CKGSB KNOWLEDGE

CHEUNG KONG GRADUATE SCHOOL OF BUSINESS

Volume No. 23

FALL 2016

$12.00

The Middle Minority

A significant new force is beginning to take shape in China

- China's population may be aging past the point of no return
- China's investment in football is having an impact on and off the pitch
- One of China's biggest property companies has grown into an empire, but how stable is its future?


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Vol. No. 23

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ISSN 2312-9905
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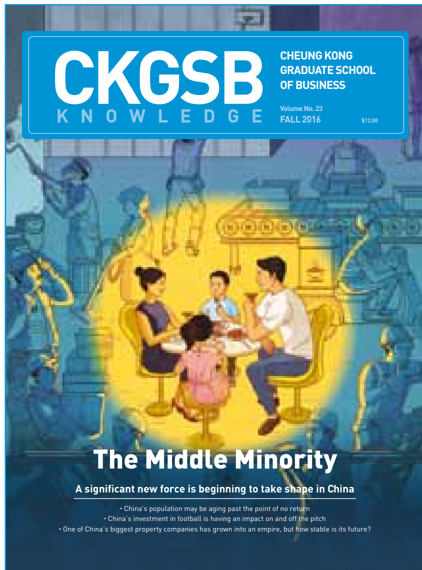
Examining China's New Middle Class

This issue of *CKGSB Knowledge* looks at some of the most interesting shifts taking place in China's always-dynamic economy, and indeed society. In our cover story, we examine the emergence of a middle class in China with what might be unexpected thoughts on the origins of this group, its nature and scale and the impact they are likely to have on China's economy. The so-called middle class is different in China from what I know the term to mean in the West, and this distinction is crucial to avoiding misunderstandings as well as calculating the influence this group will have on China and indeed the world. Their role in the economy, particularly of younger people in the category, is undoubtedly large and will only continue to grow, but the size of the group is often over-estimated, which is why we have entitled our article, on page 20, 'The Middle Minority.'



We have chosen several other topics that reflect the trends that are pushing us into the future. A fundamental question, one that arguably overshadows all others, is China's demographic bulge, caused by the decision in the late 1970s to restrict families to one child. Those chickens are now coming home to roost. Or rather, not. And the result is that Chinese society has now entered a phase of rapid aging that will see the proportion of older people in the population rise dramatically over the next couple of decades with huge implications across the board. Please read our views on this crucial topic in 'The Silver Age' on page 10.

We also address two more immediate concerns: corporate debt and the potential startup bubble. There has been a worrying rise of corporate debt in China since the Global Financial Crisis, affecting both state and private companies, and we discuss the problem and solutions in 'China's Red Inc.' on page 44. Then there is the phenomenon of large amounts of capital being thrown at young and small companies, primarily in the tech and online space, a market that to me feels increasingly overheated. We examine the prospects on page 15.

Then there is the disruptive potential of two fascinating developments at the core of China's road economy—the coming advent of self-driving cars, the implications of which we review in 'Hands Off' on page 48, and the fast-changing world of taxis—see 'Kissing Cousins' on page 37.

We profile one of the top company's on China's economic scene on page 31 of this issue, the Wanda Group, and its startling strategy of diversification. And for our Downtime section, we consider China's ambitions to become a soccer superpower—see 'Fever Pitch' on page 67, and if you are in China and have children, support the endeavor by taking them out and kicking a ball around with them.

In our interview section this issue, we have some really top-notch people giving their views on business and management, including Arthur Kroeber, one of the most respected China economic analysts of the day, and Ripa Rashid, author of *Winning the War for Talent in Emerging Markets*, on the huge benefits to be gained by giving women a bigger stake in management.

Times change and people move on, and so it is with the Executive Editor of *CKGSB Knowledge* magazine, Neelima Mahajan, who is leaving Beijing for other pastures. I am very grateful to Neelima for her assistance over the past few years in helping me to build this magazine, and I would like to take this opportunity to wish her all the best for the future.

I hope you enjoy reading this issue. We know that our topics and articles are often cutting-edge and will generate many different opinions. We always welcome feedback and comments from readers, which we would be happy to publish.

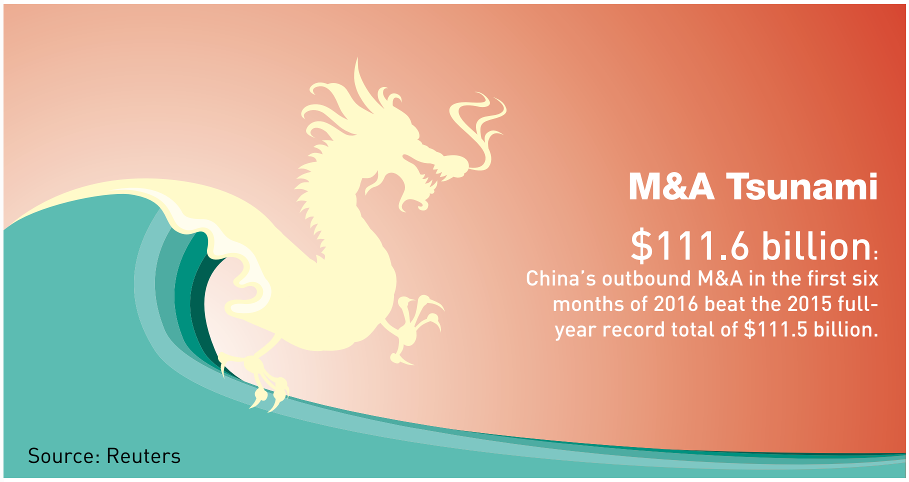
Yours Sincerely,

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



M&A Tsunami

$111.6 billion: China's outbound M&A in the first six months of 2016 beat the 2015 full-year record total of $111.5 billion.

Source: Reuters

Sitting Down at the Job

The global consultancy McKinsey estimates Chinese labor productivity is only 15%-30% of the average of other OECD countries. Steering its economy toward productivity reform could

$5.6 trillion to GDP by 2030.

Source: The Financial Times

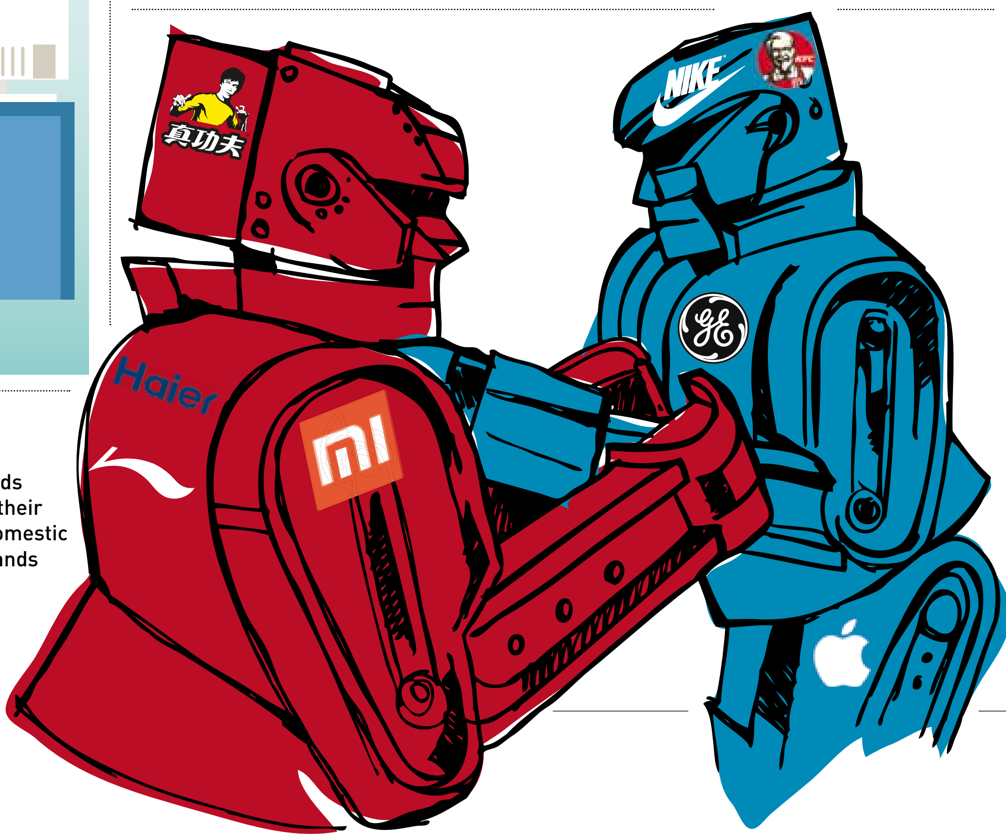
Counting on the Statisticians

China's National Bureau of Statistics added $130 billion to national GDP figures by tweaking the formula to include new parts of the economy. The addition was a mere 0.04 percentage points, compared the 0.6 points the US added to GDP when it made a similar change in 2013.

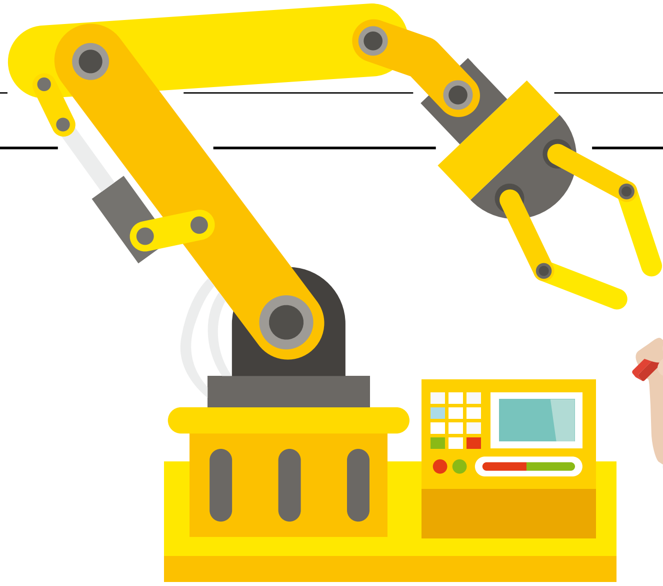
Source: South China Morning Post

Battle of the Brands

Chinese domestic consumer goods brands are capturing market share faster than their foreign competitors. In 2015, sales by domestic brands increased 7.8% while foreign brands registered a 1.8% decrease.



Source: The Wall Street Journal



I, Laborer

Industrial robot sales increased by more than 12% in 2015 to 248,000 units. More than one in four were sold to China, helping fuel fears over manufacturing job security.

Source: The Financial Times

Enter the Supercomputer

China's new Sunway TaihuLight is the most powerful in the world. Capable of 125 petaflops, and with 1.31 petabytes of memory, the computer is five times faster than US's top machine.

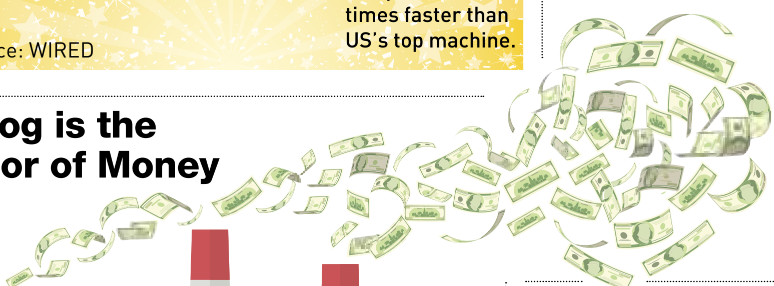
Source: WIRED

Pro Ballers and Weekend Warriors

China's professional sports market is expected to hit RMB 1.6 trillion by 2025, with an annual growth rate north of 20%. The larger amateur sports market should hit RMB 3.5 trillion in the same period, with a 12% growth rate yearly.

Source: Caixin Online

Smog is the Color of Money



China approved $15 billion in green bonds in the first five months of this year. The bonds are part of the effort to fight pollution and fund projects like renewable energy installations and electric cars.

Source: Bloomberg

Neither Yours, Nor Mine

As part of industrial restructuring in northern Shanxi province, China has ordered the closure of coal mines equal to

500 million

metric tons of capacity, about 9% of China total capacity.

Source: Bloomberg

Source: Financial Times; IBISWorld; China Internet Watch; PFSweb; Internetretailer; Reuters


The rise of China's online e-tailers, including the likes of Alibaba, which operates Taobao and Tmall, JD.com and others have transformed the way Chinese people shop. In 2015 nearly half a billion Chinese shopped online for items big and small. The online-shopping phenomenon has also supported the growth of a multi-billion dollar express delivery industry with hundreds of thousands of workers, and hurt retail.
YUNDA
韵达快运
More than **80%** of parcels shipped in China are generated by online orders
The number of packages delivered in China increased **56.4%** to **5.77 billion** in the first quarter of 2016
8,000 total express companies
Competition among the top five companies is fierce, each with about 15%-20% market share
More than 550,000 employees
China's express delivery market was worth $42.1 billion in 2015
$1
Shipping costs in China average **$1** per kilogram

The Silver Age

China's population may be aging past the point of no return

By Wynne Wang

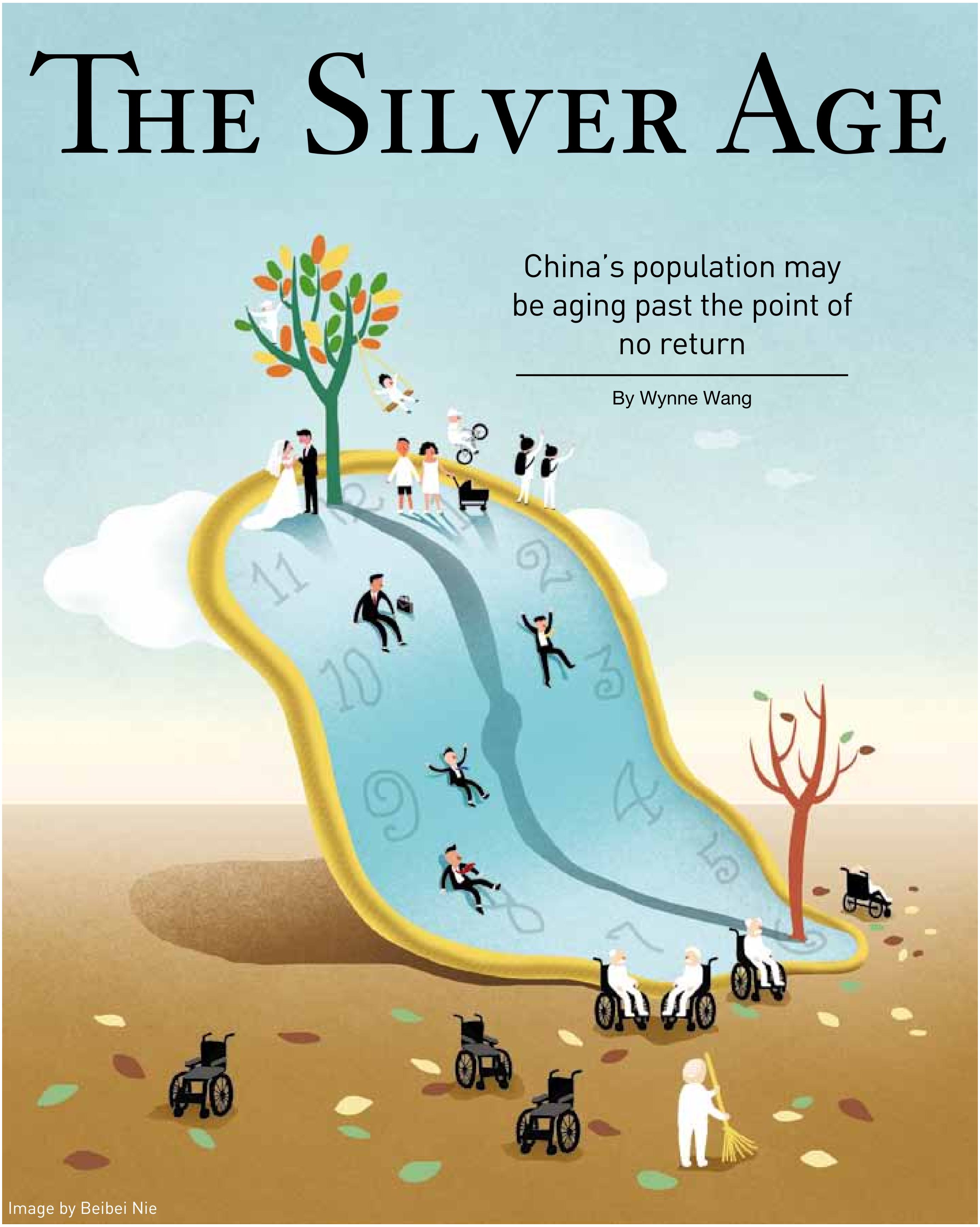


Image by Beibei Nie

China is the world's youngest superpower with the world's largest labor force of nearly 800 million people, but it seems like it has only suddenly realized it is getting old really fast.

In China today, there are roughly 7.6 workers for every one retiree, but by 2050, according to the United Nation's demographic forecast, each retiree will be supported by only 2.1 people in the workforce. Fears about how this future math plays out are creeping into society, particularly for younger people who are going to be on the wrong side of that equation.

Urban workers and their employers all contribute monthly sums into state-run pension funds, but many experts say the amounts will not cover payments for the huge extra numbers of people who will become eligible for them. In 2050, China's over-65 population is predicted to be around 370 million, up from about 138 million in 2014, already the world's largest pool of elderly at 10% of the population.

"I pay my pension money every month, but I don't know how much I will get after I retire," says Li Zijian, a middle-aged employee of an international company. "I hire nannies to take care of my children and do chores, but I don't think I can enjoy that when I grow old and really need help."

Li has legitimate reasons to worry. China's government is already leading a fight against slower economic growth. The country's official GDP rate fell to a reported 6.7% in the first quarter, from the double-digital rate maintained during recent decades. And in 2012, China's working population dropped for the first time in decades, as young people aged 15-59 fell by 3.45 million according to official data. The trend is already showing signs of acceleration with a decline of 4.87 million in 2015, the largest decline in China's modern history.

"China is far from being ready to serve such a big elderly population," says Jiang Baoquan, a demographer with Xi'an Jiaotong University. "The country needs to do much more to be prepared for an aged society."

> [China's leaders thought] the economy will grow and the people's conditions will improve if there are less people
>
> Liang Zhongtang
> Former member of the China's Family Planning Commission

China will be far from alone at the retirement home—Japan, Europe and the US are also grappling with this problem to one degree or another. But unlike its developed counterparts, China is aging while its level of prosperity is still relatively low. China's population structure is like Japan's of the 1980s, while its per-capita GDP level has only reached that of Japan in the early 1970s.

By far the biggest issue is China's low birth rate, which declined sharply in the early 1980s with the introduction of the one-child policy. Given the massive disruption in population growth it caused, and changing social attitudes toward child-rearing, many experts believe it may be too late to climb out of the demographic trap.

The Birth of a Problem

China has been an overpopulated country for many centuries, and has long suffered problems because of it, but the current demographic crisis is a 20th-century creation. During the Mao era, families were encouraged to have many children, helping the population to roughly double to one billion from 1949 to 1979. Starting in the 1970s, the birth rate began to decline naturally, from above 6 in early 1960s to 4.85 in early 1970s. But fearing a Malthusian catastrophe—a crisis caused by overpopulation and insufficient food production—the government introduced the one-child policy starting in 1978.

"Chinese leaders used very simple math while rolling out the policy," says Liang Zhongtang, a former expert member of the country's Family Planning Commission. "[They thought] the economy will grow and the people's conditions will improve if there are less people, but society has its own rules which aren't that straightforward."

Under the strictest birth control policy in world history, China's population continued to expand in the following decades, thanks to its large demographic base and improving living conditions. China's average life expectancy has also increased dramatically from 43.4-years of age in the early 1950s to 75.4 now, and medical advances are likely to push that number up further. In other words, people linger on today whereas before they would have passed on.

As a result, China today not only has the biggest population of any country in the world, but is also aging faster than any other country in history.

Globally, there is a pattern of acceleration in terms of how long it takes a society to become 'aged'—that is, when old people aged 65 or above constitute more than 14% of the population. It took France 115 years, the US 60 years, Germany 40 years and Japan 24 years, with a world average of 40 years. For China, however, it may take only 23 years. Another 11 years beyond that and it will turn into an 'ultra-aged' society, when the over-65 crowd makes up 28% of the population.

Pension Tension

China's pension system, meanwhile, barely offers a buffer. The system started too late, and it is already using the money contributed by younger people to pay current pensioners. When the baby boomers grow old, the pool will dry up, barring significant changes. Even before that, urban pensioners today receive less than half of what they used to get from the state social security system.

"According to actuarial forecasts, China's current social security system will have a financial gap of RMB 86 trillion in the future," says Hu Jiye, a professor with China University of Political Science and Law.

China's urban employees have to contribute 8% of their wages to individual retirement accounts, with employers contributing another 20%, but most of the money is 'borrowed' to pay legacy pensions of pre-1977 state workers.

China set up a national social security fund in 2000, as a supplement to the current pension system and it is now an active investor in the stock market—a move some consider to be risky—while other pension money is generally limited to Chinese government bonds and bank deposits. The fund's assets totaled $285 billion at the end of 2015, but there is still expected to be a significant shortfall. The country is also allocating more tax revenues to pay pensioners, but that is also becoming a burden on the country's finances.

"I dare say the problem will be more serious than Japan's," says Yi Fuxian, a senior scientist at the University of Wisconsin-Madison. Japan's developed nature put it in a much better position when demographic change hit. It has a social security system that covers everyone, and the universal pension and health care systems were established in 1961, well before the country started aging—from 1970 to 2015, Japan's elderly population rose from 7.1% to 26.7%, the world's highest.

But although Japan was able to maintain high pension and social-security benefits, its young people face high tax burdens, and government debt is more than double GDP. The fact that Japan can barely shoulder its burden is worrying.

Fertility Fix?

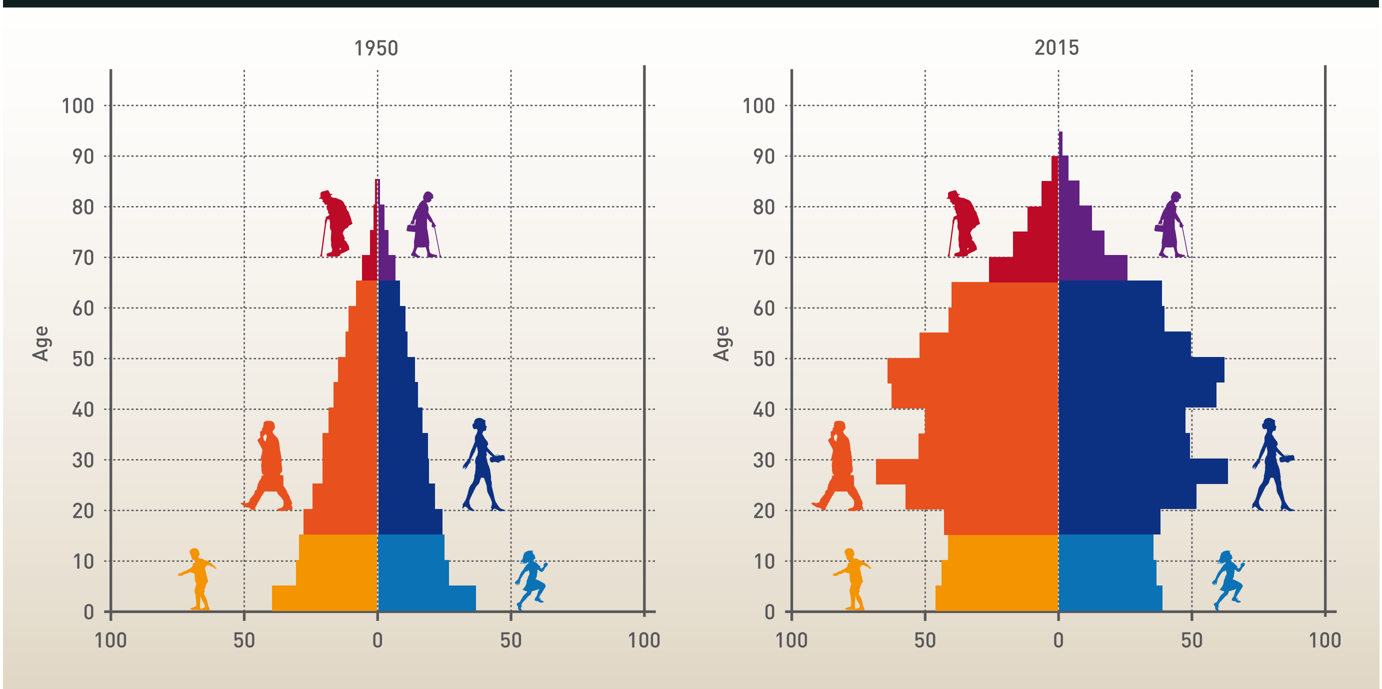
In reaction to the problem, China relaxed its family planning policy in late 2013, allowing a family to have two children if one of the parents is an only child, and the policy was further loosened in 2015, allowing every family to do so. So far the results have been lukewarm—preventing births seemed to be a whole lot easier than encouraging them.

"It was expected that the end of one-child policy may cause two million families to try for a second child," says Jiang Baoquan. "But in 2014 only 65,000 second babies were actually born. The 2013 policy relaxation did little to boost the birth rate."

The policy change may be too little too late. China's fertility rate may have inched up a bit to around 1.5 after the 2015 policy change, but it's not only well below the replacement level of 2.1, but also lower than the developed-world average of 1.7. Moreover, other low-birthrate countries have had

Generations of Change

A comparison of demographics between 1950 and 2015 show the aging population



Source: United Nations, Department of Economic and Social Affairs little success in boosting fertility via policy fixes.

In Japan's case, Junko Yasuda with Nomura Research said policies were launched to help women balance children and work. But Japanese people take having children as a private decision, and seem not much affected by the government.

"The second baby-boom generation that was born 1971-1975 [have] reached the age of 45, so they cannot have many more children," Junko says. "It means the third baby rush never came."

In China, the one-child policy fundamentally changed people's idea of raising kids, making a multi-child family something that most Chinese families no longer aspire to. Raising kids is financially and psychologically burdensome on ordinary people. Simply scrapping the ban can't offer them incentives to give birth to more kids.

"I can't afford to have a second child. It will cost me my business," says Maggie Zhao, who owns an export company in Shanghai. "I will lose my clients if I have to be away for another half year. We run a small business; you need to attend to every detail."

Maggie's mother is the one taking care of her daughter, but grandma's health condition doesn't allow her to raise another infant. Chinese public kindergartens only accept children after they turn three, and grandparents are usually the caregivers after the mothers return to workplaces. Many working mothers have to choose between babies and work as there is no daycare system in China to take in babies that are only a few months old. There are also no favorable policies for families that only have one adult at work.

Yi said Japan and Korea's failed efforts to bring up fertility rates offered China more lessons instead of experiences. Encouraging more children would mean restructuring most of the country. China's high property prices, traffic jams, and lack of childcare options are all standing in the way of increased births.

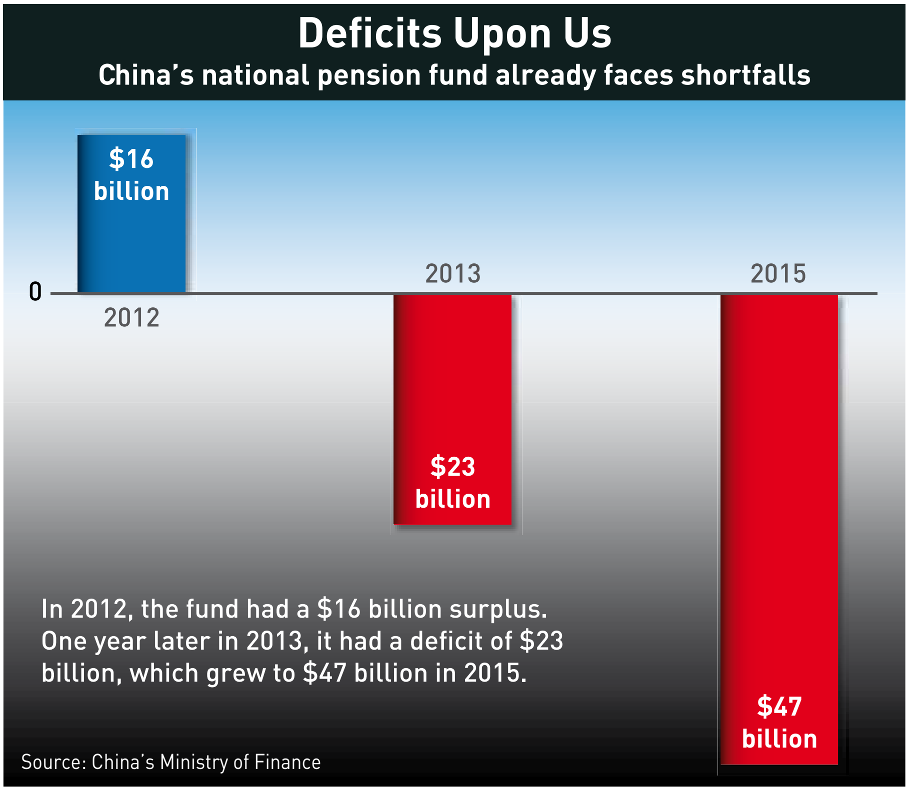
No One Way Out

With the only real fix of a higher birthrate seemingly moot, China will have to resort to a combination of adjustments to ameliorate the aches and pains of becoming an elderly society.

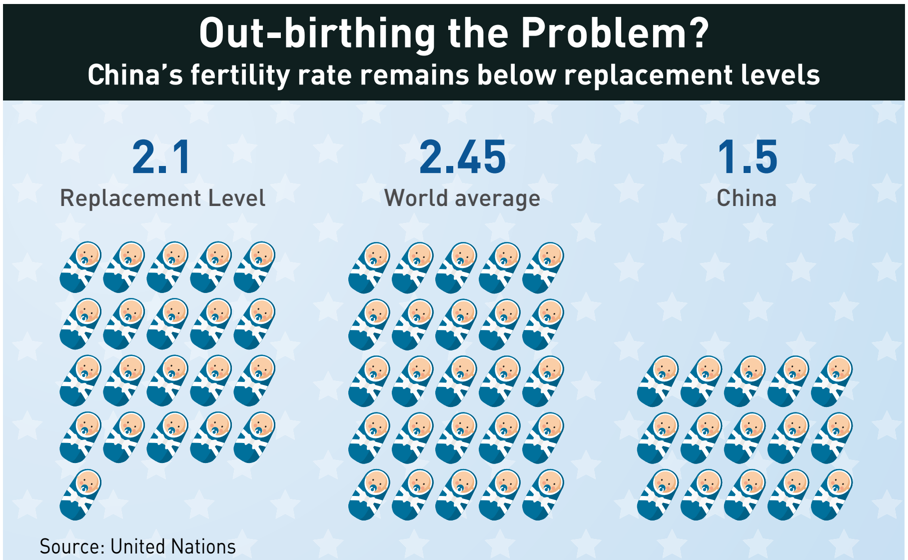
The shrinking working population can be partly addressed by higher work participation among old people, and this is already being pursued. China's authorities wrote in the 13th Five-Year Plan that they want to gradually raise the retirement age between 2016 and 2020—in China, most retirees still have the potential to work longer since they leave their jobs before the age of 60. It may also be possible to accommodate more old people in the workplace by providing flexible arrangements.

"People will have to retire later as they are expected to live longer," says Hu. "The basic rules to keep a pension system balanced is to get back what you paid." By encouraging people to stay as contributors to the system, the pool will be more balanced with more money flowing in.

China's traditional family values may also help the society to take care of both the elders and the children, since more Chinese people are inclined to live in big families than in Western countries. But the co-residence rate has dropped sharply as more people moved into cities and grew financially independent. Still, China's 2010 census indicated that 50% of old people live with their adult children. The government could encourage this trend by relax-



> I can't afford to have a second child
>
> Maggie Zhao
> Export company owner
> Shanghai



> The country will have hope only if our young people can bring more babies
>
> Yi Fuxian
> Population expert
> University of Wisconsin-Madison

ing the hukou registration system (which differentiates urban and rural people), or urging migrant workers to work in cities closer to their original homes.

"China is so big that migrant workers might be thousands [of] miles away from home," says Yi. "It's almost impossible for them to take care of their old parents."

China could also encourage more people to participate into corporate annuity plans and commercial pension plans, so elders will rely less on the mandatory state pension system. The country enjoys the highest savings rate in the world as individuals don't have many safe investment choices beyond banking deposits. By moving part of the savings into the pension plans, the country may restore their safety nets.

Habits of saving starting from a young age will help educated individuals to fare better than others. They could also do better if they were allowed to diversify their wealth from expensive property and bank savings.

But these measures are of little help to China's poor rural people, who of constitute around half of China's population. China's rural areas have more old people than cities as they have channeled the young working populations into the cities as migrant workers. A Shanghai University of Finance and Economics 2015 study shows 15.4% of the rural population is already old versus 13.3% at the national level. The research also shows that more than 50% rural elders are still working, many doing hard manual labor in the fields.

All this means rural old people will likely be hardest hit by the demographic changes. China's pension system has not yet covered everyone in the country, and rural people can hardly maintain their lives with the 70 yuan (about $10) offered every month by the state pension funds. Many of them have limited savings as they don't own the land they plant and they suffer from lack of health care services.

"There isn't much to do about the rural people," says Hu. "China's social security system can't provide every retiree as good a life as the North European countries do. Our fiscal system just doesn't have the ability."

Immigration has been the choice of many countries to fill the numbers gap, but it is hardly China's. China so far is still a net sender of migrants. Between 2005 and 2015, China saw an average of 400,000 people emigrate to other countries every year, mostly developed counties. China may also find it difficult to attract young workers from other countries simply because it isn't the only country growing old—most of the world is. There is some chance of migration from relatively young countries in the Middle East and Africa if China is willing to open its door to them, but it seems doubtful at best.

"Who would want to migrate to China? [Especially] if its economy slows down while the aging problem worsens," says Yi. "Africa's economic growth will pick up thanks to its young population, so their young people won't aspire to move to China."

One Foot in the Grave

A greatly aged population now seems inevitable and China can only hope to mitigate the impact. Efforts will no doubt be made to maintain economic growth while the working population shrinks, though an aging-related accelerated slowdown is more than likely unavoidable.

On the other hand, it is still 15 to 20 years away before China's population really starts to shrink, so the government and individuals still have the chance to move before it's too late.

"The most important thing of all is… to encourage births," says Yi. "The country will have hope only if our young people can bring more babies."

The Great Idea Bubble

How much sizzle remains in the world's hottest tech startup scene?

By Matthew Fulco

Image by Beibei Nie

Shenzhen-based dronemaker DJI is one of China's more successful startups

China has 35 tech startups valued at one billion US dollars or more, giving it the most 'unicorns' in the world after the United States, which has a whopping 138 of the once near-mythical companies. But 32 of the 35 have hit the billion-dollar valuation mark only since late 2014, and some observers see a bubble in the valuation surge.

China's startup scene has long been the most vibrant in Asia. It has produced some of the most highly valued startups in the world, including smartphone vendor Xiaomi, No. 3 at $45 billion, and ride-hailing service Didi Chuxing, No. 4 at $28 billion—although its value may balloon to $36 billion, if an agreed-upon merger with Uber China goes through. But the scene is now showing signs of frothing over as the world's second-largest economy slows and traditional asset classes such as property and equities begin to lose their sheen.

Return-hungry investors of every stripe are pouring capital into young tech companies in sectors like online-to-offline (O2O), fintech and biotech. The Tencent-backed biotech startup Icarbonx, founded in October 2015, reached a $1 billion valuation in just six months, making it one of the fastest companies ever to reach unicorn status.

Simultaneously, Beijing is pushing supply-side reform in a bid to recalibrate the Chinese economy and turn China into an advanced manufacturing power, the goal of the "Made In China 2025" initiative. To succeed, Beijing will need more home-grown technology titans that can compete globally and the hope is that startups will play a key role in that endeavor. The combination of these factors has made for a lot of excitement.

"There is certainly a startup bubble, or a soon-to-be one, right here in China," warns Stephanie Yan, head of the ZH Studio media consultancy, an experienced angel investor in China and a close watcher of the nation's startup ecosystem.

And yet, for some, the money keeps rolling in. In January, Meituan-Dianping, China's top restaurant booking and movie ticket platform, raised $3.3 billion from investors, including Tencent and VC firm DST Global, bringing its valuation to over $18 billion.

Yan concedes that China has a number of valuable, high-performing startups that are unlikely to falter. But she is concerned that with some institutional VCs tightening their belts and a glut of novice venture capitalists (non-institutional investors without a financial background) in the startup scene, Chinese entrepreneurs often lack a solid support system from their investors, "other than the money input."

"No matter how much money they raise in round A or B, many Chinese startups usually cannot survive beyond round C," she says.

The Story Behind the Surge

China's startup frenzy began five years ago as fast smartphone adoption brought hundreds of millions of new consumers online. The most prominent company to emerge from that early pack of startups was Beijing-based Xiaomi, valued at $1 billion in December 2011, before most of China's current unicorns were even founded. Notably, Xiaomi is a hardware maker, making the company an outlier—along with Shenzhen-based drone maker DJI—among the dozens of Chinese internet startups in the "unicorn club."

Many of China's top startups are in the online-to-offline (O2O) category, offering smartphone apps covering services like ride hailing, food delivery, and laundry pickup and drop-off. The demand for O2O in China is tremendous, observes Arthur Yang Zhang, a partner at the Sunnyvale, California-based Plug and Play Center, one of Silicon Valley's earliest incubators, which provides resources for young companies.

"China lacks good service companies," he says. "Big companies cover maybe half the market, which leaves a lot of opportunities for smaller players."

And with China's economy decelerating, startups are one of the few asset classes with strong growth potential. As a result, it has been easy for tech entrepreneurs to secure funding from China's internet giants (Alibaba, Tencent and Baidu), venture capitalists and private-equity firms.

Beijing is providing further momentum as it seeks to reshape China as an advanced manufacturing power. As the offical annual GDP growth rate fell to a 25-year low of 6.9% in 2015, China's state-backed venture funds raised about 1.5 trillion yuan (about $220 billion) in 2015, according to the research firm Zero2IPO. It is the largest fund pool in the world for startups.

"There's a huge amount of money trapped in China because the government doesn't want it to leave," says Jamie Lin, co-founder of Taipei-based AppWorks, one of the largest accelerators in Asia. "There's nowhere for it to go right now—except into startups."

Much of the cash is contained in "government guidance funds," which are operated by both central and local government agencies. There are 780 such funds, with tax revenue or state-backed loans providing most of their capital. To date, the government has yet to issue specific guidelines for how the funds should be managed, so experimentation is the norm, market observers say.

> There is certainly a startup bubble, or a soon-to-be one, right here in China
>
> Stephanie Yan
> Media Consultant and Angel Investor

But government support for tech startups goes well beyond funding. Since 2014, it has also opened 1,600 high-tech incubators for startups. In May 2015, China's State Council issued new guidelines to boost high-tech entrepreneurship. And in a June 2015 statement, it said: "It is imperative that we intensify structural reform, boost efforts to implement the strategy of pursuing innovation-driven development, and all institutional obstacles should be moved to give way to mass entrepreneurship and innovation."

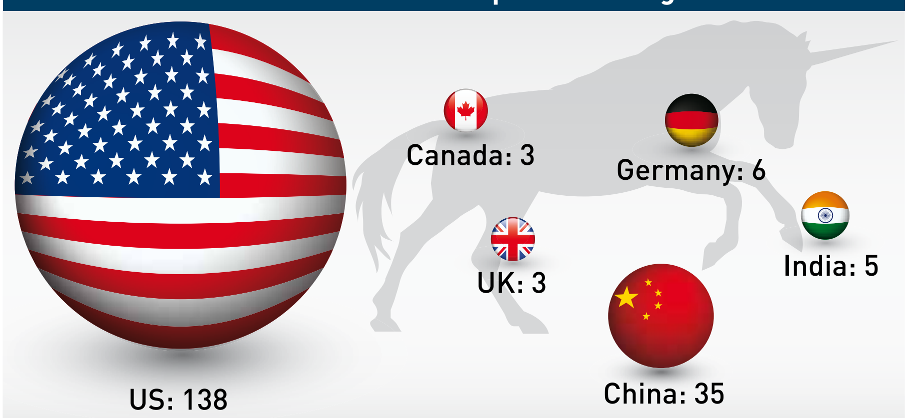
"Some people have argued that the government's mode of support for startups is not conducive to nurturing an innovative, entrepreneurial ecosystem," says ZH Studio's Yan. "There's some truth to that."

Still, she acknowledges the positive role government-backed incubators on China's eastern seaboard are playing. "Those organizations play very constructive roles as the early stage net for startups established by Alibaba and Tencent alumni, who personally told me that without these incubators and the VCs they helped bring in, they would have been less likely to launch their companies."

The Chinese authorities "are directing where the market is going," says Zhang, from Plug and Play Center. "Unicorns in China can only become unicorns because they are affiliated with prominent forces."

Unicorn Populations

Billion-dollar valuation startups are no longer so rare



Source: VentureBeat

Coming Down to Earth?

Meanwhile, the Chinese government has taken steps to ease overheating in the startup market. According to a May report by the Chinese-language business publication *Caixin*, the China Securities Regulatory Commission (CSRC) is moving to restrict firms in traditional industries from investing in tech startups, for instance by refusing to approve private share placements in a sector outside of a traditional firm's core business. Additionally, the CSRC will more

Visitors at the 2015 Global Mobile Internet Conference in Beijing

carefully scrutinize merger and acquisition activity involving traditional companies and tech startups.

Those moves come as more experienced investors are becoming more cautious. Compared to even a year ago, "there's less hubris and more humility," says Rui Ma, a partner at the Silicon Valley-based 500 Startups accelerator and the company's head of Greater China operations. "For a startup at the early stage, it takes much longer to raise money. Investors want to know: What is the technology and IP [intellectual property] that you have that differentiates you?"

Plug and Play's Zhang raises the example of the ultra-competitive and fragmented O2O fruit segment. "If you're selling pineapples online, you better know exactly who your customers are and have cloud-based business intelligence tools to prove it to investors," he says.

The upside of the market slowdown is that investors are less likely to back pedestrian business ideas in hopes of quick returns, which gives entrepreneurs more incentive to innovate, Ma observes.

Following several high-profile startup failures, "people are a little bit more cautious now," Ma notes.

In March, the state-owned *China Daily* newspaper reported the Beijing-based e-commerce startup Metao was "facing imminent closure." The news came as a surprise given the company had raised a total of $35 million from series A and B funding rounds in 2014 from prestigious VCs including Matrix Partners China and Morningside Ventures.

The Chinese-language *Sina* site reported in March that Metao founder Xie Wenbin was new to e-commerce and aimed to carve out a niche for Metao as a business-to-consumer platform offering heavily discounted products from overseas. Although Xie enjoyed some initial success, by 2015 he was ensnared in a head-to-head price war he could not win with e-commerce giants JD.com and Taobao. Metao never reached its Series C funding round, and was headed for collapse by late 2015.

Then in April, China's official Xinhua News Agency reported the leading Shanghai-based grocery retailer Yummy77.com had filed for bankruptcy. Founded in 2013, the company received a $20 million investment from Amazon in 2014 that brought its valuation to $100 million.

Like Metao, Yummy77.com faced fierce competition from China's e-commerce juggernauts, including Alibaba, JD.com and Yihaodian. Market insiders say Yummy77.com spent beyond its means on warehouse construction and a logistics network, and was unable to generate sufficient profits to offset those costs. A management team of online grocery retailing novices did not help matters.

Changing Fortunes

Those failures aside, to date none of China's major startups have collapsed. But some market observers are beginning to wonder about the viability of China's top unicorn, Xiaomi. Once the hottest rising star in the global handset market, Xiaomi's sales have plateaued. It missed its 2015 shipment target of 80-100 million handsets by a wide margin, selling just 70 million units. In the first quarter of 2016, rival Chinese smartphone maker Oppo overtook Xiaomi in terms of units shipped.

Worse yet, Xiaomi is struggling to deliver its smartphones into the hands of consumers. The company's strategy of negotiating low prices with its suppliers in order to reduce costs is taking a toll, observes Eddie Han, a smartphone industry analyst at the Taipei-based Market Intelligence & Consulting Institute (MIC).

"Suppliers see their prices and margins decline when they do business with Xiaomi, so some of them now prefer to work with other brands," he says. As a result, "Xiaomi ends up with component shortages that put a dent in its shipments."

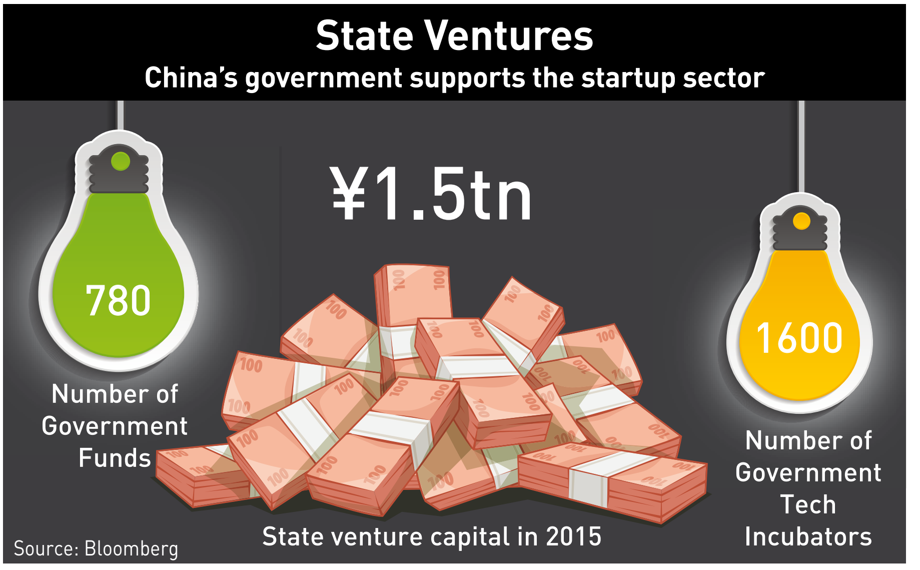
Brand positioning is a problem, too. Han notes that Xiaomi is squeezed between the premium and mid to low-range market segments, offering little to distinguish itself. In the high-end market, for instance, Huawei is winning market share with "impressive hardware, such as a force-touch Leica camera or [a] homegrown high-end processor," he says. In the low-end and mid-range market segments, LeTV and OnePlus offer top-notch smartphones for a fair price.

"It is hard to say whether this trend [of Xiaomi losing market share] is reversible," he says.

As for Xiaomi's much-touted internet-of-thing ecosystem, since it is likely to duplicate the same model used for its smartphone business, that is, the same concerns arise.

"Whether this will be the right move to make will depend on whether Xiaomi will be able to obtain enough revenues from content, services, and VAS (e.g. video, finance, online retailers, ads, and data analytics) and whether its suppliers will provide stable supplies to Xiaomi despite the decline in their margins," Han says.

By contrast, Didi Chuxing's prospects look considerably better. Its announcement in August to acquire Uber China's operations eliminated its main competitor in China's lucrative ride-hailing market, although the deal is currently surrounded by some regulatory uncertainty. Didi also has the support of the Chinese government, and is backed by a suite of heavyweight investors: Alibaba, Tencent, Softbank, Apple and ChinaLife.



AppWorks' Lin says Didi Chuxing "is in a much better position than Xiaomi. I wouldn't be surprised if in one year, Didi's valuation is higher than Xiaomi's."

'Late Summer'

Didi Chuxing's case is not isolated: Many of China's top startup companies have solid user bases and revenue streams, and some are profitable, notes Lin of AppWorks. He is dismissive of speculation about a tech startup bubble in the world's second-largest economy.

"The situation in China now is completely different from conditions prior to the dot-com crash," he says, referencing the infamous collapse of tech stocks in the early 2000s that wiped out over $5 trillion in market capitalization between March 2000 and October 2002. "There will be price corrections in the valuations of Chinese startups, but the risks are only borne by the companies and private institutional investors. The public isn't involved."

Critically, heavyweights in the global investment community remain sanguine about Chinese startups. In mid-July, veteran Silicon Valley investor Jim Breyer—known for his early investment in Facebook—and Chinese firm IDG Capital Partners announced they had raised a massive $1 billion VC fund in China, defying concerns about an overheated market. The new fund will invest in a number of industries such as technology, media, health care and energy.

According to data compiled by Dow Jones LP, the fund is the largest China investment fund backed by Breyer and IDG to date. Their investment collaboration in China dates back to 2005 and comprises seven funds including the most recent one. Accel Partners, Breyer's former firm, collaborated with IDG on the first five funds, while the more recent two are between his new firm, Breyer Capital, and IDG.

In a statement, Breyer expressed admiration for "the caliber, creativity and drive of Chinese entrepreneurs working across a range of industries." He added: "China continues to represent tremendous long-term investment opportunities, particularly in companies applying machine-learning and artificial intelligence to revolutionize a multitude of industries, including financial services, healthcare, and social media, to name just a few."

Is he correct? To a certain degree, says Lin of AppWorks. "The China startup scene has reached late summer," he says. "The heat has peaked, but the days are still warm."

The Middle Minority

A significant new force is beginning to take shape in Chinese society

By Tom Nunlist

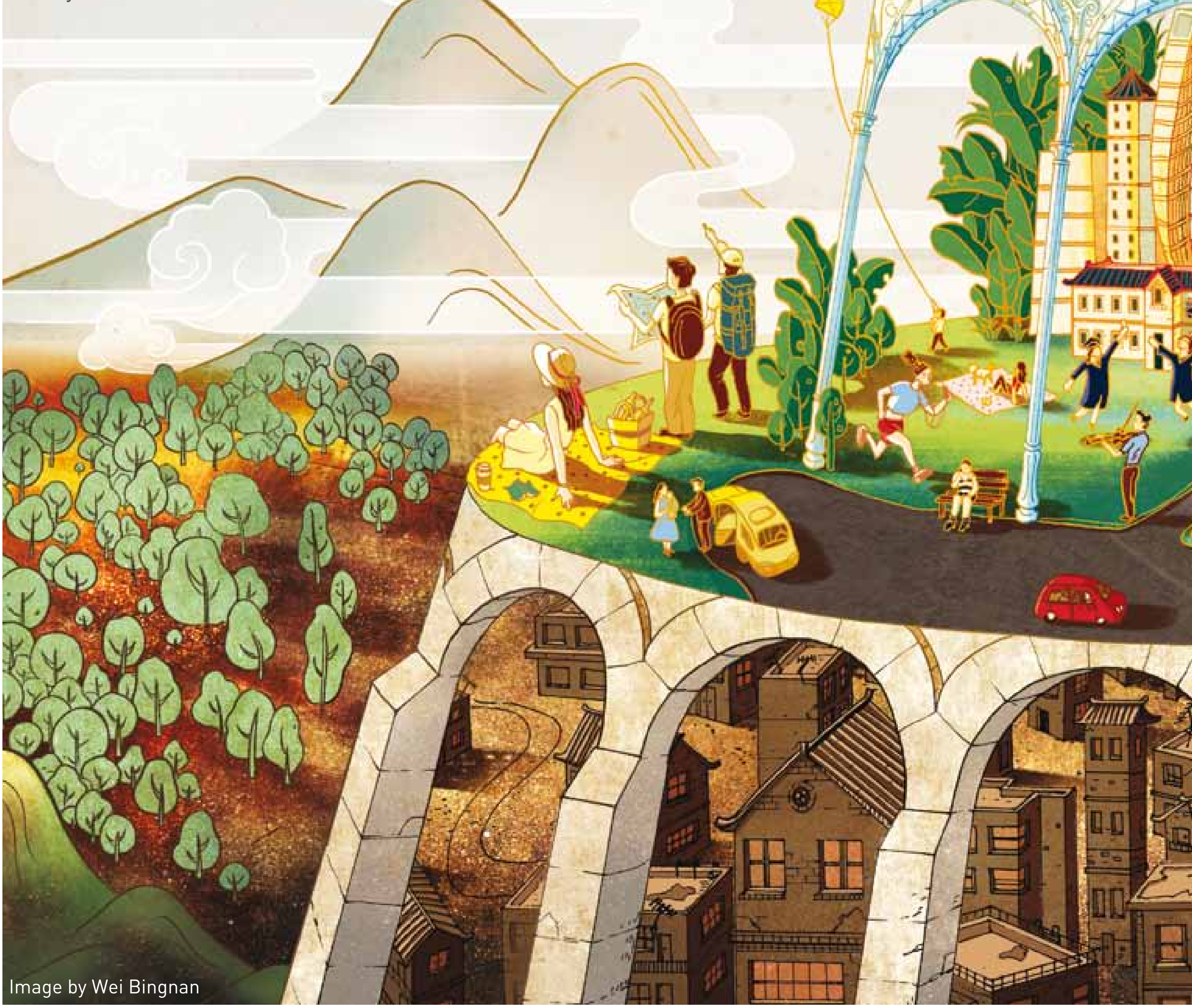
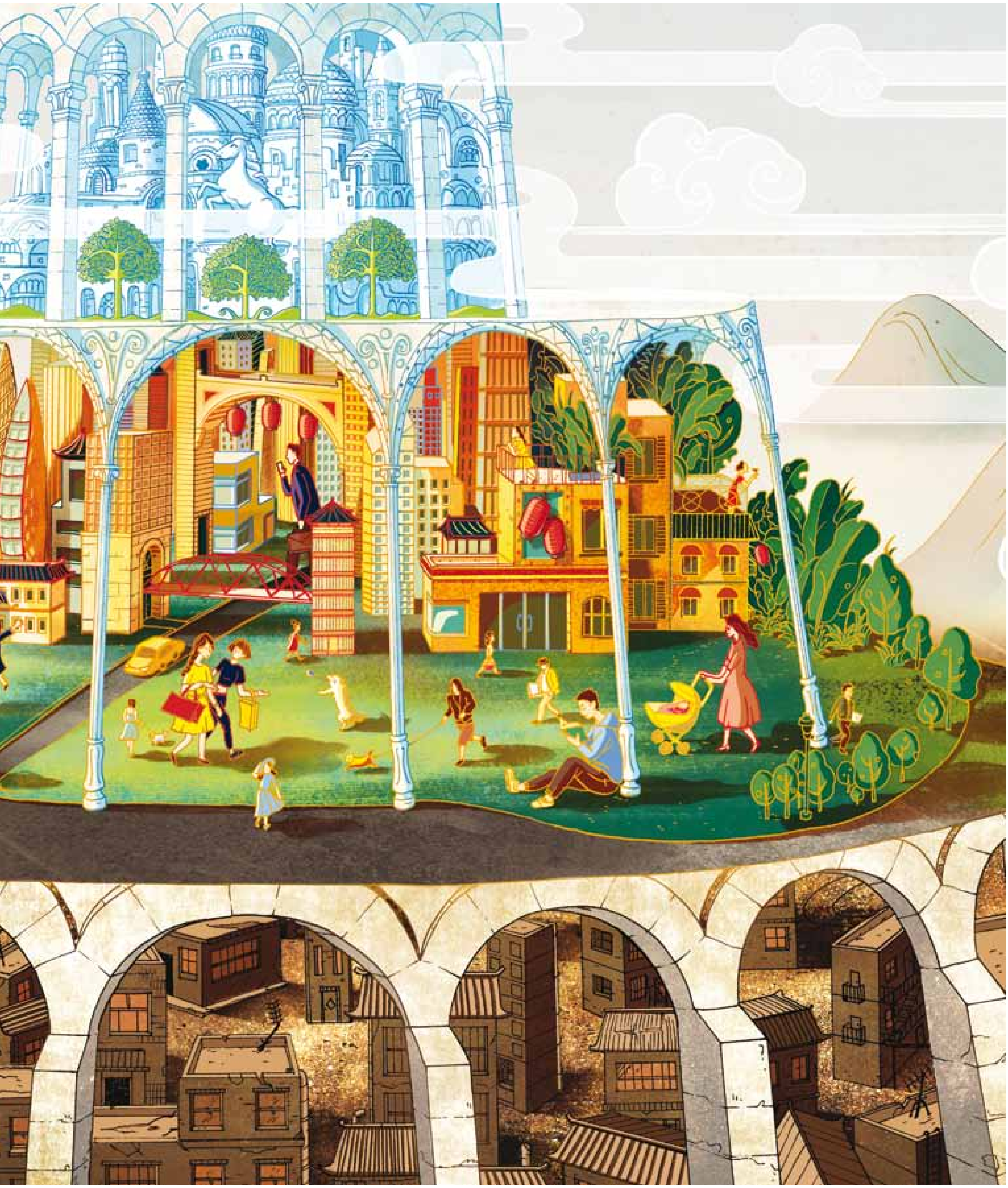


Image by Wei Bingnan



Fu Cong is 33 years old, owns his own home and car in Shanghai and likes to drink shochu at a speakeasy-style Japanese bar on occasion, when he's not at work in an international media company or spending time with his wife. In the past few years he's gone cold on his long-time photography hobby in favor of scuba diving, and if you're interested he can recommend the best dive spots in Thailand. It's a comfortable life, but Fu does not consider himself to have made it.

"I'm definitely not middle class," he says. "My income is not high enough."

Credit Suisse, which last year estimated the size of China's middle class at 109 million adults, would likely disagree with that. The Chinese government would as well—the official bar for middle class is an annual family income RMB 80,000 per year (around US $12,000), which adds up to more than 145 million people. But that's only one of many ways to define the term, with others including education level, home ownership, lifestyle and career, to name but a few. Getting agreement on what, or who, counts as middle class in China and what doesn't is fiendishly difficult, not least for Chinese people themselves.

In contrast to Fu, Fiona Gao, a middle-aged business woman, is very clear about her social position.

"I became middle class the day I bought my first apartment," she says.

Zhi Hua, also a middle-aged businesswoman, also identifies herself as middle class, and places the moment of ascendance on graduation day from university.

Ralph, meanwhile, is a Shanghai ad salesman in his early thirties who has both an apartment and a university degree, and yet he categorically rejects the idea of being middle class, again on the basis of income.

But fuzzy as the edges may be, it is beyond doubt that a huge number of Chinese people over a span of the past two decades or so have achieved a level of prosperity and financial independence never even dreamed of by their forebears. They are, at least by the standards of popular conception, appearance and habits, middle class, a group that has never before existed in a substantial way in China's thousands of years of history.

> "[The middle class is] going to be at the epicenter of every social change that is going to happen... they are the ones that will complain about policy
>
> Luigi Tomba
> Senior fellow at the Australian Centre on China in the World, Australian National University

They take vacations and spend already $200 billion overseas annually, although currently only 4% of Chinese have passports. They go to spas and drink Starbucks, which now has over 2,000 locations in more than 100 Chinese cities. They sent more than 300,000 of their children overseas to school last year to countries like the United States, where they added $9.8 billion to the US economy in student fees and other expenses. Consumer spending in China, largely driven by this new class of people, amounted to $4 trillion in 2015. By comparison, in the US it was about $14.8 trillion dollars.

But they are also a nervous group, increasingly inclined to voice their concerns on issues from home ownership and environmental degradation to food safety. And many of them have the means to make other arrangements if necessary, moving their money and even themselves out of the country. In short, the presence of a middle class in Chinese society is suddenly very obvious and there is much debate about what impact its existence will have on China's future.

"They are going to be at the epicenter of every social change that is going to happen," says Luigi Tomba, senior fellow at the Australian Centre on China in the World, Australian National University. "They are educated, they are the ones that read newspapers, and travel and spend money, they are the ones that will complain about policy."

Don't Put Me in a Box

When trying to understand this new group of people—an unprecedented middle to Chinese society—the first task is to get a grip on the slippery terminology.

"My preference is to discard the term 'middle class' because it comes with certain freight," says Arthur Kroeber, cofounder of Gavekal Dragonomics, a research firm based in Beijing.

As Kroeber explains it, someone of Fu Cong's description aligns very closely with what we think of the Western middle class—home, car, vacation, white-collar job, the whole lot. But identification of people with a certain lifestyle can get in the way of understanding the significance of this group within China.

"Because you use the word 'middle,' I think everyone has embedded in their mind that if you did an income distribution curve, [they are] the people who are in the middle," says Kroeber. "But by even the most generous estimate, this is a small minority of the total population, and it basically represents the economic elite in China, so it's not the 'middle' of anything."

Professor David Goodman, of Xi'an Jiaotong-Liverpool University, who has long been studying the so-labeled middle class in China, adds further nuance to this understanding.

"Only [about] 15% of the working population of China earns more than RMB 80,000 a year," Goodman says. "If we're talking about disposable income to have a middle class lifestyle, that's nothing." For reference, that income figure just barely tips over the poverty line for a single person in the United States and, cost of living differences notwithstanding, it's still not a lot of money.

In other words, this same group by one measure is in the top tier, and by another still quite poor. A bit of a skeptic, Goodman proposes that something else entirely is going on in this group.

"My argument is that you've got a discourse of middle class-ness, and that's interesting because it then puts the attention on consumption," Goodman says. "It's an aspiration. You might not really be [middle class], in the sense of a sociological definition, but you might be because you want to perform that way."

> By even the most generous estimate, this is a small minority of the total population
>
> Arthur Kroeber
> Co-founder of
> Gavekal Dragonomics

Tomba neatly crystallizes the nature of the definitional dilemma.

"The size and type of middle class, and the kind of people you include in it depend much more on the point of observation than on the actual reality of things," he says. "I always think the middle class is anything that you want to make of it."

But how, then, is it possible to make sense of Fu Cong and his peers, who are apparently a relatively poor elite that enjoys a consumption-based lifestyle while simultaneously claiming not to belong to a group that we're all inventing on the fly?

The answer lies in the origin story.

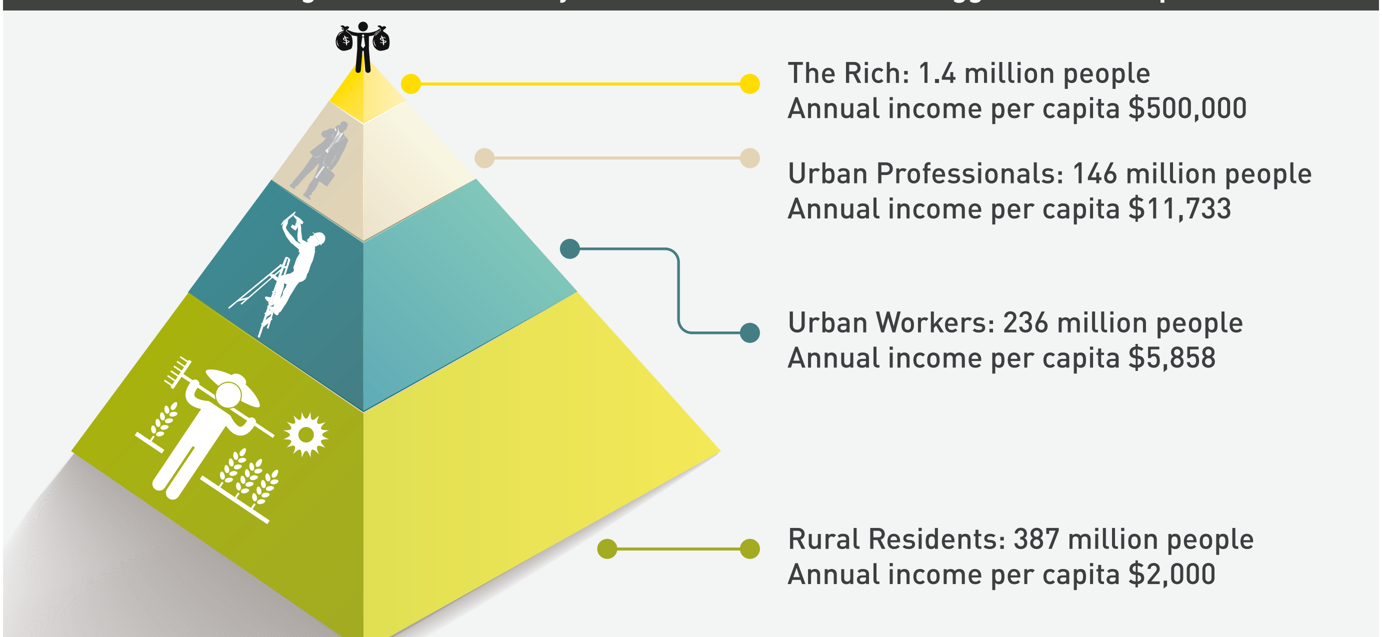
"Instead of thinking about how big the middle class is, you think about where it comes from, and in particular how did it become a thing in China," says Tomba.

Staked to the System

The roots of China's middle class today stretch back to Shanghai in the 1920s and 1930s. But that small proto-middle class and culture was destroyed after the communist takeover in 1949, and a new

Consumer Classes

Defining the middle class by income—the base is much bigger than the top



Source: China NBS, CN Politics, Goldman Sachs Global Investment Research 'middle' elite of state officials and state organization staff members was created during the 1950s and 1960s. Suffice it to say, China prior to the changes following Mao's death in 1976 was not, contrary to popular conception, a flat society.

"China's intermediate class, the middle class, before 1991 was comprised largely of professional and managerial types who ran the state," says Goodman.

But this group was quite small, and the basic distinction was who did, and didn't, work for state-owned industries and organizations—"work units." These units provided stable income, as well as food, education, healthcare and—crucially to the story of China's middle class—free housing. The genesis moment of the China's contemporary middle class came in the late 1980s when the government embarked on dismantling this system, and began selling off the state organization housing to its residents.

"At first, they did not want to pay for housing because they weren't before, so they didn't realize what an enormous advantage it was going to be for them," says Tomba. That leg-up became apparent in the mid-1990s when the mortgage market started. As Tomba adds, "They had an early-entry ticket."

As the property market heated up through the 1990s and beyond, home prices rose. People with the good fortune to have been assigned state homes were able to buy second apartments and derive additional income from rent. Those with a continued connection with the state sector were also able to get better credit to add to their advantages. In other words, China's middle class today is very much a party-state creation.

"Their wealth comes from being a part of the [Chinese Communist] system," Tomba says.

Both Tomba and Goodman stress that not all the wealth of this group was created in precisely this way—there are also the entrepreneurs who appeared in the 1980s. But here again, there was usually a state connection: According to Goodman, more than half of all private entrepreneurs in China today used to work in the party-state system. Wang Jianlin, founder of Dalian Wanda and Asia's richest man started his adult life as a soldier, for instance.

Indeed, it isn't only academics that point out the Party connection to the origins of the Chinese middle class—Goldman Sachs says nearly half of the 146 million people officially in the middle class are still on the public payroll.

Many of the more cataclysmic predictions about the new middle class in Chinese society overlook this basic fact, which will to some extent at least shape the impact it has, because they have roots and a psychological investment in the system.

> "Does it really matter how much middle class we have? I really don't believe so. It's really how you look at your targeted consumer
>
> Jessie Qian
> Head of Consumer Markets
> KPMG China

Money and [some] Power

Talk to any businessperson in China today, and the topic inevitably turns to the so-called middle class—how much they travel, how to design a coffee house based on their expectations, what kind of cars they buy, the dynamic between them and the party-state, how their brand preferences are changing, their impact on society, *ad infinitum*. It's not just another hot topic, it's the zeitgeist.

"Pretty much every consumption trend that you can identify today has to do with the growth of this middle class of consumers," says Kroeber. "They are really the core of understanding the emerging Chinese economy over the next decade."

A cursory look at a few key numbers hammers home the seismic nature of the shift in progress. Chinese consumer spending grew from $1.5 trillion in 2007, to $4 trillion last year, about 37% of total GDP. But even these eye-popping numbers mask the true extent of change—one must look at how the structure of the economy has changed as it grew, and put those numbers in a better context.

In 1952, just three years after the birth of the People's Republic, consumption comprised a whopping 76% of economic activity—of course, this was because there was very little industry. From there, the share of consumption underwent a long, slow decline. In 1999 it was 47% of GDP, and in 2011 it was just 28%. Since then it has been growing, but it has a very long way to go to reach US level of roughly 70% of GDP.

The prospect of this growth has companies hungry—the Demand Institute estimates that consumer spending in China will continue to grow at 5.2% per year for the next 10 years, slower than previous decades but still robust. How much this growth in consumption can be chalked up to the rising 'middle class,' however, is questionable.

"China is a big market just because of the number of people we have," says Jessie Qian, Head of Consumer Markets, KPMG China, in Shanghai. "But does it really matter how much middle class we have? I really don't believe so. It's really

Millions of Chinese people are racing toward a richer future

how you look at your targeted consumer."

Regardless of how you look at this new group as consumers, their impact will surely go beyond just economic growth. As commentators are wont to proclaim, demands for control over one's life go hand-in-hand with affluence. While China's middle class has benefitted heavily from the current system, it also has to deal with its legacy in the form of apocalyptic smog, food safety scandals, a degraded environment and lack of rule of law. And there are the beginnings of signs of pressure being put on the government to make changes.

Last year's smash hit documentary, *Under the Dome*, attacked pollution issues with a personal, emotional appeal of the narrator's concern for her newborn daughter. The video was viewed over 100 million times before it was pulled from the web—Dali Yang, director of the University of Chicago Centre in Beijing, called it "a middle-class manifesto." And censored or not, the government has responded with serious cleanup efforts.

"You have seen significant pushes by these emerging affluent consumers for cleaner air and cleaner food," says Kroeber. "The government has had to respond to this by getting much more serious."

But whether or not concerns around these types of issues constitute some kind of middle class consciousness is considered dubious by many observers.

"I don't think there is any middle class consciousness," says Tomba. "[The issues] sit next to one another, but they never have some sort of umbrella organization."

Risk in a Generation

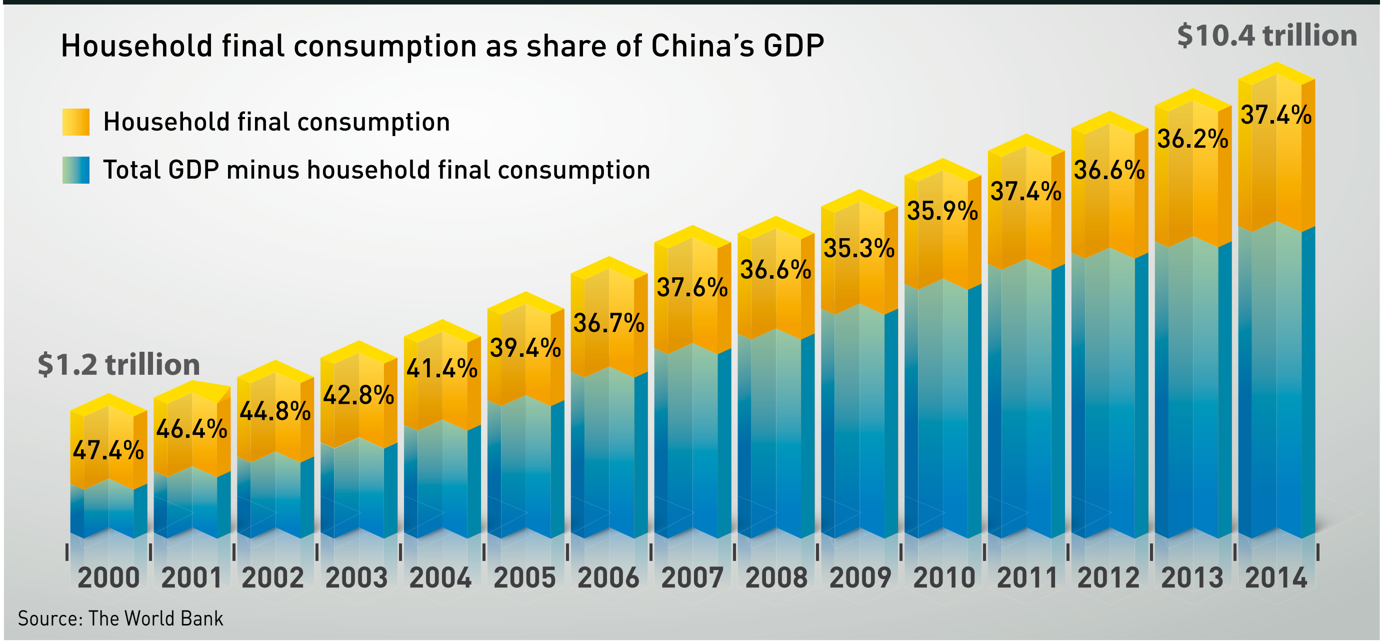
Somewhat ironically, the biggest issues facing the new middle class involve the very thing that propelled them to their status in the first place: property.

Even casual observers will note the first and fundamental contradiction of wealth via property in China—the fact that home 'ownership' is very much in quotation marks. At the end of the day, the state remains the owner of all property, and 'bought' land is actually only leased land. Most commonly, the lease term for urban land is 70 years, which pushes the issue of what to do when the lease expires a fair way into the future. There are exceptions, however, and this year has provided a taste of what may come to pass.

In April in Wenzhou, a southeastern

Room to Consume

As China experienced rapid growth, consumer spending as a proportion of GDP steadily shrank



Source: The World Bank

city, some residents were caught off guard when the local government informed them that the 20-lease on the land under their building was due to expire and some apartment sellers were told to pay a fee of up to one-third the value of the holdings to roll over the leases. This naturally did not go over well with residents, and while the final outcome is to be determined, the case highlighted the legal limbo in which all 'homeowners' in China live.

But the more pressing issue may lay with the property market and how it has developed since those first homes were sold off in the late 1980s. While the first generation received a windfall, the second generation is taking it on the chin.

"If you are a young couple, you have a double disadvantage," says Tomba. Not only did they miss out on the state-backed fire sale, but also the housing market since has rocketed toward the outer limits of reasonable valuation. With the caveat that the Chinese housing market varies greatly by location, prices in Beijing and Shanghai are now more than 30 times average income, and five of the world's ten most expensive cities in these terms are in China.

"We have a crisis in the second generation of the middle class, which may look much more like the US or the UK because they have the same troubles," Tomba says. "They can't buy a house, they can't afford a good lifestyle, and their salaries are not growing as much as they would like."

On the other side, the older generation has much, or even most, of its wealth sunk into housing, partly because of a lack of savings and investment vehicles in China. That makes the threat of a valuation crash much more salient. What this means on the whole is that the first and second generation of China's new middle class is, in a sense, on opposite sides of the status quo.

This and other problems have seemingly provoked a flight response. A 2016 survey by the *Financial Times* found that 45% of Chinese middle-earners wanted to trade at least 10% of their savings for foreign currency, and that another 29% had already done so. This problem has escalated so much that the government has repeatedly cracked down on cross-border cash flows, even restricting foreign ATM withdrawals.

In the last five years, Chinese have spent more than $110 billion buying real estate in the US alone (including corporate purchases), and 90% of US investor visas go to Chinese citizens. One estimate says that companies and individuals have moved $1 trillion out of China in the past 18 months—clearly not the behavior of a secure group of people.

On the other hand, only a small number of people can really afford to leave—it may even be more an elite strategy than a middle-class one. So that only leaves one viable alternative: Make the best of it here.

Certain Change

When trying to come to grips with what exactly China's new middle is, or who does or doesn't belong to it, solid answers are virtually impossible to come by. In turn, attempting to predict what long-term effect the new middle class will have on China's society and economy is correspondingly more difficult. In the end, however, pursuing concrete resolutions may not be as valuable as simple patient observation.

"I think what matters is that certain people are growing their wealth and they are more aware, and creating new mentalities," says Tomba. "[It is these] accumulated mentalities that will have an impact."

The Heat is On

A less-than-healthy regulatory environment is holding back China's pharmaceutical industry

By Matthew Nitkoski

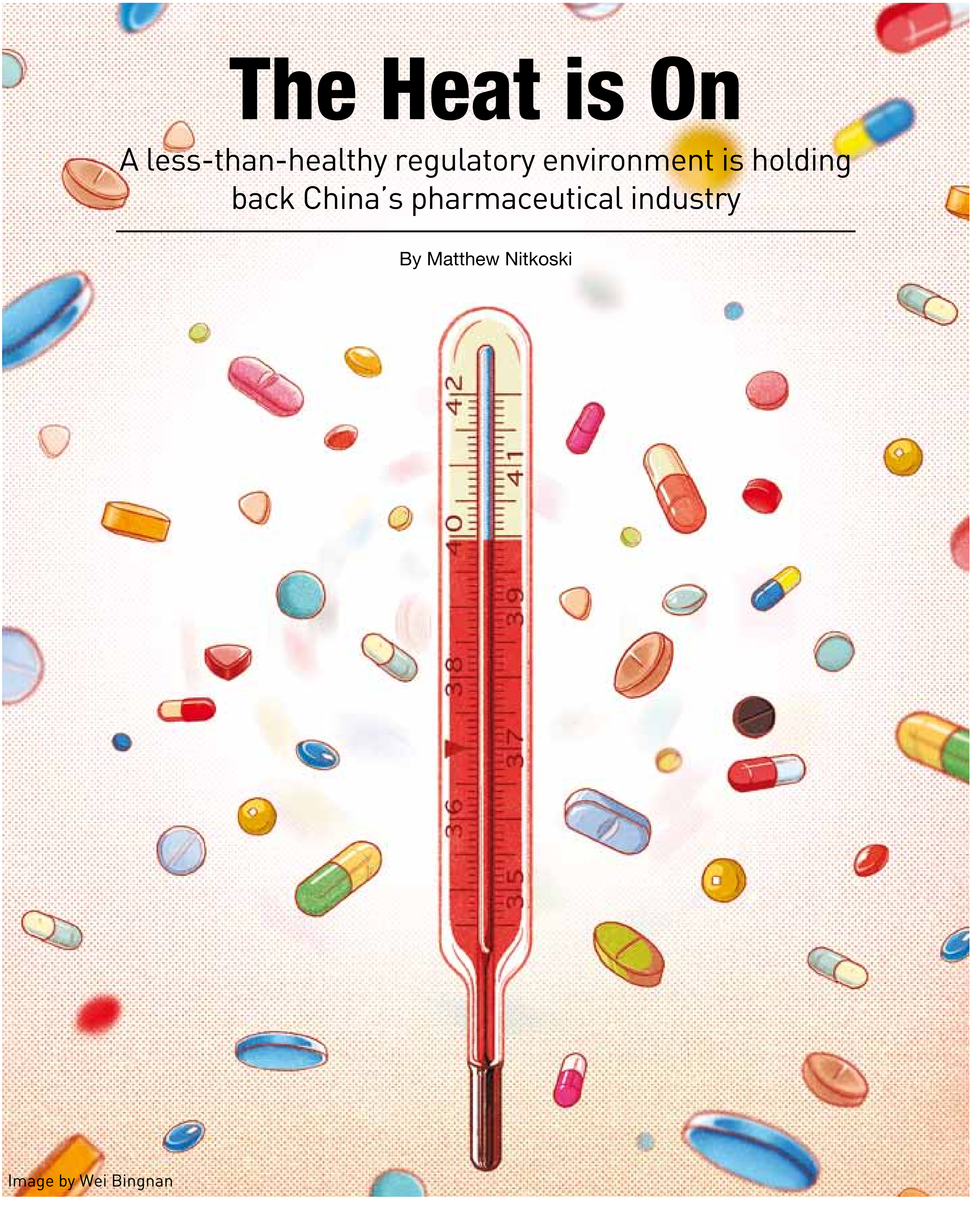


Image by Wei Bingnan

A police investigation into a vaccine trading scheme in the eastern Chinese city of Jinan was nearly a year old when the story broke in March 2016. The news quickly went viral as outraged parents, citizens, and lawyers questioned how over two million expired vaccine shots could have been approved for distribution to hospitals and clinics throughout the country.

The scandal was just the latest setback for China's pharmaceutical market, which is being held back by a dysfunctional healthcare system. On the consumer side, hospitals are overly reliant on drug sales for revenue, and doctors are chronically underpaid, both of which have led bribery scandals and even attacks on doctors by disgruntled patients, and of course drug safety. On the drug development side, pharmaceutical companies domestic and international are hamstrung by onerous regulations. And on top of that, the regulatory apparatus itself is under threat from corporate poachers armed with high-paying job offers.

The combined weight of these and other unresolved issues dragged pharmaceutical sales growth in China by multinational pharma companies down from over 20% in 2013 to only 5% in 2015. But even this hasn't stopped global drugmakers from placing big bets on continued China market growth.

Last year, overall pharmaceutical sales in mainland China totaled over $115 billion, placing China behind only the United States ($330 billion). With a population of over 1.3 billion, the sheer size of the market all but guarantees that the Chinese market will continue to grow in spite of any problems faced by the healthcare system.

"Healthcare is the one market where the market size equals the population," says Kent Kedl, a Senior Partner in Shanghai at Control Risks, a London-based global risk consultancy. Kedl has directed crisis management for several high-profile cases in China's healthcare sector. "Not everyone will buy premium oncology drugs or AIDS treatments, but everyone needs healthcare at some point."

"

Healthcare is the one market where the market size equals the population

Kent Kedl
Senior Partner
Control Risks

Sickness Market

China's large and still growing population makes it an ideal market for local companies as well as multinationals. But it is money—rising household wealth and rapid increases in healthcare spending—that has transformed China into the world's second-largest pharmaceutical market. According to the World Bank, annual per capita expenditure in China on healthcare rose from $44 per person in 2000 to $420 in 2014 and this trend is set to continue as wages and living conditions improve.

Further driving demand are Chinese citizens' changing lifestyles and habits. Living in crowded, polluted cities and working at white-collar desk jobs has dramatically increased the incidence of chronic ailments such as hypertension, diabetes, arthritis, cancer and cardiac disease. These health issues, once considered more Western problems, have sparked demand for new, advanced drugs to lower blood pressure, ease aches and pains, and lengthen life spans.

China's aging society is also driving demand. Currently, around 16% of China's population is over the age of 60, but this percentage is expected to grow considerably in coming years, with some estimating that nearly 25% of China's population will be over 60 by 2030. Although this demographic conundrum vexes Chinese authorities, the growing elderly population will very likely be a boon for the healthcare industry.

With such fantastic growth potential, the number of local drug companies has risen to keep pace with China's swelling demand. Many of these domestic drugmakers first appeared during China's 'opening up' period in the 1980s, as the government started to promote new drug development and provide assistance to local manufacturers. According to the Council on Foreign Relations, a New York-based think tank, the number of domestic drugmakers in China increased from around 680 to over 6,000 between 1980 and 2000.

Recognizing the pharmaceutical industry's enormous potential, Beijing included additional policy support in the 12th Five-Year Plan unveiled in 2011. The plan highlighted life sciences as one of the "seven emerging strategic industries" that would fuel China's future growth. Accordingly, the government has incentivized local drug development by investing over $1 billion in drug R&D, aimed at disease research, facilitating start-ups, and incentivizing the establishment of new R&D centers.

Multinational companies have also taken advantage of the generous incentives by establishing on-the-ground R&D centers.

"China encourages companies to locally manufacture their R&D products," says Katherine Wang, a life sciences regulatory lawyer and partner at Ropes & Gray LLP. "In principle, companies with local operations are eligible for fast-track approval for new products."

These benefits have encouraged multinationals to establish research campuses in Shanghai, a city quickly becoming a global pharma R&D hub. In 2014, Sanofi established its Asia-pacific Research center in Shanghai, while earlier this year, Novartis finished work on a $1 billion research campus located on the outskirts of the city.

At the same time, highly-skilled researchers born in China and now working abroad are being wooed back home.

"Qualified research scientists are being offered generous compensation packages to return to China and work for Chinese companies," says Kedl. These returnees have expanded the local talent pool, allowing companies to pursue more advanced research projects.

Together, the combined effects of favorable policies and repatriation of skilled scientists are transforming China into a key link in the global pharmaceutical manufacturing chain. In 2012, China became the world's largest exporter of active pharmaceutical ingredients (APIs). APIs are the biologically active parts of a medicine and include pharmaceutical mainstays such as penicillin, ibuprofen, morphine, and vitamins. In 2013, Chinese companies produced over 2.7 million tons of APIs.

China has also become an ideal location for contract research organizations (CROs)—companies that provide support to pharmaceutical, biotechnology, and medical device industries worldwide. Epitomizing the rapid expansion of China's drug R&D industry, Shanghai-based WuXi AppTec has grown into one of the world's largest CROs. Capitalizing on high demand growth, it has expanded its capabilities to provide a panoply of services.

"Other than a CRO, WuXi has successfully built an open-access platform with end-to-end drug discovery, development and manufacturing capabilities that can substantially lower the cost and increase the speed of testing a scientific hypothesis, thereby improving R&D productivity," says Dr. Steve Yang, WuXi's Executive Vice President and Chief Operating Officer.

But while WuXi regularly collaborates with biotech companies around the world, Chinese drugmakers have found it more difficult to translate domestic preeminence into international success. This is partly due to China's expensive and time-consuming drug approval process.

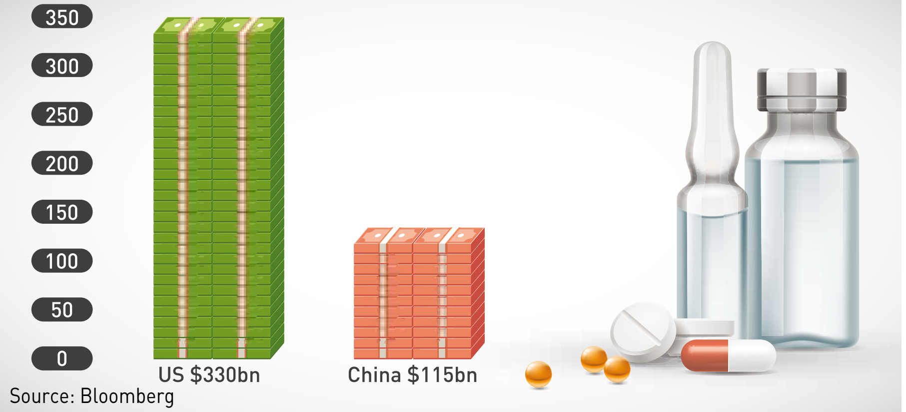
"When you apply for a new product approval in China, this requires a local clinical trial on Chinese patients. This requires another approval," says Wang. "Companies basically have to go through two approval processes: one for the clinical trial and one for the actual product approval."

Waiting for approval to begin clinical trials can take upwards of a year in China, double what it takes in the US and Europe. And then approval of the final product dossier can take months to years. While multinationals, too, must slog through this lengthy process, they have the advantage of being able to sell in Western markets to generate revenue while awaiting approval in China.

But the bigger is issue is China's healthcare system—an outdated setup facing the dual pressures of rising healthcare costs and a steadily growing pool of healthcare recipients. To truly free up China's domestic industry, Beijing will have to make tough decisions regarding doctor compensation and hospital revenues.

Runner-up

China was the world's number two drug market in 2015



Source: Bloomberg

Rescuing Healthcare

While scientists researching the new medicines are receiving better and better pay packages, the doctors actually prescribing medications are chronically underpaid and overworked. Because of this, many doctors have come to rely on under-the-table handouts and gifts to supplement their meager salaries.

Chinese doctors' need for higher salaries combined with multinationals' desire to push their products onto the market has encouraged bribery. Patients, frustrated with lengthy wait times and suspicious of doctor's true motives, have even physically struck out at hospital staff. In 2014, there were over 1,400 such reported "security incidents" in hospitals—stories of patients attacking doctors have become familiar media headlines.

Hospitals themselves have also become reliant on drug sales to generate anywhere between 40% and 60% of their total revenue, and according to Bain & Co., almost all of their profits. In contrast, in the US, pharmaceutical sales only account for around 10% of overall healthcare spending and a much smaller chunk of hospital revenue. This dependence has created a system whereby Chinese hospitals sell products at higher prices to patients, who in turn pass the cost on to health insurance. This has created a headache for regulators who want to expand access to healthcare and promote local industry while simultaneously reducing costs.

"Regulators can talk about changing prices, but right now hospitals rely on mark-ups to make money," says Kedl. "You can take this away from them, but they still need to make money."

Additionally, health scares and corruption scandals continue to rattle citizens' confidence in locally-made products. Incidents such as the 2002 SARS outbreak, the 2007 toxic cough syrup case, and the 2008 poisoned baby formula scandal linger in the public consciousness. This year's vaccine scandal has reignited concerns.

"The vaccine scandal further shattered my faith in China's medical system," says Pengqiao Lu, a China market analyst who recently moved to United States. "[It] has made me reluctant to visit the hospital in China."

Huang Jing, a new mother with an 11-month old son, shares similar feelings of distrust.

"I've been closely monitoring the Chinese vaccine scandal, but there's not much I can do besides postpone my son's vaccination date," she says.

Chinese authorities, well aware of the public's flagging trust, have begun to clampdown on the flow of money circulating among drugmakers and doctors.

In a landmark 2014 case, a Chinese court found GlaxoSmithKline, a UK multinational drugmaker, guilty of bribery. Along with a $488 million fine, the fallout from the case damaged GSK's reputation and forced the company to overhaul its China marketing. The case reverberated throughout the drug industry.

"It was a wake-up call," says Kedl. "Up until the GSK case, multinationals mainly had to deal with the US Foreign Corrupt Practices Act, and, to a lesser extent, the UK Serious Fraud Office. Now these companies also have to pay attention to the CFDA [China Food and Drug Administration] and local Chinese corruption laws."

The threat of being taken to court has complicated life for multinationals because most lack experience working with local regulators to ensure compliance with newly enforced bribery laws.

"The new laws are challenging companies' government relations departments. Prior to the GSK case, they mainly worked with getting new products approved. Now, government affairs has become a whole different animal," says Kedl.

Adding to the challenge is the lack of qualified staff at the CFDA. Just as Chinese scientists have been lured away from pharmaceutical positions in the US or Europe, regulators at the CFDA have been enticed by local drug companies promising lucrative pay packages. This brain drain has made it difficult for understaffed regulators to keep an eye on new developments.

Responding to questions regarding the recent vaccine scandal at a March 2016 news conference, CFDA head of drug supervision Li Guoqing candidly admitted, "There are dead spaces and blind zones for regulation and inspection."

> There are dead spaces and blind zones for regulation and inspection
>
> Li Guoqing
> Head of Drug Supervision
> CFDA

These "dead spaces" have made it difficult for both regulators and drug companies, not to mention increasing public risk.

Road to Reform

Faced with a daunting set of challenges, Chinese authorities have moved to separately address each of the problems facing China's healthcare and pharmaceutical industries.

To create a stable, functioning healthcare market, regulators must tackle three main issues, according to Kedl. First, regulators must reform how hospitals are compensated. Currently, state and local governments only provide around 10% of total funding to public hospitals. Second, doctors must receive greater compensation. Finally, state and local governments need to agree on one procurement process for drugs. Currently, it is not clear who has the final say in negotiating the prices that hospitals pay for drugs. This system makes it difficult for drugmakers as well as hospitals.

To improve China's drug approval process, the CFDA's first step has been to aggressively recruit more trained staff into its ranks, according to Andrew Yu, Director of Strategy and Operations at Deloitte China.

"The second step has been to establish a 'green channel' mechanism that expedites the approval process for innovative drugs in high demand," he says.

In 2013, this "green channel" allowed US drugmaker Pfizer to bring an innovative lung cancer drug to China's market in only 11 months—a previously unthinkable timeframe for a brand new product. "Finally, in July 2015, the CFDA raised the requirements for generic drugs and forced companies to provide evidence that their products are as effective as existing innovative drugs," Yu says.

Drugs that failed to meet these standards would be dropped from the approval process, thereby reducing the backlog current clogging the CFDA approval pipeline.

An additional concern for drug companies is China's spotty intellectual property record. Nevertheless, "China's IP laws have made big strides in recent years. Multinationals are more likely to stay away due to the lengthy registration process rather than fears of copying," says Yu.

Foreign brand name products also carry an additional advantage.

"While there is always the risk of a copycat product being released, there is a general belief among the Chinese population that brand-name, international products are superior to local drugs," Yu says.

Prognosis

Reviving China's healthcare system and reforming the country's drug approval process will take considerable time, and it is impossible to forecast how these separate but complementary changes will play out. But despite the uncertainties, all of the elements are there for China to become a global pharmaceutical hub, with rising domestic demand, qualified professionals, top-level political support, and foreign interest in the local market.

China may still have a way to go before it can launch its own, homegrown blockbuster drugs, but the market will probably be there to support them when they appear.

"Despite all the challenges in the healthcare sector, this is the one sector that everyone is betting on," says Kedl.

A Company Called Wanda

One of China's biggest property companies has grown into an empire, but how stable is its future?

By Tom Nunlist

Image by Wei Bingnan

Among the many changes to China's economy and society in recent decades, the privatization of housing since the late 1980s—which helped create a big part of China's economic engine—was arguably the most pivotal. Dalian Wanda was born at the same time and has ridden the same wave to become one of China's biggest companies.

Wanda is now a massive conglomerate, having spread far beyond its apartment block origins, but getting a clear sense of just how big it is, is difficult because most of it is not listed and financial information is sparse.

Wanda Group is owned by Dalian Hexing Investment Co., which is in turn owned by its founder, Wang Jianlin, now the richest man in Asia with an estimated net worth in 2015 of $30 billion. According to a statement by the company in January, the company's assets were RMB 634 billion ($96 billion) in 2015, up 20.9% from a year earlier. Total revenue was $44.02 billion, up 19.1% from 2014, with 65.6% of that coming from the company's Hong Kong property arm, Dalian Wanda Commercial Properties Ltd. The company has some 130,000 employees.

The Group came to global attention in 2012 via its acquisition of AMC Theatres, the second-largest North American movie house chain. It has since become a major force in the global movie industry not only with screens, but also production companies and a forthcoming studio complex in northern China that will be among the world's most advanced.

Wanda is now also looking to break into the theme park business and opened up a $3.2 billion park in Nanchang just days before Disney inaugurated its $5.5 billion Shanghai operation, with which Wanda has an openly awkward rivalry.

"Disney really shouldn't have entered the mainland," Wang said in an interview on state-run CCTV in May. "We will make Disney's China venture unprofitable in the next 10 to 20 years." Wanda says it is planning 19 more theme parks in addition to the ones it already has.

In addition to theme parks, Wanda's empire now includes ski resorts, broadcasting rights deals, property abroad, football teams, and even hospitals. In total, Wanda spent $15 billion in acquisitions last year, with both the scale and breadth of the expansion raising eyebrows—it is not clear where all that capital comes from.

"It's a very aggressive level of diversification," says Michael Cole, founder of the China real estate analysis website Mingtiandi. "Most companies are not going to say in a single year that they are going to make major new initiatives in a few different industries."

At the same time, Wanda's core property business is undergoing fundamental changes, partially switching from property development to property management, while its signature Wanda Plaza malls are in at least a few cases showing signs of stress. The company announced that it is expecting a 12.4% drop in revenue this year from 2015, the first ever decline in the company's history, as income from real estate slows.

> "The China property market is still one of the most profitable markets among all the industries in China
>
> David Hong
> Head of Research
> China Real Estate Information Corp

"I am quite negative on Wanda," says David Hong, head of research at China Real Estate Information Corp, which provides data and analysis on China's real estate market. "I don't see that Wanda has a very good way [of changing the model]."

Whether or not Wanda can handle so many new ventures while at the same time shifting its core business is uncertain. But on the other hand, founder Wang Jianlin is among the most ambitious (and well-connected) businessmen in mainland China, and his track record so far is enviable.

Location, Location, Location

Wanda is very much a product of when it was founded, and of the founder himself. After 16 years as a soldier in the People's Liberation Army, Wang left the military to set up Wanda with $80,000 of borrowed money in 1988, and his timing could not have been better. China had just started to create a private property market by devolving state-owned worker apartments to the workers, as well as beginning the sale of land rights to private builders. The development race was on.

According to *The Economist*, Wang built an early reputation in his hometown of Dalian by seizing the opportunity to redevelop the city's slums into forests of apartment blocks. As the Chinese economy continued to boom, the company grew large in a property explosion that has financed local governments and created huge wealth for developers and buyers for much of the past 20 years. At the heart of it was the sale of land use rights by local governments to developers at cheap rates.

The nature of this system has for years fuelled speculation about the importance of Wang's relationships to Wanda's success, suggestions he has batted away. Last year, *The New York Times* published the results of an investigation which, among other things, revealed stakes in Wanda Cinemas and Wanda Commercial Properties allegedly once owned by relatives of senior leaders.

Michael Cole puts it more succinctly.

"You don't succeed in real estate in China without having good relations with the government, because all land comes from the government," he says. CCTV, China's state-run television network, has twice named Wang "Economic Person of the Year."

By 1992, Wanda was incorporated and became one of the first shareholding companies in post-Mao China. In 2002 the company opened its first Wanda Plaza, a chain of malls which became its signature development and a key business driver—the 100th Wanda Plaza was opened in Kunming in 2014. In December of that year, the company took most of its property business public in the form of Dalian Wanda Commercial Properties on the Hong Kong Stock Exchange, raising $3.7 billion dollars. It was the largest listing in the world ever by a real estate company at the time.

But Wang has not limited his company to the real estate and property industry, for both business reasons and to satisfy his enormous ambition. In a CNN interview on July 4, 2014, Wang said, "Our goal is to make Wanda a brand like Walmart or IBM or Google, a brand known by everyone in the world, a brand from China."

Diversification

Wanda's company name, in Chinese, roughly translates as "all things are achievable," and in the past few years the company has more than lived up to that ethos, pushing into one venture after another.

Major diversification efforts began in the mid 2000s, with the company creating a focus on the tourism and cultural industries. In 2012, Wanda invested about $3 billion in the Changbaishan International Resort, a ski park located near China's border with North Korea. Although ski culture in China is still nascent, the investment is expected to pay off following the Beijing Winter Olympics in 2022.

Already a household name in China, Wanda started to gain visibility in the West when it acquired AMC Theatres for $2.6 billion dollars in 2012. Since then, it has expanded its cinema holdings further snapping up Carmike and Hoyts, in the US and Australia respectively, making it the world's largest cinema operator, a strategy that has been questioned by some industry observers.

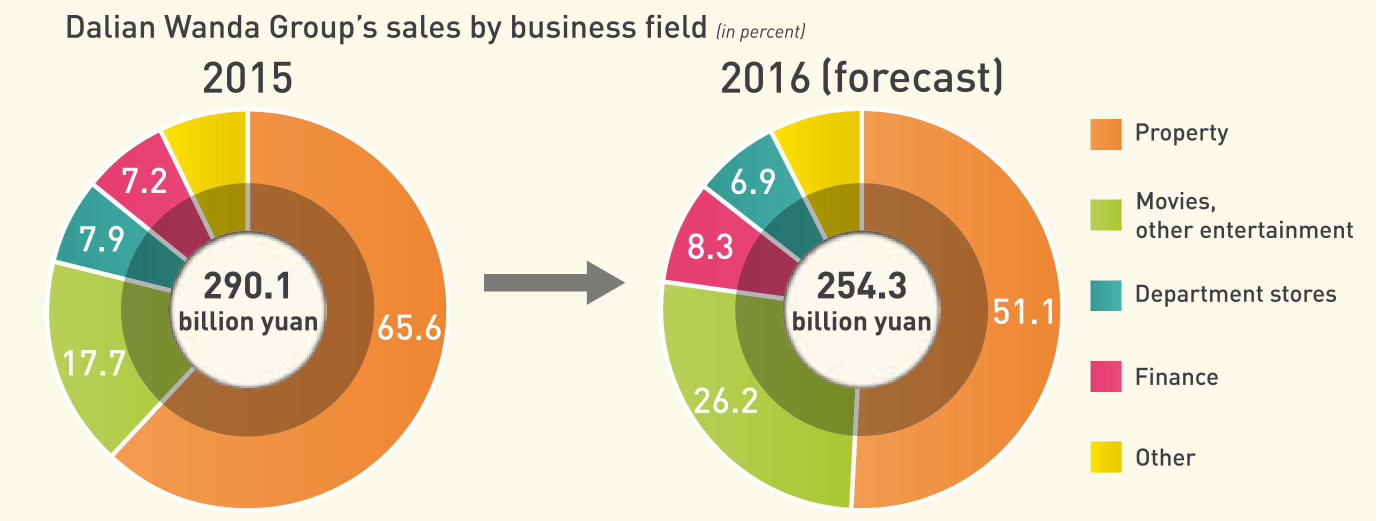
"Most investors have not been [keen] about movie theaters in the US, or other developed markets for many years," says Cole, citing historically declining attendance.

On the flip side, however, China's domestic movie industry has been doing very well, with insiders and commentators this year predicting that it will become the new Hollywood. Likely for that reason, Wanda purchased Legendary Entertainment, makers of the film *Jurassic World*—in January for $3.5 billion. And the company is also spending $8.2 billion on Wanda Studios Qingdao, set to open in 2017, as one of the largest and most advanced production set complexes in the world, complete with a permanent underwater stage. (Wang arranged for some of Hollywood's biggest stars, including Leonardo DiCaprio and John Travolta to be present at the 2013 project launch.) Sports have caught the eye of the company as well. In February 2015, Wanda paid $1.2 billion to buy Infront Sports & Media, which holds broadcasting rights in Asia for the FIFA World Cup, and the Basketball World Cup. A month earlier, it acquired a 20% stake in football club Atlético Madrid for $48 million. Later in August, it bought Ironman Triathlons for $650 million.

There are other giant Wanda investments almost everywhere you look. In January, it announced at $2.3 billion joint venture to build private hospitals across mainland China. In 2015, Wang Jianlin met with Indian Prime Minister Narendra Modi to announce $10 billion in investment in India over the next decade to build hospi-

Shifting the Business

Diversification is changing Wanda's revenue structure



Source: Nikkei Asian Review

tals, airports, schools—more or less entire towns.

"One thing you'll notice about Wanda is the sheer volume of announcements they make… virtually a major announcement every week," says Cole, who is a bit skeptical about the follow-through on many of these projects. "There is a lot of PR in that PR."

David Hong agrees, noting that a large degree of diversification and a lot of hot air is somewhat common among China's big property companies.

"Developers try to say a lot of stories," he says, pointing to a lack of progress on many of them. "I think diversification is only a story until they make some real implementation."

Theme Park Ambitions

But the scheme that has attracted by far the most attention recently is Wanda's efforts to break into the theme park industry. Just before Disney cut the ribbon on its highly anticipated $5.5 billion Shanghai park this summer, Wanda opened up its own $3.2 billion attraction in the inland city of Nanchang, 730 kilometers west of Shanghai. But what has attracted people most so far isn't the park, but Wang Jianlin's derogatory comments on Disney in the lead-up to the opening.

"The frenzy of Mickey Mouse and Donald Duck and the era of blindly following them have passed," Wang told media in May. "[They are] entirely cloning previous IP, cloning previous products, with no more innovation."

Ironically, a gaggle of Disney-owned characters, including a Star Wars Stormtrooper, showed up at the Wanda park opening, about which Disney promised to take action. Cole of Mingtiandi downplayed that aspect, citing the presence of third-party vendors, but did look askance at Wang's general approach of attacking Disney.

"Let's say, it's an unusual strategy," he says. "Generally when you are trying to promote your project you don't devote too much time talking about your competitors."

While the theme park is not Wanda's first—the company opened Wanda Xishuangbanna International Resort in Yunnan Province last year for $2.5 billion—they are

> "
> The frenzy of Mickey Mouse and Donald Duck and the era of blindly following them have passed
>
> Wang Jianlin
> Founder
> Wanda

still new to the business overall. And they have announced plans for 19 more parks, including five outside China, although the locations have not yet been announced. The company already broke ground on at least one of the domestic parks, another $2.5 billion venture near Guilin in China's southwest. The park is expected to open in 2020.

The sheer scale of these plans has left some skeptical about their ability to follow through. But Dennis Speigel, founder of International Theme Park Services in the US, takes a longer view. Speigel and his company have worked on theme parks in 50 countries, and helped create the business in China from the mid-1980s to the late 1990s.

"They are building at the right time, particularly with the large emerging middle class," Speigel says, recalling that other companies have successfully broken into theme parks from zero experience in the past, notably Six Flags, the American theme park chain founded in 1961, which now has 19 locations in North America. "The market is there, the people are there… one common denominator that I have found in my 45 years is everybody wants to have fun."

In terms of the development of the theme park industry, China could be entering its boom years. According to Speigel around 80 parks are currently being built around the country, so the competition will be stiff. In addition to Disney, Six Flags is aiming to open up Six Flags Haiyan, a $4.6 billion park in Zhejiang province just 45 miles from downtown Shanghai, in 2019.

However, having been in the industry so long, Speigel anticipates that although Wanda will face a lot of hurdles—learning "how to build the plane," as he puts it—they will ultimately be successful.

"These guys are tenacious taskmasters with tremendous vision," he says, noting also the mountains of money being spent. The a vision aspect is, of course, reminiscent of the patron saint of theme parks himself, Walt Disney.

Risk Guesstimation

But behind all the flash and headlines over acquisitions and resorts, Wanda's core property business is looking a bit shaky, a fact that Wanda has been open about. Wang Jianlin himself said in January that it could take four or five years for the market to absorb unsold housing stock in tier three and four cities, which is the primary reason for the sales decline in many Mainland markets this year.

The Chinese property market is unquestionably experiencing some broad changes. According to David Hong, the market in tier one and two cities is strong, but margins have dropped from 40% to 20-25%. Anywhere else, is difficult to make a profit at all because of the vast oversupply. But while switching away from those cities may be a good thing for Wanda, Hong sees a different problem: inconsistency.

"In 2011 they say they all want to move into tier three and tier four cities," he says of Wanda and many of its peer developers. "2013, they are thinking [that] going into tier three and four is stupid, and they say now we need to go back to tier one and two."

The companies performing the best, he says, are the ones that have stuck to a single business model.

But perhaps a bigger uncertainty is the future of the ubiquitous Wanda Plazas, which helped make the company a household name in China. The group is beginning to use a so-called 'asset-light model,' which involves selling off the actual property, but continuing to derive revenue via management fees. The strategy is intended to limit risk exposure, but it also limits the upside.

"The biggest profit for developers is land appreciation and housing appreciation," says Hong, noting that Soho has also tried this strategy and took a stock hit as a result. "I think the capital market will not give the same valuation as previously."

Then there are the malls themselves, which Wanda continues to build despite an overall slowdown in retail sales. One source, who wished to remain anonymous, but who worked for a retailer opening anchor stores in about 100 Wanda Plazas, said that the company's malls have dropped in quality and many are now poorly managed. According to him, some malls were even skimping on basic services such as air-conditioning in the summer to save money.

Hong was similarly blunt about quality: "If you visit those [Wanda Plazas] in tier three, four, and even in tier two cities, I think that you see there is no function at all, and no one is visiting the shopping center at all."

Similar factors prompted credit rating agency Moody's to change its outlook for Dalian Wanda Commercial Properties, the Hong Kong-listed real estate arm, to negative in February, which reflects its concerns over the company's increased execution risk and weakening credit metrics and liquidity.

"In the past they [had] a very big property development portfolio which can help them to generate good cash flow to support part of these funding needs," says Kaven Tsang of Moody's, who is Moody's lead analyst for Dalian Wanda Commercial Properties.

In other words, the company will likely have to rely on more debt in the future. But Tsang noted that Wanda's property arm's debt leverage remains appropriate for its investment grade rating. Moody's, however, only assesses the property subsidiary and not the entire Dalian Wanda Group.

> "Generally when you are trying to promote your project you don't devote too much time talking about your competitors
>
> Michael Cole
> Real Estate Analyst
> Mingtiandi

In fact, taking stock of the entire business is more or less impossible, which could easily become a source of stress for investors.

When asked where it came up with the $15 billion for last year's buying spree, and the additional $3.5 billion and $1.1 billion for Legendary and Carmike this year, the company replied, "We have various means other than borrowing."

Liabilities are a similar mystery, with a US analyst telling *Nikkei Asian Review* in March, "It's a complete black box."

Add to this Wang's recent efforts to take the Hong Kong-listed property arm private, a surprising move given it has not yet been two years since the 2014 blockbuster IPO. The reason is ostensibly to relist on the mainland because the stock price in Hong Kong has underperformed expectations.

But relisting is a difficult process in China with a long queue, and Wang initially had trouble reaching an agreement with stockholders, even after including a promised share buy-back if a relisting didn't happen within two years. However, *The Wall Street Journal* had reported on August 15th that shareholders voted to accept a $4.4 billion buyout—a 10% raise on the previous offer. Still, it far from clear that the move is a net positive for the company.

"From a credit perspective [delisting] could be negative," Tsang says. "First of all, delisting could mean that they are not required to comply with the listing rules before any relisting, and secondly, the information disclosure or transparency could be lower."

Too Big to Fail?

But despite various concerns, real estate is still an incredibly lucrative business on the Mainland.

"The China property market is still one of the most profitable markets among all the industries in China or even in the world," says Hong. "If you look at the top 100 players, almost all of them are making profits. Whereas if you look at all other industries, many of them for example, like TMT (technology, media and telecommunications), only the leaders break even."

And Wanda has another strength as well, given the relationship between the property business and the state in China.

"Most of the major revenues of the local governments, especially for the lower tier cities, they all rely heavily on land sales," Hong explains. "Because of this they are likely to [help] those developers that they previously supported, that go into any kind of financial difficulties."

The anonymous source, who has met Wang Jianlin in person, put it a bit more directly.

"The only way they can really disappear is if they fall into political disgrace."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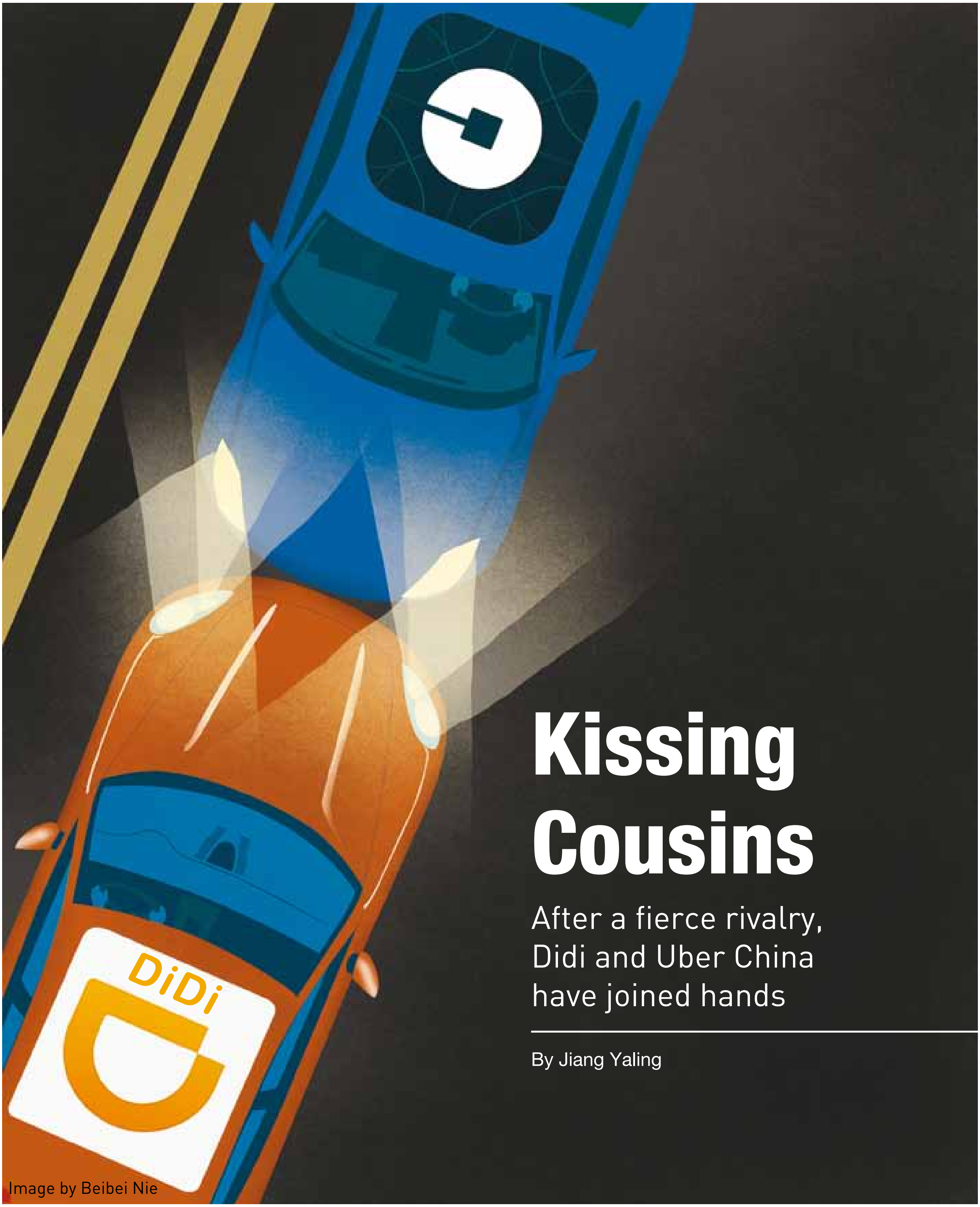


Image by Beibei Nie

Kissing Cousins

After a fierce rivalry, Didi and Uber China have joined hands

By Jiang Yaling

In transit tech terms, 2012 was a simpler time in China—the Shanghai metro system only had 303 stations (364 today), Segways had not yet been overtaken by hoverboards, and if you wanted to hail a taxi, you had to flap your hand out into the street. But that same year, China's top ride-hailing service Didi Dache set out on a course of disruption.

San Francisco-based taxi booking firm Uber commenced its international expansion in 2012, and Cheng Wei's Xiaoju Technologies—the formal name of Didi Dache—was one of a myriad car-hailing mobile apps launched around that time seeking to copy Uber's model in the world's biggest market of people needing to go places.

After four years, Didi is just about the last man standing. The company adopted its current name, Didi Chuxing, when it merged with domestic rival Kuaidi Dache in 2014, following an intense struggle. And this August, it announced its pending absorption of Uber China after a bitter marketshare battle that in 2015 bled both companies of over $1 billion each. The proposed marriage will create a company valued at $36 billion, with investors including Baidu, Alibaba and Tencent, China's tech company trifecta known as BAT, as well as Apple, which invested $1 billion in Didi this June.

There is no doubt that the world of on-demand transit has changed for Chinese people—so much so, that manually hailing a cab can now sometimes be difficult. But Zhang Yi, CEO of third-party market consultancy iMedia, sees all the changes as a net positive.

"The traditional taxi industry does not [meet] Chinese people's needs any more—Didi spotted the industry's weak spot," Zhang Yi says. "Without these hailing apps, Chinese people's happiness index would be a lot lower."

But there is a flipside to the convenience. According to CNIT-Research, a Chinese internet data research firm, by Q1 of 2016, Didi had 85.3% of the private-car hailing market while Uber China had 7.8%, which suggests their combined market share after the merger will be over 90%.

> "There will be only one company ruling the entire online [car-hailing] industry, which isn't exactly great news
>
> Zhang Yi
> CEO
> iMedia

Market dominance by one player is not necessarily in the interests of consumers.

"There will be only one company ruling the entire online mobility industry, which isn't exactly great news," iMedia's Zhang Yi said.

The deal is currently facing scrutiny from the Chinese authorities and the timeline for completion is unclear. But CEO Cheng Wei is already working on building an ever-more convenient world, with more services and even driverless cars.

4-400-4,000

Ride sharing rose from nothing fast. Didi Dache started as one of over 30 players vying to gain a foothold in China's transportation market and, as is often the case for startups, the early days were rough.

"In the first month, we knocked on 100 taxi companies' doors in Beijing and were turned down by all of them," said Cheng Wei in an address to the National School of Administration. "They wanted to see official documents from the transportation commission but we did not have any."

The first breakthrough was a small taxi company which owned just 200 cars, but a small window was all it needed. Alongside offline promotions, Didi's name spread through word-of-mouth, and business began to take off.

The company offered an attractive proposition to both sides of the deal, both supply and demand. For riders, it offered more flexible mobility solutions, enabling them to book rides to designated locations at any time, instead of passively waiting by the side of the road.

For the drivers, it provided new ways to make money. While a few taxi drivers own their cars and register them at state-owned taxi companies, most rent the car from these companies and pay monthly rental fees. So the business is essentially a state-owned enterprise, and drivers have not been faring well in recent years. The basic fare in the year 2000 was RMB10 in Shanghai, and after 16 years, it has risen by only RMB4. Before online-booking apps took over the taxi market, the average monthly salary of taxi drivers in Shanghai was approximately RMB6,000, a bit less than $1,000.

But when drivers use Didi, they say, they can boost their income, in a few cases to as high as RMB20,000 a month. And private car owners can link into the Didi network as well, providing extra convenience for riders, and extra competition for the drivers of the state-owned taxis.

"If earning RMB2,500 a month is defined as a job opportunity, Didi has already provided two million of them," President Jean Liu said at the China Internet Conference in Beijing this year.

What Liu did not say, however, is that those job opportunities have been supported in large part by subsidies aimed at garnering market share. In addition to ride fares, drivers have been receiving bonuses after completing a certain number of orders, premiums during peak times, as well as referrals for new downloads of the app. Riders, too, have received encouragement in the form of subsidized trips, which has at times made using Didi cheaper than taking a cab the old-fashioned way.

But this has not been an affordable strategy for the company, to put it mildly. In the 2013-14 pre-merger subsidy war with Kuaidi Dache, the companies blew through some $700 million combined. Despite the high technology being used, it all amounted to a rather crude strategy of paying for customers and drivers.

Eventually investors from both sides called for it to end, and the two companies announced a merger in February 2015, with subsidies also drawing to a close. As a consequence, ridership dropped by 40% for at least some time, according to a person familiar with the matter.

Even so, after just four years, Didi now has some 4,000 employees (not counting drivers), and has been profitable in close to 300 of the 400 cities in which it operates, according to its Vice-President of Strategy Zhu Jingshi. This success has brought with it anticipation of an IPO, but the company is still unprofitable overall, having suffered a staggering $1.8 billion loss in 2015, according to the top business magazine *Caixin*.

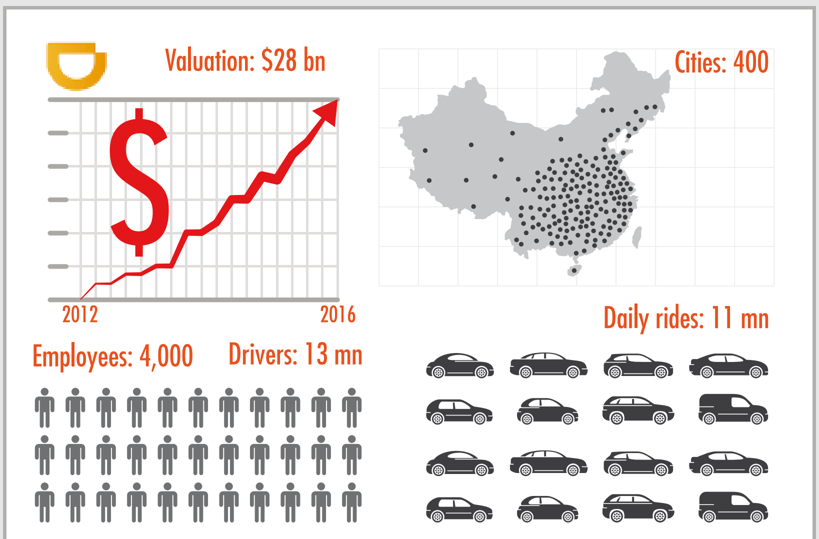
> Uber China was running out of ammunition
>
> Yuan Yan
> Investor
> Reid Fund Management

Analysts, however, are optimistic on Didi's IPO prospects, but unsure about when it might happen.

"Didi definitely has the need to go public in the next three years," says Zhang Yi, "Otherwise it would be too difficult to secure the return of investment."

Didi by the numbers

Didi has grown from zero to hero in four years



Source: Didi, pre-August merger announcement

Road Rage

Bitter rivals, arch nemeses, mortal enemies—after the merger with Kuaidi, Didi Chuxing and Uber China were all of the above.

Stepping over the remains of the US tech giants that have tried and so far failed to gain entry to China's market—Google, Facebook and Amazon, to name just a few—San Francisco-based Uber Technologies Inc. rode into China in February 2014. Uber's first move stood in contrast to those who have been forced to stay outside the Great Wall: It created a local unit, Uber China, to help it attract local investors and avoid potential restrictions.

According to Didi's CEO Cheng Wei at the Yabuli China Entrepreneurs Forum 2015 Summer Summit, an influential gathering of entrepreneurs, the famously aggressive Uber founder, Travis Kalanick, flew from the US to deliver an in-person ultimatum: either give Uber a 40% stake in Didi or prepare for battle. Cheng Wei chose the latter.

Using the same subsidy tactics as before, the rivals initiated a bitter war of attrition to gain market share. During the height of hostilities, Uber gave drivers RMB7,000 for completing 85 orders per week on top of a premium, and Didi's private-car drivers received as much as double the paid fares.

The bloodletting was spectacular, with Uber losing more than $1 billion in China in 2015, a number not even close to Didi's losses. The sheer scale of the amounts being thrown away fueled speculation that Didi and Uber China would call a truce and merge, but such talk was dismissed by both sides.

"A merger is simply impossible," a Didi spokesperson told *CKGSB Knowledge* in June, which echoed Didi's position just before its merger with Kuaidi in 2015.

Just weeks later, the rumors were borne out. On August 1st, the two companies announced a deal that will merge the giants—Didi and Uber China's valuations are $28 billion and $8 billion respectively—into

The Chinese government recently legalized car-hailing apps, removing some uncertainty

a monster. Under the terms, Uber China agreed to pass on its Chinese operations to Didi, in exchange for one-fifth of the combined company's stake. *Reuters* said Didi also will invest $1 billion in Uber Global (already valued at $62.5 billion), Kalannick will serve on Didi's board, and Didi's CEO Cheng Wei will join Uber's board.

In hindsight, the deal seems to have been virtually inevitable. The rivals had shared a few major investors including BlackRock, Hillhouse Capital, and ChinaLife, and shortly before the merger, there were signs from parties on both sides that the bloodbath had become too much to bear. Given Didi's far greater scale, Uber found itself backed into a corner.

"Uber China was running out of ammunition, was it going to pull out a knife and fight till the death?" says Yuan Yan, and investor at Reid Fund Management. "Why not join the nemesis and share the world while it was still worth a certain value?"

To iMedia's CEO Zhang Yi, the merger is a win-win, at least on financial terms. "One definitely can't say that because Uber China surrendered, it means it's lost," he says. "Yahoo's merger with Alibaba won a large return on investment, the same with Uber China. As for Didi, the merger has bolstered its own valuation."

Some cab drivers see the situation a bit differently, however. "Didi can't compete with the quality of Uber, so buying them makes sense," says one Shanghai cab driver.

Hold the Celebration

Despite the seeming finality of the announcement, all may not be over—only the plans have been announced, and the merger may be subject to regulatory review.

Danyang Shen, spokesman for China's Ministry of Commerce (Mofcom), said on August 2nd that they had not received an application from the two companies. "According to anti-trust regulations and the State Council's requirements, business operators are obliged to file a case to Mofcom, otherwise a merger cannot be carried out," he said.

Didi responded quickly, saying that previous major mergers in the internet area have not required a filing, and they are simply following suit. They also cited the lack of profitability as a reason for exemption from regulatory oversight.

"Uber China and Didi are not profitable yet," Didi said in a statement to *Reuters*. "Uber China's turnover in 2015 didn't meet the RMB400 million requirement for the anti-trust process."

But industry experts are concerned that the merger will create a new monopoly and may eventually violate anti-trust laws. Both Yuan Yan and Zhang Yi express worries that it is bad news for the growth of the industry.

"It has great significance for both the market and consumers," Zhang Yi says. "[For] the online mobility industry, there will probably only be one company ruling the entire space whereas there used to be several major players. [For] customers, their options have been reduced from a variety to one."

Indeed, the subsidies that attracted customers and drivers alike are already disappearing. Some Didi customers posted screenshots of price hikes on Weibo, suggesting they were already feeling the effects. And when Didi and Uber China lowered their subsidies earlier this year, the action was met with anger amongst drivers who demonstrated in Beijing and Guangzhou, a situation that could conceivably recur.

"Shanghai has around 70,000 taxis, and I'd say there are now 250,000, maybe more than 300,000 cars, working the same market," says another Shanghai cab driver. "But the rice bowl is the same size."

Eyeing the Bigger Picture

One way of keeping everyone happy may be to offer new services, and in this Didi is well ahead of the curve. Since the merger with Kuaidi, Didi has introduced new services nearly every month—Hitch (ride-sharing), Chauffeur, Didi Bus, Didi Test Drive, and Didi Enterprise to name but a few.

The Uber merger will very likely lead to even more initiatives, with Kalanick saying the deal "frees up substantial resources for bold initiatives focused on the future of cities." He links it with everything from "self-driving technology to the future of food and logistics."

Self-driving cars have perhaps received the most attention—Apple's pre-merger investment in Didi was made with this in mind—but that still seems to be a development that will take more time to come to fruition.

"Most car manufacturers including BMW have announced their predictions on this subject—they won't go into mass production for another 10-15 years," says Dr. Tang Huayin, who works in research and development in the automotive industry. "Didi doesn't have any apparent advantage. There are so many areas where it would have to rely on others—the making of cars, self-driving sensors, algorithms. Having said that, their biggest strength is dominance of the end-user market."

What is more certain is that CEO Cheng Wei has a big vision, and experts have compared his nurturing strategy with that of Alibaba, a company that spent 10 years losing money before delivering the largest IPO in history.

During a speech at the China National School of Administration, Cheng Wei gave his prediction of Didi's next hurdle, "If [the] "internet of things" is at the beginning of an internet company's agenda, after it has gathered a huge amount of data and has more advanced algorithms, it will move on to artificial intelligence."

Where artificial intelligence might takes things for this business, who knows. But seen from an individual's point of view, one cannot deny that the ride-hailing app revolution has changed the meaning of 'getting around' for the whole nation, just as the company name 'Chuxing' suggests in Chinese.

"I no longer have to desperately wait on curbs during peak hour," a 25-year-old Didi user, Hangwei Wu, says. "My life has less uncertainty now."

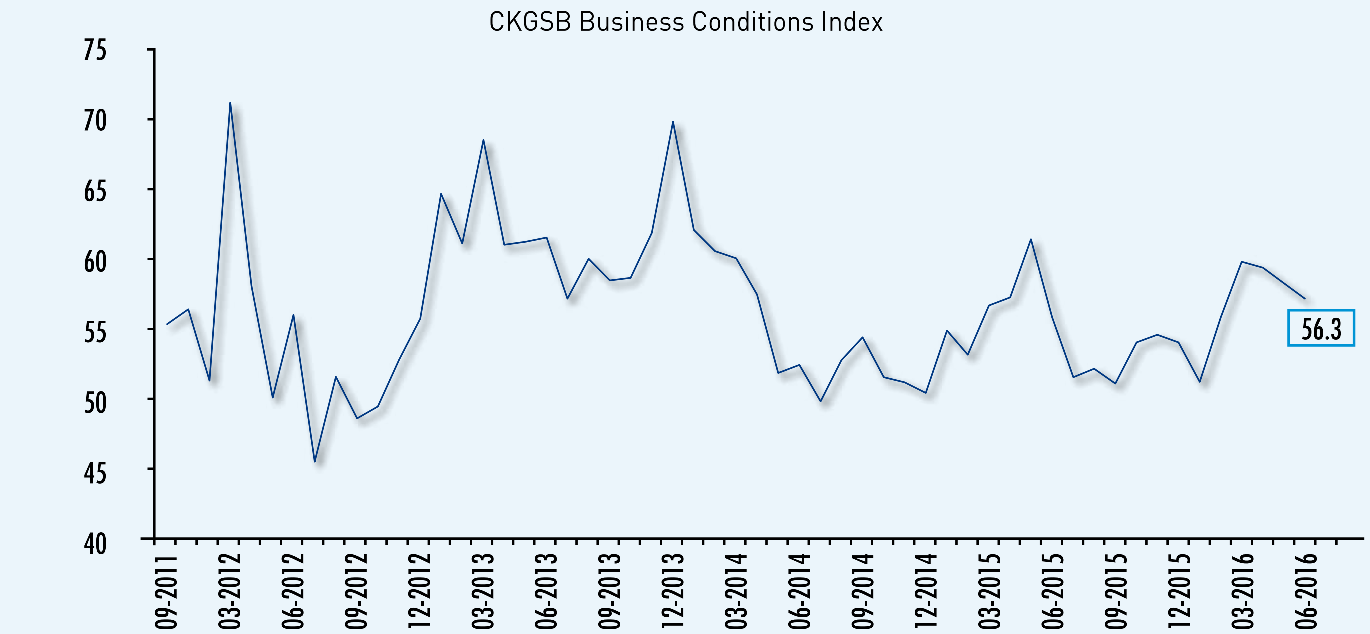
Down, But Not Out

Optimism prevails, but is on the wane

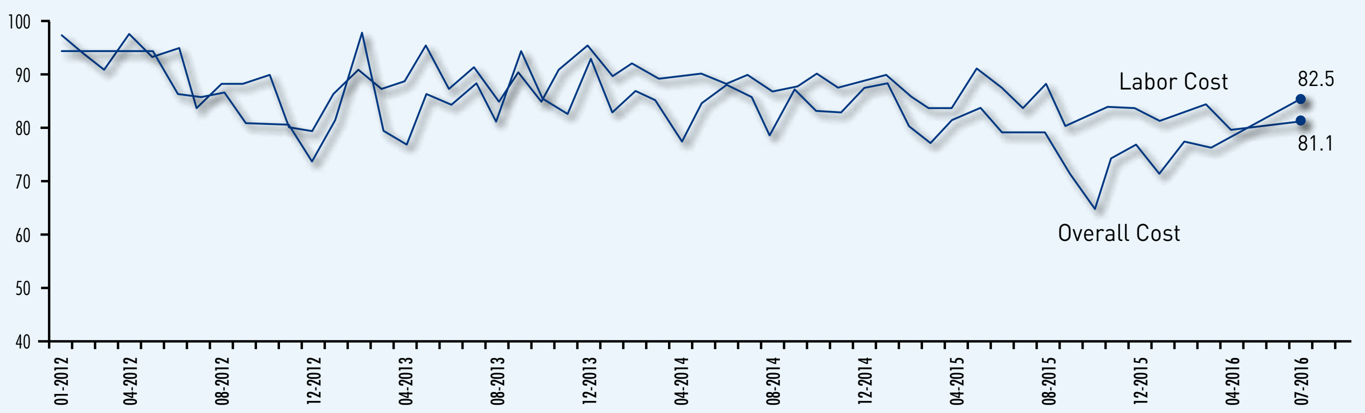
The CKGSB Business Conditions Index (BCI) registered 56.3 in July, slightly less than June's 57.1. Despite a small dip, this shows that for CKGSB's sample, which represents relatively successful businesses in China, the next six months are viewed with a degree of optimism. But it is also noteworthy that the BCI has now fallen for four months in a row. The BCI comprises four sub-indices: Corporate sales and inventory levels rose slightly, the latter surpassing the threshold of 50. The corporate profits index dropped by close to five points, but remains above 50, and the financing environment remained below 50.

The BCI, directed by Li Wei, Professor of Economics at the 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. As our sample firms are in a relatively strong competitive position in their respective industries, the CKGSB BCI indices tend to be higher than government and industry PMI indices.

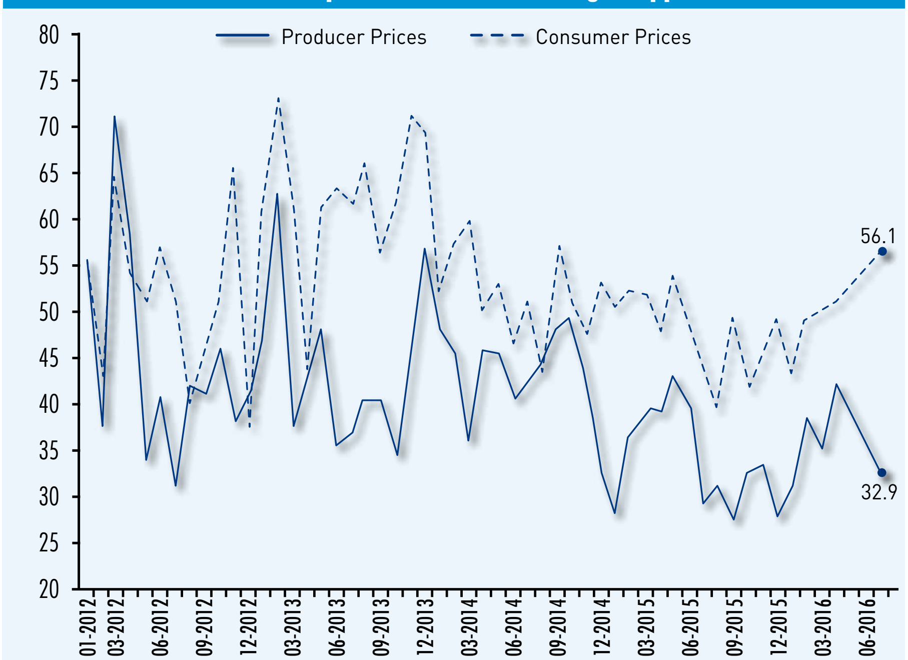
Business confidence remains positive, but is declining…



...with costs still quite high



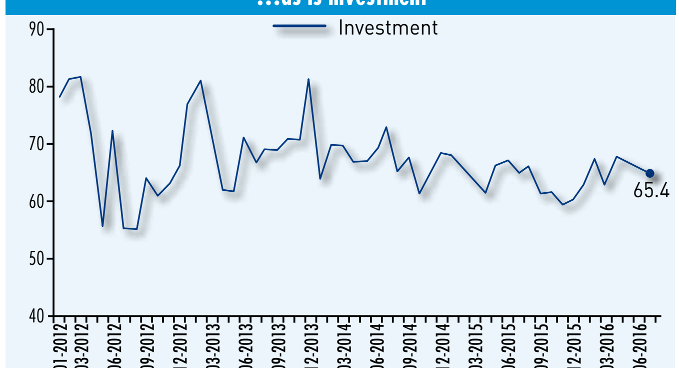
Producer and consumer price indices are moving in opposite directions

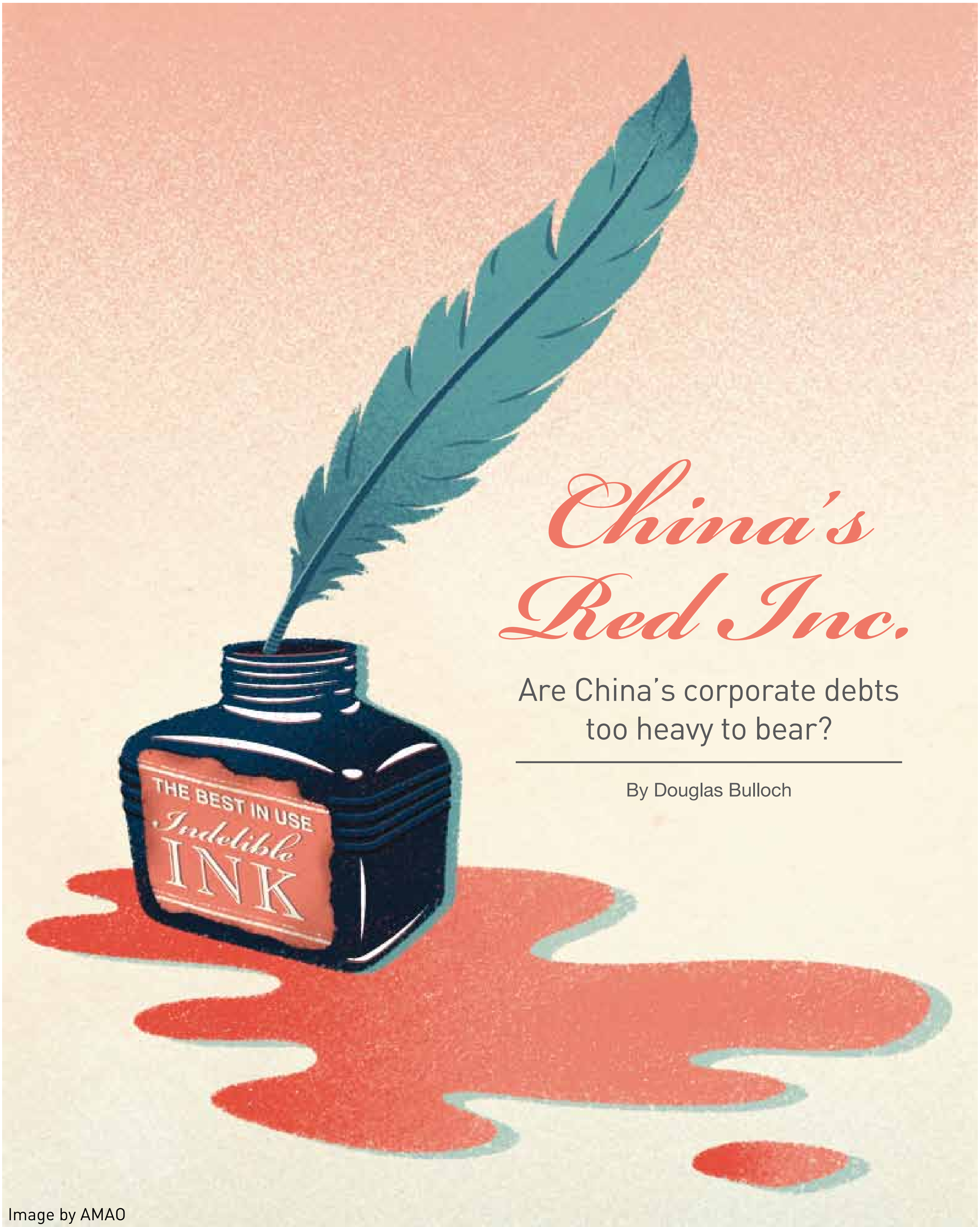


In July, labor costs fell slightly and overall costs expectations also fell slightly, but these two indices are both still over 80. Price indices for producer and consumer goods moved in entirely different directions during the month, with the consumer goods index rising from 46.9 to 56.1, while the producer goods index fell sharply from 40.3 to 32.9. Chinese firms are facing some issues: cost inflation is growing apace and while consumer prices have recovered slightly, it is unclear whether that recovery can sustain its momentum. However, in the face of adversity, our sample firms continue to recruit and invest. Regardless of the macroeconomic conditions over the past five years of the BCI, the Chinese firms sampled have prioritized corporate investment and recruitment, providing a conundrum for observers.

Recruitment is still strong...

...as is investment





China's Red Inc.

Are China's corporate debts too heavy to bear?

By Douglas Bulloch

Image by AMAO

China's corporate debt is rising fast. In most countries this would herald a wave of bankruptcies and be thought a lead indicator for an imminent correction. China, however, inspires a wide vocabulary of qualifications on the part of analysts, as the government has a high level of control and and a notably low tolerance for slow growth.

China's debt position is in fact not out of line in total with many other developed economies, but the proportions are markedly different. China's 'government debt' is relatively low, but 'corporate debt' is variously estimated between 145% and 170% of GDP, which is "very high by any measure," according to the IMF.

But the problem when trying to understand the details in China is often in the definitions. Differentiating between public and private in China can be challenging, and the point at which corporate debt, even for private companies, precipitates insolvency is also highly dependent upon non-commercial factors, such as who, exactly, stands to lose out. In the state sector, a company may have lost money for years and nurse liabilities it will simply never be able to pay off, but it will still give the appearance of being a going concern.

These are the so-called 'zombie' companies, clearly being kept alive by the state for reasons other than economic viability—typically to maintain employment for their workers. Beyond them, however, the picture is more complex. Some sectors of 'China Inc.' are booming, while older industries are piling up new liabilities to meet old ones.

So is China's corporate debt rising to support real economic growth, or merely to stave off an inevitable—and long-anticipated—moment of reckoning for inefficient, state-backed producers?

Matters of Principal

In June 2016 the IMF estimated the total amount of corporate debt in China at 145% of GDP, but Guonen Ma, Visiting Research Fellow at the Brussels-based think tank, Bruegel, and Professor James Laurenceson of the Australia-China Relations Institute (UTS), University of Technology, Sydney, used Bank for International Settlements (BIS) data and put the figure higher, at 170% of GDP for the end of 2015. This compares to a global average estimate of less than 93%, with the US and the UK in the low 70s, and even debt-mired Japan at only 100%. In other countries, government debt is typically higher, but internationally, corporate debts are usually considered private liabilities and are therefore limited by the prospect of insolvency if they get too high.

> "Signals aren't being sent to invest in the things that need to be invested in
>
> Patrick Chovanec
> Chief Strategist
> Silvercrest Asset Management

According to the IMF, State-owned Enterprises (SOEs) are responsible for 55% of all China's corporate debt, a proportion which if applied to the BIS figures means they account for debt equivalent to 94% of GDP, while contributing only 22% of output. That also suggests that the private sector in China is not out of line with international norms, with corporate debt at about 76% of GDP.

Drilling down further reveals that among the SOEs, there is a higher debt profile in the old smokestack industries of coal, iron, steel and chemicals than the more service-oriented sectors like airlines, tourism and healthcare.

When it comes to the source of all this debt, the banking sector in China is largely state-owned, indicating that the normal distinction between government debt and corporate debt doesn't fully apply in China, serving instead to disguise debt levels.

Patrick Chovanec, Chief Strategist at Silvercrest Asset Management, suggests the difficulty in distinguishing between public and private debt should be thought of as "intentionally ambiguous, because then everything gets the backstop of a supposedly solvent state."

With the state seen as the ultimate underwriter of more than half of the outstanding corporate debt, this explains the general belief that a financial crisis is not imminent and could not occur unless the state itself approaches insolvency.

State-owned Stimulus Tools

Before the global financial crisis (GFC) in 2008/9, China's corporate debt position was much lower, totaling less than 100% of GDP. But the downturn following the GFC pulled down corporate earnings and reduced the ability of firms to handle problems through internal financing. According to Ma and Laurenceson, "the government responded to the crisis by implementing a stimulus in the form of corporate but government-sponsored capital expenditure … With the share of internal financing of capital expenditure declining markedly, a jump in external financing, mostly debt, was the logical consequence."

Following this stimulus, there has been no sustained recovery in corporate earnings, and corporate debt has risen between 50% and 70%, with the biggest annual rises coinciding with the stimulus injections of credit in 2009 and 2015.

Leslie Young, Professor of Economics at the Cheung Kong Graduate School of Business in Beijing, further explains that "the government in 2015/16 decided it needed to stimulate the economy… and it ordered the state banks to lend to state enterprises." This, combined with the continuing dearth of corporate earnings, indicates the challenging economic environment that followed the GFC had not yet abated, he says.

Mapping out the liabilities gives some additional perspective. For example the Dongbei Special Steel Group (DSSG) attracted much media attention after it defaulted on seven sets of bonds, worth $722 million, following the reported suicide of its Chairman in March. The total debt it carries is $6.7 billion, or 84% of its assets. DSSG, according to research published by Mizuho Securities Asia in August, is a group originally consolidated in 2004 from three pre-existing regional steel producers, two of which were regarded as unprofitable 'zombies.' Since 2008 it has borrowed heavily—along with many other steel companies—to support expansion.

Now, of course, China's problems with overcapacity are well known, particularly in the steel sector, leaving much of this debt essentially unserviceable and weighing heavily on the finances of Liaoning Province, where it is located.

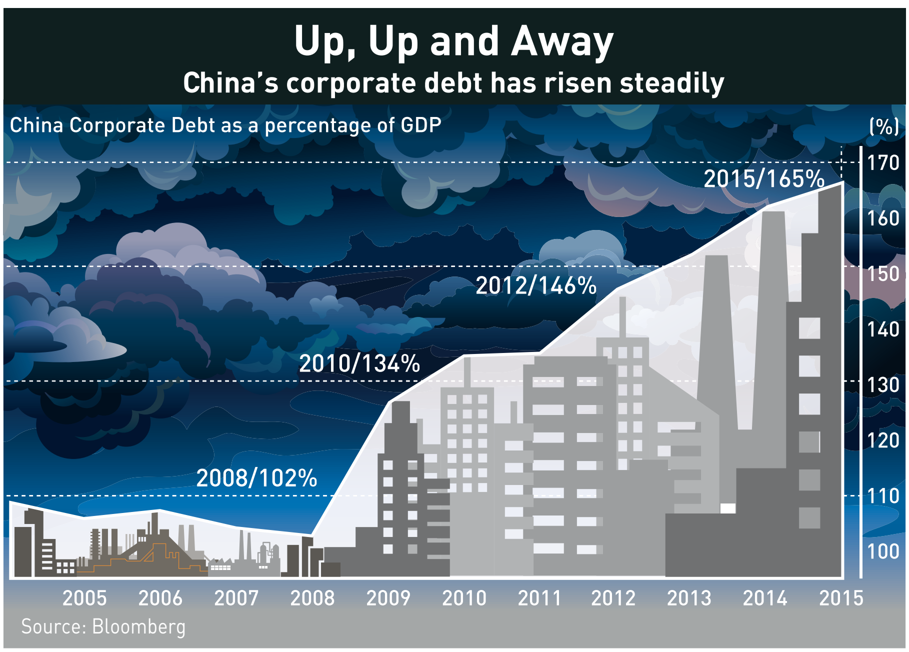
This example is reflective of problems China-wide, and the origins of this huge build-up in corporate debt can be properly understood as the consequences of poorly planned and inefficient expansion of the SOEs—a point reinforced by Chovanec, who says "a lot of fiscal spending [was] channeled through state enterprises."

In other words, SOEs in China are not simply state-owned assets, but also conduits for expansionary economic policy. When the state needs growth, they can simply order it up, with the short-term costs falling on the deteriorating loan books of the state-run banks. The long-term costs, however, in non-performing loans (NPLs) and prolonged poor earnings then crowd out the ability of banks to loan commercially to the 'real' private sector.

Unintended Consequences

While the decision of the Chinese government to support growth with massive stimulus measures in the aftermath of the GFC is understandable, the quality of the actual investments is crucial. And it increasingly appears that much of China's stimulus has simply made the need for structural reform more urgent.

"State corporate debt has been rising more quickly than among private firms," says Andrew Collier of Orient Capital Research in Hong Kong. "The amount of money they invest in Fixed Asset Investment (FAI) skyrocketed in 2016, rising 23.7% in April." For context, he adds that "private FAI gradually declined in 2015 and fell to a year low of 5.2% in April 2016." Explaining this disparity, he points to two reasons: Beijing pushing state firms to invest to boost the economy, and private firms declining to make investments.



Chovanec goes further in outlining the distorted incentives produced by state-directed investment, suggesting that "there are lots of areas in the Chinese economy where there's room for huge productivity gains. In agriculture, in logistics, in healthcare in services… and yet," he adds, "why would you invest in those hard areas… when you can flip property and know that the government's got your back because they can't afford for the property sector to unravel?"

This highlights what he suggests is "the problem of bubbles. It's not that prices go up and down and people lose their shirts, it's that it sucks the oxygen out of the room. Signals aren't being sent to invest in the things that need to be invested in."

All of which points to the need to stop clogging up the banks with poor-quality loans to old smokestack industries, and allow them to lend commercially to the more dynamic and productive sectors of the economy. First, however, the banks' loan books would need to be cleared of bad debt, and in order to do this, someone would need to take a loss. That Collier says, is something "everyone will be fighting to avoid responsibility for."

According to UBS, however, the so-called 'cleanup' has already begun. Their analysis of 765 banks in China showed that as much as $271 billion of impaired loans were shed between 2013 and 2015, with another $93 billion in capital raised during the same period. To attain a sustainable debt ratio, however, an additional $677 billion in bad debt needs to be offloaded, and another $300 billion in capital raised. Plans to do just that, with Beijing's support, are underway.

But Chovanec sees a deeper correction as necessary. "If you've got a country which is making a lot of bad investments, then that's going to be a problem no matter what their debt level is." He considers the corporate debt problem part of a wider spectrum of problems rooted in uncertainty over the effects of certain policy actions, suggesting that the Chinese government "cannot pull on a thread, because [they] just don't know what will unravel." He further believes this uncertainty has "frozen economic reform."

And the results of the stimulus program from 2008/9 are now plain to see in the aggregate overcapacity that China (and the world) is now facing. As Young says: "Now that they can make [all this] stuff, who wants it?"

Catch 22?

This is a problem Beijing's leaders have been wrestling with for years, but implementation of inevitably painful solutions to overcapacity problems have mostly been postponed.

"The much-vaunted 3rd Plenum Reforms (from 2014) have not really gone anywhere," says Chovanec. "[There has been] nibbling around the edges, but it hasn't been entrenched because of the fear of destabilization."

Professor Young, however, is more sanguine, believing that "it'll be a politically, driven cleanup. The fundamental impulse of the Chinese state is to not make a million people angry." Whatever happens, he says, "they'll never allow a major bank to default, they'll find some other way to deal with it."

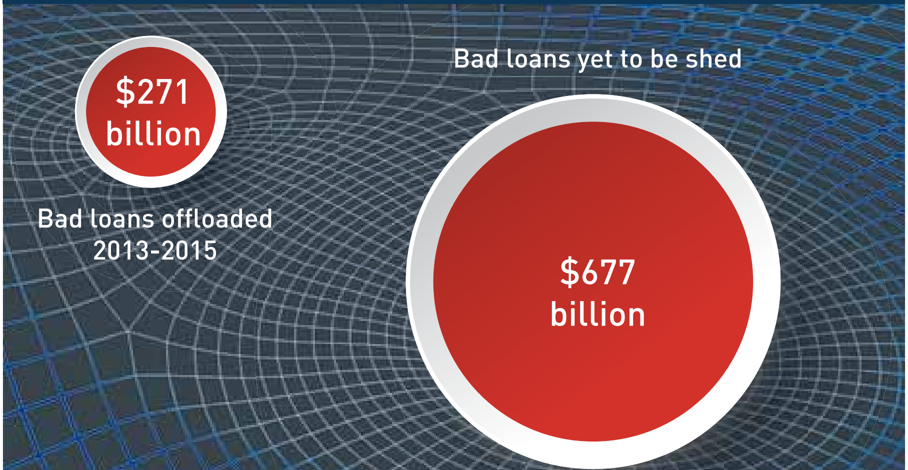
Chovanec thinks that eventually, "a lot of [debt] will be socialized." The problem with this, however, is that it avoids the immediate consequences and may perpetuate bad habits.

"When companies default, at least they stop doing what they shouldn't be doing anymore," says Chovanec. "When you never have that and you socialize all the losses, it looks nice and neat and nobody ever goes bankrupt but at the end of the day the losses are still there." At some point, he says, it will imperil the entire system.

Professor Young thinks that such en eventuality is a long way off, and that China still has plenty of room to maneuver. His reasoning depends on the unusual character of China's development, featuring a large amount of "state-owned assets—principally land—to back [the accumulated debt]. And, because the money

Shadow Cleanup

China's banks are offloading bad loans, according to UBS



Source: UBS

"The government decided... it needed to stimulate the economy... and it ordered the state banks to lend"

Leslie Young
Professor of Economics
CKGSB

has been used in pretty sensible ways," in Young's view there is "at least... a pretty decent chance you'll get the money back."

Ma and Laurenceson conclude their research with a range of recommendations, believing that, while the immediate risk of a financial crisis is low, there is nevertheless an urgent need for "accelerating SOE reforms and bad loan disposals, dealing with both debtors and creditors while enhancing efficiency."

Avoiding a Conclusion

There is a remarkable consensus that while China Inc. is falling deeper into the red and a correction of some sort is necessary, a financial crisis is not imminent. But the drag on growth caused by poorly-invested credit, itself pumped out to keep the aggregate growth figure looking perky, will likely worsen over time.

The deeper problems are revealed when fast-rising corporate debt is assessed against the wider context of falling growth and lower returns from investment. Beyond this, the enormity of China's industrial overcapacity suggests that conditions for credit-fuelled growth are not likely to improve anytime soon.

"They want to have a correction without having a correction," says Chovanec, adding, "the longer that goes on, the worse it gets."

Hands Off

Chinese companies are joining the driverless bandwagon

By Matthew Fulco

Image by Han Xiao

In April, Chongqing Changan Automobile Co. deployed a self-driving car on a 2,000-km road trip from its headquarters in Chongqing to Beijing. The car completed the journey in six days, employing self-drive technologies that Changan says are comparable to those of Tesla models already available. The company says it expects to launch a self-driving car commercially within three years.

China is keen to deploy self-driving cars for the same reasons as everyone else is: Autonomous vehicles are tipped to significantly improve traffic and environmental conditions. According to research by the Boston Consulting Group (BCG) and the World Economic Forum, widespread adoption of automated vehicles could reduce automobiles on city streets by 60%, vehicle emissions by 80% and traffic accidents by 90%.

The Chinese authorities also intend autonomous vehicles to help drive the country's transition into advanced manufacturing.

"The 'Made in China 2025' roadmap has made self-driving cars a key priority," says Tzeng Chiau-ling, an analyst at Taiwan's government-backed Market Intelligence & Consulting Institute (MIC). "China is poised to set up a connected car development platform which will have support from the Ministry of Information and Industry Technology (MIIT)."

Some experts believe Beijing's top-down control capabilities could even give China an edge over the US and Europe in the race to develop self-driving cars. While the West has superior technology, its governments lack the authority to swiftly implement massive infrastructure projects and a large part of taking self-driving cars mainstream will involve refitting existing transportation infrastructure.

With that in mind, China's success with high-speed rail could augur a bright future for the nation in terms of driverless vehicles. China easily boasts the world's largest high-speed rail network: 19,000 km, or 60% of the world's total, most of which was built in the past decade.

Will driverless vehicles arrive in China equally fast? They will, if Baidu and the city of Wuhu (about 200 km west of Shanghai in Anhui province) have anything to say about it. The Chinese search giant is deploying autonomous vehicle technology in the city in support of a bold bid by Wuhu to become the first city in the world to go totally driverless by 2025. It is a fast track that has to bypass a fair number of roadblocks to succeed, but it is clearly a goal worth aiming for.

> "'Made in China 2025'...has made self-driving cars a key priority
>
> Tzeng Chiau-ling
> Analyst, Market Intelligence & Consulting Institute

Driving Conditions

The most obvious reason for China to go driverless is to make its hazardous roads safer. According to the World Health Organization (WHO), more than 250,000 people die on China's roads annually. Pedestrians, cyclists and people on motorcycles comprise 60% of the deaths.

The WTO estimates there are 18.8 traffic-related deaths in China per 100,000 people per year, about average for middle-income nations but more than double the rate in developed countries.

"Countries cannot develop sustainably when this many people are dying and being injured on the world's roads, as they go about their daily lives," Bernard Schwartländer, the head of the WTO's China office, said in a May statement. "Road crashes impoverish families, ruin livelihoods, and impose a heavy burden on countries' health systems, societies and economies."

Most experts believe it will take China decades to reduce auto accidents and develop a less combative driving culture, but driverless cars may speed things up. And the benefits of self-driving cars may go far beyond improved safety to relieving congestion and air pollution.

"Congestion has become severe in Chinese cities," observes Anderson Chan, global communications manager at Ford Motor Company in Detroit. "There is a shortage of parking spaces; the public is increasingly aware of air pollution." Self-driving cars combined with car sharing and automatic parking could enhance the efficacy of car use, he says, "reducing accidents caused by human error, enabling drivers to better use their travel time, and meeting the huge demand for quality mobility services in China."

It would seem that just about everybody is on board. A survey conducted by BCG in July found Chinese consumers were enthusiastic about self-driving cars: 81% were willing to ride in one, compared to 75% a year ago, suggesting that the recent crash of a Tesla vehicle in the US has not dampened the enthusiasm of Chinese consumers for automated vehicles.

Juliet Wang, a marketing director at an educational institution in Shanghai, looks forward to self-driving cars arriving on China's roads. "Many Chinese people drive recklessly, so automated cars will make China's roads safer," she says, adding that automated vehicles will save people's time. "You won't need to bother getting a driver's license anymore," she points out.

Off to a Fast Start

Auto brands and tech companies alike are racing to tap China's nascent automated vehicle field, and Germany's BMW has been one of the most active automakers. In late 2014, the German automaker entered into a partnership with Internet giant Baidu, known for its data mapping and artificial intelligence acumen. In an email to *CKGSB Knowledge*, BMW China's corporate affairs department said a demo car based on a BMW 3 Series GT successfully demonstrated Highly Automated Driving (HAD) technologies including Automatic Lane Change on a Chengdu highway in June. "BMW became the first premium car brand to apply this function in actual road conditions in China," they said.

Roger Sheng, a director at research firm Gartner in Shanghai, reckons the superior technology of foreign auto brands gives them an edge in China's self-driving car market. "Telsa is taking leadership in providing ADAS (Advanced Driver Assistance Systems), while BMW is more active than other luxury auto brands in automated vehicles," he says. "If Tesla can manufacture vehicles in China, I expect it will be a strong player. Chinese automakers are more likely to be followers in this market."

Ford's Chan says, "China is one of the most important markets for Ford not only in regards to our core business but also for mobility opportunities. We are proactively working on bringing the most advanced Driver Assist Technologies to Ford and Lincoln products."

Among Chinese technology brands, Sheng says Baidu is best positioned to make inroads in self-driving cars. "It is the most aggressive investor [in automated vehicles] among Chinese tech companies now," he says.

In April, Baidu announced it had formed a self-driving car research team based in Silicon Valley that it plans to expand to 100 people by the end of the year. The team will be part of Baidu's newly-created Autonomous Driving Unit (ADU). In a statement, Wang Jing, senior vice president of Baidu's ADU, said: "Baidu is fully committed to making self-driving cars a reality. Autonomous vehicles will save lives and make transportation more efficient."

At *The Wall Street Journal's* Converge technology conference in June, Wang told the audience that Baidu intends to launch its self-driving cars globally by 2021. He noted that the company is already testing its model on public roads in Beijing and Anhui, as well as in "a closed testing area in Shanghai." Wang said he hopes Baidu's car can eventually be tested in 10 cities across the country.

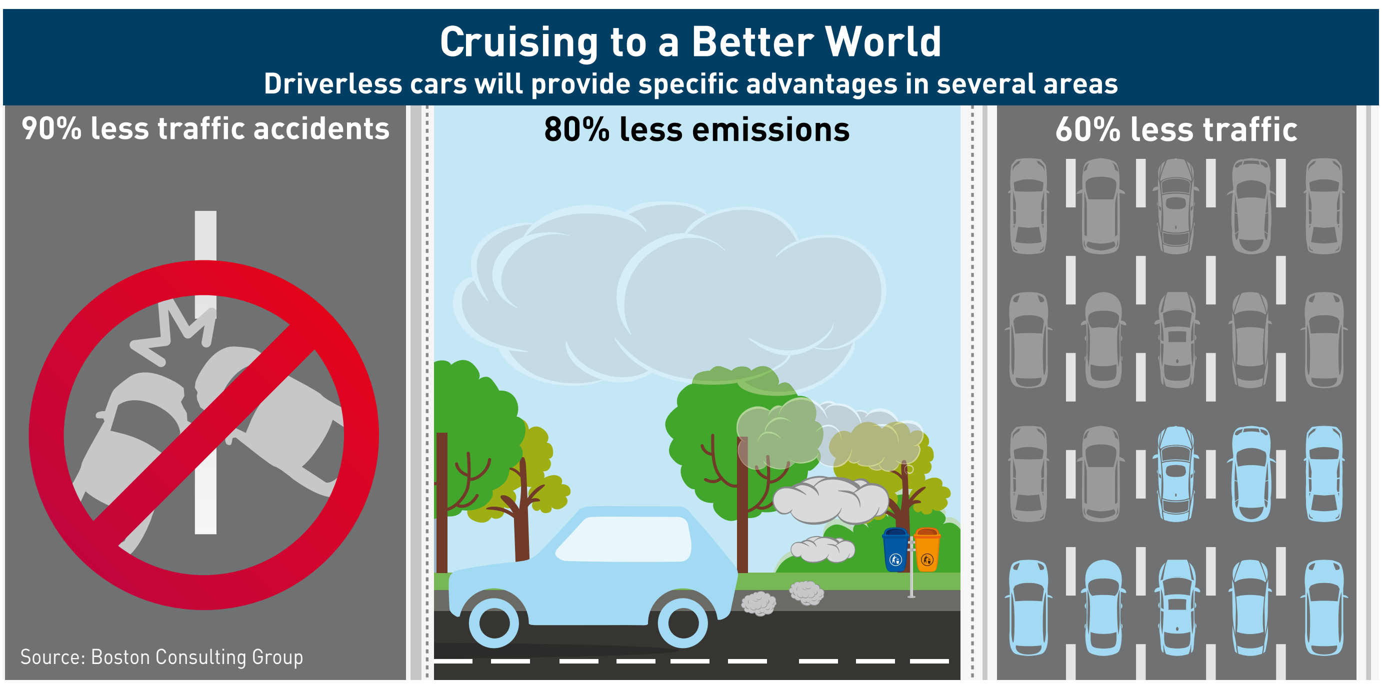
"Baidu has been devoted to developing artificial intelligence technology for a long time and its self-driving car has reached a leading international level in terms of deep learning and high-resolution mapping capacity," Wang told *CKGSB Knowledge*.

Beijing Takes the Wheel

While the Chinese market looks ripe for self-driving cars, government support will be integral to widespread adoption of automated vehicles. "Compared to other countries, the Chinese government's support will be a main driver to develop self-driving cars as the level of complexity in vehicle regulations is relatively high in China and the Chinese government plays a key role in verifying which technical standards are optimal for China's driving environment," says Tzeng of MIC.

He notes that in June, China set up its first national test site for connected and self-driving cars in Shanghai, which aims to facilitate R&D, standard studies and policy formulation, and test and certify connected car technology. At the Shanghai base, test cars will initially be put through 29 different driving simulation programs, such as vehicle collision, brake alert and pedestrian crossing alert. The government plans to expand the number of testing programs to 100 by late 2017.

As part of the launch of the demo base, General Motors unveiled its newest connected vehicle (V2X) technology. Wide deployment of the technology could eliminate 81% of "non-impaired" light-vehicle crashes, according to the US National



Highway Traffic Safety Administration (NHTSA). "The newly-opened Demo Base provides an excellent location to carry on our research on intelligent and connected vehicles in China," said John Du, director of the GM China Science Lab, in a statement.

From 2018-2019, 5,000 automated vehicles will be deployed in an expanded testing area of 100 square kilometers. Testing will also be done in the Shanghai suburb of Jiading, at the Auto Expo Park and Tongji University's Jiading campus. And then in 2020, China plans to launch a self-driving vehicle demonstration city near Shanghai.

Some industry experts have been encouraged by Beijing's approach to automated vehicles. "The Chinese government is taking a 'top-to-down' approach to push hard on self-driving cars, and the attitudes are generally positive so far," notes Ford's Chan.

Meanwhile, a draft roadmap for autonomous vehicles backed by the MIIT is in progress. The plan is expected to call for deploying self-driving cars within three to five years on highways and for urban driving by 2025. Observers say the roadmap will likely outline technical standards, infrastructure and regulations. Such a uniform framework for managing the introduction of automated vehicles would be a significant departure from the US's fragmented laws and standards, which vary by state.

A Long Road Ahead

Market observers are generally bullish on self-driving cars in China, but a few caveats remain, one of which is consumer attitudes. In contrast to the highly encouraging BCG survey, a J.D. Power/Tencent survey of 5,000 consumers in China conducted in the spring of 2016 found that only 9% were very positive on the prospects of unmanned mobility.

"Driving in China is still a novelty and serves as a kind of socio-economic status symbol of having arrived," JD Power Vice-President and Asia-Pacific general manager of automobile operations Geoff Broderick said in a statement. "As the market matures, consumers in China are rapidly becoming exceptionally discerning and are seeking value when considering technology and other features. This creates a unique set of preferences that are important for manufacturers to understand."

> I don't want an automated vehicle. People should be the ones in control of machines
>
> Gerald Fu
> Shanghai-based media sales manager

Gerald Fu, a Shanghai-based media sales manager and owner of a BMW 3 Series car, told *CKGSB Knowledge* that automated vehicles do not interest him. "Driving is fun," he says. "I don't want an automated vehicle. People should be the ones in control of machines, not the other way around."

Indeed, the appetite of Chinese consumers for motoring remains healthy. From January to June, retail sales of cars, sport utility vehicles and multipurpose vehicles increased 9.5% to 10.8 million units, up from 8.4% a year ago, according to the China Passenger Car Association. There remains plenty of room to grow as well. Vehicle ownership per thousand people in China was just 110 in 2015, compared with 800 in the US and 500-600 in Europe, according to data compiled by Ford.

Ford's Chan suggests that "more studies should be done regarding consumer attitudes of self-driving cars in China" to get a more accurate reading of the true situation.

He cites regulatory ambiguity as a potential obstacle to the development of self-driving cars in China. "There is at present no clear regulations on self-driving cars in China," he says noting inconsistent definitions of automation levels as well as accident obligations. Additionally, he observes China "has not developed technical advantages in self-driving vehicles yet, compared to Europe or the US" All of those factors "will potentially become big barriers for the development of self-driving cars in China."

Meanwhile, following the fatal crash of a Tesla Model S car in Florida in May, China's auto industry regulator She Weizhen told automakers in July not to test their self-driving vehicles on highways before relevant regulations are released. Then in August, another Tesla Model S was involved in a minor collision on a Beijing highway while the driver had 'autopilot' mode engaged. Tesla responded by stating the mode was for driving assistance, and subsequently changed the language on its Chinese site from "self-driving" to "self-assisted driving" (in translation).

Research firm IHS predicts it will take China twenty years to become a global leader in autonomous vehicles. But by 2035, IHS forecasts, China will have deployed 5.7 million vehicles on its roads "with some level of autonomy," more than any other country in the world. High sales volume and robust consumer demand for new technologies will drive growth of the automated vehicle sector in China, IHS said in a June press release.

Gartner's Sheng agrees it will be a long time before self-driving cars are the norm on Chinese roads. "Most Chinese automakers do not think they will be available in the short term due to the absence of regulation and complexity of China's transportation conditions," he says. "There could be some progress in the next five years but the commercialization challenges remain significant."

Conversations

A New Beverage for a New Age

Esteban Liang, Managing Director Asia, Costa, discusses coffee in China

By Tom Nunlist

While tea remains China's choice in terms of hot, caffeinated beverages, coffee has been making significant in-roads in the past two decades. But it is not so much a breakfast staple of the workaday life as a modest status symbol for young consumers in China's newly prosperous age. Coffee, says Esteban Liang, Managing Director of Costa, Asia, is an "affordable luxury."

In this issue's C-Suite interview, Liang discusses the history of coffee in China, as well as Costa Coffee's experience in the Middle Kingdom thus far. From introducing the coffee house concept to Chinese consumers, to attempting to ride the middle-class wave, it has been an interesting journey, but one that is still only beginning.

Q: How long has Costa been in China and how has it grown in scale up to now?

A: This is the tenth anniversary in China. The first shop was opened in Shanghai, on Nanjing Road, and that was 2006. We now have presence of close to 400 stores throughout China. Most of the stores are in Beijing and Shanghai—each of the cities probably has around 100 stores. And then we have presence in all major provinces and capitals. So altogether we must be in around 30-plus cities in China.

Q: All food and beverage is a bit of a lifestyle choice, but coffee houses are in a unique spot—it's about the products but *it's also about the lifestyle. How easy was it to sell that whole package?*

A: I will say in ten years China has changed so much, and Shanghai is not an exception. Ten years ago, it was a bit more difficult; coffee was not really so well-known. It was a product that you really had to position in the market, some people had never experienced it before. The concept of a coffee shop was probably not that developed at the time, which is radically different from what is happening right now. You mention correctly "lifestyle," and that's what defines what a coffee house is. And that's very different from what a coffee house might be in Europe or some other places. Coffee houses in China are a place to see and be seen. Product is important, but it's not only about the coffee itself, it's not only about the food. It's about the music, the store environment, the service, the whole package. I always use a sentence to describe it: "It's not about the coffee experience, it's about the café experience," which is the whole thing.

And right now it is clearly much easier than it was ten years ago, because this is what the type of emerging middle class, the trendy people, are looking for now. They want to go to places that they identify themselves with, places where they feel good, where they can be seen, where they will take a selfie and share it with their friends on social media, because they are proud of what they have achieved and they want to show it.

Q: In coming to China, did Costa have to change itself to fit the customer, or was it more educating the customer about what Costa already was?

A: I think it's a combination, first with the product. We have our core coffees, what we call our famous five, Americano, cappuccino, latte and so on. Those are core drinks that will never change, and the recipe is exactly the same as we would have in the UK. But then, of course, you have seasonal drinks that vary in each country, and that are very much catered to the tastes and needs of the local consumers.

Then you have other things like store design. Right now, we are in a store that just opened three weeks ago, and you will never find any store like this outside of China. This concept is very unique and it's very tailored to the local market. I will say it's probably less functional and more stylish, exactly for that reason because we want to attract customers that want to experiment with lifestyle. They want to be stylish and trendy and modern.

Q: Can you go a little bit deeper into the balance of localization versus staying true to the original?

A: Everything starts with research. The first seven years of Costa in China we didn't localize that much, and it was probably more about transplanting the model we had in the UK. I will say in the last two years we have really made a great effort in trying to understand the local customer—understanding what are the customers looking for when they go to a coffee shop, what are the main drivers for them to go to a coffee shop, and we discovered that environment is probably number one, even above the product itself. They do like coffee, they do want to learn more about it, but the first thing for them is environment and service. In terms of a coffee shop, they don't expect table service, but they do expect to be treated politely. And in terms of store design, they are really looking for something more stylish, more trendy and modern, compared to say how a Costa would be done somewhere else in the world. So this is how we have tailored store design. We are sitting in a place where we have a wall with real plants—this is something Chinese people care about. They are increasingly concerned about the environment, pollution and everything, so this is our little touch about social responsibility. One of the things we are thinking about is to install air purifiers in the stores. Make people feel clean, you're safe here.

Costa's latest store in Shanghai

Q: When you talk about the place having to be more stylish, is that because coming to a coffee shop is still a bit more of a luxury here than it is the UK or the US?

A: Coming to a coffee shop, but not only a coffee shop, also some restaurants and clubs, it's part of the vision or the image that the customer wants to portray to the world. By coming to these places, you are telling the world that you belong to this environment, that you belong to this experience, that you like it and that you want to be part of it. So definitely. I wouldn't say coffee is a luxury, but it's an affordable luxury. And the positioning, yes, it's slightly higher than in the Western world.

I think coffee in the Western world is more for practical things. It's more a convenience thing—you grab a coffee and you go to work. You may even do that in the petrol station. Here in China that hasn't happened yet, because here in China if you want to have a cup of coffee, you want to enjoy it in a nice place. But China changes very fast. I'm sure in a few years, we will start to have coffee in service stations, or drive-throughs, which are still not very popular in China.

Q: China is an extremely diverse place, both socially and economically. Is there a big difference between a Shanghai Costa and a Costa in a provincial capital further out?

A: I would say the gap is closing quickly. The second-tier city customers, they do travel. Not only to the first-tier city type shops, but they are also traveling into Asia. They also know what they like and what they want. So I would say they are also very quick in adapting to trends. In terms of customers, I wouldn't say there is a big difference. You could actually say there are probably more customers of the type that we want to attract.

Of places outside of big cities, I would say it's also easier to attract talent, that's my perception. Our staff and partners are even more engaged than they are in the big cities. I think maybe it's because of the issue of opportunities. In the big cities there are a lot of jobs. In the second and third-tier cities there are maybe not as many opportunities, and that's why they become so much more engaged.

Q: Your biggest competition is of course Starbucks—but how does the competitive relationship here compare to that in the UK, your corporate home base?

A: If you look at where Starbucks is in China compared to us and also the UK, I would say it is exactly the opposite. We are a very clear number one in the UK, and they are a very clear number one in China in terms of the number of stores. They came to China about seven years earlier than we did, in 1999. And I think they did a good thing, which was educating the Chinese customer about what coffee shops were. So in some ways they had already spread the seed of coffee in China, which made things a bit easier for us.

Generally, they are a great company and they are doing nicely and probably we could learn some things from them. But we are proud of what we are, and we think that we have a good way of expanding in China. I mean, this market is huge. Right before I joined the company I was doing my research, and there's one statistic I really found interesting: What is the country that drinks the most coffee in the world, up to 1,000 cups per person per year? That country is Finland. That's close to three cups a day, and the same number for China is four cups per person per year, average. Obviously that's because in China there is 1.3 billion people, there are a lot of people in the villages who have never had coffee. You can see where the potential is. And given the size of this market, and how this market is going to change—just the urban population of China is still only 50%—so you see the potential, where we have to be

> We've been here ten years and it's just getting started

in the future. There is no doubt that China is the place to be, and Starbucks may [remain] the biggest in China, they may stay the biggest one in terms of number of shops for many years. But I think what we're trying to do is position ourselves differently, to be slightly more premium, even though we are a big chain. No difference in terms of price, but in terms of the experience itself. The environment, the products that we offer, the service. If we can do that, I think we will be a very strong number two in China, and I think this is the position of Costa in China. Hundreds or thousands of stores at some point, that's big enough. We will be super successful.

Q: Indie coffee shops are something that you're starting to see more of. What does that say about the current environment?

A: This is the third wave of coffee, the artisanal coffee operators that really started and are very strong in other Asian countries, like Taiwan or Korea, even Japan, but are just starting right now in China, especially in places like Shanghai. It's quite interesting how coffee started in China. What we call the first wave was the instant coffee, Nescafé. And then you had the second wave, the Starbucks, the Costa, mass chains. And China is now in the middle of the third wave, what we call the artisanal coffee operators. People that maybe own one or two stores, or the biggest ones maybe ten, fifteen. They are relatively small, and they pride themselves on being very expert in making coffee, having blends and single origins, different brewing techniques, being very sophisticated. But we see, or what I perceive in the market, coffee houses or coffee companies like us, we are trying to bring more innovation, more blends, we are trying to bring single origins here in China, different brewing techniques and not just the traditional espresso based brewing techniques, like pour-over and cold brewed.

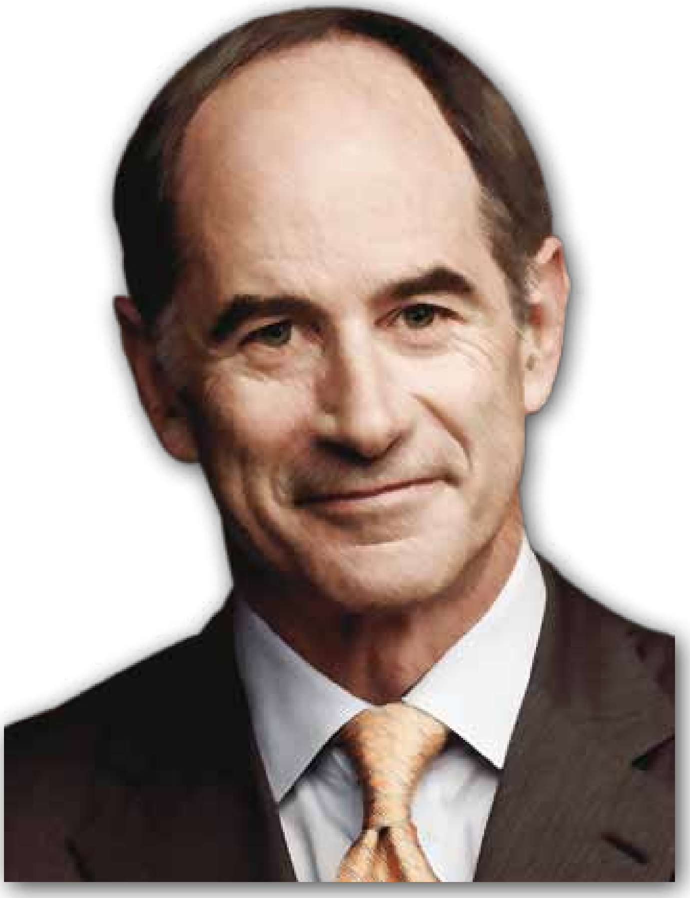
The artisanal operators do that already, but they lack the scale to make their business giant. They are trying to open more shops, learn more things about how to run the business, whereas we are improving or developing our coffee credentials at the same time. So in the end, I think we are all going to meet at what I call wave 2.5. They are trying to grow bigger, we are trying to use more techniques, and we will all meet in the middle.

Q: Has the market development in China tracked other Asian nations, or is it different?

A: China's quite unique. You look at other markets in Asia, for example Korea is heavily influenced by the US, while Japan is a mixture of the US and Europe. The Japanese love everything that's French, so there's a big influence on things from Europe as well. Taiwan, there's a lot of Japanese influence, and China is a mixture of everything. There's a lot US and Europe, but it's also influenced by all the neighbors in Asia. So it's a mixture, with all the traveling that is happening here, with Chinese people going to Hong Kong, Tokyo, Taipei, and seeing these things, these trends. And many Asian countries have been quick in establishing themselves in China these past few years as well.

Q: What is the future of Costa, and the market in general in China?

A: The market is huge, and things are just getting started. We've been here ten years and it's just getting started. The future is bright. We have to make sure we stay close to what the customers want, and if we do that I don't have any doubt that this company can have thousands of stores. It's going to be super successful. You can see that coffee shops are the places that people really want to be.



The Lost Art

Roger Martin, former dean of the Rotman School of Management, talks strategy and creative thinking in business

By Tom Nunlist

Roger Martin is the former dean of the Rotman School of Management at the University of Toronto, where he still teaches. As a corporate strategist, consultant and academic, he originated the concepts of integrative thinking and design thinking, with companies such as Procter & Gamble and Lego putting them into practice. He is the author of a number of best-selling books, including *The Opposable Mind* and *Playing to Win: How Strategy Really Works*. Martin is also the Director of the Martin Prosperity Institute, which researches long-term income inequality and the stagnation of median incomes in the United States.

In this interview, Martin discusses the decline of strategy as a corporate art, his strategic-thinking paradigms, as well as practical application of those ideas.

Q: You've spent decades in corporate strategy. How has corporate strategy changed along with the changing world economy?

A: It has changed in a number of ways. One, I would say, is that the bloom is a bit off the rose of strategy. I'm a strategist, but I have to say the enthusiasm within corporations for strategy was arguably higher in the 1980s and 1990s than it is today. And that's, I think, because strategy became too much of a dry analytical, quantitative exercise that CEOs said, well I have to do this, and I know the board wants a strategy but I'm not sure how much value this has to me. And then there's the whole critique that success is all about execution and not about strategy. I think that critique is vapid, in the sense of this notion that a mediocre strategy well-executed will beat a great strategy poorly executed. But how do we know that there is a great strategy that was poorly executed? What is our mechanism for figuring that out? And the answer is there is none. So it is fair to say that what has changed is that there are lots of CEOs who question the true value of strategy.

Two: I think a bunch of CEOs have fundamentally misinterpreted what Henry Mintzberg said about emergent strategy. Henry was an early critic of the technocratic approach to strategy. What he said is that if you look back after the fact, not many things happen as you would expect, and strategy actually changes on the basis of the world evolving. It doesn't necessarily evolve the way you predict. So strategy has to be emergent. Many CEOs read that to imply "don't have a strategy, just do whatever comes along," which is not at all what he was saying. They think he meant to always wait and then react. I think that's a losing proposition.

And then the last would be the emergence of the tech sector of being so dominant and this notion that in the tech sector you can't plan anything because the cycles are too short. So I think those things are all a challenge to strategy.

I would say, for what it's worth, that strategy as a way of thinking has become a bit of a lost discipline.

Q: How do we get it back?

A: I don't know entirely. Honestly, I shake my head a little bit. I personally try to do it. I work for about a dozen CEOs of big corporations around the world on strategy and interestingly enough, lots of them have strategy departments, but not many people in them are actually practiced in strategy, even though many are from large consulting firms. But it's fun. They are very smart and when I teach them tools and techniques for making strategy choices, they are excited by it, and have a real appetite for becoming better strategists. The problem is that strategy just isn't taught or practiced enough anymore.

> Executives that do well and make a real difference are the ones that don't accept that we have this unpleasant tradeoff, that I have got to do either X or Y

What I have the highest hope about is the development and embrace of design in business, for what it's worth. And why that is, is because we have to get away from strategy as planning. Strategy is analyzing what currently exists, and on the basis of that analysis saying, okay this is what we should do.

Q: In your concept of "integrative thinking," you balance two opposing models, and for a layman, that goes against conventional thinking. How does a decision-maker best deal with conflicting goals?

A: The reason for the model is that it turns out that the executives that make a real difference for their organizations are the ones that don't accept the notion that when they face an unpleasant tradeoff, that they have to chose either one side or the other. I have to build small hotels, or big city-center convention hotels, for example. Instead they ask: "what is possible to create based on the existence of those two models?" That's what Four Seasons founder Isadore Sharp did. He said, fair enough, that's what everyone says are the two opposing choices, but I think there might be other possibilities, and he used his creativity, his imagination, his skill to come up with a better model. That's what integrative thinking is. It's not that you continuously say, it might be this, it might be that. But when you are faced with a tradeoff that you know in your heart is not the right tradeoff to make, but there is a better way, you take personal causal responsibility for finding that better way, and that's what Sharp did at Four Seasons. And that's how you create huge value as a CEO.

Q: Can you expand on the Four Seasons example?

A: So Sharp said of his first hotel, which was a roadside motor inn, the Four Seasons Motor Hotel, that he loved the intimacy that these motels had. But with 50 to maybe at most 150 rooms at a motel, and low prices, you don't have the annual revenue necessary to justify building the infrastructure that a business traveler would need. You have maybe a swimming pool, maybe a bar/restaurant but that's it. He then built a big 1,600-room convention hotel in the middle of the city, and that had every amenity known to mankind—workout rooms, conference rooms, ballrooms, everything a business traveler could want. But he thought it was big, cold and impersonal.

Those were the two models that essentially worked. There were huge chains, Westin, Hilton, Hyatt on one end, and Motel 6, Holiday Inn on the other. Sharp didn't like either one of those, and instead of choosing one or the other, he asked himself: how can I build a model that would give me the intimacy and comfort of a motel, along with the amenities of a big hotel? His insight was that business travelers don't like being in luxury hotels. What they miss is home, where their loved ones are, and the office where they can be productive, because they've got their productivity infrastructure. He set out to redefine luxury as a service that makes up for the environment you left at home or at the office. His hotels are between 150 and 300 rooms, less than half of the size of a minimum-scale business hotel, that have the intimacy of a motel but thanks to the superior form of luxury, enable Four Seasons to charge such a high price premium that it can afford every amenity necessary to make the hotel outstanding. On that basis he built what is now known as the Four Seasons model, which is a different model than any other in the industry. The hotels are smaller, the service is completely different. It doesn't attempt to win on grand architecture and décor, but rather a kind of service that makes up for what you left at home or the office.

Q: And what does it take to do integrative thinking?

A: The interesting thing about these integrative thinkers that I've found is what they do is they dive deeply into, or fall in love with, each of the existing models to dig out of them the things that are special and wonderful about those models in order to build a new and better model. This is in stark contrast to most people who feel that their job is to choose from among the existing models. They are trained to be very judgmental about models rather than appreciative of models because they see their job as eliminating all but the best model. So when I ask people to do integrative thinking, I tell them that I want them to sequentially fall in love with the two models. Fall in love with the first model. Treat it like it is the only model in the world. Ask only what is great about it. Forget what's bad about it. After they have appreciated it thoroughly, I tell them to forget about it as if it doesn't exist anymore and go and fall in love with the other model. That's not normal decision-making behavior. But it allows them to mine the best elements of each, which provides clues about how to combine those elements to create a new and better model. At that point we give them three ways to search for that integrative solution. Right now, I'm working on another book, in fact, on how to do that.

> If you are going to make computer chips, you have to understand transistors and electricity... rules that aren't going to change. But consumers change all the time

Q: Another one of your concepts, "design thinking," again balances two different approaches—intuition versus analysis. Is this technique more about complementing the strengths of each approach, or canceling out the weaknesses?

A: It's more on the complement side. But this gets to something that Aristotle said. He created the initial rudiments of the scientific method, and in his book *Analytica Posteriora* he laid out what is cause and effect, and what is science. What people ignore is that he put a warning in the back of the book and then wrote a second book that followed up on the warning. To paraphrase, he said this method is for the part of the world that cannot be other than what it is. For example, if I drop an object it will fall at the same speed now, tomorrow, the next day and forever in all situations.

But he said there's another part of the world where things can be other than what they are, my relationship with you for example. If I scream and yell at you all the time, we'd have a crummy relationship. If I answer your questions nicely, we'd have a good relationship. There's a huge part of the world where things can be other than they are, and in this part of the world, the job of humans is to create a future. And he said that the method laid out in *Analytica Posteriora* is inappropriate and shouldn't be used for that part of the world.

The part of the world that can be other than it is requires a different thinking process. It requires the imagination of possibilities, and the selection of the one for which the most compelling argument can be made. And so essentially you need both. There's part of the world where you have to analyze with all your might "what is," so you can understand "what is" and exploit it. But there's a whole other part of the world, and for that you need this designerly approach. So they are complements.

If you are going to make computer chips, you have to understand transistors and electricity etc., and those are rules that aren't going to change. But if you are going to understand how to sell stuff to consumers, you have to understand that they are changing constantly. For them, you need to create the future to be special.

Q: You write books for business leaders, but are any of your ideas applicable to everyday life?

A: I think if you are wondering about your personal career strategy, integrative thinking and design thinking are very applicable. Readers of *The Opposable Mind* have told me that it has helped their marriage or helped the relationship with their children. So I have come to believe that it offers practical advice for individuals. I've often thought about writing a more personal development-oriented book, and I may some day.

Making sense of China's economy

Arthur Kroeber, author of *China's Economy: What Everyone Needs to Know*, talks about how China got here and where it might be headed

By Tom Nunlist

Arthur Kroeber is managing director of the Beijing-based economic research firm Gavekal Dragonomics—formed in 2011 via merger with Dragonomics, which he co-founded in 2002—and editor of its journal, *China Economic Quarterly*. He is also a senior fellow of foreign policy at the Brookings-Tsinghua Center in Beijing. He worked as a financial reporter in Asia from 1987-2002.

Kroeber is the author most recently of *China's Economy: What Everyone Needs to Know*, a comprehensive introduction to China's rise from an economic backwater in the early 1980s to the world's second-largest economy. As he describes, the country has achieved almost miraculous advancement in a mere 30 years, but at the same time is beset with a host of structural problems and contradictions that it must grapple with, especially as economic growth begins to slow. In this interview, Kroeber offers his analysis on how China got here, where it might be headed, and how to understand the changes and implications.

Q: You come from a background studying history, rather than economics, and that informed your book, China's Economy: What Everyone Needs to Know, *a great deal. Why is the historical perspective necessary in talking about the Chinese economy?*

A: It's true in talking about any economy, because an economy is not a bunch of math equations, it's a bunch of arrangements between people and the institutions they create and evolve over time. I have a pretty strong view that in any economy you have to look first at the underlying political arrangements and understand how they create certain kinds of conditions and constrain economic policymaking... I think it is particularly important in a place like China that is not a mature, relatively slow-growing developed economy, where there is greater space for just looking at economics from a technical perspective. China's a fast-growing economy where the structures are changing very quickly, and that increases the importance of understanding the historical and the political context.

Q: Maybe also, and this is my guess, if you were in the United States and you were talking about a European economy, there is a certain level of commonality there, whereas China is very different from what you already know.

A: Yes. The other thing is that a lot of economic analysis was developed in the United Kingdom initially, and then taken over by the United States, and a lot of modern economic analysis really takes its starting point assumption as the US is kind of the normal situation for all economies. But development economists have understood for many, many years that the rules that apply to a developed economy, and specifically the US, often to do not apply to a developing economy.

Q: Are there any limits or pitfalls in tackling economic understanding from the historical perspective?

A: There's certainly a lot less limits and pitfalls that arise as a result of taking into account political and historical factors than arise from ignoring them. Any perspective obviously has some bias and I think the biggest bias is not so much from the historical perspective, but it's from the outsider's perspective, right? I'm a foreigner, I'm not Chinese, I haven't grown up in this society and that imposes certain limitations on my scope of vision, and the book I wrote is essentially for a foreign audience. I hope it can be useful to Chinese readers as well, but there is a very different perspective that people inside a country have on their own development, as opposed to people from outside a country.

> Most of [China's] economic growth is going to come not from throwing new capital into the system, but by becoming more efficient

Q: Why do you think people tend to get hung up on drawing conclusions from certain headline numbers, like GDP, and how can one guard against that habit?

A: I think it's the natural tendency if you are looking at a large and complex thing that's very difficult to understand, to try and boil that down to a certain small number of variables or factors that we can easily analyze, and we all do that to varying degrees. You just have to understand that every time you make a simplification there's a cost to that, and you should, as a matter of intellectual honesty, go back and reexamine your assumptions from time to time.

On that specific thing, there are a couple of factors. First of all, there is a degree of historical amnesia, that countries that are already rich very quickly forget how they got rich. They assume that the way they are now is the way that they've always been, and so a simple example would be that the US is a highly market-driven consumer economy, and many elements of that are not the reasons we got rich, but the consequences of getting rich. So losing sight of what the causes and consequences are is something that's very easy to do.

The second thing more has to do with international geopolitics and geo-economics, that when China hit its most intensive investment stage in 2005, 2006, 2007, this had some pretty substantial impacts globally, in terms of interest rates, wages and so forth elsewhere in the world. China had a huge current accounts surplus for example, and this was very difficult for the rest of the world to absorb. A lot of other countries took the view that the way that [China was] growing was causing problems, therefore [China] should stop growing that way, and that is a legitimate conversation to have.

Q: My general sense right now is the popular view on China and its economy is one of pessimism, but is that attitude a grounded one?

A: "Popular" in my view would be what most people think. If you look at the latest Pew Global Attitudes survey, one notable fact in there is that a number of people in the United States considered China to be the world's leading economic power and the US number two from about 2010 to about 2012, or 2013. In the last couple of years that's started to shift and now a clear majority of Americans are back to thinking the US is the number one power economically and China is number two. To me that's not pessimism, that's just a kind of return to reality, because if you look at any metric, absolute size of GDP, level of technological development, influence over global trading and investment institutions, the US is far more important and influential than China. So the aberration was this period where people thought that China was taking over the world because of its high growth rate. What we now have is a more realistic assessment, [which is that] it's a very large economy, it continues to grow very fast, but it has a lot of problems. And just because you are growing fast doesn't mean that your absolute position in the world has changed all that much. So think at the popular level there is a pretty clear-sighted understanding now of where China stacks up globally. [But] when you talk about representations in the media and in the financial world, I think you get some very clear biases. [In] the media… there is a tendency to look for hot stories, and often exaggerate trends of the moment. So when China is growing fast the tendency is to say they are taking over the world, and when it slows down there is a tendency to exaggerate that and say everything is terrible. That's just a natural feature of the news cycle… There are parts of the financial sector that look particularly at the financial risks in China and say [that] these look very high and therefore the financial system is going to blow up and it's all going to be a disaster. And that I think is an exaggerated view that stems from… a very narrow perspective.

Q: In the book you made a point about switching away from investment-led growth to increasing efficiency. What does that mean?

A: When an economy starts out very poor, as China was 35 years ago, and moves toward becoming rich, it basically has to go through two phases. The first phase is just simply accumulating a lot of capital, because the way that you get rich is that you have a lot of capital to play with. Poor countries are poor because they don't have a lot of capital, they don't have factories, they don't have infrastructure. So if you are a worker and you have nothing to work with except your bare hands, metaphorically speaking, it's hard for you to be productive. But if you have access to modern machinery, modern technology, modern transportation networks and so forth, you have a lot more than your hands to work with. You can multiply the value of your labor many times. The difference between a rich country and a poor country is that a rich country has a lot of capital endowments. So stage one is to just accumulate as much capital, as much technology, as much infrastructure, as much industrial capacity as you can…

But then what happens is that you get, basically, to a point where your capital endowment is roughly where it needs to be for a modern economy, and then you don't have to throw that much more capital into the system. And the way that you understand that this is happening is that when you don't have that much capital you can almost randomly build new infrastructure, and it will generate a very high return… But then as you get closer to that frontier, what happens is that the return on those capital investments starts to go down, and you start to observe that if you put in another mile of road, or another power plant, or a steel factory, the return on this investment is way lower than it used to be… Then what you are left with is that the only source of economic growth is greater productivity, which means getting a higher return out of the capital that you have already installed.

> There is a very strong desire to keep a very large state role in the economy, and I think… that's a real obstacle

My argument is that China clearly is several years into this transition where returns on capital have been declining, basically since 2008, and very steeply in some [sectors]. And in the future, if you look at the next 10 or 20 years of Chinese growth, they are going to have to keep building more capital resources, but at a much slower rate than in the past. Most of your economic growth is going to come not from throwing new capital into the system, but by becoming more efficient and more productive in using the capital that you already have.

Q: But how do you go about making those efficiency gains?

A: This is the big question, and economists will give you, with great authoritative voices, very clear answers to this. But in my view it's harder to say. I think every country has to kind of feel its way toward that, and it is not easy. But the simplest way of thinking about this is that an awful lot of energy has been devoted to channeling investment into basic infrastructure, basic industries, [which are] capital intensive projects. And you now need to channel investment more towards service sector activity, consumer-facing activity, because that's where the returns are.

I think the second dimension of this is that, fundamentally, when you are in this capital accumulation phase of growth, a strong state and state-owned enterprises can be very useful agents, because it is fairly obvious what you need to do, and it does not require a high degree of complex thinking. And you also need to tolerate a situation where you might build some infrastructure that you don't get much of a financial return on immediately. So state companies that are not focused on quarterly returns, but just getting stuff done, can be very useful. When you are just building stuff it is fine to have a big state and a lot of state-owned enterprises.

But when efficiency is the main thing, we know from a wealth of data that state-owned firms are much less efficient at using capital than private firms. And much less nimble at catering to consumer demand. So it seems pretty clear that one of the ways that you make this transition is that you streamline your state-owned enterprise sector, you reduce your reliance on the command economy, and on state-driven growth mechanisms, and you allow a bigger role for the market and for the private sector. There are a lot of ways that you can do this, a lot of places that you can draw this line in terms of how much state and how much market that you want, but the direction, I believe, very clearly has to be towards less state and more market.

Q: Do you think China is moving in the right direction with those adjustments?

A: It's unclear. You look at certain metrics and you can see that the private sector share of almost every economic indicator continues to grow, but it is growing at a much slower rate than it was five or six years ago. So the impetus toward a more market-driven, more private sector economy seems to have weakened. And at the top level of policy you see President Xi Jinping has basically outlined a vision of economic growth that is very heavily reliant on a big role for the state-owned enterprises. There is an emphasis on consolidating SOEs so that they are even bigger. There doesn't seem to be a lot of appetite in the government at the moment for large-scale deregulation to reduce the state role in any given sector. So we are getting mixed signals, but I think one of the signals we are getting is that there is a very strong desire to keep a very large state role in the economy, and in my opinion that does create a real problem. That's a real obstacle to China making the move to a more efficiency-driven economy.

Q: Is that different from other Asian economies?

A: I think one of the big differences between China and the places it most resembles—Japan, South Korea and Taiwan—is that they have relied much more heavily on state-owned enterprises from the beginning. Japan basically had none. Korea had a few but then privatized them in fairly short order. Taiwan had a lot, but it also had a very vibrant small and medium enterprise private sector that was basically just allowed to do whatever it did.

But China, because it started out as a communist economy where everything was owned by the state, has a much, much stronger bias toward state ownership. And that is a big difference between China and the rest of the northeast Asian development stories. I think if you want to be skeptical about China, this would be one of the grounds for skepticism, the question being, can you really become like Japan, or even like South Korea, if you have this insistence on retaining this gigantic state role in the economy? Maybe the answer is no.

State-owned firms are much less efficient at using capital than private firms

Q: How would you place your bets on the future?

A: [After a few years] the problem [will be] you are left with an economy that is still highly reliant on credit, where the quality of that credit has deteriorated and lead to a lot more bad loans in the banks, and you have a need to have a significant correction to the property market because it has just been allowed to go too fast for too long. And I think at that point, you really get down to the question of, is the government really going to make the structural changes in the economy necessary to reduce reliance on investment, focus more on consumption, get more market forces to reduce the role of the state, to have a more private-oriented economy? If the answer to that question is yes, then I think that what you likely have is a much more volatile and complicated period from 2018-2020. If they try to execute some of these reforms you may have some real hits to growth, because a lot of these reforms will, in the short run, reduce economic activity.

But at the end of the day, if all of that is done successfully, you could wake up in the early 2020s and the economy could be growing in a healthy way, without a huge increase in credit, at maybe 5% a year. That's the good scenario, and I think that is about the best we can anticipate.

So then let's assume that they don't do those reforms because they are too difficult or too complicated or they don't really want to do them—what happens then? I think there are two possible outcomes. One is that you have a buildup of pressures in the financial system and it just blows up in some kind of crisis. That's what a lot people in the hedgefund community and the financial industry in general tend to worry about—that this steady increase in the debt level in the economy ultimately will lead to some kind of crisis moment. And I think that's possible, we can't discount it. But I actually think that's less likely than another bad scenario.

That scenario is that the government has enough resources to anticipate a financial crisis and stop it from happening, but the way they do that is essentially the way that Japan did it in the 1990s, which is that they throw more and more money into more and more infrastructure projects, which keeps the economy ticking over, and prevents the necessity for people to recognize bad loans and restructure.

But because the productivity of this capital is falling you just get into slower and slower growth all the time, and where you wind up at the end of the day is that the economy is barely growing at all, and is piling up higher and higher levels of debt. And you get there without an obvious crisis, but you end up with a high-debt, low-growth stagnation scenario.

It may seem weird to talk about that in China today because it's a pretty vibrant economy still, and growing pretty fast. But you know, if we don't see a major change in the economic policy direction, I think that's basically where we wind up seven or eight years from now. And as Japan's experience has shown, once you get into that trap, it is very difficult to get out of it. And it is particularly difficult to get out of it if you have a rapidly aging population, which China will have worse than Japan.

Right now, China looks like Japan in 1980—a lot of workers, not that many retirees, but 20 years from now China will basically look like Japan today. Very few workers, and a lot of retirees. It's hard to get growth from that dynamic. So I tend to think that if you have a bad outcome in China, it will be expressed not through a blowup or crisis or something exciting happening, but a long, slow slide into stagnation.

The Potential of Professional Women

Ripa Rashid, Executive Vice President, Center for Talent Innovation, discusses women in the emerging markets workplace

By Tom Nunlist

When it comes to thinking of gender equality in the developing world, a hefty portion of attention is, rightfully, devoted to women at the lower end of the economic spectrum—for example female workers in the Bangladeshi garment industry, or in China's factories. For these women, entering the workforce in a relatively low-paying job can make a big difference in life outcome for them and for their families, with the gains they make multiplying over several generations.

But inequality at the other end of the spectrum, in the white-collar professional world, also has an enormous impact on individual lives, and on entire economies. Women in China are now half of the educated workforce, but play a disproportionately small role in management, and are routinely held back by an outdated system of work. The result is that society's investment in educating women is largely wasted. Ripa Rashid, managing partner at Hewlett Consulting Partners, executive vice-president at the Center for Talent Innovation, and co-author of *Winning the War for Talent in Emerging Markets*, discusses the significance of, and challenges faced by, women in the workplace, both in China and elsewhere.

Q: Winning the War for Talent in Emerging Markets *was written just about five years ago. In that time, what has changed for women in the workplace in these markets?*

A: The research for that was actually done six or seven years ago. What's shifted is, I think, that women's roles, regardless of which economy they're in, have become more global. As businesses become more and more global, including companies that are headquartered in the emerging markets, the span of control that professional women are managing is becoming even more global than what we had encountered before.

We have a more recent publication, *Growing Global Executives: The New Competencies*, and in that we surveyed 11 global geographies including China, but not just emerging markets. We also looked at middle-income markets such as Turkey and South Africa. What we found is that the challenges for women working across multiple boundaries are a little bit different than those for men. We found that the kind of tightrope of how to project credibility, convey authority and emotional intelligence, varies widely as is obvious for both men and women across geographies. But for women, those latitudes of how they should display authority and emotion are quite distinct.

Q: Could you explain that a little more?

A: Absolutely. What we found was that to really be successful as a global executive for men or women, there are three areas that both men and women really need to nail. The first one is projecting credibility across global markets. This really builds on some work we did previously on the intangibles of leadership. How is one perceived as "leaderly?" The second piece was about inclusive leadership, and the third piece was around really navigating the landscape of gaining advocacy in sponsorship among leaders who will really pull for you to advance and give you greater visibility – how do you develop advocates who will promote you?

We decided to explore gender differences within these 11 geographies. What we found in China was a polarity around projecting authority, which is a big part of displaying strong executive presence as a leader. One question was, how are leaders expected to project authority: in an assertive way or in a restrained way? We were expecting, in Asia, more of a preference towards restrained authority, regardless of gender. However, what we found in the case of China was that 68% of respondents said that women should be projecting authority in a restrained way, versus 10% of respondents who said the same for men.

58% of the professional women in our sample in China were providing monetary support to their parents, and on average it was anywhere from 15-20% of their annual salary. That's a significant responsibility

Q: So when it comes to Chinese women wanting to be effective executives, should they conform to those ideas of what a good female leader is, or fight against it, or just do what they do?

A: That question is spot on. We always caveat our research findings saying that it is descriptive and not prescriptive. When it comes to navigating executive presence, this question comes up all the time. Are we asking female executives to conform to a leadership paradigm, which really still encodes a level of the double-standard? We're not. We are really trying to make women aware of the double standard, as well as men, and make leaders aware of that.

Q: My impression is that your work isn't so much about gender equality in the workplace, but rather about looking at gender equality from the workplace, using the career as a starting point. Is that the right idea?

A: We intended our work, and it is the thread that runs through all of our publications around women's issues at the Center for Talent Innovation, to really look at women's careers in a holistic frame. So looking at women's experiences in the workplace, but also women's interface with the culture, the system, and the processes that are in place. And in that attempt to be more holistic, we are looking at demographic and social trends, as well as sociological elements such as the family and environment.

One of the most fascinating data points we found in *Winning the War for Talent in Emerging Markets* was that 58% of the professional women in our sample in China were providing monetary support to their parents, and on average it was anywhere from 15-20% of their annual salary. That's a significant responsibility, and that has implications that, as you astutely point out, relate to women's commitment to work. If you are not just supporting yourself, but also helping support your parents, the onus to succeed at work becomes that much more important. And then the other fascinating piece we found in terms of the influence of coming up against the systems and processes at work, we found the rise of what we call the "extreme jobs" in terms of push factors. We found in our research that regardless of whether women in China were working for multinationals or locally-based companies, was the average working week was over 70 hours a week. And it was the highest of the five countries—the BRIC countries plus the UAE. But what was fascinating was that was not just driven by after-hours work and calls, but also driven by the incredibly onerous commute. The original definition was a job of more than 60 hours of work per week, after hours, unpredictability etc.—that really has a medium-term impact on the sustainability of ambition as well as health.

Q: A Korean woman we know in her mid-40s is struggling to find a job back home, but nobody will hire her because she is unmarried. How do you push back against that kind of thing?

A: We haven't done any research in Korea. But in terms of the age factor, that's not rare at all. We actually find in our work on executive presence, which is again around projecting "leaderlyness," that for men, regardless of geography, that window is a much longer window than it is for women. For women, the sweet spot of what it takes to be viewed as leaderly is a much narrower band. We haven't looked at it systemically, but just anecdotally, men have about 18 years of runway in which they can be thought of as the next great thing as a leader in a large organization. For women it's less than half that.

But to answer your question, you can address this issue by talking about trends and markets. This goes back to the traditional elements of the business case for retaining women, which is predicated on the talent pool, and the market place shifts that are inevitable. Women are 50% of educated talent in China today. In reality, if you are a large organization looking to hire top talent, 50% of your talent is going to be female. And ruling out that 50% gives you a narrower pool of talent and skills. In terms of the marketplace, particularly for consumer-facing companies, that's a no-brainer—82% of consumer decisions globally are made by women. Another argument is innovation, where there is a clear linkage between teams that have greater diversity and the outcomes of what they produce.

Q: And how to go about retaining women in the workplace?

A: It's about thinking through what the workplace should look like. Women are suffering from the stranglehold of the traditional workplace paradigm, which evolved from military models, from the production line, of how work should be done in certain hours, in certain places, and with certain career lock-step advancement models. In spite of the fact that the workforce has transformed radically in the past 60 or 70 years, we still adhere by-and-large to a very similar work model. So I think the question remains, what can organizations do to rethink the way work is done. Silicon Valley in the US, and the tech sector in general, are beginning to introduce broader, different notions of what work is and how you construct it. One of the things that I found very disturbing in my time working in Asia is the kind of adherence to the very traditional, face time-driven, lock-step career model, where flexible career opportunities, where any kind of off-ramping or sabbatical opportunities were all viewed as accommodations for women and not as a reality for the future of work.

Women are 50% of educated talent in China… if you are a large organization looking to hire top talent, 50% of your talent is going to be female. And ruling out that 50% gives you a narrower pool of talent

Q: Taking the long historical view, how long before women's issues in the workplace are not only overcome, but quaint?

A: Sadly I think this is where reality sets in. I am inherently an optimist. I don't think I could do the work I do if I were not. But any of the numbers that project when gender parity can be reached, or try to anticipate the timeline of equality for women in any arena, and there are many studies on this, are dire. Gender parity will not be achieved for at least another 70 years, definitely not in my lifetime and lucky if it's in my children's lifetime. So on that front, I think there is a real impetus, for those of us who are able, to advocate and keep the conversation alive and keep it as a burning platform. There is no room for complacency here. Because it's not just about gender parity in what we can do, it is really about economic efficiency and growth. Obviously it is the right and moral thing to do, but beyond that it is incredibly inefficient to be generating legions of highly talented, ambitious, able women in our education systems around the world, then having them drop out of the workforce and not contribute to the bottom line. It's hugely costly. A lot of the sensitivity studies that have been done recently by McKinsey and others show that if Japan were to tap into its female workforce, its economic doldrums would be partially alleviated. So for me, it's also a question of economic and bottom-line value. It's incredibly inefficient, not to mention unfair, to be investing in the education of women, and to have the opportunities constrained for them at different points in the pipeline. It makes no sense whatsoever. It's irrational.

Fever Pitch

China's desire to become an elite football nation is having an impact on and off the pitch

By Chris Russell

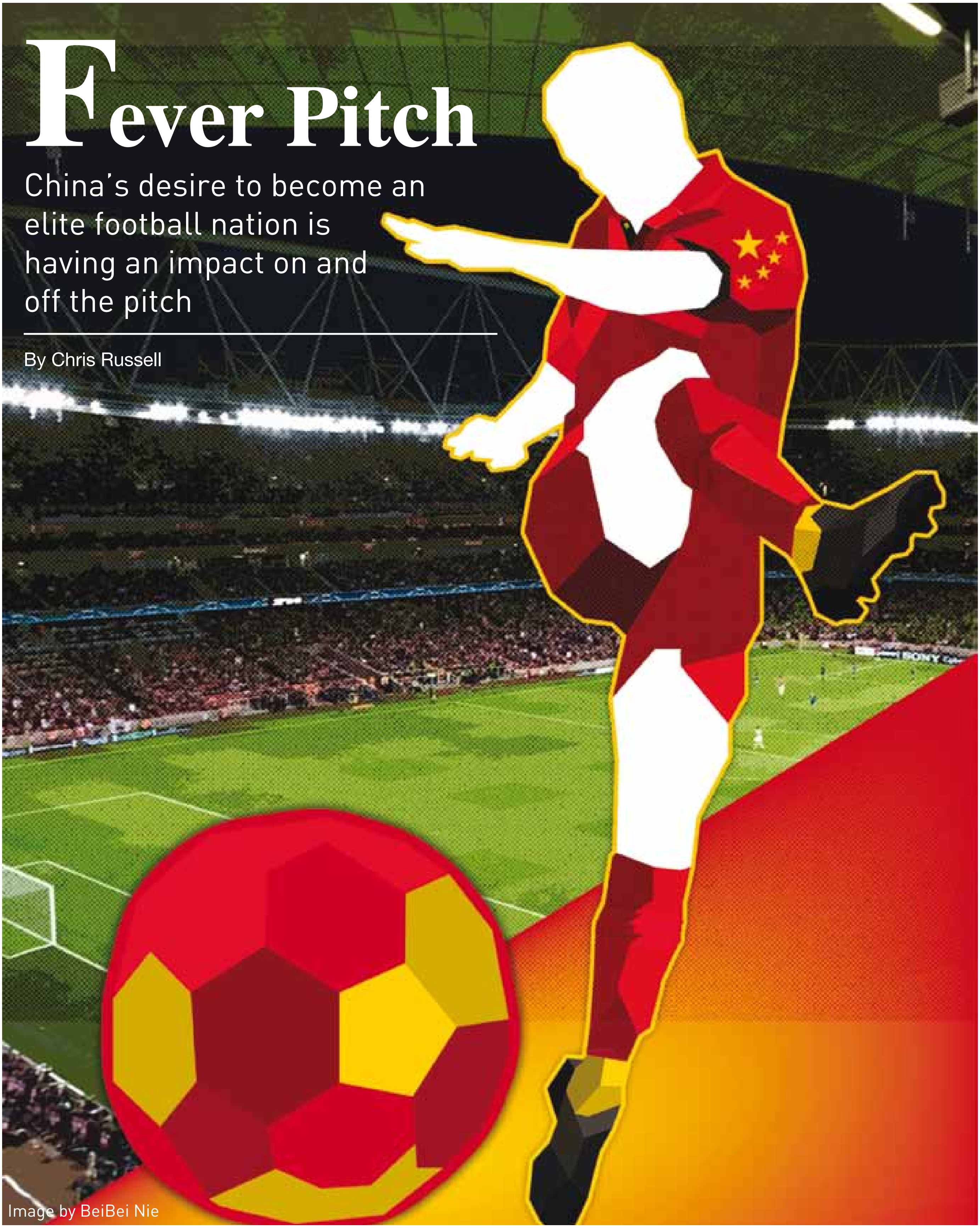


Image by BeiBei Nie

Sport loves an upset, and none more so than soccer. But some upsets come as more of a shock than others.

When China lined up against a second-string Thailand team one June evening in Hefei, Anhui province in 2013, few would have expected anyone but the team in red to emerge victorious. That they lost 5-1 was a huge blow even to China's weary football fans, some of whom caused a small riot after the game. The fixture was friendly, but it crystallized what everyone knew: China's national team was rubbish.

But even then, China's club football was beginning to change, both on and off the pitch after years of corruption scandals. Months earlier, Xi Jinping, a noted soccer fan, ascended to the presidency, and in November of that year, Guangzhou Evergrande claimed the team's first, and China's second, AFC (Asian Football Confederation) Champions League title, the top club competition in Asia.

Since then, the government has unveiled grand visions for the game's development, exhibiting a desire for both international prestige and a more consumption-based economy. At the same time, China's club teams have developed a voracious appetite for top foreign players and coaches, spending extravagant sums in their bids to get them, raising eyebrows in football's traditional strongholds in the process.

But the question arises of whether this will be enough for China to kick on, or if the country will continue to remain in the lower leagues of world football.

"One of the things that China very rapidly needs to come to terms with is that there isn't necessarily this direct correlation between what you spend and what you get out," says Simon Chadwick, Professor of Sports Enterprise at the University of Salford's Salford Business School.

Soccer is increasingly a part of Chinese life

Lining Up

Although China's involvement with football in some senses stretches back millennia—a form of football, unrelated to the development of the modern game, was played in ancient China—it has nonetheless lagged behind most nations, despite forming its first professional league, the Jia-A League, in 1994, roughly the same time as the J.League in Japan. The Jia-A League later morphed into the Chinese Football Association Super League [CSL], but continuing weak performance has had a knock-on effect on enthusiasm, and you are more likely to see Chinese people playing badminton or basketball than soccer.

Yet there is huge appetite for the game in spectator terms. Foreign competitions such as the English Premier League (EPL) draw big TV audiences, and according to FIFA the 2014 World Cup in Brazil had its greatest reach in China, with 252.3 million viewers, or 18.1% of the total population, and 12% of total global viewership.

"Most of my friends are more interested in the EPL or (La Liga) [than the CSL]," says James Choi, a marketing director at a Chinese language school from Shanghai who grew up supporting Shanghai Shenhua.

But the CSL enjoys a following too, and last year it saw an average attendance of over 21,800 per game, an increase of 16.7% on 2014, according to KPMG's Football Benchmark. Those numbers compare favourably to more famous and prestigious leagues, such as Italy's Serie A, but they can't be taken at face value given China's population.

China's field performance also needs improvement. Although observers say CSL standards have improved, currently the men's national team languishes 81st in FIFA's rankings, below Zambia. On the one occasion when China did qualify for the World Cup, in 2002, the team exited at the first stage without scoring a single goal.

All of which stands in contrast to China's success in many Olympic sports. There, a top-down training model has yielded amazing results, but football, as a team sport, is less suited to such a model, meaning there is no quick fix.

But it is not all doom and gloom. The women's team has reached a World Cup final and is currently ranked 12th. Meanwhile, Guangzhou Evergrande Taobao has added a second AFC Champions League title in 2015, and twice appeared at the FIFA Club World Cup.

A Game of Two Halves

The government, for its part, has made

clear its intent to do everything it can to boost football at all levels.

In March of this year, the Chinese Football Association (CFA) and government bodies including the powerful National Development and Reform Commission unveiled a plan to transform China into a soccer superpower by 2050. If all goes according to plan, by 2020 there will be 20,000 soccer academies, 30 million elementary and middle school students playing the sport, 60,000 new pitches and more than 50 million participants.

This drive has been given extra weight by Xi Jinping's heavily publicized interest. He gave his approval to an earlier football reform plan released in March of last year and set up a so-called "small leading group" dedicated to developing the sport (other such groups focus on cybersecurity, the economy and the military).

Businesses and entrepreneurs have heeded the call, pouring money into both player acquisition and commercial infrastructure. Of these, the property company Dalian Wanda has been particularly active—it bought a 20% stake in Atlético Madrid for $52 million, acquired Infront Sport and Media, a Swiss sports marketing company, for $1.2 billion and signed on in March to become a top-tier FIFA sponsor through to 2030. The CSL has benefited too, with China Media Capital and its subsidiary Ti'ao Dongli splurging $1.2 billion on the league's five-year broadcast rights.

"What we're now starting to see through this almost conglomeration of Chinese football is integrated supply chains being constructed," says Chadwick.

Investment has extended to the acquisition of big name foreign players, with the CSL's spending on international transfers in the winter transfer window hitting $296 million. And some of these players, such as the Brazilian Alex Teixeira, have spurned more illustrious European teams by opting for China. But such sums aren't necessarily the best use of money.

"Are you honestly saying there's nothing better they could do with that money? There's no grassroots or youth level investment that they could make instead?" says Cameron Wilson, editor of the Chinese football website, Wild East Football, who makes a point of calling the pitches in the CSL a "disgrace."

Scoring the Winner

But for all the grand plans, implementation remains a challenge. Corruption in the Chinese game, which has sullied the image of the sport in the eyes of Chinese fans for years, still lingers—a total of 33 players and officials were banned in 2013 for match-fixing, for example.

Another issue is the time frame proposed for ascendance to global soccer domination. China is attempting to recreate what took over a century to develop in Europe. Successful implementation will require sustained effort from successive administrations and the businesses now investing, and some are not convinced of the latter's commitment.

"There's currently still a massive disconnect if you look at the business model of a football club in China," says Mark Thomas, Managing Director at S2M Group, a sports events company based in Shanghai. "Most of them are obviously making huge losses."

Cultivating a true fan culture will become all the more important then, and Wilson points out that the reform plan specifically highlights this as an important area. In particular, the document has provisions against clubs moving or changing their names, color or logos, an all-too-common occurrence in the CSL's history, which has undermined the clubs' histories and identities.

On top of this is the drive to encourage participation among children, which will hopefully create a new generation of both players and fans. Standing in the way, however, are cultural issues that typically see education and job prospects prioritized by parents. But Chadwick notes that real effort is being put into shifting parents' attitudes, and even a US-style college model based around scholarships is beginning to emerge, making a pursuit of the sport more viable and appealing.

"It's also about developing a commercial population that can help any sport be sustained properly in the long term," says Thomas.

Certainly, when it comes to the government's objectives, it is the commercial side that seems most likely to succeed, especially given the extent to which the likes of Wanda are already enmeshed in the global entertainment industry. But if there is one target that all agree is pretty much nailed, it is China hosting a World Cup, and the deal-making of the last few years has played no small part in that.

"There's some very astute, very shrewd, some very subtle politicking taking place by the Chinese to exert influence, to exert pressure on FIFA and other relevant stakeholders to ensure they are in a very strong position to quickly bid for a World Cup in the near future," says Chadwick.

Add to that China's track record on big sporting events, and the result looks like a foregone conclusion, eventually.

"Given the infrastructure and the support from government you can guarantee a successful World Cup in China that will help open the sport up to a bigger market—commercially, obviously the brands behind football would love it to be there," says Thomas. "It's just a matter of time."

Getting Perspective

Jacob Parker recommends books on China for executives

At the US-China Business Council (USCBC), we frequently receive requests from our member companies on the best reading material to prepare new executives for a new role in the China market.

For the executive with limited time who hopes to gain a broad understanding of the business environment, I recommend Jim McGregor's *One Billion Customers*. In addition to offering a variety of case studies on foreign companies entering the China market, the book also highlights a number of China's current leaders in former business and government roles. For example, Wang Qishan—currently the head of the Discipline Inspection Commission—is featured prominently in one case, highlighting his time as the head of one of China's state-owned banks. A similar book is Henry Paulson's *Dealing with China*. As the head of Goldman Sachs and later U.S. Treasury Secretary, Paulson has spent much of his career engaged with China's leaders, granting him a nuanced perspective on the market. Both books analyze many of the same cases from different perspectives, McGregor's from the discerning eye of a journalist, Paulson's from a man who was personally involved.

For the executive interested in China's economy, Nicholas Lardy's *Markets Over Mao* gives a constructive view of the drivers behind China's economic growth. Most executives tend to receive their economic news from sources like *The Wall Street Journal* or the *Financial Times*. But while the reporting is top notch, it often paints a bearish perspective based on the most recent economic data. Lardy's book looks at the decline of the state sector and increased prominence of private companies and ultimately draws a more holistic view on China's future economic potential. Competition with Chinese companies is one of the top challenges USCBC companies face when operating in China; Lardy's book helps demystify these dynamics.

A less well-known book is Eric Shepherd's *Eat Shandong*. Nearly all senior executives working in China will someday find themselves at a banquet with liberal spirits and toasting. Shepherd's book looks at the cultural dynamics behind Chinese banqueting, and how it is used to manage interpersonal relationships. The book goes into greater detail than most readers will be able to practically utilize, but I personally find many of the recommendations—lower the lip of your glass below the lip of the person toasting you, sequences of toasts, cultural cues—to be enormously useful. The book also highlights a selection of Chinese idioms which can be leveraged to great effect.

One of the best authors on China that has escaped the notice of most readers is Lucian Pye. His books *The Spirit of Chinese Politics* and *The Mandarin and the Cadre* analyze the often conflicting themes of China's cultural norms. Though originally published in 1968 and 1988, respectively, both are as relevant today as when written. Pye's academic style can at times be challenging, but for the patient reader he is among the most insightful analysts on China's political and commercial dynamics. He explores everything from the transition from Maoism to Dengism, Chinese intra-party politics, and the development and maintenance of interpersonal relationships. Understanding these themes is critical for any executive with an eye towards a true understanding of China's culture.

Regardless of how fascinating China is, from time to time I need a break. I just finished *Barbarian Days: A Surfing Life* by William Finnegan. The book recently won the Pulitzer Prize for biography and for good reason—it is a beautifully written story of a man's travels, relationships, and career, explored through the lens of his experience surfing.

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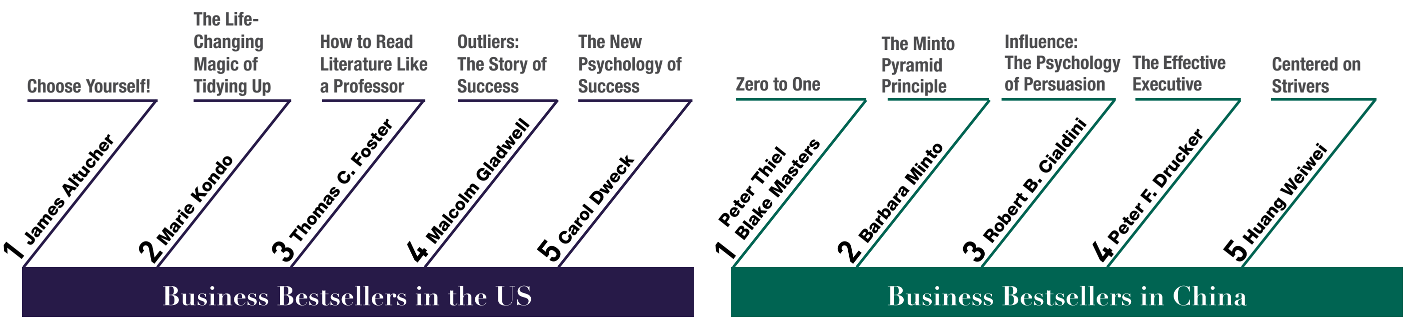

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