



cutting through complexity

MNCs in China

Making the Right Moves

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Contents

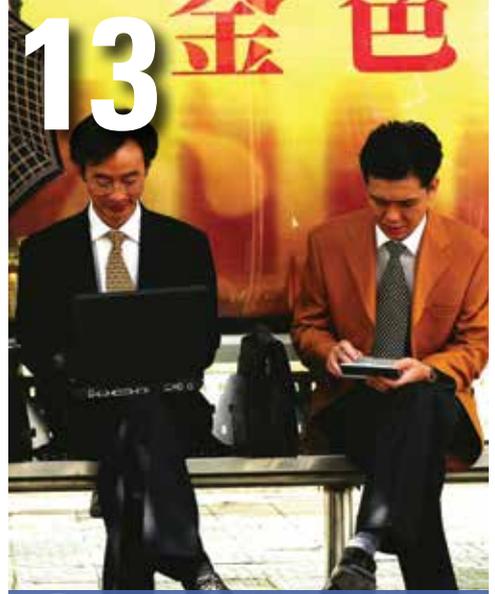


Foreword

A still growing but more complex China

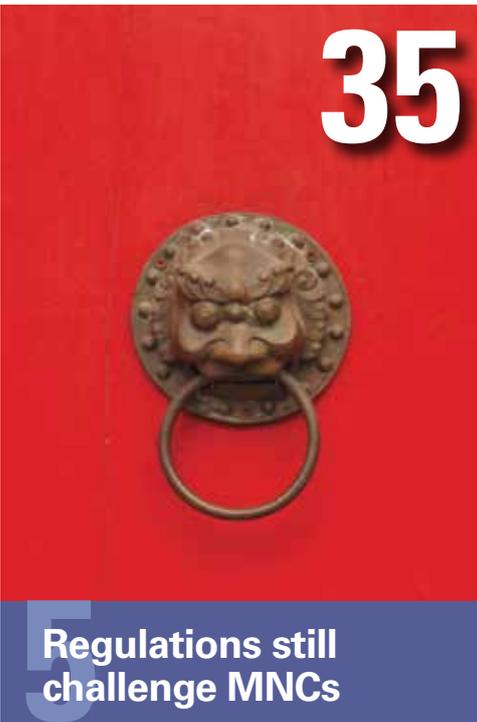


07



13

Business models matter, not copycats



35

Regulations still challenge MNCs



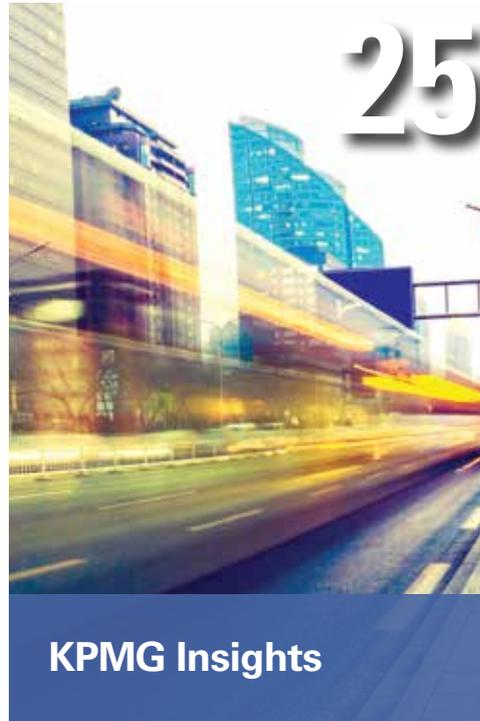
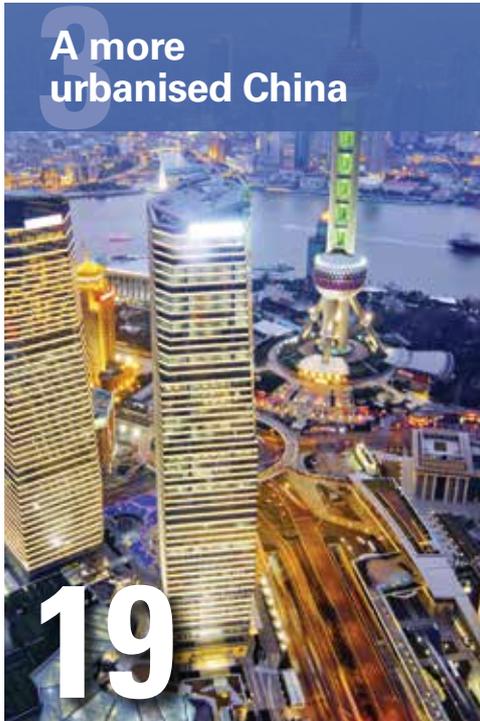
Rethinking talent

41



47

China's fast changing global role



Case studies

<i>Marks & Spencer</i>	11	<i>BASF</i>	34
<i>PepsiCo</i>	12	<i>Pfizer</i>	39
<i>eBay</i>	17	<i>Clariant</i>	40
<i>DHL</i>	18	<i>Unilever</i>	45
<i>CBRE</i>	23	<i>Artesyn</i>	46
<i>United Technologies</i>	24	<i>Eaton</i>	51
<i>Lenovo</i>	33	<i>VF Corporation</i>	52

Foreword



Stephen Yiu

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China continues to present many opportunities for Multinationals (MNCs); and MNCs continue to play a key role in the development of China's economy.

A perusal of today's headlines might incline a casual reader to think that MNCs are becoming increasingly sidelined in an ever more confident China, but the truth is in fact much more nuanced than this. In fact, given China's ambitious and visionary program of policy reforms announced in 2013, in many ways China's need for insights, technology and know-how from outside its boundaries has deepened across numerous sectors.

The growth rate of China's economy may be declining as it matures, but in absolute terms it is still significant and the world's top multinationals remain attracted by the opportunities arising from increased consumer spending, urbanisation and infrastructure development.

Conducting successful business in the world's 2nd largest economy is however increasingly challenging. Competition, from both international and domestic players, remains fierce; the rise of e-commerce and the sophisticated Chinese consumer are challenging established business models; attracting, developing and retaining talent is more critical than ever. Added to these is tougher enforcement and a higher emphasis on compliance in an already complex regulatory environment.

These challenges and the increasing significance of China to global corporates' results have resulted in an increased focus by multinationals on innovation, efficiency and the bottom-line. The CEOs of the multinationals we spoke to point out the need to be flexible and prepared to adapt in the market, in particular as they expand inland. They emphasise innovation and differentiation as they face higher competition from Chinese domestic players who have rapidly moved up the value chain, have been quick to embrace e-commerce, and are increasingly becoming global. They note how internal control, compliance and corporate governance have had to step up to a new level.

As China progresses through its next stage of reform, new opportunities and challenges will emerge, both for multinationals investing in China and for Chinese domestic companies investing overseas. The companies that succeed will be those that have a clear direction and strategy, and an ability to implement and adapt.

Our report highlights the strategic importance of the China market for multinationals and the actions being taken by several leading companies to grasp the opportunities and respond to the challenges.

We would like to thank all of our contributors, in particular those executives interviewed, for their insights and input.



Ben Simpfendorfer
 Managing Director,
 Silk Road Associates

China has not only emerged as the world's second largest economy, but also its most complex. This shouldn't be a surprise given the country's GDP is equivalent to the combined output of Brazil, Russia, India, and the next ten largest emerging markets. It is inevitable that commercial scale of this magnitude will create its own unique opportunities and challenges.

Slower economic growth will only add to the complexity, as local and foreign companies struggle to sustain the same record-breaking sales growth rates of the past decade. But for all the worries about the outlook, the 'China opportunity' is simply evolving and there is good reason to remain bullish.

For multinationals it is no longer enough to simply have a presence in China. Leading multinationals are instead asking 'Which China?' and so taking a more selective approach to identifying the opportunities and challenges.

Just consider the fact China has over 140 cities with a population greater than 750,000, compared to just over 100 similar-sized cities in Western Europe and the United States combined. For all the excitement about tier-two and tier-three cities, operating distribution or marketing networks across such a large geography is an immense challenge for even the largest companies.

But it is these complexities that make the China story so compelling. Leading companies and regional governments will enjoy the scale to

design innovative solutions to today's challenges, for example in relation to infrastructure and the environment. Observers of the country should be increasingly focused on those commercial or regional innovations, rather than simply tracking China's national GDP rates.

Multinationals continue to have a strong role to play in China's commercial future, even if they are likely to find operating conditions far harder than in the past. Indeed, for all the focus on China's national champions, the Chinese government recognizes that multinationals will continue to play a critical role in the country's economic transition over the decade.

Perhaps the most exciting challenge will be the rapid evolution of business models, whether because China is seeking to leapfrog the West in its adoption of e-commerce, digital media, and big data solutions, or because companies need to respond to potentially crippling labour and skills shortages owing to the ongoing decline of the youth population simultaneous to rising demands for new skill sets.

And so it is more critical than ever for MNCs to engage with the Chinese government, as the new leadership embarks on another historic period of reform. Being part of the debate in today's rapidly changing China will leave companies more prepared to compete in tomorrow's global economy given China's commercial clout will continue to rise even as GDP growth rates slow.

KPMG highlights

A still growing, but more complex China

What does today's China hold for MNCs? Top CEOs are optimistic in spite of the country's slower economic growth. But they are also fiercely focused on the big trends transforming the business environment. Of course, some of these aren't new, but the speed of change in China is phenomenal. The result is that today's China is a more complex China. Increased competition, rising costs, talent management and regulatory compliance remain among the key challenges faced by MNCs.

Leading Chinese companies are not just competing with multinationals but are even beating them at their own game. What has changed? CEOs point to how local competitors are exploiting innovations, such as e-commerce, digital media, and big data, in order to capture market share or create new markets entirely. Faced with these challenges, the most successful multinationals are adapting fast and securing scarce talent. Those who wait risk being consigned to ever declining market share.

It is no longer enough to simply claim a presence in China. Executive teams must ask "why are we in China? Are we here to serve China, or are we here to serve the world?". And, having made a decision, they need to execute at a global level, not just local. That means head offices must make sure they are on top of today's China. If not, the country's growing global importance means that missing out on commercial opportunities or suffering losses will have a material impact on a company's global performance.

China in the world

Few countries are urbanising as fast as China. But CEOs must be pragmatic about the challenges of selling to China's many third- and fourth-tier cities. Even some of the world's biggest multinationals are searching for innovative ways to extend their reach, such as by operating hub-and-spoke models or partnering with local partners to tap into the country's smaller or more remote cities. Simply going it alone in less developed regions is increasingly tough, especially when trying to develop sales channels and recruit employees.

Selling to China's many cities is not as easy as it looks

New business models are disrupting multinationals

Economic growth has slowed, but costs continue to increase. Many organisational structures are overly complex after a decade of booming growth. It's no surprise that CEOs talk about the need to focus more on the bottom line, find new efficiencies and simplify structures. MNCs must exploit their first-mover advantage in areas such as shared services, human resources, or R&D. If not, leading local companies will catch-up fast by adopting world-class practices. History tells us that when faced with a challenge, China's business community does not simply stand still.

Finding new efficiencies in a slower China

1 A STILL GROWING, BUT MORE COMPLEX CHINA

China has entered the next phase in its historic rise. GDP growth rates have slowed, but matter less than in the past. Today, the focus is on fast changing commercial realities that are more important to the bottom-line.



Egidio Zarrella
Clients & Innovation
Partner, KPMG China

MNCs are asking themselves, why are we in China? Are we here to serve the domestic market, or are we here to use the country's talent pool to serve the global market? If targeting the domestic market, then MNCs need to decide whether to play the volume game or niche sectors. It's an important question, as the volume game is getting tougher all the time. It requires a huge and sustainable budget. Local competitors are also big and often have deeper pockets.

What does today's China hold for MNCs? Economic growth has slowed but CEOs are still optimistic about the country's outlook. They have reason to be: the country's GDP is still rising at a faster rate than in most other countries, and from a significantly larger base. Since the last edition of this report in 2012, the expansion in China's economy has been equivalent to adding the GDP of Sweden, South Africa and Nigeria to overall output. The sheer size and continued growth of the economy continue to present opportunities for MNCs.

The Government is effecting the next stage of reforms and key areas are being addressed where we will see significant changes over the next 5-10 years. This includes an acceleration of infrastructure investment reforms and shared ownership reforms of State Owned Enterprises (SOEs), which will present new strategic partnering options for MNCs. In addition, the government is strengthening the support provided by financial institutions in the further development of the economy, broadening market access and protecting intellectual property rights, all of which will help to drive further innovation.

The speed of change in the business environment is monumental. CEOs talk admiringly of local competitors that have evolved rapidly to compete and even beat the world's leading companies. E-commerce and digital media are challenging existing business models, while managing regulations and talent remain critical focal points. The result is that today's China is vastly more complex and capturing

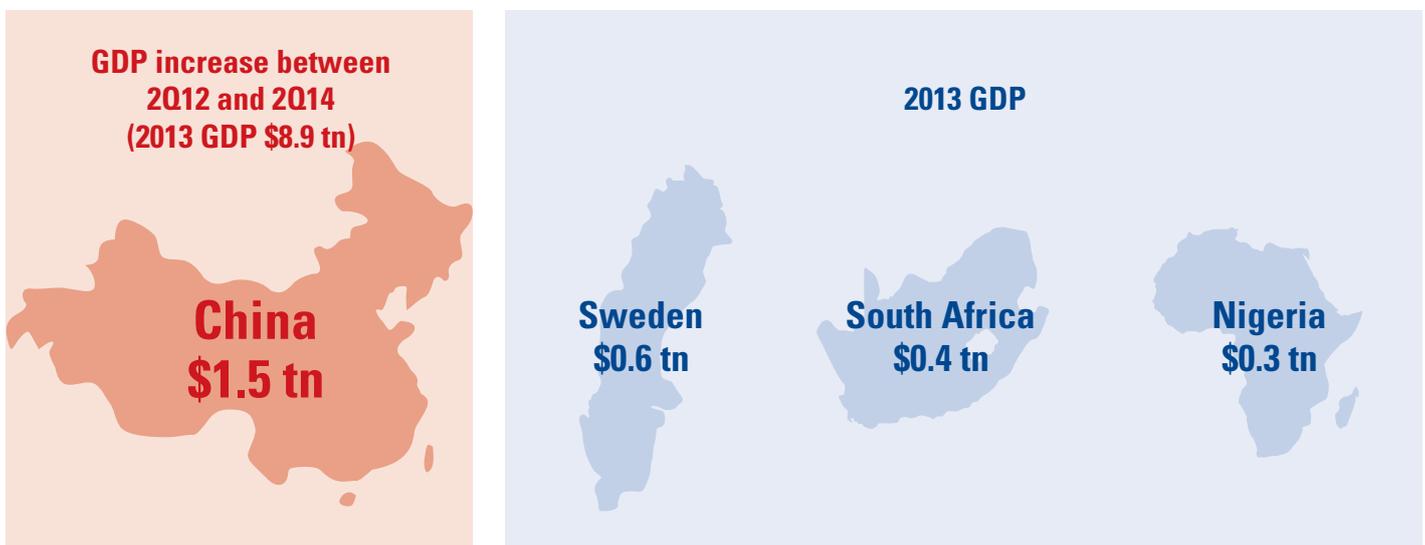


emerging opportunities is more challenging. Top CEOs are no longer satisfied by simply being in China. They are instead defining in which China they seek to compete.

As Curt Hutchins, Asia Pacific President for Eaton, a global power management MNC, argues: "To be successful, it is no longer enough just to be here. You have to segment the market and align your value proposition."

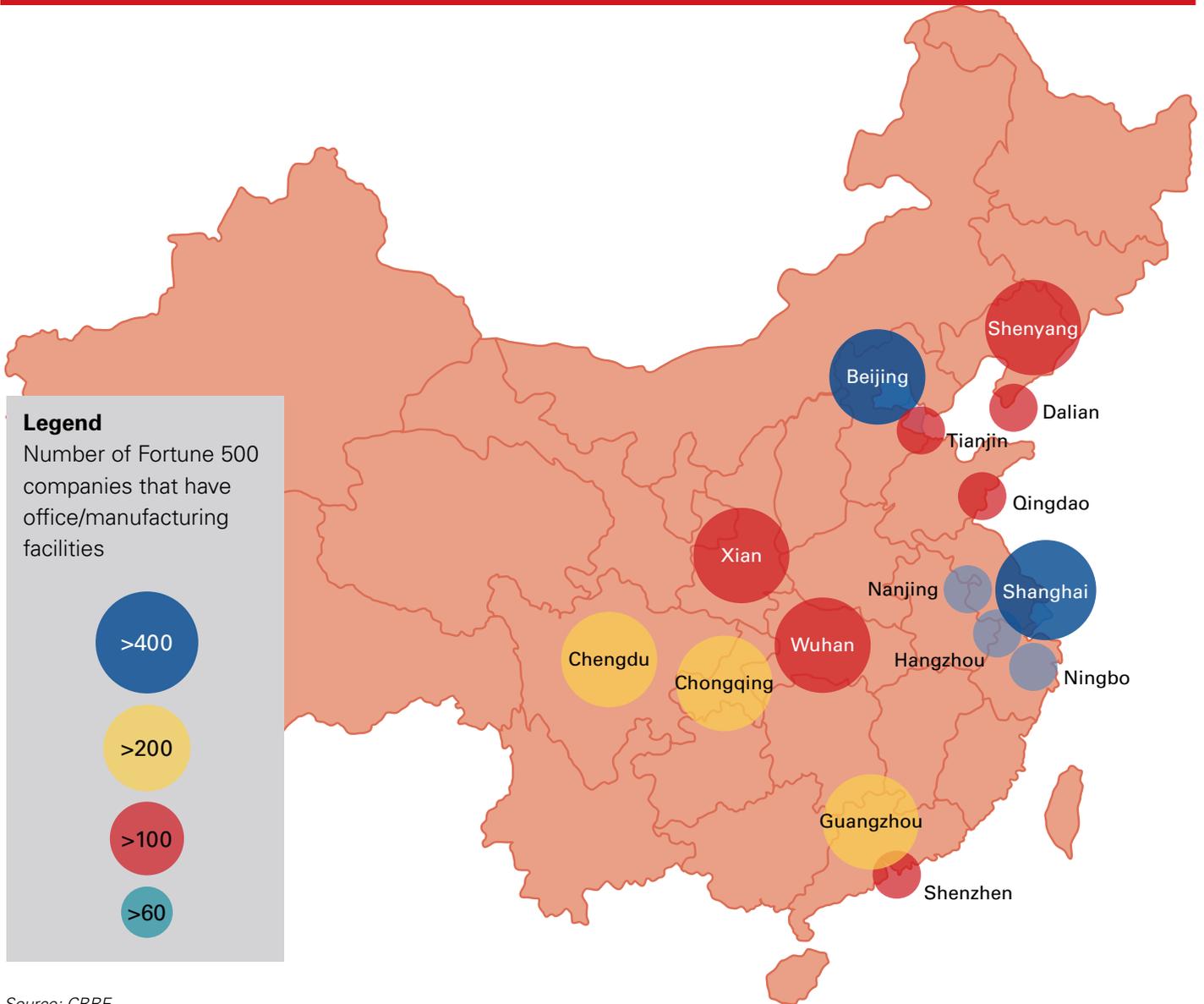
The increase in China's GDP since Q2 2012 is large by any measure

\$ trillion



Source: The China National Statistical Bureau, IMF

A collection of regional markets? Fortune 500 companies footprints in China



Source: CBRE



One of the biggest challenges is making sure your product, pricing and promotion are appropriate for the fourth and fifth-tier cities. Consumers in these cities are becoming a lot more sophisticated. They are increasingly exposed to satellite television and far more aware of brands than in the past.

CEOs now talk of ignoring quarterly GDP growth rates to instead focus on the big trends that are reshaping business: from the growing individualism of consumers to the rise of e-commerce; from the challenges of selling to smaller cities to securing talent for future growth. Some of these trends are new. Others have evolved since our last report. But these are the trends that will determine whether MNCs thrive or rather just survive in today's China.

And it is not just MNCs that are recognizing this new reality. Leading Chinese firms are also maturing rapidly, as they move faster to adopt innovative technologies, or simply benefit from the fact that today's China is more a collection of regional markets, rather than a single national market, and so are able to prioritise local insights and relationships. For MNCs, such firms are fast evolving into local competitors and in an increasing number of cases, as serious global competitors.



David Frey
Head of Inbound
Investment,
KPMG China

Some MNCs have been asking serious questions about their future in China. Still, for those really thinking about global competition, they are rightly staying on the basis that if they can't succeed in China today, they may not be able to succeed anywhere in the world tomorrow.

Surveys of American and European companies consistently rank private-owned Chinese companies as a greater competitive threat than the state-owned companies. The country's state giants still benefit from a low cost of capital and strong government relationships, but the higher flexibility enjoyed by the private sector has enabled these companies to adopt new technologies and business models quicker. Private-owned companies are also well placed to benefit from China's urbanisation given their local presence and knowledge in the emerging cities. MNCs concede that the level of private-sector competition has seriously intensified over the past two years, at least when looking at leading firms.

The most successful MNCs will be able to adapt rapidly to these challenges. As David Frey, Beijing-based Partner at KPMG China, points out: "Some MNCs have been asking serious questions about their future in China. Still, for those really thinking about global competition, they are rightly staying on the basis that 'if we can't succeed in China today, we may not be able to succeed anywhere in the world tomorrow, as China is becoming the cauldron of competition'"

That's certainly true in the sourcing sector where there simply is no alternative to China's vast scale and growing domestic markets. Rising wage costs have pushed retail and sourcing MNCs to look for other low-cost options, but China remains the largest supplier of most consumer goods, even in labour-intensive sectors such as apparel where single Chinese provinces are shipping more product than entire Southeast Asian countries.

CEOs openly admit that today's China is a far more challenging place to compete. Yet, it is a market in which they need to compete successfully given the size of the economy and opportunity, and the increasing significance of China to global corporate results – whether this is in the form of Chinese affiliates' profitability, capturing Chinese consumer spending overseas, or being able to retain market share in their home market, as China's leading companies expand overseas.

MNCs that are more focused on China's growing complexity will be better positioned to exploit future opportunities, as opposed to those focused only a slowing growth rate. This is similar to market evolution in the developed world. But some MNCs in China are still too often overlooking the speed of change in China and so are unprepared for the next phase of China's remarkable rise.

Did You Know:

In 1990, China accounted for 4 percent of the global economy. Today, its share has grown to 15 percent.

China's three largest provinces by GDP - Guangdong, Jiangsu, and Shandong - would all rank among the world's 20 largest economies.¹

China's GDP accounts for more than half of the combined value of Emerging Asia's GDP.²

1,2 Source: IMF



Tailoring to the China market

Richard Thomas, Head of Far East Region,
Willy Wu, General Manager, China Sourcing, Marks & Spencer

Richard Thomas is the Hong Kong based Head of the Far East for Marks & Spencer (M&S), a British retail MNC with 1,850 employees in Greater China across sourcing and retail and 85,813 employees globally. Willy Wu is the company's General Manager, China Sourcing.

It is popular to talk of a China + 1 sourcing strategy as a response to China's rising costs. Marks & Spencer however, have adopted a China+ 5 strategy. "This model provides our European consumers with more choice and innovative products. China should be the core of any sourcing strategy and remains very important for certain products, such as outerwear, accessories, and ladies softwear. You can't produce these categories in Cambodia, for instance, as the production process is complex," Thomas explains.

"However, you also need duty-free options, such as in Bangladesh or Cambodia," he adds. "Myanmar is another potential duty-free option, although it will be a slow-burn story due to the level of complexity and the infrastructure challenges of dealing with such a newly emerging market. Indonesia and Vietnam are no longer such low-cost places, but are still options. When I am assessing all these options, I am thinking about what China and ASEAN can provide M&S collectively."

How important is innovation to your China business? "M&S has a history of innovation. When nylon was first invented, we were the first to bring it to market, and we continue to constantly upgrade our product. For instance, we have upgraded 40 percent of our women's wear products in the past year, such as by improving the fibres or performance elements. But there

has to be a perceivable benefit to the customer and sold at a similar price," he says.

"So far, most of the development has been done for the European customer. But we are starting to innovate for our Asian customers. For example, Chinese customers want UV-protected umbrellas, whereas the umbrellas we sell in the U.K are designed to protect you from the rain, not the sun. This is a



good example of how we will have to start thinking about end-use and what suits the local Asian market."

Regulations are meanwhile a challenge for a company that sources and retails across so many markets. "We produce all products to the highest standards. But each of our 45 markets, including China, has its own performance standards and test methods, and that adds to the level of complexity, especially as our China sales grow," Wu says.

What is the solution? "Local sourcing is an option, and we are approaching the inflection point where it might make sense for us to source more goods in China where they are being sold in China. We also look to engage officials, show them around our factories, and explain our commitment to quality and sustainability so they understand our

business a little better," he explains. M&S is looking to sell across multiple regions and cities in China, and that creates issues for the company's business model. "M&S operates a number of different retail models around the world," says Thomas. However, China is the first country where we will have several models working together. That's because China is like several countries rolled into one. We have a multi-channel store in Shanghai which has been enormously successful. But you can't have a flagship store in every city. Franchise models also allow you to grow more quickly into other cities. It's also more capital efficient."

There is also rising competition from Chinese companies. "In the third-tier and fourth-tier cities, local companies definitely have an advantage. They tend to see local needs better. Their decision making is also much faster. But then developing an international business is not just about opening physical stores in as many cities as possible. It's also about developing your distribution channels, IT infrastructure, and multichannel model," Wu adds.

"For instance, a few years ago we were shipping goods from China and then shipping them back to the Far East. We now know we can't supply the Far East unless we have the right supply chain in the region, and that means some local buying and local distribution hubs. It means there needs to be constant innovation and we have had to invest quite heavily. In fact, you have to invest just to stand-still."

"Still, from an M&S perspective, we can also trade on our heritage. After all, we've been trading for 129 years and that's something local competitors can't claim."



Adapting flavours for China

Jun Tu, CFO, PepsiCo Greater China Region

Jun Tu is Greater China CFO for PepsiCo, one of the largest food and beverage companies in the world, and whose products are sold in some 200 countries across the globe.

For PepsiCo, R&D plays an important role in the company's expansion in Mainland China. "In November 2012, we opened a new Asia R&D Center in Shanghai. This state-of-the-art facility is PepsiCo's largest R&D center outside of North America. It serves as a hub of new product, packaging and equipment innovation for PepsiCo's businesses throughout Asia. There is an advanced culinary center and test kitchens focused on developing and tailoring PepsiCo food and beverage brands for distinct, locally relevant taste preferences throughout the region. In addition, the facility is equipped with a pilot manufacturing plant that allows researchers to quickly test new product ideas and support efforts to significantly accelerate the pace of PepsiCo's innovation in China and other growing Asian markets."

He continues, "If you look at the latest innovations that have been successful in China they haven't only come from the U.S., but also from other Asia markets, such as Korea and Japan, especially in terms of the savory snacks. The Chinese want a lot of variety in their snacking, and there's always a strong taste preference for Chinese local or Korean/ Japanese flavors. So we take inspirations from multiple countries, as well as traditional Chinese cuisine, and created many unique and highly popular flavors, such as Cucumber, Chicken & Tomato, etc."

That also means catering to the differences between specific regions in China. Tu notes: "Last year we did a marketing campaign for our potato

chip products called 'Do us a flavor'. We had several local celebrities advocate their favorite flavor and allowed people to vote on their own favorite. The flavors were inspired by the famous local dishes from various regions. The marketing campaign was a great success, as it ignited our consumers' passion for their favorite local foods."

In March 2012, PepsiCo completed its strategic alliance with Tingyi, whose subsidiary, Tingyi-Asahi Beverages,



became PepsiCo's franchise bottler in China responsible for exclusively manufacturing, selling and distributing PepsiCo's carbonated soft drinks and Gatorade brands. The alliance creates the country's leading LRB manufacturing network with nearly 100 plants with a national distribution network. The strategic alliance has generated positive results for both companies since being formed. "We have been in China from a beverage perspective for more than 30 years," says Tu. "But there is still plenty of runway for our future growth. For a start, our manufacturing network only covered part of the country. In addition, we didn't have extensive distribution networks in fourth or fifth-tier cities. And the rural area was a whitespace for us." He continues: "Partnering

with Tingyi gives us much expanded manufacturing footprint, and they also have an extensive distribution network in the fourth- and fifth-tier cities. That means you can ship product much quicker to these consumers with better service, a critical success factor in today's competitive markets."

Selling to the fourth and fifth tier cities also has its unique challenges regardless of the business model.

"One of the biggest challenges is making sure your product, pricing and promotion are appropriate for the fourth-tier and fifth-tier cities. Consumers in these cities are becoming a lot more sophisticated. They are increasingly exposed to satellite television and far more aware of global brands than in the past, and affordability is catching up as well."

Tu says, "That should be a huge growth opportunity for us. Only 40 percent of the population has ever tasted our Lays potato chips brand, for instance," he adds. "Our food business is 100 percent wholly-owned. We have a vertically integrated system. Food safety is a high priority, and we certainly want to ensure a highly safe manufacturing environment for both beverage and food systems."

PepsiCo meanwhile faces similar talent management challenges to other MNCs, and yet has also won awards for "Top Employer in China" over two consecutive years. Tu attributes the company's success to the fact "Pepsico has a long track-record in the country and that gives people confidence in their career paths. We also have a strong sense of social responsibility and that is becoming increasingly important for employees"

BUSINESS MODELS MATTER, NOT COPYCATS

The rise of digital media, big data, and e-commerce are challenging established business models at a time when Chinese shoppers are spending more. Local competitors have been quick to respond.

CEOs consistently report that the speed of technology innovation has changed the rules of the game in China. Chinese companies are using digital media, big data, and e-commerce in ways that often lead practice in Europe and the United States. They are turning established business models upside down and in doing so taking the commercial battle to MNCs. This is a challenging notion for those who still see the developing markets as consistently lagging the developed world.

To thrive, MNCs must be prepared to innovate at a faster pace in China than in other parts of the world. If not, they will find themselves struggling to compete with local competitors and increasingly demanding customers. Indeed, CEOs talk admiringly about the speed at which nimble local competitors are adapting to new technologies. MNCs, by contrast, were seen as often burdened by their experiences over the past 30 years in developed markets.

Digital media is a common point of difference. MNCs once used their scale to buy expensive advertisements on traditional media. But local competitors have been quick to spot the change in consumer behaviour and the rapid take-up of mobile technologies. Many have leapfrogged traditional media and gone direct to digital media, especially mobile platforms such as Weibo or WeChat, and so overcome China's vast distances to tap into new markets.

"Many local competitors do not have the resources, particularly in marketing, to compete head-to-head with MNCs. As a result they have looked to identify other ways to reach consumers, such as e-commerce and digital media," says Tony Latham, Unilever's Senior Vice President Finance, Global Supply Chain.



Tony Latham,
Senior Vice President
Finance, Global Supply
Chain, Unilever

The business model is evolving very rapidly in China. The ability to reach out to our target consumers has been transformed in the past few years. You can still reach customers through television. But so much more media is now consumed online. Local companies have been faster to identify this change.



Did You Know:

By 2015, e-commerce transactions in China are projected to reach USD540 billion, or 7.5 percent of total retail transactions, and by 2020, China's e-commerce market is forecasted to be larger than those of the US, UK, Japan, Germany and France combined.³

The Chinese government is 'targeting 1.2 billion 3G/4G mobile users (85 percent penetration) by 2020, up from 233 million at the end of 2012 and 325 million in June 2013.'⁴

As KPMG's recent online survey showed, consumers in China are increasingly sourcing one-of-a-kind products online, ones that are not always available in the physical stores. They are also likely to research brands and compare offline and online prices. Retailers can capitalise on this by expanding their products inventory and Stock Keeping Units (SKUs) online, and availing themselves of domestic social media and marketplace platforms in China.

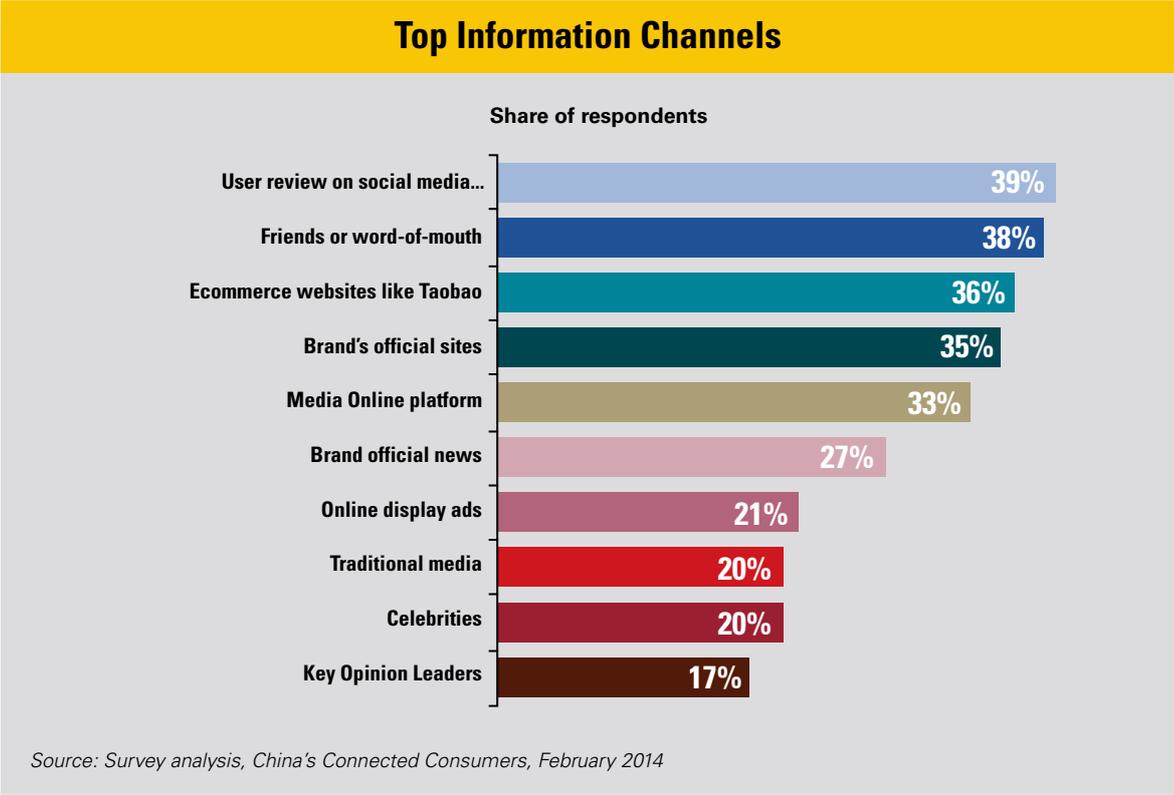
However, they must also be aware of the challenges. Jessie Qian, Partner-in-Charge, Consumer Markets, KPMG China, says: "Luxury brands use e-commerce more for international marketing purposes, including targeting the travelling Chinese consumers. After-sales and maintenance of customer service and authentication of the product are ongoing challenges. The issue of guarantees and warranties are also a challenge for luxury online shopping."

Big data is another area where Chinese companies are leading the developed world. John Lin, CEO, Greater China, eBay, points out that Chinese traders using the company's international sites are more likely to invest in big data to understand their customers. eBay itself employs 2,000 people in China in order to serve the company's own global analytics business and finds itself competing for talent with not only China's IT sector, but also the country's financial sector.

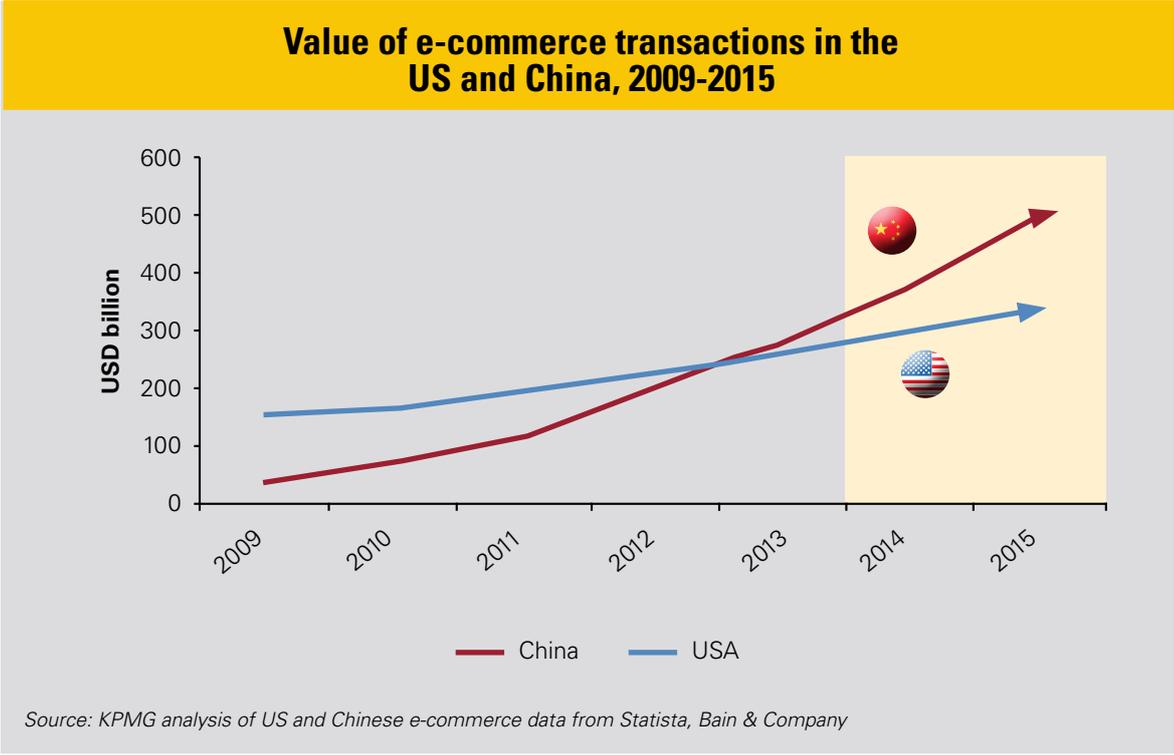
In addition, major internet companies are using their social platforms to collect customer information and have also created transaction platforms to understand consumer spending patterns. They are combining the two information sources to provide customers with relevant insights.

³ Source: Amanda. 'China E-Commerce Market to Reach 30 Trillion Yuan in 2020'. China Internet Watch. March 13, 2013 <http://www.chinainternetwatch.com/2007/china-e-commerce-market-2020/>

⁴ Source: CLSA report - 'E-Normous' 2013



The IT revolution has in short created a new commercial battleground. Today's CEOs are less concerned by low-end copycats. They are less convinced that MNCs superior capital resources and distribution networks are critical to success. Instead, most are focused on how to best use technological innovations to benefit from the rise of the Chinese consumer - their growing individualism and appetite to distinguish themselves.





Jessie Qian
Partner-in-Charge,
Consumer Markets,
KPMG China

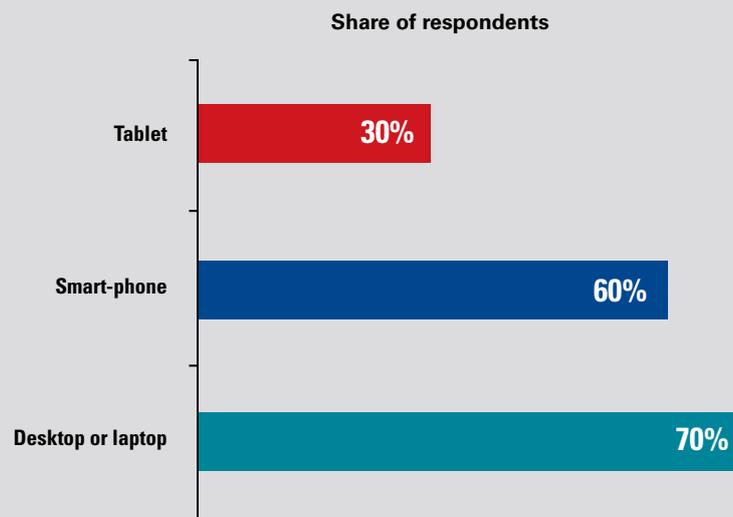
Luxury brands use e-commerce more for international marketing purposes, including targeting the traveling Chinese consumers. After-sales and maintenance of customer service and authentication of the product are ongoing challenges. The issue of guarantees and warranties are also a challenge for luxury online shopping.

Lenovo's Asia-Pacific CFO, Helmut Zödl, describes this as "consumer-led" innovation. "The 'consumerisation' of products and business models is happening faster in China than elsewhere in the world," he explains. "The Chinese consumer has a strong independence in decision making and a greater influence on how you might sell a product or services. This means companies will be increasingly competing on the basis of product innovation and speed to market."

Egidio Zarrella, Clients & Innovation Partner, KPMG China, adds: "Companies are realising the value of information and that, if used correctly, analysis of this information can be a real differentiator. They have typically assessed historical patterns, but we increasingly see predictive analysis being used in order to determine consumer spending."

Encouragingly, leading MNCs are responding to the challenges. PepsiCo, for example, recently ran a digital media marketing campaign for its potato chip products called 'do us a flavour'. "We had several local celebrities advocate their favourite flavour and allowed people to vote on their own favourite," says Jun Tu, CFO Greater China Region. "The marketing campaign was a great success, as it ignited our consumers' passion for their favourite local foods."

Consumers in China increasingly use mobile devices to shop online



Source: Survey analysis, *China's Connected Consumers*, February 2014

Having long anticipated the Chinese consumer's rise, MNCs are finding that the rules of the game have been turned upside down. The opportunity is still vast, but harder to realize. The levelling of the playing field and the rise of local competition - as a result of business model innovation - has even seen major retail MNCs restructure or pull out of the market. It's no longer enough to simply be present in China. Having the right business model will be critical to tapping into the coming wave of consumer spending.

An online strategy

John Lin, CEO, Greater China, eBay

John Lin is Greater China CEO of eBay, a US-headquartered internet MNC with approximately 2,000 employees in China and 35,000 globally.

eBay's work with Chinese merchants offers an alternative view of how MNCs are engaging with China to grow their global business. "We have two main businesses," says Lin. "The first is getting Chinese merchants to sell more products on our international eBay sites. The second is helping Chinese merchants set up their sites to target Western consumers who prefer using PayPal."

"We have evolved an entire ecosystem to help our Chinese merchants sell abroad as a result. For instance, when sellers become bigger, they also need to become more efficient – it is much harder to sell 50,000 units than 5,000. So we teach them how to automate operations or introduce middle management. We also offer other general training, such as learning about design rights or intellectual property rights. These are all critical to being able to scale a business, especially when moving into fast-growing and therefore more challenging markets, such as Brazil or Russia.

Lin has meanwhile noticed a change in what Chinese merchants are selling on the company's international sites. "Initially, they just took Chinese products and sold what they thought was good or cool. But that didn't fly. However, Chinese fashion is evolving fast as a result of consumers upgrading, and so is increasingly similar to the West. People here are buying skateboards and camping equipment, for instance. That means more pull-through opportunities from China to the rest of the world than in the past, and Chinese merchants are adapting fast," he says.

"What amazes me is the amount of data interpretation Chinese merchants will use to understand their Western consumers," Lin adds. "They will invest in data to understand why consumers are buying – attributes, size, style, etc. That's the DNA of e-commerce. It is also very different to how merchants behave in Japan, Korea, Taiwan and Southeast Asia where they are typically more conservative and worry about the sunk cost of using big data. Perhaps



the mentality is related to China's size – it's a bigger market, therefore big data can help a merchant scale."

Is eBay worried about its Chinese competitors looking for opportunities abroad? "We aren't. After all, the share of retail trade for e-commerce is still very low and there is still so much opportunity."

China also plays a major role in eBay's global strategy, even if the company is not a major player in China's domestic market. "We have 2,000 people in China. Some are R&D people working on global projects. We also have a lot of analysts in China supporting our global business. The talent pool is fantastic, and analytics, risk modelling, and logistics technologies are now a core competency for us. We also have customer support people in China, as

it is actually easier to find multilingual people in China than in many other countries."

Still, recruiting and retaining analysts is a constant challenge. "Finding enough big data analysts can be tough. Everyone is building up risk modelling operations, such as the banks. Local players also already match our pay and are building much nicer facilities than in the past," Lin says.

How does eBay attract top talent? "We focus on culture. We are a first-mover in the internet industry. We are also a Silicon Valley company. We ask 'who do you want to work for – a bank or an internet company?' We also offer a better work-life balance. Ten years ago we used to attract people who wanted to work 20 hours a day. But today we get more employees who also want a life or want to travel as they get more affluent. MNCs can cater to that."

Lin meanwhile argues that China is innovating, but mainly with respect to scale. "I find the Chinese merchants I work with are as good as anybody. But they are more likely to pursue innovations that are guaranteed to succeed. And Silicon Valley entrepreneurs still have a greater appetite. Perhaps that again has to do with the greater scale of China's markets and so merchants are inclined to look at their competitors, study them very hard, and then try to copy them and do one better. It is a greater payoff given the size of the market."



In the fast lane

Jerry Hsu, CEO Asia Pacific, DHL Express

Jerry Hsu is CEO Asia Pacific for DHL Express, a German international express MNC with 6,500 employees in China and 100,000 globally.

What is DHL's biggest challenge in the years ahead? "We used to deliver mainly B2B for export. But it's now increasingly B2C for domestic consumption," says Hsu. "However, B2C is much harder, especially the 'last mile', as you might have to deliver a package three times before it finally reaches a family. B2B is much easier, as most offices work regular hours and are concentrated in specific parts of the city."

"Everyone in the logistics industry is assessing how to deliver to consumers with speed and reliability. For a start, we see a real need for large consolidation centres around the country. We also need to take a fresh look at our IT systems in order to deal with the complexity of shipping B2C, especially the 'last mile'. So far, there has not been any real breakthrough in the delivery model," he says.

"The challenges are no different to the Western world. In fact, the US, UK, Australia probably have a more advanced and disciplined approach," he adds. "But in China, the per piece cost is dramatically different, as the average item purchased can be much lower than in the West," he continues, highlighting the unique challenges for logistics companies in China where they tend to ship a larger number of small-value goods.

And what about the challenges of supplying consumers in China's more remote regions and cities? "Generally speaking we are much further ahead in terms of the coastal provinces. Less so in the Western provinces, simply because of the timing, and we still have some issues, such as lack

of infrastructure or lack of coverage modes. It is a challenge to find skilled labour with adequate language capabilities, but this will change as the region further develops."

Hsu meanwhile sees implementation of regulations by specific provinces and even municipalities as another of DHL's key challenges. "The trucking industry has always been fragmented. Every province has its own regulations with



respect to crossing borders, the type of truck, or highway toll fees. It will take a lot to knock down those barriers. And for now, we have not really seen a good national trucking firm."

However, he notes that the new leadership is helping to change the situation. "The biggest impact has been the anti-corruption campaign. The central government has taken measures to streamline processes and put in place stricter governance. That's really starting to take effect which is good for the long-term growth of the sector and the economy."

Hsu also sees implementation of regulations by customs as another key issue for the logistics industry. "China is trying hard to get world-wide standards. But the rules are changing constantly. That is often due

to changes in the market itself, such as e-commerce, where customs officials are all of a sudden dealing with an entirely new sector or goods," he says.

Hsu first worked in China with DHL in 2002 after 15 years prior China experience with Chrysler and its Jeep JV in Beijing. He has separately seen rapid changes in the labour market during that period, but especially over the past 10 years.

For all the growing challenges recruiting and retaining staff in China, Hsu notes that DHL Express' staff is fully localized in China. "We have just one expatriate among our 6,500 China-based employees. And that expatriate really serves as a liaison between our China operations and overseas business," he says. "It is much easier to hire locally today because of the growing number of returnees who studied and worked abroad in the early 1990s."

DHL has been in a JV with Sinotrans since 1986 and Hsu emphasizes that this relationship is critical to the company's success. "Our JV partners support us through their government relationships. But it is DHL that mainly directs the daily operations. We don't have a choice. Our business is international and so we need to operate with the same processes in every country. That relationship is perhaps unique in our industry. It also means we don't have the same conflicts as do many JV partners."

3 A MORE URBANISED CHINA

Urbanisation remains a major growth opportunity. But it's not a simple numbers game. MNCs will have to adapt to regional differences as they are challenged by operating across so many cities.



Dr Albert Heuser
President & Chairman,
Greater China, BASF

It is estimated by 2020 the urbanisation rate of China will be around 60 percent; the government aims to guide urbanisation of around 100 million rural residents of the central and western regions, therefore infrastructure development remains important and China's SOEs will play a key role here.

CEOs describe the rise of urban China as one of this decade's great commercial opportunities. The country's urban population rose by more than 200 million people over the past decade. It will rise by the same over the next. Of course, this isn't a new story. What is new, however, is how MNCs are responding to the opportunities. No longer are CEOs 'starry-eyed' about the opportunities, but instead talk of a growing pragmatism in the face of greater complexities and challenges.

For a start, there is a vigorous debate in China itself about what is the desirable pace of urbanisation. Nevertheless, the pressure to build bigger cities in resource-constrained China will create new opportunities for MNCs that can provide smart solutions. Ross Shuster, North Asia President for UTC Building & Industrial Systems, talks of the fact that "the country is motivated to experiment and innovate and you see increased R&D in the area of green buildings and intelligent buildings."

Innovation will also take place in the service sector. Local governments must find ways to provide health, education, and other critical services to growing numbers of urban residents. Finding ways to deliver such services more cost-effectively, such as through leveraging the country's fast developing IT industries, will offer new opportunities for MNCs, such as Pfizer's development of a mobile phone application to help doctors search for case studies.



Did You Know:

China's urban population is forecast to rise by another 200 million people by 2030.⁵

For MNCs looking to tap these opportunities, it will be critical to build relationships with each municipal government, city by city. Identifying local stakeholders and priorities will take time, but the process also underscores the complexities of profiting from China's rising urbanisation and the need to move beyond headline numbers. These challenges will be especially acute when venturing into the country's smaller cities.

CEOs already talk of the challenges of operating in China's smaller cities, especially when searching for skilled talent or managing growing businesses. Rob Blain, Executive Chairman, Asia Pacific at CBRE Group, a US-headquartered commercial real estate services MNC, captures the change as he describes how CBRE is moving to a hub and spoke model, recognizing that the company cannot spread itself too thinly over too many cities.

The idea of more than 'one China' is also evident in how MNCs are devising strategies for specific regions and market segments. Leading Chinese companies are behaving much the same. "We divide China up into mature and emerging markets," says Lenovo's Helmut Zödl, describing how the company views China's mature cities as no different to selling in Europe and the U.S., but emphasizes the importance of a strong distribution model to success in China's emerging cities.

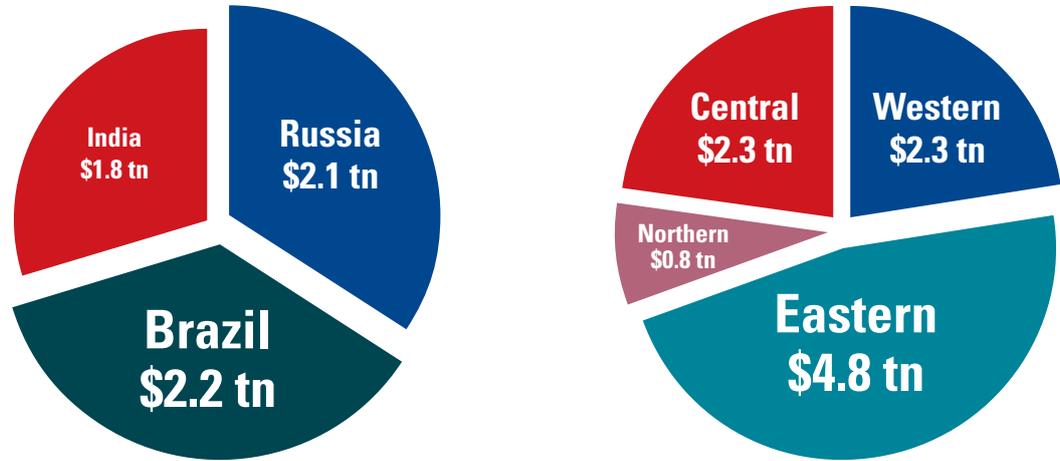


Rob Blain
Executive Chairman
Asia Pacific, CBRE

"We have introduced a hub and spoke strategy in China. We will still maintain a presence in the tier-two and tier-three cities, but will consider consolidating some of the service lines offered in those cities and instead, focus on five key hubs - Beijing, Greater Shanghai, the Pearl River Delta, Wuhan and Chengdu."

⁵ Source: United Nations Population Division

China's GDP by region compared to the BRICS

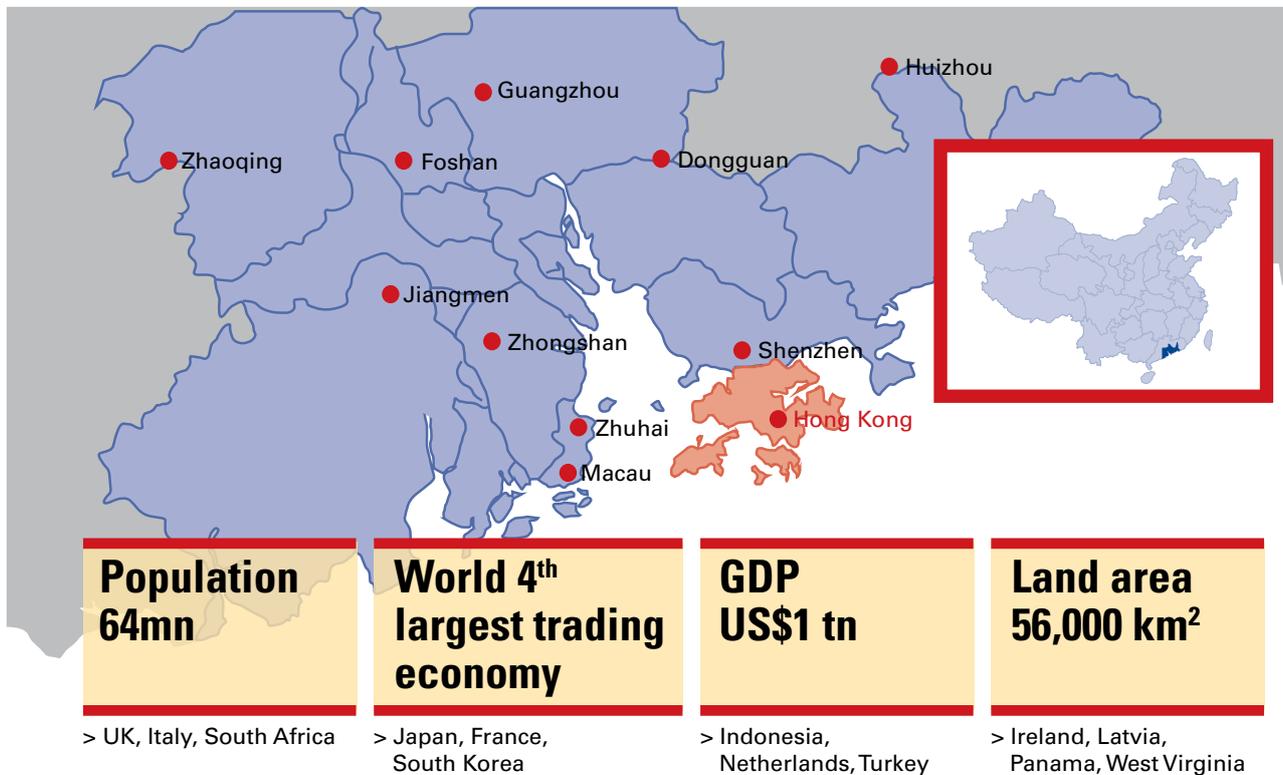


Source: IMF, CEIC, and SRA

The sheer size of specific regions makes such segmentation feasible. Just consider that China's four largest coastal provinces all have GDP's larger than any Southeast Asian economy. If it makes sense for MNCs to recognize the market differences between Indonesia (GDP of USD870 billion) and Malaysia (USD310 billion), then why not the differences between Guangdong (USD1,020 billion) and Jiangsu (USD970 billion), even appointing a business head for each region?



Greater Pearl River Delta



Source: InvestHK

Trying to sell to so many cities will also shape business models. VF Group, an American lifestyle apparel MNC, sells through 2,500 stores in China. But managing some 15,000 sector employees in an industry with 40 percent turnover rates would be a challenge, and so the company remains committed to its partnership-based model, even as it simultaneously develops new distribution and warehousing models in order to assist local partners to respond to the challenges of e-commerce.

MNCs are only just starting to respond to the challenges discussed so far. Equally important though is explaining the changes to colleagues in the head office. For outside observers, China can often appear a single entity, and yet the country is a diverse collection of regions and cultures, each often similar in size to a mid-sized emerging economy. Ensuring colleagues around the world understand the scope of those challenges is critical to strategic success.

Did You Know:

China is home to 143 of the world's 633 cities with populations greater than 750,000.⁶

Twenty three of the world's 100 largest cities are in China.⁷

6,7 Source: United Nations Population Division



A hub and spoke strategy in China

Rob Blain, Executive Chairman, Asia Pacific, CBRE

Rob Blain is Executive Chairman, Asia Pacific for CBRE Group, Inc., a US-headquartered commercial real estate services firm with 1,300 employees in China and 44,000 employees (excluding affiliates) globally.

With a long-established China business, led by Ivan Poon, President, it is striking that CBRE recently revised its five-year strategy in order to better grasp opportunities in China's many smaller cities. "We call it a hub and spoke strategy," says Blain. "We will still maintain a presence in the tier-two and tier-three cities, but will consider consolidating some of the service lines offered in those cities, and instead focus on five key hubs – Beijing, Greater Shanghai, the Pearl River Delta, Wuhan and Chengdu."

Why the change in the company's strategy?

"In simplistic terms, we were stretching ourselves too thin in the second- and third-tier cities," Blain says. "We now take a more client-driven approach and assign specialists from our hubs to work with clients wanting to enter those cities. It's a more efficient allocation of resources and also improves efficiencies in our hubs."

Blain also points to other advantages of adopting a hub and spoke model. "Focusing on the hubs makes it easier to retain our best people, as we can provide a more robust work environment in the hubs compared to the smaller cities." Blain notes that retaining staff is a challenge for any international property service company these days, echoing a point made by others in this report. "CBRE has a great record for staff retention, but the growing sophistication of local developers means we always need to be improving to meet the challenges as they hire more actively."

What other strategies help with retention?

"For young professionals with transferable skill sets, we actively encourage them to transfer within the China business, although it can be harder for families to move," Blain explains. "We are also seeing return on our investment regarding regular management training. We track our best people,

putting them into like-minded groups to help them identify customer outcomes and best practice approaches to new business. We also find that spontaneous acknowledgement of good work helps tremendously."

He adds, "In fact, we have very few expatriates in the China business. And where we do have expatriates, it usually relates to our inbound and outbound work – multinationals inbound and local companies outbound. We now have China desks in London, New York, Los Angeles, Chicago



and Sydney, staffed by bilingual Chinese or foreigners, whose sole responsibility is servicing those outbound requirements globally."

The growing strength of CBRE's domestic business has meanwhile changed the company's customer profile. "A decade ago we were probably 20 percent domestic and 80 percent offshore. Today, we are probably 70 percent domestic and 30 percent offshore," says Blain. "The needs of our domestic client base are growing at a faster rate than are inbound enquiries and we have a broad mix of developers, companies looking to occupy space as tenants, and companies looking to better service their property assets."

Nevertheless, although CBRE's China business is growing, the company's Asia Pacific headquarters are in Hong Kong. "It makes sense for our senior leadership to be here," explains Blain. "It also created a

hub of excellence with our shared services all based in Hong Kong – Finance, IT, Legal and Operations. And, of course, the city has advantages such as the ease of doing business, its legal framework, the transparency of the financial framework, and risk and governance provisions."

Blain meanwhile describes the expansion of the mid- to high-end luxury retail brands in China as mind-blowing. "It is nothing for large luxury brands to look at opening 20 to 50 stores across China. And then you have domestic retail companies who have long-standing local relationships and are expanding at an even faster rate. Sure, economic growth is slowing, but you've got to take into account the sheer weight of the population, and that mid-tier business professionals moving up the ladder are in a position to buy more."

"We also see a growing number of domestic financial institutions demanding premium office space and we have no problem filling up space," he says. However, will rising demand from domestic companies push MNCs further out into the suburbs? "We certainly expect to see more of that, if only because that's the model that has worked so successfully in the rest of the world. MNCs don't need to be in the centre of the city, but instead out in the business parks. The industrial logistics companies are already looking for potential opportunities."

Finally, what about the growing importance of sustainability? "Foreign developers understand that they need to tick all the sustainability boxes if they want to attract MNCs. The better domestic developers, especially those who have worked with offshore developers, also have a better understanding of sustainability, especially when involved in the design and construction of iconic buildings. But for other domestic developers, it is a longer journey, although awareness grows every year," he says.



A solid foundation in China

Ross Shuster, President, North Asia, UTC Building & Industrial Systems

Ross Shuster is the North Asia President for United Technologies Corporation's (UTC's) Building and Industrial Systems division (BIS), based in Shanghai. The BIS division counts some 23,000 employees in China, among UTC's global employee base of more than 200,000. BIS products and services promote safer, smarter and environmentally sustainable buildings and includes the Otis elevator, Carrier heating & cooling, and Kidde fire safety & security brands.

Shuster sees cities and urbanisation as China's new source of commercial strength. "The country is motivated to experiment and innovate and you see increased R&D in the area of green buildings and intelligent buildings. There is also no other place in the world that will have the same scale when building new cities, and that scale is already resulting in some significant innovations coming out of China," he says.

Chinese companies are also set to benefit from that scale and Shuster expects growing local competition as a result. "There used to be a large number of local companies each with a small market share across most of our segments. But there has since been consolidation, and we are now starting to see the emergence of one or two private firms in each segment that are potential global players. They are not yet our most significant competitors. However, I could see them eventually turning into competitors not only in China, but also on a global basis," he says.

How does UTC respond to that competitive threat? "The benefit we have today is that as a global company we are able to invest in R&D across the global enterprise, so we can scale that investment. Without global scale, it could be difficult for local companies

to scale up their R&D investment to the same level. It has stressed to us the importance of investing in R&D and scaling up innovations on a global basis," he says.

"Seven years ago or more, our R&D centre in China was focused on localizing products from our global portfolio, often taking out cost or technologies. Today, what we design in China is a global-standard product. And what we have been able to do is



turn our R&D activities from simply localizing product to leading technology development efforts for our global business," he explains.

"In fact, we have more than doubled our investment in R&D in China over the past five years. That is critical spending if you hope to outpace both local and global competition in the China market."

What is UTC's biggest challenge? "The biggest challenge we have to address over the next five years is talent: recruiting talent, developing talent, retaining talent. Today we hire over 3,000 new employees per year in China. At every level of our organisation it is a challenge. Talent is a potential limit to growth, especially at the service-level front-line, where

certifications are a requirement. If you don't have those people, then you can't service equipment," Shuster says.

"A key part of our recruitment programs is UTC's relationships with vocational schools. We currently collaborate with 24 schools in China and are on the way to increase this number to more than 40 by end of the year. We also work with the schools to select the right students, and then commit to employing them and bringing them into our organisation after their education," he adds.

UTC is also exploring more innovative solutions to the problem. "We see acquisitions as ways to expand our capabilities and to acquire a new portfolio of customers that would benefit from our integrated offerings. We are also looking to establish partnerships in different cities. But equally important is the ability to bring in large numbers of new people into our business, especially in front-line service positions."

In spite of staff challenges, UTC has already localized most of the company's China-based positions. "Out of 23,000 employees in China, we have roughly 100 expatriates, and almost all of our general managers roles are already localized. For the most part, expatriates tend to be either in R&D or regional roles. And even then, we are developing our Chinese managers to eventually assume regional roles. That is one reason why people are coming to UTC, as they look for multi-country roles in Asia," he concludes.

KPMG Insights



Stephen Mercer
Partner-in-Charge,
Multinational Clients,
KPMG China

“The global economy is moving East and China is at the centre. More so than ever, MNCs need to have a clear China strategy; whether that be selling to or within China, sourcing from China or even just understanding the impact of Chinese outbound investment and the Chinese consumer on their home and other markets. Effective implementation of strategy is key.”

A key challenge for any MNC in China is talent management. MNCs are always looking for talent and there are many bright students. And yet, many graduates still fail to find jobs. MNCs need to be increasingly innovative in attracting and retaining talent. For example, KPMG has set-up a shared services centre in Foshan, partnering with one of the local universities. The university selects promising students and KPMG teaches them auditing skills and provides a paid internship while they are studying. For those who perform well, we invite them to join KPMG. I would encourage MNCs to collaborate more closely with local governments and universities in this way.”



Peter Kung
Senior Partner,
Southern China, KPMG



David Frey
Head of Inbound Investment,
Global China Practice,
KPMG China

“MNCs are rationalising their business structures after an extended period of rapid growth. Those companies that arrived in China 20 years ago might today have 30 or 40 legal entities, and that has created complexity. We are now helping those same MNCs rationalise their structures to just five regional entities, for instance. That process eliminates the number of audits, governing boards, and a whole range of governance controls. I see lots of opportunities for buying out JV partners, now that the laws permit wholly-owned foreign companies and streamlining business for future growth.”

“There is a direct correlation between people and business performance, and that is where data analytics comes into play. If a CEO in China wants to increase revenues by 20 percent, then how many people will be needed, what skills will they require? We can use the data to map the skills of the employee and manage the employee life-cycle. Human resources needs to move into the next generation and operate as a strategic business partner of the overall business.”



Susie Quirk
Head of People and
Change Advisory,
KPMG China

“Multinationals’ ability to innovate and adapt is critical to success. In the long run, we see greater opportunities for foreign companies to establish full-fledged manufacturing operations in China, with a primary focus on the Chinese market. The Chinese tax authorities have implemented several regimes to grant favourable tax treatment to foreign invested companies that develop and own technologies in China, conduct local R&D activities to maintain such intangible assets, and interface directly with Chinese customers to tailor goods or services for the domestic market.”



Khoonming Ho
Head of Tax,
KPMG China



Benny Liu
Head of Audit,
KPMG China

“China’s regulatory environment remains challenging. The government’s anti-graft campaign, new regulations and tighter enforcement have raised the bar significantly. Multinationals need to ensure their internal controls, corporate governance and compliance processes keep up to speed.”

“The Chinese outbound investment story has only just begun. We expect to see continued significant investment by Chinese companies overseas. While this may be perceived as a threat by some MNCs, it also provides significant opportunities for attracting investment or entering into strategic relationships.”



Peter Fung
Chair, Global China Practice,
KPMG China



Jessie Qian
Partner-in-Charge,
Consumer Markets,
KPMG China

“Competition is increasing as consumers increasingly travel further overseas. This helps to broaden their knowledge of products and therefore their expectations of better customer service and sales experience. Brands need to maintain their image and have synergies in their marketing and product selections both in China and also overseas, in order to cater to those traveling consumers.”

KPMG Insights



Egidio Zarrella
Clients & Innovation Partner,
KPMG China

“There is a perfect storm in China of technology and high-spending that is asking some tough questions of MNCs. Many companies wrongly assume that Chinese consumers are no different to those in the West some 20 or 30 years ago. But high-spending Chinese consumers have leap-frogged the West in many respects, as they are going straight to e-commerce, rather than physical stores. More often physical stores are simply showrooms with consumers later placing their order online. It is also wrong to assume that China is a single market. Each province, and even city, is a different market.”

“The China outbound M&A story is ultimately about improving a Chinese company’s domestic position. For instance, I am seeing more activity in the agricultural sector. But it is largely related to food safety and taking control of the supply chain. Chinese companies are picking up lessons and know-how and then bringing it back to their domestic market. As a result, there has been a shift in the focus of investment. South America and resources are still a focus however interest is coming back towards developed Europe, technology and know-how.”



Rupert Chamberlain
Head of Transaction Services,
KPMG China



Kai Cui
Partner-in-Charge,
Shared Services and
Outsourcing Advisory,
KPMG China

“MNCs in China are increasingly engaging in shared services. However, it is no longer just about economies of scale, cost and streamlining processes. Today it is more end-to-end, focusing on an MNC’s competitive advantage and asking how we can create value for our business. That is what companies are really talking about.”

“Supply-chain is top of mind for most MNCs. If we look back historically, many people came to China to source or manufacture cheap products. But much has changed since then. They are now asking ‘what is China today?’ Is China part of our global strategy, our Asia strategy, or is China just for China? They are looking at their manufacturing footprint and asking what that means for the local or global supply-chain. At the moment, two out of every three of my conversations with MNCs are on this point.”



Peter Liddell
Head of Supply Chain Consulting,
KPMG China



A MORE EFFICIENT CHINA

There is a lot of talk about China moving up the value chain. But MNCs and local firms are as much focused on improving efficiencies and bottom line profitability.

What does a slower growing China look like? For the past 20 years, foreign and local companies typically played a volume game. But volume growth has slowed even as cost inflation has remained high. CEOs talk about 'taking a breath' after the past decade's boom and, rather than simply trying to sell an extra car or open an additional store, they are today focused on restructuring organisations or evolving business models to find new value-propositions. The increased significance of China to corporates' global results has also resulted in greater focus on bottom line profitability and efficiency, rather than just top line growth.

Where might MNCs look to improve efficiencies? Many have been left with complex organisations as CEOs struggled to grow operations fast enough to keep pace with double-digit sales growth. Today the same CEOs are trying to consolidate what might be 20 to 30 entities or more, across the country; or acquire local partners to take advantage of new ownership rules; or consolidate supply-chains designed to serve single factories rather than national operations.



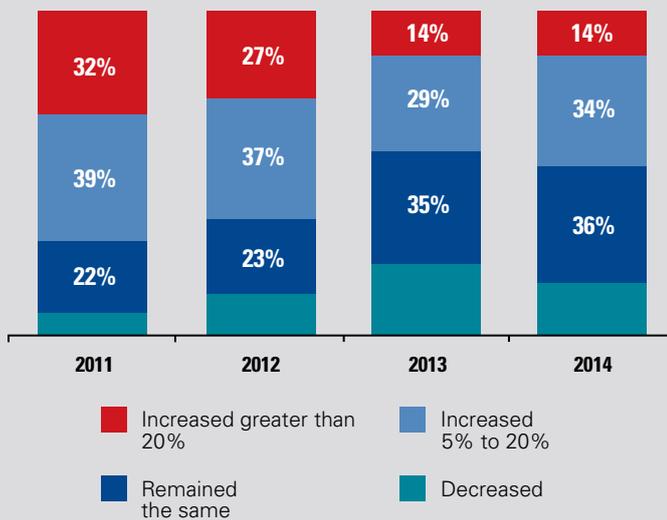
Tony Latham,
Senior Vice President
Finance, Global Supply
Chain, Unilever

MNCs have been investing in China for the growth story. But with the exception of a few, profits are not always in line with the global average. Therefore, companies are going to have to work out the long term financial viability of their business. They are going to have to find the right financial model to remain profitable.



European companies' EBIT growth is sluggish in China

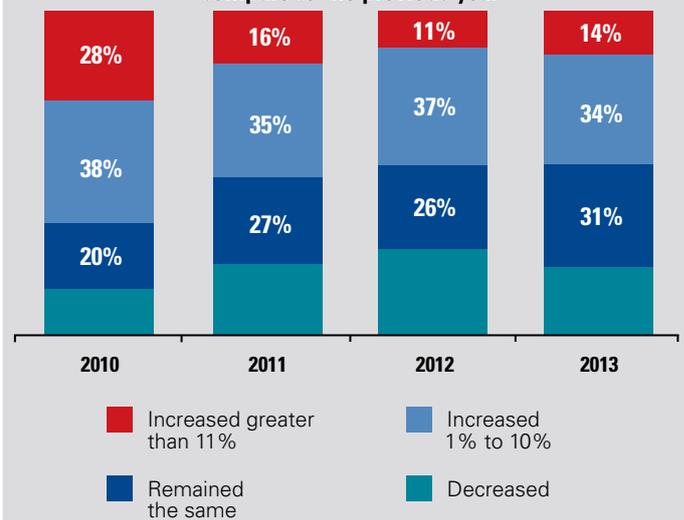
How did your company's EBIT compare to the previous year



Source: Business Confidence Survey 2014, European Chamber of Commerce in China

U.S. companies' operating margin growth has slowed in China

How did your company's overall operating margins compare to the previous year



Source: China Business Report 2013-14, American Chamber of Commerce in Shanghai

Rupert Chamberlain, Head of Transaction Services, KPMG China, has observed a particular focus on partnership structures: "MNCs are reassessing their Chinese operations, asking whether a joint-venture was the right approach; did they enter joint-ventures because they wanted to, or had to. We are going through a phase where companies once said, 'I have got China on our map', but now how are they going to make sure the China business is making money."

Some MNCs are also looking for ways to reach out to local partners and help them deal with weaker sales and higher costs. VF Group's Aidan O' Meara explains how the company's conversations with local partners are increasingly about how to improve productivity, not just distribution. "We have to be an enabler" he says, pointing to the firm's ability to share operating capabilities, such as CRM systems, across multiple brands as a key strength.

Some MNCs are also benefiting from local players looking to move up the value-chain and remain profitable in today's slower-growth world. Jan Kreibaum, Regional President Greater China and Korea for Clariant, a Swiss specialty chemicals company, observes how government policies have put pressure on state-owned firms to replace outdated equipment and, as a result, "we get chances to support local partners and customers to upgrade their production facilities."

Indeed, local players are not standing still. Many are similarly looking to streamline, such as by using shared-services. Many are starting with a blank sheet of paper and so can adopt best standards from the outset. Not all will succeed. But for those leading Chinese companies looking to match the best practice of MNCs, and even surpass them in some areas, they will emerge as more efficient and productive competitors.

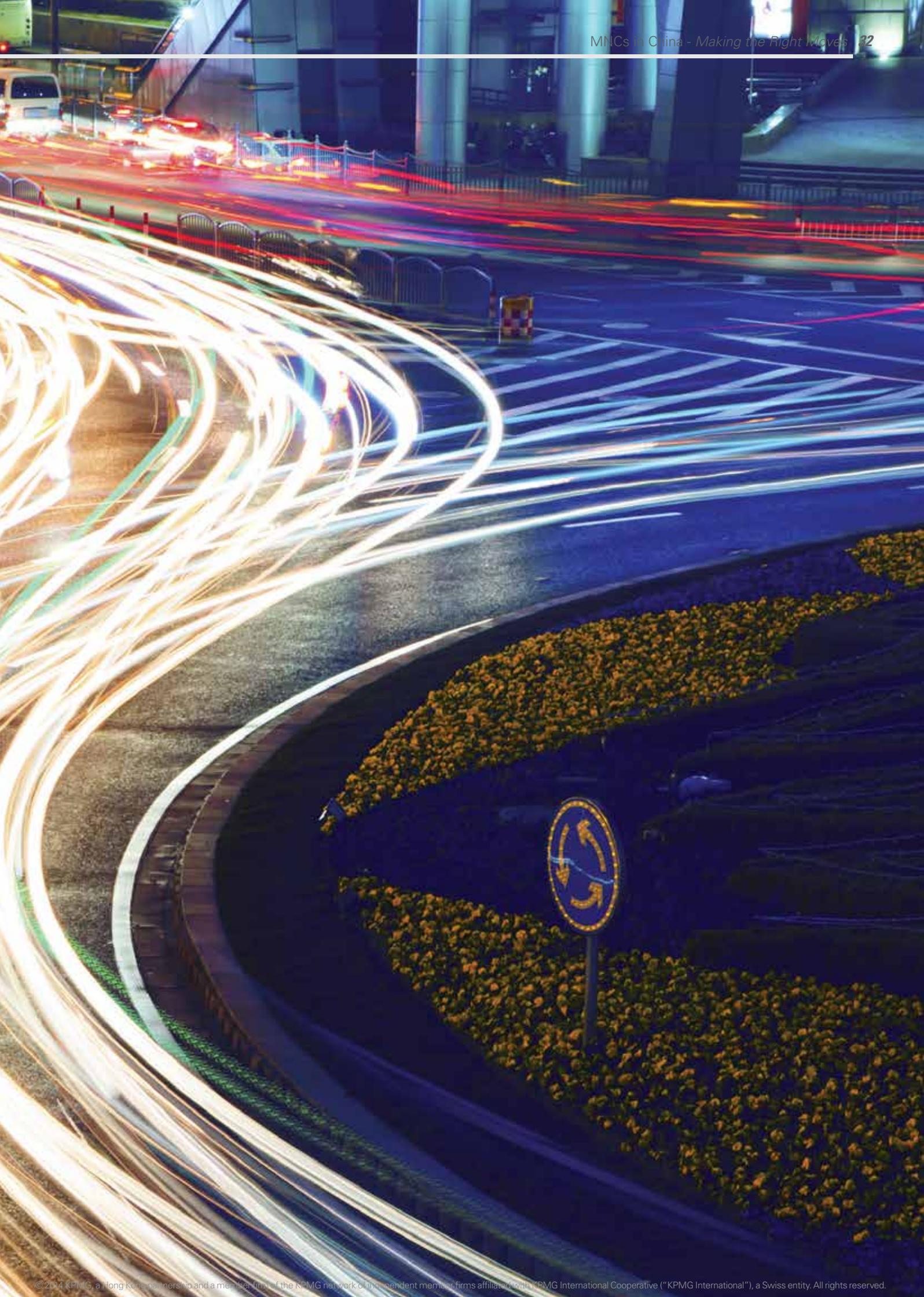
Kai Cui, Partner, KPMG China, has observed a real change among the country's biggest state-owned firms in recent years. "I am increasingly talking to SOEs about how to build a shared services centre, what are the lessons learned. They are maturing fast and when I talk to them about shared services for example, they already understand the concept. They don't want to simply copy the best practice of MNCs, but are asking how can they do it better than the MNCs."

The upshot is that a more efficient China may yet be the most important result of declining GDP growth rates. It is still early days with the data showing the slowdown in earnings or operating margins for many American and European MNCs starting from 2012. But the best performing MNCs and local companies are already finding ways to cut costs and identify more efficient and profitable business models. This is ultimately a positive development for the country and will lay the foundation for the next wave of growth.



Rupert Chamberlain
Head of
Transaction Services,
KPMG China

MNCs are reassessing their Chinese operations, asking whether a joint-venture was the right approach. They used to prioritize making sure they had China on their map, however, nowadays it is more a case of how to ensure the China business is profitable.





A global footprint

Helmut Zodl, CFO, Asia Pacific, Lenovo

Helmut Zodl was until recently the Hong Kong-based Asia Pacific CFO for Lenovo, a Global technology MNC with 48,000 employees worldwide. He has since taken up a new role as CFO of Lenovo's Global Enterprise Group & the Americas Group, located in the US.

“ ‘Consumerisation’ of products and business models is happening faster in China than elsewhere in the world” – this is the driver of innovation, he says, when asked about the key opportunities in Lenovo's industry in the coming years. The Chinese consumer has a strong independence in decision making and a greater influence on how you might sell a product or services. This means companies will be increasingly competing on the basis of product innovation and speed to market.”

“The rise of e-commerce also means we have to work more proactively in this field,” he adds. “It will be a key factor for how consumers buy going forward, especially in the urban areas where it is much more convenient to buy online. “All this means that innovation and change are central to our company, and so we adjust our business model and organisation constantly to cope with change in customer expectations and needs.

What is your biggest future challenge? “I see two areas. From inside China, it is business model innovation and the impact customers have on product development through social media. When we do social media engagement in Asia, we get responses you would not dream of in Europe or the U.S. So listening to your customer and getting their feedback into the final product or service is critical,” Zodl says.

“From outside China, it is the MNCs who are looking to be strong inside China and so acquiring local companies or partners,” he adds.

As an MNC with China heritage, what role does China play in your global strategy? “We believe a global culture defines a true MNC. And our global leadership team includes more than 25 nationalities out of a total of less than 100 senior executives. It is really a very broad mix of talent and everyone brings something different to the table. Giving staff and executives international experiences inside and outside of China is critical to create diverse and innovative teams but more importantly is a common culture and core values



that bring everyone together and ours are defined as commitment and ownership.

Zodl also discusses the challenge of running a global Chinese company. “You can't run an international company from just one location. And so while Beijing and other Chinese cities have a role to play, Hong Kong serves as an important hub from a management perspective. It's an especially good hub for senior management activities, as well as managing sales and distribution networks across the region.”

He continues: “In fact, it is critical to combine our best talent from across the globe and so develop a best in class development process. Some things you can do very well in Shanghai or Wuhan, while others are better done in Japan. We even have designers in Hong Kong because of the city's design

schools. It's that aggregation of global talent that is critical.”

China continues to be important for the company's growth plans? “In terms of both our consumer and commercial strategy, China is our core-market and our objective is to be the number one player in that market in all key segments of our industry. However, only a strong home market is not enough for a global company so our objectives are changing and we plan to have core markets around the globe. It is also fundamental that we do things locally in each of those core markets and it is a growing focus for us to be a strong player in both the U.S., Europe, Japan as well as Latin Americas” he explains.

The fact Chinese companies such as Lenovo are meanwhile increasingly attracting talent is also creating challenges for most foreign MNCs. “For us, it is quite easy to recruit staff, largely because we have a strong brand name,” Zodl maintains. “In fact, our situation has changed a great deal over the past years with respect to talent, and I now get CVs of top industry talent on a very regular basis. It is also because we run an open door culture, offer employees opportunity and ownership, and have the right mix of incentives, much like any leading MNC.

As one of China's most successful MNCs, Lenovo's approach to the China market also offers lessons for foreign MNCs.

“We divide China up into mature and emerging markets,” Zodl says. “You have the mature cities, such as Beijing or Shanghai, where customers are as sophisticated as they are in Europe and the U.S. You then have the emerging cities that are very different and where you need a very strong distribution model if you are going to penetrate what are usually third- and fourth-tier cities.”



The right catalysts for China

Albert Heuser, President Functions, Asia Pacific and President & Chairman, Greater China, BASF

Dr Albert Heuser is President Functions, Asia Pacific and President & Chairman of Greater China for BASF, a German chemicals MNC.

In Greater China, BASF posted sales of over €5.48 billion in 2013 and employed about 7600 people as of the end of that year. Globally, BASF had sales of about €74 billion in 2013 and over 112,000 employees as of the end of the year.

For a chemicals MNC, disruptive changes in the long-term outlook matter. So where does Dr Heuser expect the next big change in China to come from?

"We believe the most disruptive force will be the speed of the shift in societal focus: away from unfettered growth and investment, towards meeting the challenges of sustainability," says Dr Heuser.

"Society will be making increasingly high demands on all types of businesses that operate in China. These demands will then need to be addressed with a combination of locally-developed solutions and international technologies. Overall, this is an opportunity rather than a threat for BASF. With our wide range of strengths globally and in China, we can support the innovative development of key local industries such as energy-efficient vehicles, alternative energy, and sustainable food packaging."

In turn that might bring opportunities for increasingly supplying local state and private-owned firms. "It is estimated by 2020 the urbanisation rate of China will be around 60 percent, the government aims to guide urbanisation of around 100 million rural residents of the central and western regions, so infrastructure development remains important and China's SOEs will play a key role here," says Dr Heuser.

"We therefore see opportunities to work with industries including building and construction, railway, waste treatment, water treatment, alternative energy

etc. Meanwhile, we also provide comprehensive solutions to help China improve agricultural production efficiency to ensure foods and nutrition supply."

For some MNCs, those state-firms might yet emerge as global competitors. But on this point Dr Heuser points out that: "Domestic chemical companies in China have made remarkable development in certain sectors, based on higher technical standard and improved product expertise. But are China's national champions, the



global challengers of today and tomorrow, more likely to be our allies, or our adversaries? At BASF, we like competition as it makes the chemical industry as a whole better."

"The question of the challengers from emerging countries is one that some industries have just begun to address. Meanwhile, other industries have already been exploring this topic for many decades. The chemical industry is one of the latter – due to the highly global nature of our industry, and due to the fact that we are an enabler industry and therefore need to be in emerging markets very early on."

The company operates in both Hong Kong and Shanghai, with each city playing important local, regional and even global roles. "Our Pudong site includes both our Greater China Headquarters and Innovation Campus Asia Pacific. We have

also established our Asia Pacific regional engineering and procurement platform in Shanghai, which additionally plays a global role," he says.

"I myself, one of the two regional presidents in Asia Pacific, am now based here, acting also as the president of BASF Greater China as well as Asia Pacific regional functions. In addition, some regional and global business units have their global head offices in Shanghai."

"Hong Kong is our regional headquarters for Asia Pacific. Additionally, in 2012 we established the global headquarters of our dispersions and pigments operating division in Hong Kong."

Given that BASF has based some global heads in Shanghai, to what extent is the company localizing employees? "We believe that some of BASF's greatest strengths come from diversity: the combination of expertise from local, and international perspectives," Dr Heuser says. "For example, in our Greater China Leadership team we have two senior vice presidents, who are Chinese, responsible for market & business development, country platform and functions respectively, working together with myself from Germany and a senior vice president from Australia. At the same time, we also have posted colleagues from China and elsewhere in Asia Pacific to senior positions in Europe and North America."

In terms of regulatory issues, Dr Heuser notes: "The increasingly stringent environmental legislation such as the Emission Trading Scheme and environment protection tax have brought challenges to the chemical industry and industrial sectors in general. In order to stay competitive and thrive, we encourage the chemical industry to optimize manufacturing processes and adopt constructive initiatives that are implemented in an open, fair and flexible manner."

5 REGULATIONS STILL CHALLENGE MNCs

Regulatory change remains a key challenge for MNCs, especially as they simultaneously grapple with complex organisational structures and an accelerated rate of regulatory reform.



Benny Liu
Head of Audit,
KPMG China

China's regulatory environment remains challenging. The government's anti-graft campaign, new regulations and tighter enforcement have raised the bar significantly. Multinationals need to ensure their internal controls, corporate governance and compliance processes keep up to speed.

CEOs are generally disappointed by the pace of regulatory reform. This is not a deterrent to MNCs operating in the country, but regulatory issues are a concern for any company wanting to tap into the country's rising urbanisation: MNCs expanding into more cities across more parts of the country will find themselves dealing with a growing number of local government officials, and an increased risk of different interpretations of national or provincial rules.

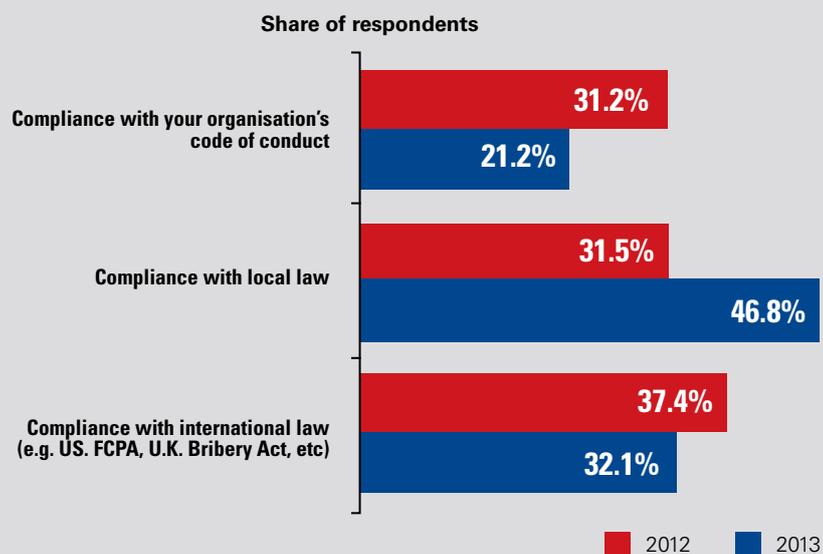
Indeed, for all that China is a single market, the country's GDP is equivalent to the 15 largest non-BRICS emerging economies. It is also distributed across 31 provinces and over 140 cities with a population larger than 750,000. These are the sorts of figures that compare to entire continents and, not surprisingly, regulations may be applied inconsistently, even if they are world standard.

In our discussions, CEOs were especially concerned by a perception that foreign companies may be held to a higher standard. For MNCs competing mainly with other foreign companies this is less of a concern. But it is seen as being a persistent challenge for those operating in sectors where local competitors account for a large share of the market and where demand is more evenly spread across smaller cities.



Our discussions also indicated that officials appear to be generally enforcing regulations more strictly than in the past. This is partly attributed to the government's anti-graft campaign. CEOs talk of how this, combined with the complexity of regulations, is creating potential new commercial or reputational risks in unexpected areas.

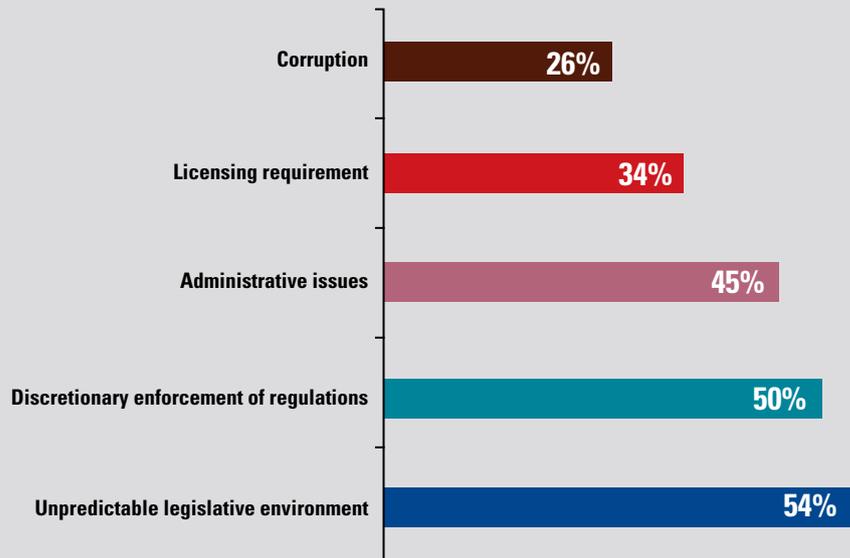
Which areas of legal compliance are most important to your business in China?



Source: China Business Report 2013-14, American Chamber of Commerce in Shanghai

European firms and Top 5 regulatory challenges to their future business in mainland China

How significant are the following regulatory obstacles to you when doing business in mainland China



Source: Business Confidence Survey 2013, European Chamber of Commerce in China

It is also critical at a time when regulators are increasingly pro-active. China's anti-graft campaign is the most high-profile example of the country joining the United States and the United Kingdom as a new global regulatory player. A recent survey of American companies in China showed a huge jump in the number of companies that considered compliance with Chinese law to be relatively more important when compared to complying with US Foreign Corrupt Practices Act (FCPA) or the UK Bribery Act.



Grant Jamieson
Partner-in-Charge,
Forensic,
KPMG China

Last year was a watershed, as Chinese regulators started to become more proactive. With the new leadership in place, the regulators are starting to publicly identify industries where they are openly investigating companies. This means there is a new global regulatory player, and if you are an MNC in China then you not only need to be aware of U.S. or UK law, but also Chinese law.

Grant Jamieson, Partner, KPMG China, explains: "Last year was a watershed. With the new leadership in place, the regulators are starting to publicly identify industries where they are openly investigating companies. This means there is a new global regulatory player, and if you are an MNC in China then you not only need to be aware of U.S. or U.K law, but also Chinese law. MNCs' awareness of how they conduct themselves in China has had to step up to a new level."

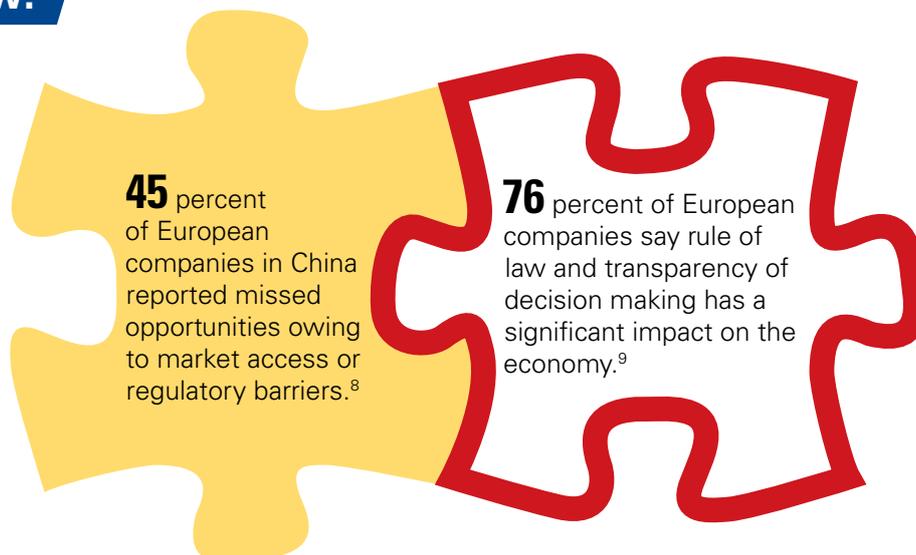
Jamieson suggests that MNCs need to make sure that the Chairman and the board are sending the right messages from the top. They need to have the right policies and procedures in place, as well as the correct training and checking, such as using data analytics to check for payments outside the normal course of business. They also need to make sure the company's internal audit people are also looking for fraud or corruption, and that these people have direct access to the board.

Such concerns add impetus to the organisational restructuring already taking place. Some MNCs are choosing to buy out joint-venture partners and take advantage of new laws that more readily allow wholly-owned enterprises. This reduces an organisation's complexity. But it also makes it imperative that a newly acquired subsidiary complies with Chinese and foreign regulations, especially for new employees unfamiliar with best practice.

Most MNCs are meanwhile still digesting the recent leadership change and its impact on regulations. The Shanghai Free Trade Zone is perhaps the most significant of those changes. And yet there remains much uncertainty. The zone has received significant attention not just within the region, but also from head office, according to some. Yet, few of the CEOs we spoke with saw the zone having any immediate impact on their business with most of the benefits accruing to the financial sector.

For this reason it is important that MNCs remain engaged with the regulators. “For the first time, the Chinese government has solicited public views on three existing laws related to MNCs (i.e., the Law on Wholly Foreign-Owned Enterprises, the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-Foreign Contractual Joint Ventures), rather than just a draft law,” says Qiang Li, Managing Partner for O’Melveny and Myers in Shanghai. “It is critical that MNCs participate in the rulemaking as much as possible. In fact, it’s a good time to be part of the change, as there is movement on the regulatory front and China still views MNCs as bringing value to the country.”

Did You Know:



^{8,9} Source: Business Confidence Survey 2013, European Chamber of Commerce in China.



Compliance a key focus

Dr. Wu Xiaobing, Regional President, China, Pfizer

Dr. Wu Xiaobing is Regional President for China for Pfizer, the global pharmaceuticals MNC with 9,000 employees in China and 77,000 globally.

What are Pfizer's biggest challenges in China? "Compliance and talent," says Dr Wu. "Every company in China must learn to be more compliant. In China, there are many regulatory agencies, especially in the pharmaceuticals industry. In the past, those agencies might have issued a regulation, but the interpretation and enforcement of the regulations continues to evolve. MNCs must be aware that what may have been allowed in the past may not be allowed going forward."

He continues, "MNCs should adopt a more cooperative approach, create more win-win situations, and ask how industry can help the government achieve its vision," he says.

Turning to the challenges of talent recruitment, Dr. Wu says, "We manage our China leadership team pretty well but still have issues in terms of workforce turnover. You have to give employees very good money. But you also have to give people freedom to explore their potential and feel empowered. So people really feel this is a team where we can work together and feel supported. In Pfizer, we have very diverse teams. We ask questions, listen to different perspectives."

Perhaps most striking for Pfizer are the issues of dealing with a young workforce. "We have a lot of young employees and our workforce of 9,000 has an average age of 29," says Dr Wu. "There is much more individuality than

the previous generation. They are also much more engaged in terms of social responsibility and are very passionate about helping migrant workers' children, for example, and willing to devote their own time and resources to these children. It's wonderful to see our employees give back to the community."

He adds, "Local companies are also paying very well. Some local pharma companies pay their executives even better than Pfizer." So why do many



people stay in the MNCs? "Because the MNCs can provide other benefits, such as a better working culture or a better work life balance. In local companies, by contrast, GMs tend to dictate everything. There is also still prestige working with a foreign company, especially for many young people who are more internationalized and want to speak English." Pfizer meanwhile sees local competitors as a growing challenge. "Local industry is working on improving their quality. In the past, we differentiated ourselves on quality, but the gap is narrowing. Sure, the R&D

capabilities of local companies are still very much in a developing stage. But the government is working on the new standards, and asking local companies to improve their quality, and so companies are raising their standards and we are seeing a definite improvement. That said, MNCs still do the research and development for most of the new, innovative drugs," says Dr Wu.

Is counterfeiting a concern for Pfizer? "Yes, we have seen counterfeiting for popular drugs," says Dr Wu. "But the trend has not worsened. The good news is that the government is very aggressive in tackling the problems, and we work together with the government on these issues. The government has also classified such infringements as a criminal act, which is a major improvement."

Pfizer also uses China to support the company's global operations and has some 700 R&D people in the country. "We have two R&D sites in China. Both are part of the global research value-chain rather than doing stand-alone research. For instance, we are doing statistical work in China for Pfizer's global clinical trials," he says.



Strengthening a China presence

Jan Kreibaum, Regional President, Greater China and Korea, Clariant

Jan Kreibaum is the Regional President of Greater China and Korea for Clariant, a Swiss specialty chemicals MNC with 1,500 employees in China and over 18,000 globally.

“Chinese firms are moving up the value chain and becoming more sophisticated,” he says when asked about local competition. “The quality is often comparable. They are also improving rapidly in terms of introducing better processes and documentation. Many local companies are putting more and more emphasis on innovation and some privately owned enterprises (POEs) are acquiring foreign talent by whatever means possible. For instance, I’ve seen some local competitors hire experienced Japanese retirees.”

However, he argues that Clariant has the ability to stay ahead by creating new market openings. “Our customers are also increasingly demanding and that creates opportunities for us. Take food safety as an example. A lot of our products go to the food packaging industry and our customers increasingly want full traceability. They want to be able to go to their suppliers further up the value chain and trace where all our products are coming from. Clariant is really good at this. We are very good at adapting or developing our existing offerings.”

Clariant’s market has meanwhile changed in recent years as China’s domestic economy evolves. Much of the big growth nowadays is coming from the booming locals, especially the POEs. Take the mobile phone industry and its use of pigments. In the past, we would have done a lot of development work with Western mobile phone

companies. But now there are local companies that are selling huge volumes and also planning to go outside China. We are currently putting a lot of focus on such booming local companies and their needs,” he says.

Does operating in a highly regulated industry create challenges for Clariant? “The regulatory framework is in place and it is being more strictly applied as a result of the recent anti-graft measures. We see the Chinese Government



putting more emphasis on enhancing the enforcement,” he says.

However, Kreibaum also notes that tightening regulations have in some cases benefited MNCs. “We have seen instances where the government has shut down a producer near a first-tier city because the company was unable to deal with tightening environmental or other regulations. Because of the high level of standards Clariant adopts globally, we get chances to support local partners and customers to upgrade their production facilities to comply with the new regulations. That creates opportunities for us to grow our domestic business.”

However, such an ambition means having enough feet on the ground to understand local demand and develop local relationships. “We have 1,500 employees in Clariant spread across 18 cities in China. Our expatriate employees either have Asia Pacific roles or specific technical skills. We also want to bring more Asian nationals into top management positions, including regional roles. In addition, several key talents have been transferred to Switzerland with the expectation that they will develop skills and relationships before returning to Asia.”

Is it hard to retain such top local talent? “When I came in 2005, people were switching jobs mainly because of salary, but now they are moving for career opportunities or CV development. Training programmes are very much in demand as a result, and we have also set up a special retention programme for the ‘must keep’ talent, such as those with special technical skills or those critical to the business. But it’s still tough sometimes to compete with the POEs which will offer special packages with guaranteed payouts, such as after an IPO,” he says.

6 RETHINKING TALENT

MNCs continue to face challenges in recruiting and retaining staff. The worsening talent shortfalls will require innovative strategies.



Helmut Zodl
CFO, Asia Pacific,
Lenovo

It is critical to combine our best talent from across the globe and so develop a best in class development process. Some things you can do very well in Shanghai or Wuhan, while others are better done in Japan. We even have designers in Hong Kong because of the city's design schools. It is the aggregation of global talent that is critical.

Talent shortages remain a critical issue for MNCs. This isn't a new subject, but CEOs in China are devoting proportionately more time to the problem than their company may be globally. Head offices are also grasping the severity of the issue, especially after discovering that wage rates for some skilled staff are higher in China than they are in home markets. The mismatch in skills and ongoing decline in China's youth population will only ensure the issue remains top of the corporate agenda.

Two developments intensify the challenges since our last report. Local companies are increasingly bidding for talent, offering similar pay rates and often more attractive incentives, unrestrained by the regulatory requirements of publicly listed companies in the West. Some CEOs also worry that China's emerging corporate giants, such as ICBC, Lenovo, or Tencent, have stronger brand appeal for China's new graduates and are seen as employers of choice.

The rapid evolution in business models, especially in the e-commerce and digital media space, is also worsening the skills mismatch, meaning MNCs risk running up against limits to growth. Unilever's Tony Latham, says: "There simply isn't enough talent globally in the areas of digital media, big data, or e-commerce. Any digital strategy that doesn't include a talent component is destined for medium to long-term difficulties in realising the opportunity".



Did You Know:

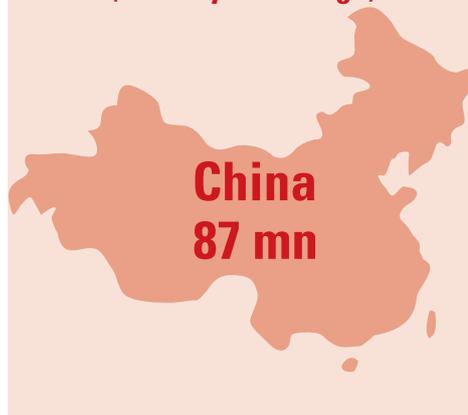
In 1990, China's median age was 24.8 years. By 2030, it will reach 42.1 years.¹⁰

How are leading MNCs responding? Increases in pay and benefits are common. Leading MNCs are also offering more regular promotion opportunities, as well as building cultures that are more attractive to staff. Some CEOs also argued that a new generation of employees is seeking a better work life balance and so actively seeking opportunities at MNCs, rather than local companies where working hours still tend to be relatively long.

China's declining youth population (0 to 30 years of age)

Million persons

**Youth population decline
between 2015 and 2025
(0 to 30 years of age)**



Total population



Source: World Bank & United Nations, Population Division, World Population Prospects

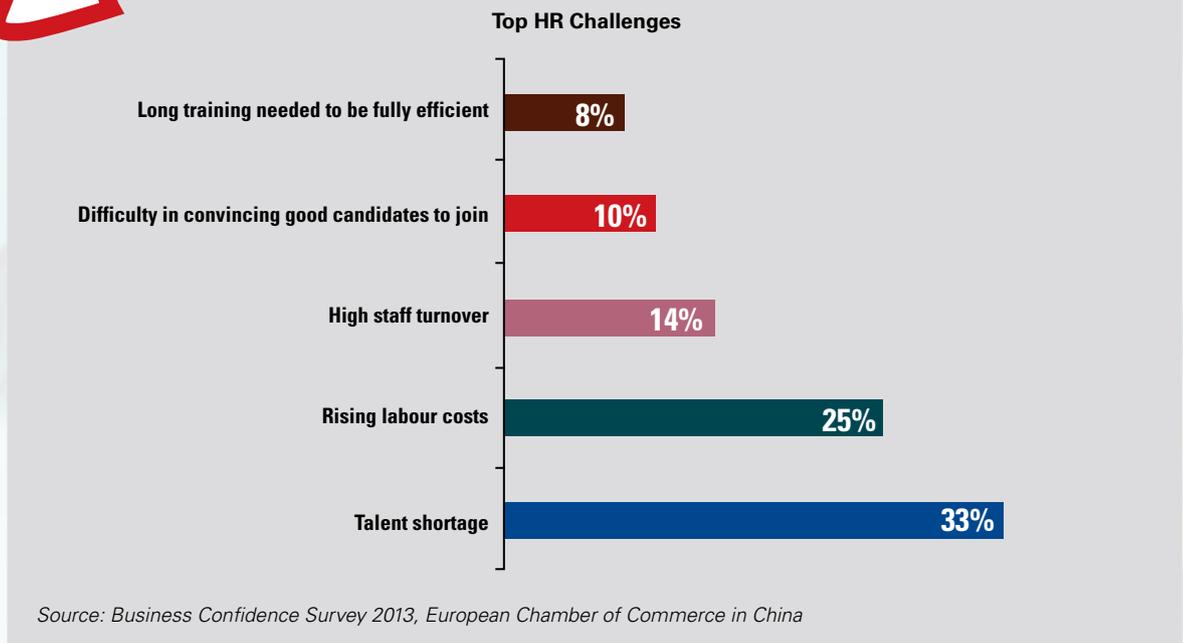
¹⁰ Source: United Nations Population Division

Did You Know:

90 percent of American companies in China are worried about rising labour costs.¹¹

MNCs have also started aligning themselves with universities. Take UTC Building & Industrial Systems, the building technologies MNC, which has relationships with 24 vocational schools. “We work with the schools to select the right students, and then commit to employing them and bringing them into our organisation after their education,” says Ross Shuster, North Asia President. The company collaborates with the schools to select the right students and employs them after training.

Ranking of European firms’ top HR challenges



The youth population (less than 30 years old) is forecast to decline by 118 million people by 2030.¹²

MNCs will also be forced to find increasingly innovative solutions, such as through the use of data-processing technologies in order to automate certain jobs—from data analysis to legal services—much as the manufacturing sector has turned to robotics. Some MNCs may even turn KPIs on their head, using predictive analytics to help managers understand what revenue targets they can achieve with the people they have in China, rather than the reverse.

Susie Quirk, Head of People & Change Advisory, KPMG China, talks about a breakdown in the relationship between pay and profit as a driving force for such innovative responses: “CEOs are understandably focused on labour costs. China’s ageing population has contributed to wage inflation of at least 10 percent annually for the past three years, as well as a big shortfall in the number of people with leadership, operational management, or transformational management skills.”

The implication is that recruitment and retention of talent will be a major differentiator for all companies in China over the coming years. The situation will worsen before it improves and those companies able to find innovative solutions will raise the ‘talent ceiling’ to their growth rates. China might even start to export innovative talent management practices to the rest of the world—an unexpected, but nevertheless critical source of innovation in tomorrow’s ageing world.



Susie Quirk
Head of People and Change Advisory,
KPMG China

CEOs are understandably focused on labour costs. China’s ageing population has contributed to wage inflation of at least 10 percent annually for the past three years, as well as a big shortfall in the number of people with leadership, operational management, or transformational management skills.

11 Source: China Business Report 2013-14, American Chamber of Commerce in Shanghai

12 Source: United Nations Population Division





Innovation & talent in China

Tony Latham, Senior Vice President Finance – Global Supply Chain, Unilever

Tony Latham is the Senior Vice President Finance - Global Supply Chain for Unilever, an Anglo-Dutch consumer goods MNC with 170,000 employees globally.

“We are seeing an increasingly sophisticated Chinese competitor, both in terms of their products but also their business model innovation,” he says when talking about challenges in the industry. “There is still a risk of competitors reverse engineering product formulations and selling a similar product 30 percent cheaper but these are not the competitors who are succeeding in today’s market. It is no longer a real source of competition for us.”

“Many local competitors do not have the global resources particularly in marketing to compete head-to-head with MNCs. As a result they have looked to identify other ways to reach consumers, such as e-commerce and digital media. A number of local competitors have been particularly progressive in connecting with consumers on mobile devices,” he adds.

“Business models are evolving very rapidly in China. The opportunity to reach our target consumers has been transformed in the past few years. Whilst television remains an important medium, visual content is increasingly being consumed online. A number of local companies have been quick to capitalize on this, whereas foreign companies up until recently still relied heavily on television.”

It is topical to talk about the opportunities around e-commerce, but what about the challenges?

“It is important to find the right balance of investment and the right proposition

across various channels. E-commerce retailers appreciate exclusive offerings as differentiation drives online traffic. Companies are now using different ways to manage their channels effectively including online exclusive new product launches, which may later be rolled out more extensively to all retailers, differentiated pack sizes and cross category promotional packs.”

Unilever is also responding to the challenges of staff recruitment and



retention. “Talent management has been high on our agenda in China for the past five to six years, both at the level of our local management and Global Executive Board. Unilever has made good progress in terms of capability building and retention, reflected in increasingly preferred employer status in China. Unilever China has also started to become an exporter of talent to the rest of the Unilever world.” Latham says.

He then points to a future challenge. “There simply isn’t enough talent globally in the areas of digital media, big data or e-commerce. Any digital strategy that doesn’t include a talent component is destined for medium to long-term difficulties in realising the opportunity. MNCs need to develop

a specific capability and retention strategy around all things digital in their business if they have any hope of succeeding in that space” Latham says.

“The composition and capabilities of talent will also need to change, as we move increasingly into e-Commerce, digital media and understanding how best to use big data. The skill sets required will be very different. It is in some of these emerging areas that we are now focusing a key part of our people strategy”

There has been a lot of talk about the Shanghai Free Trade Zone (FTZ), but does he see opportunities? “The Shanghai FTZ and the opportunities that it could potentially present are evolving rapidly. I think it is an excellent initiative and we continue to evaluate how we can leverage the Shanghai FTZ for the benefit of Chinese consumers. Within the Shanghai FTZ I see a trend of the government subtly shifting responsibility for compliance with regulations to the suppliers of goods and services. This places additional responsibility and accountability on those companies, ultimately a positive development. We are exploring how we can use the Shanghai FTZ to import products from Unilever’s vast global brand portfolio specifically for sale online, hence giving Chinese consumers access to many more of Unilever’s wonderful products.” Latham says.



A Regional Player

George Foo, COO, Artesyn Embedded Technologies

George Foo is the Hong Kong-based COO for Artesyn Embedded Technologies, a global power conversion MNC, and formerly part of Emerson Electric, with 9,000 employees in China and 22,000 globally.

China used to account for 85 percent of Artesyn's Asia-based employees, but that number has since fallen to just 50 percent. "Today, we have 9,000 employees in the Philippines and the number is growing, especially among our production workers. We have also moved our back office functions from the U.S. to the Philippines as well as established a strong R&D center in Manila. We also have two manufacturing facilities in the Filipino cities of Laguna and Cavite." The key is finding competent, demanding and disciplined managers.

What about the rest of the region? "We used to have a plant in Vietnam where labor costs were lower. However, we had to deal with a workforce that was prone to labor actions, we faced challenges in recruiting and keeping professionals, as well as serious wage inflation. We also found that rent, facility and logistics costs were higher when compared with China," Foo says. "Doing production in Vietnam has its advantages when building simple, high volume, high labor content products (e.g. consumer electronics). However, when we decided to exit the simple, high volume electronics space, we decided to exit Vietnam since we lacked the volume to amortize the relatively high fixed costs. We also took a look at India, but remain concerned about labour regulations, government bureaucracy, and poor infrastructure. We are also seeing wage inflation of around 30 percent in Indonesia combined with memories of the political unrest during the late 90's, further limiting our choices," he adds.

"Unlike some other industries, the Electronics business, because of the high investments required in skilled professionals and facilities, we cannot shift production overnight and we must take a longer term view when selecting manufacturing sites. I do see, perhaps, a possible shift of higher end electronics

manufacturing from China to Malaysia if inflation in China continues to remain at double digits. In fact, some of my top people in China are Malaysian and finding excellent professionals will not be an issue. However, supply chain costs are still higher in Malaysia relative to China and the latter's supply-chain remains exceptional by comparison," Foo says. "There are also a growing number of automation companies in China and I see that as making China more competitive in the future. The country has an uncanny ability to reinvent itself"



"There's also a high severance cost to exiting China, especially if you are closing plants or legal entities. Too many hurdles," he says, citing those costs or hurdles as an additional reason to remain in China in spite of the country's rising costs.

What about Artesyn's R&D in China? "We have scaled back our R&D activities in China owing to rising costs for engineers and high turnover. However, the China market is huge and the Chinese demand products that are custom designed for local use. To us, this means putting our engineers where our customers are, and so we have implemented a policy of conducting R&D in China for China."

Foo is meanwhile also seeing growing competition from local players. "Our biggest competitor remains the Taiwanese. However, we need to keep an eye on emerging Chinese competitors. Not a competitor of our's but certainly an example of a successful Chinese

electronics company is Huawei which has emerged as an important global player and continues to build its global presence. You also see other emerging Chinese players in the Electronics sector, such as Lenovo and Xiaomi, so you can never be too complacent. In fact, the local players force you to be more competitive, especially given that most of our local competitors tend to be nimble private-owned firms," he says.

Foo also notes that business conditions in China are changing fast partly because of the government's anti-graft measures, as well as other recent regulatory reform. "Officials are now more strictly enforcing those rules over the past year, and that is contributing to rising hidden costs. However, we see this as a positive aspect as it levels the playing field between ourselves and those same local competitors."

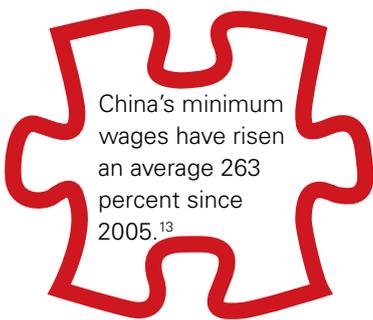
What is the biggest change Foo has seen during his 17 years in Asia? "Labour costs including social insurance benefits" he replies. "The speed of the increases and the additional social requirements are remarkable. Turnover rates are also a problem and finding sufficient labour in China remains a real challenge for the manufacturing sector. In short, we still face a 'War for Talent' in China. That said, the labour force is also more knowledgeable about their rights, which is a positive development across the region since it levels the playing field for those of us who are in compliance."

Training is important to Artesyn as a means to offset wage increases in China by boosting employee productivity. However, Foo also points to the fact that training is helping to nurture the next generation of Artesyn's management. "My successor won't be an American-Chinese guy, but rather home-grown local talent," he says. "In fact, we have recently promoted our first mainland Chinese plant General Manager. It's great to see this new generation of management"

7 CHINA'S FAST CHANGING GLOBAL ROLE

It's no longer enough to simply have a China business. Leading MNCs are instead asking what China means for their global strategy, especially as the country's commercial complexity grows.

Did You Know:



Ross Shuster
President,
North Asia,
UTC Building &
Industrial Systems

Simply having a presence in China is no longer enough. The smartest CEOs are reassessing what their growing China business means for an MNC's global strategy. Egidio Zarrella, Clients & Innovation Partner, KPMG China, is part of that dialogue: "MNCs are asking themselves, why are we in China? Are we here to serve the domestic market, or are we here to use the country's talent pool to serve the global market?" he says.

Most MNCs are in 'China for China'. Surveys of American and European firms show that some sixty percent and seventy-five percent of firms, respectively, are in China to sell to local customers. In our discussions, the overwhelming share of MNCs were primarily selling to the local market, rather than manufacturing for export, confirmation that China's economic rebalancing from an export-oriented to domestic-focused economy is well on track.

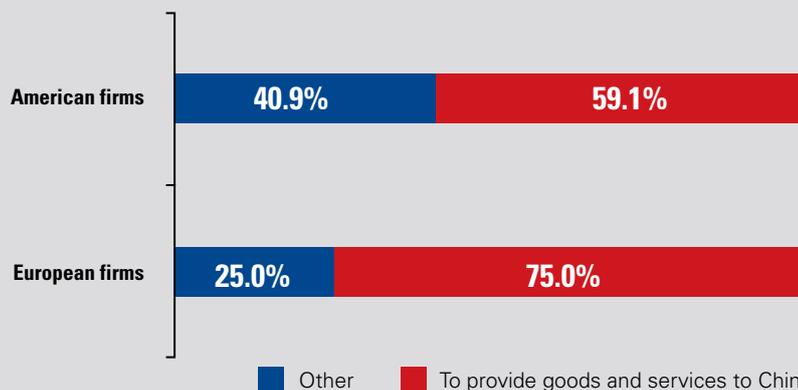
There used to be a large number of local companies each with a small market share across most of our segments. But there has since been consolidation, and we are now starting to see the emergence of one to two private firms in each segment that are potential global players. They are not yet direct competitors. However, I could see them eventually turning into competitors not only in China, but also on a global basis.

13 Source: National Bureau of Statistics of China



What is your company's primary reason to be in China?

Share of respondents



Source: *China Business Report 2013-14, American Chamber of Commerce in Shanghai & Business Confidence Survey 2013, European Chamber of Commerce*

Note: Results are aggregated from two different surveys and American survey is limited to goods and services sourced in China for China.

For those MNCs in 'China for China', full localisation of employees is no longer just a vision: it is the market standard. In our conversations, almost every MNC claimed to have fully localized their China-based workforce: take the example of UTC Building & Industrial Systems, a building technologies MNC with just 100 expatriates out of 23,000 employees; or DHL, an international express MNC with just a single expatriate among 6,500 employees.



Curt Hutchins
President,
Asia Pacific, Eaton

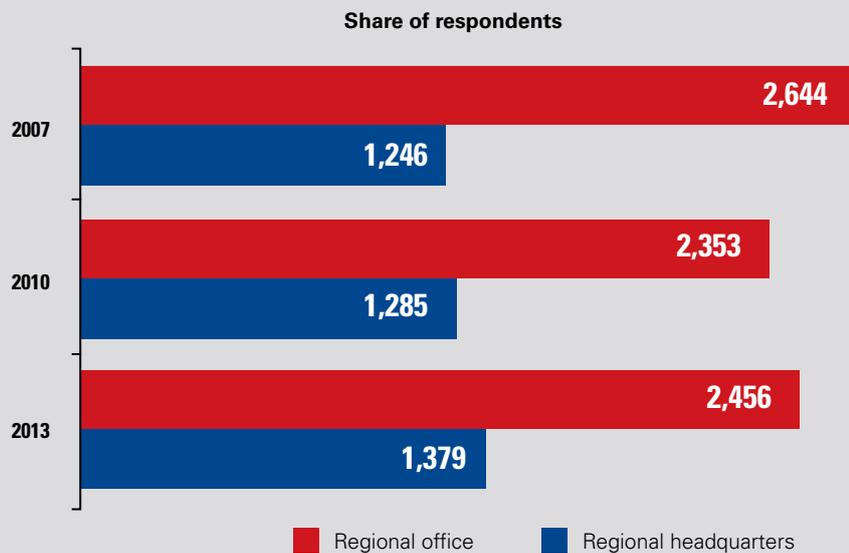
It is absolutely crucial that you are in China for China. But on occasions, China can be all consuming, such as the challenge of recruiting and retaining staff. And, so there is a risk that regional managers based in China might overlook other opportunities, such as in Korea or the oil sector. I see it as a balancing act.

Moreover, for those foreign managers still in the country, most are serving regional or global markets, not local: consider the MNCs moving their global procurement heads to China in recognition of the country’s importance to their global sourcing strategy, or others that have at least one global executive board member based in China to fulfil governance responsibilities given the sheer scale of local operations.

And yet some CEOs we spoke with were also privately worried that regional managers based in Shanghai, may be too easily overwhelmed by China’s large and complex markets and so might overlook opportunities in the rest of Asia. This was not seen as being the case for those regional managers based in the more internationalized Hong Kong, which continues to serve as a regional headquarter for many MNCs. There is resistance to dividing management teams between the two cities, but most CEOs felt the ‘right’ strategy had yet to be settled.

There is also still good reason to be in China for the world. E-Bay’s 2,000 China-based employees is just one example. However, MNCs are also starting to conduct R&D in China. “Today, we have six R&D centers in China employing 1,200 engineers. Some of our very influential R&D groups are now based in China and we see innovation that is benefiting our businesses in developed markets,” says Curt Hutchins, Eaton’s Asia Pacific President.

Foreign companies in Hong Kong with regional offices and headquarters



Source: Hong Kong: The Regional Business Hub, InvestHK

In the end, China’s importance to an MNC’s global strategy is likely to follow similar lines to that of Europe or the United States—further localisation in response to a growing domestic market, even as the China operations provide greater input to the global business, ranging from global shared services to representation at the global executive board level. That said, the fact that China is still a different stage of development will add to the complexity.

For MNCs, this means identifying senior executives who can successfully translate local insights to their global board or colleagues in overseas offices. If not, there will remain constant tension between an MNC’s global strategy and the reality of doing business in China. Indeed, it is this disconnect that remains a critical issue for most MNCs, especially given that rapid change in China’s economy means that market assumptions get old fast.





A balancing act

Curt Hutchins, President, Asia Pacific, Eaton

Curt Hutchins is the Shanghai-based Asia Pacific President of Eaton, a global power management company with 18,000 employees in China and over 100,000 globally.

“The China market is a huge opportunity whether it’s growing at 8 percent or 6 percent,” he says. “But to be successful, it is no longer enough just to be here. You have to segment the market and align your value proposition. The market is incredibly competitive and there will always be low-value competitors nipping at your heels, but that forces businesses to have clear alignment of the total value proposition to target customer’s needs.”

Eaton has reorganized in response to those opportunities: “We have had a focused shift in strategy beginning in 2000 when 80 percent of all our revenues were in the US. We have made major changes in the makeup of our business mix and geographical footprint to be a truly global partner for our customers. Today over 50 percent of our revenues are in International markets with four regional headquarters. We moved our APAC regional headquarters from Hong Kong to Shanghai in 2005 and we continue to invest in our infrastructure and capabilities to serve the local Asia market. It is absolutely critical to us achieving our growth objectives.” Hutchins says.

To what extent is Eaton localizing products? “There are many facets of localisation. It is critical to localize manufacturing in order to shorten lead times and align cost points to the market. But there is also a need to localize research, development and application engineering. Engineers who develop for the mature markets often have a difficult time adjusting their paradigm to aligning products

to emerging markets, whereas local engineers are more in tune to customers and competitors positioning them to better tailor products for the China market,” Hutchins says.

He adds: “For the mainstream local market, value proposition is highly cost sensitive and usually will include reduced requirements with respect to durability or performance. The localisation of product design and manufacturing helps you find a new



relationship between that value proposition and cost. So as a company, we continue to increase the share of local product every year with several products nearly 100 percent localized.”

Hutchins also argues that the local market has unique characteristics. “The first is the speed at which things change. The second is the country’s scale, as that changes the way you think about cost and innovation. If we design a product in the U.S, we might need to engineer it to be sold across multiple platforms to get the necessary scale to make it cost effective. But in China, a product designed for a single platform can achieve the same scale as in the U.S and that scale has proven to be an area for innovation,” Hutchins says.

Eaton has also had some real success stories as a result. “Today, we have six R&D centers in China employing 1,200 engineers. Some of our very influential R&D groups are now based in China and we see innovation that is benefiting our businesses in developed markets.”

Local competitors are meanwhile a challenge. “State owned firms tend to approach their business investments and their cost of capital quite differently than global MNCs that have accountability to shareholders. The market robustness in China over the past decade has resulted in quick decision making and capacity expansion whereas seasoned MNC leaders carefully examine both the upside and downside associated with significant capital expansion investments.” Hutchins says.

“As the economy reaches a new normal growth rate, it is clear that market segments have overbuilt in terms of capacity and we will likely see the pains associated with right sizing that will be a learning opportunity for local leaders and likely have an impact in the longterm decision-making.”

What are some of your bigger challenges?

“The challenges around visibility, clarity, timing and consistency in the interpretation and implementation of regulations are common challenges faced by most MNCs regardless of industry.”



A bright outlook for China's retail sector

Aidan O'Meara, President, Asia Pacific, VF Corporation

Aidan O'Meara is the Hong Kong-based Asia Pacific President of VF Corporation, an American apparel and footwear MNC with 2,000 employees in China and 59,000 globally. VF's portfolio of thirty brands includes The North Face, Timberland, Vans, Lee jeans and Nautica.

O'Meara has seen a fundamental change in China's retail sector over the past two years. "A lot of industry conversations a few years ago were about 'door' growth, or how quickly you could expand into new cities. There was an element of land-grab and it was hard to see how some of the models being promoted were sustainable under any scenario," he says. "But that changed around late 2012 and there's less froth today, which is good for a company like ours as it levels the playing field."

What were the key drivers of the slowdown? "We saw a lot of investment in commercial real estate and a significant increase in available space. There was also an element of high expectation and the retail trade got ahead of itself, so once growth slowed down, inventories started rising rapidly. That subsequently led to a lot of promotional activity, and consumers have become accustomed to getting a good deal, which in turn has put pressure on channels."

"That said, I still think there's a lot of opportunity as you go deeper into China where many cities were insulated from the broader shift in sentiment. My view on these cities in general hasn't changed significantly," he adds

What are the implications for the sector? "Most players are reconsidering their retail distribution strategy as a result of the past two years. And it's not just slower growth that is the challenge. Productivity growth in China is not rising fast enough to offset operating cost

inflation, as costs, such as labour or property, have been pretty much unaffected by the slowdown. The ability of brands such as ours to price higher to fully offset higher cost inflation is limited."

In spite of the challenges, O'Meara remains confident about the company's current China strategy. "We want to sustain our partnership model, as we believe there are advantages to working with the most professional



and best-funded local partners. The thought of us running 2,500 stores with six people per store and 40 percent staff turnover would be a monumental effort. You're often dealing with local decision-makers and so the stores are also best managed locally," he says.

Nevertheless, there will be some tweaks. "We have to be an enabler and help our partners deal with a multichannel market. So a lot of our conversations with local partners are about improving productivity, rather than just pushing distribution. We are also constantly talking about e-commerce and managing our inventories holistically, whereas we currently work more like a wholesale business, and that makes it difficult to move inventories around," he adds.

"In fact, we recently announced a 900,000 square foot distribution centre in Kunshan between Shanghai and Suzhou, which we will use to support all our brands and is one of our biggest investments in facilities globally."

O'Meara meanwhile expects consolidation in the retail industry. "We can look at the outdoor industry, where there are about 800 brands, and the top four account for maybe 40 percent of the business. Many regional manufacturers will struggle to develop into brand owners as you need to scale to really develop strong operating capabilities. Take VF as an example. We have a series of distinct brands, but are sharing our operating capabilities, such as our CRM systems, across our brands, and that helps us significantly in the market," he says.

O'Meara also sees the sophistication of Chinese consumers as steadily rising. "There's a huge thirst for information and knowledge, and we've tried to tap into that through digital and social media," he says. "Our VANS brand is an example. We're doing very little traditional media and are instead focused on events, such as festivals or sponsorships, and amplifying these mainly through our digital platforms. For a brand that was only launched in 2008, we're getting 30,000 unique hits a day on our Tmall store. That buzz is very much regionally driven, but it's amazing how quickly it spreads virally."

In spite of all the changes in the retail sector, O'Meara remains bullish on China's outlook. "It is still the world's biggest opportunity. Sure, it has become more challenging and competitive. But the market is also more level than it was a few years ago, especially for a public company like us, as a result of a more balanced approach to investment across our competitive set."

About Silk Road Associates

Silk Road Associates is a strategy consultancy helping clients grow their commercial footprint across the fast growing Silk Road economies with a specific focus on China, Southeast Asia and the Middle East.

We provide a range of services from business strategy design and market studies to executive briefings and programs. Our directors include experienced consultants, business strategists, economists, and operational specialists. Our clients are present in a variety of industries and include multinationals, mid-sized companies, and financial institutions.

Founded by Ben Simpfendorfer, a leading specialist in the commercial rise of Asia and author of "The Rise Of The New East", we understand the challenges of operating across multiple countries and within an increasingly interconnected region. With offices in Hong Kong, Beijing, and Melbourne, we also provide insightful and independent local knowledge on the region's fast changing markets.

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About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have 155,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture license in Mainland China. KPMG China was also the first among the 'Big Four' in Mainland China to convert from a joint venture to a special general partnership, as of August 1, 2012. Additionally the Hong Kong office can trace its origins back over 60 years. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm's appointment by some of China's most prestigious companies.

Today, KPMG China has around 9,000 professionals working in 16 offices; Beijing, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Hangzhou, Nanjing, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Xiamen, Hong Kong SAR and Macau SAR. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently and rapidly, wherever our client is located.



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KPMG Global China Practice

KPMG's Global China Practice

KPMG's Global China Practice is a community of professionals whose core objective is to provide high quality, consistent services to China inbound and outbound investors around the world. With teams of China experts, cross-border investment advisors and Mandarin speakers in KPMG's network of member firms, the Global China Practice brings China insights and China investment experience to Chinese clients investing overseas, and multinational clients interested in investing or expanding in the China marketplace.

With senior professionals based in China working together with local member firms in roughly 60 key locations around the world, KPMG's Global China Practice has the technical, regulatory and industry experience – and the commitment – to help clients achieve their internationalisation and globalisation strategy.

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