and timepieces in particular were early targets of the campaign.

Q. What are the common mistakes that foreign companies make when trying to sell to Chinese consumers?

A. I would go back to the opening line of Anna Karenina: "All happy families are alike, and all unhappy families are unhappy in their own way" [laughs]. There's a pretty basic set of rules on how to do it right, but a multitude of ways to screw it up. But I think if I had to boil it down, impatience and irrational exuberance about the market and not really taking the time to understand all the implications of doing business in China. The number two mistake is companies who rush into China without properly caring for all of their intellectual property. Number three I would say is assuming that the relationship with Chinese consumers is a one-way conversation with you speaking to them. [Also] don't be swayed by short-term market changes. There's a long game here. The other mistake I would say you need to avoid is not properly understanding the context of where the government is taking the economy and the direction of the economy. Always be keenly aware of the latest regulations, rules, because it's much easier to go with where they're going, than to go against it.

Beyond the Bottom Line?

As China re-embraces traditional beliefs and religion, just how is this affecting business in the country?

By Chris Russell
Additional reporting by Nancy Gong

In downtown Shanghai, only a stone's throw from a busy, traffic-clogged road, sits the White Cloud Daoist temple. The air heavy with the scent of incense, priests ring bells and bang drums, breaking the relative peace inside the high temple walls as a man bows repeatedly before a shrine.

The setting might seem to contrast with Shanghai's avowedly, and proudly, commercial nature, but such places of worship have been making a strong comeback, having previously fallen out of favor. That said, they are perhaps the last places you would come to look for business advice, yet here, as with so many things, China defies expectations.

"Quite a lot businessmen come to visit here," says Song, a priest at the temple. "They have different purposes for coming—some people pray for more business and money and some people pray for having good health… [but] many of them also come to learn."

State of the Nation

As a country whose culture stretches back thousands of years, China has naturally played host to all manner of religions and schools of thought throughout its history, and many still have great relevance today. From the country's five officially recognized religions—Buddhism, Islam, Protestantism, Catholicism and Daoism—to the country's myriad folk religions and traditional beliefs like *feng shui*, spirituality and superstition inform much of the population, even if the country lacks the overt religiosity found elsewhere. And in addition there are also the philosophies bequeathed to China by the likes of Confucius.

With China today, in the view of many people, suffering from a crisis of trust and a vacuum of faith, Chinese people have begun to reacquaint themselves with their traditional and spiritual heritage. Exact numbers of the followers of some of these schools of thought are hard to estimate, for a number of reasons—some, such as Confucianism and folk religions, are poorly recorded, or not at all, and many individuals are happy to combine beliefs from several different religions or philosophies.

Confucius looms large over Chinese society, and his influence is felt in business too

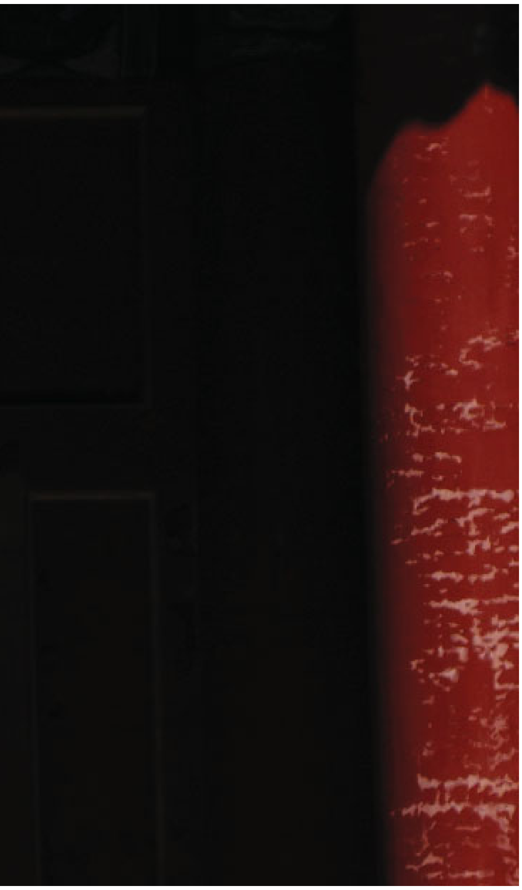
Nonetheless, a 2012 Pew Research Center report estimated China had 244 million Buddhists, 294 million followers of folk religions, 68 million Christians and 9 million believers in "other religions" (including Daoism). The number of religiously unaffiliated people stood at 700 million. Within those figures for believers are millions of business people, and their ideas and practices are now manifesting themselves in the management of China's companies.

The Good Books

"For quite some time businesspeople in China have employed *feng shui*, geomancy, and other Daoist practices for warding off bad fortune and ensuring success," notes John Osburg, author of *Anxious Wealth: Money and Morality Among China's New Rich* and Assistant Professor of Anthropology at the University of Rochester.

But a key change has been the way that traditional religions and philosophies, as well as 'new' belief systems such as Christianity, have begun to have a tangible impact on business management and practice. A number of China's leading business people have spoken of how such beliefs have influenced their business thinking.

Alibaba's Jack Ma, when asked about his management philosophy in a 2013 interview with Washington University professor Xiao-Ping Chen for *Chinese Management Insights*, made frequent mention of the role traditional Chinese beliefs in providing a basis for his management ideas. "Through endless thinking, I have groomed, little by little, my own management philosophy in the company, based on Tai Chi, [D]aoism and Buddhism," Ma said. "I never talked about this directly, but they are the source and nutrition of our management philosophy."



He's far from the only one in looking to these beliefs for management inspiration. Chen Feng, CEO of Hainan Airlines and a devout Buddhist, has spoken of how Buddhism, Daoism and Confucianism play a role in the company's corporate culture and approach to social responsibility. All employees are required to read up on traditional Chinese culture, points of which they recite daily during their training, and senior executives are given additional reading materials—staff are occasionally tested on their knowledge of these points. Moreover, managers are encouraged to be "a model of virtue".

"I believe that if the Chinese do not learn and understand the core values of the traditional culture, there will be no foundation for future growth," Chen said in an interview with *The Boston Globe*.

Moreover, Shalom Saada Saar, Professor of Managerial Practice at the Cheung Kong Graduate School of Business, identifies Fosun, popular hotpot chain Haidilao and energy firm Kaidi as just a few examples of companies drawing upon Buddhism, Confucianism and Daoism in their decisions about how to operate. "Now [there are] really a growing number," he says.

Such thinking has laid the foundations for a number of business management books in recent years that have incorporated religion or traditional beliefs—*The Analects of Confucius: A Management Diary* by Shao Yu, *Management Wisdom of the Book of Changes* by Zeng Shiqiang and the *Chinese Management Diaries* series, which looks for inspiration from, amongst others, Chinese emperors and philosophers, have all been successful entries in the genre.

"The books are selling quite well and company managers want to read these kinds of books," says one editor, who declined to be named, at Times Bright China, a company involved in the publishing of *Management Wisdom of the Book of Changes* and similar volumes. "Regarding our future publishing plans, we definitely will publish similar books that combine company management and traditional Chinese culture."

These ideas flow into the classroom too. "We collaborate with universities such as Fudan, who have classes for tutoring CEOs, and give a one or two-day class teaching something like management concepts mentioned in the Tao Te Ching," says Song at White Cloud Temple.

Practice Makes Perfect

Given the diversity of beliefs and the range of industries they are applied to, their actual manifestation in business practice is equally varied. Still, Saar identifies tenets from three of the major belief systems that businesses can learn from, all centered on the concept of harmony.

From Confucianism, a crucial idea is harmony among people. "What does it mean if you don't create harmony with people around you, if you don't create the culture that cares about people? Then you cannot grow the organization—people will escape, either physically, or [in] their mind," says Saar. "You must create harmony among people if you want to succeed."

Meanwhile, Daoism promotes harmony between people and the environment. "Daoism in one sentence is: 'harmony with the environment'," he says. That has implications for business in terms of energy, recycling, pollution and so on, as well for creating a company culture in which people can grow and develop.

Finally, from Buddhism, Saar identifies the idea of being at peace with oneself as important to business. If you don't have that, he says, then it is very hard to influence others.

According to John Osburg, the main influence that these beliefs have on some business people is in terms of their own personal conduct, with them foregoing hedonistic or shady business practices as a result. In many cases, that has a negative impact, straining professional relationships, but not always.

"Some of the Buddhist businessmen I interviewed also spoke of positive effects of their beliefs," says Osburg. "They explained that now many view them as more trustworthy as a result of their faith, and this has helped them win clients and investors. Furthermore, in both Christian and Buddhist circles you find business networks forming around those with shared religious beliefs."

But the engagement of Chinese businesspeople with religions and traditional beliefs isn't without complications, and not everyone uses them as a route to an enlightened business philosophy. "For the majority, their engagement with religion is really just a means of ensuring good fortune and warding off bad luck," says Osburg. "In other words, it's just another means of enhancing their business success."

While the White Cloud temple might play an unexpected role in the grooming of China's executives, it still only plays a small part in the hectic, commercial city. Similarly, traditional beliefs overall have only a modest influence on the thinking of Chinese businesspeople for the majority of whom the bottom line will remain the bottom line.

Layover Literature

James Mabey gives his top picks for in-flight business reading

The job title of Senior Vice President for one of the premier hotel companies in the world might conjure images of a posh job wrapped in a corner office with sweeping views, but while I love my office in Singapore, truth be told, I'm rarely there. My position has me hopping on flights to Beijing, Bali, and Dubai, sometimes all within the same week. That allows me to meet a lot of great people in a lot of different countries, but as a result I spend a lot of time in airports and on planes. So once my calls and emails are taken care of, I break out the occasional book—here are a few favorites culled from years of long layovers.

One of my top picks would be *Thinking Fast and Slow* by Daniel Kahneman. Most of us believe that people are rational and that, a few impairments aside, most people will act in with sound reasoning. Kahneman, who holds a Nobel Prize in behavioral economics, systematically dismantles this notion. Using thought experiments, case studies, and other concrete examples, as well as statistically significant studies to back it all up, Kahneman exposes the regular and predictable errors in thinking that even hedge fund managers and Ivy League valedictorians fall prey to.

We all would like to think we're good at our jobs, that our knowledge and expertise set us above the crowd. We believe that hard work and applying ourselves in our field will make the difference between success and failure. But while hard work and vigilance shouldn't be discounted, the truth is that behind the world of reason and logic that we think we live in is a complicated clockwork of subconscious evaluations and unseen judgments that are constantly operating behind the scenes, and what's more, these judgments and processes can be unreliable in very predictable ways.

As Kahneman shows you the patterns behind these regular thinking errors, or cognitive biases, you'll start to recognize them in conversations and business meetings. But even more importantly than being able to recognize them in others, you'll be able to recognize them in your own intuitions, if you're vigilant enough. You'll recognize when you're being lazy in your thinking, relying too heavily on instinct and when your natural biases are feeding you what amounts to be the right answers to the wrong questions.

Another book that has shaped my understanding of business is *How Google Works* by Eric Schmidt and Jonathan Rosenberg, Executive Chairman and former Senior Vice President of Products at the company, respectively.

Google is what it is today because it operates differently from other companies on a fundamental level. This applies to how they hire employees (the stories will floor you) to how they develop products. The basic idea is that we live in the 21^{st} century with 21^{st} century technologies and resources, yet many companies, big and small, are still run the same way as they were in the 20^{th} century without anyone giving a second thought.

Aside from discovering how torturing a job candidate at an airport for hours can improve a company's vision and performance, you'll learn why Google believes that the most important thing your managers do is hiring. You'll learn how the knowledge worker of the 20^{th} century is being replaced by the "smart creative", and you'll begin to get a sense for how our current corporate structures, which were created to reduce expensive mistakes, are outdated compared to ones that can intelligently harness fast, iterative development.

While these two books have been pivotal in my approach to business, I'd be remiss if I didn't throw out a few honorable mentions in broader categories, including a few fictional works, such as the historical novel *Gates of Fire* by Steven Pressfield, the science fiction work *Ender's Game* by Orson Scott Card or the quintessential classics of Edgar Allan Poe and Lewis Carroll.

James Mabey is Senior Vice President of Development Asia-Pacific at Jumeirah Group

Business Bestsellers in the US

1. When to Rob a Bank — Steven Levitt, Stephen Dubner
2. The Motivation Manifesto — Brendon Burchard
3. How to Manage Your Money When You Don't Have Any — Erik Wecks
4. Strengths Finder 2.0 — Tom Rath
5. Go Pro — Eric Worre

Source: Amazon.com

Business Bestsellers in China

1. Zero to One — Peter Thiel, Blake Masters
2. Big Data — K. Cukier, Viktor Mayer-Schonberger
3. Influence: The Psychology of Persuasion — Robert Cialdini
4. The Hard Thing About Hard Things — Ben Horowitz
5. The Effective Executive — Peter Drucker

Source: DangDang.com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