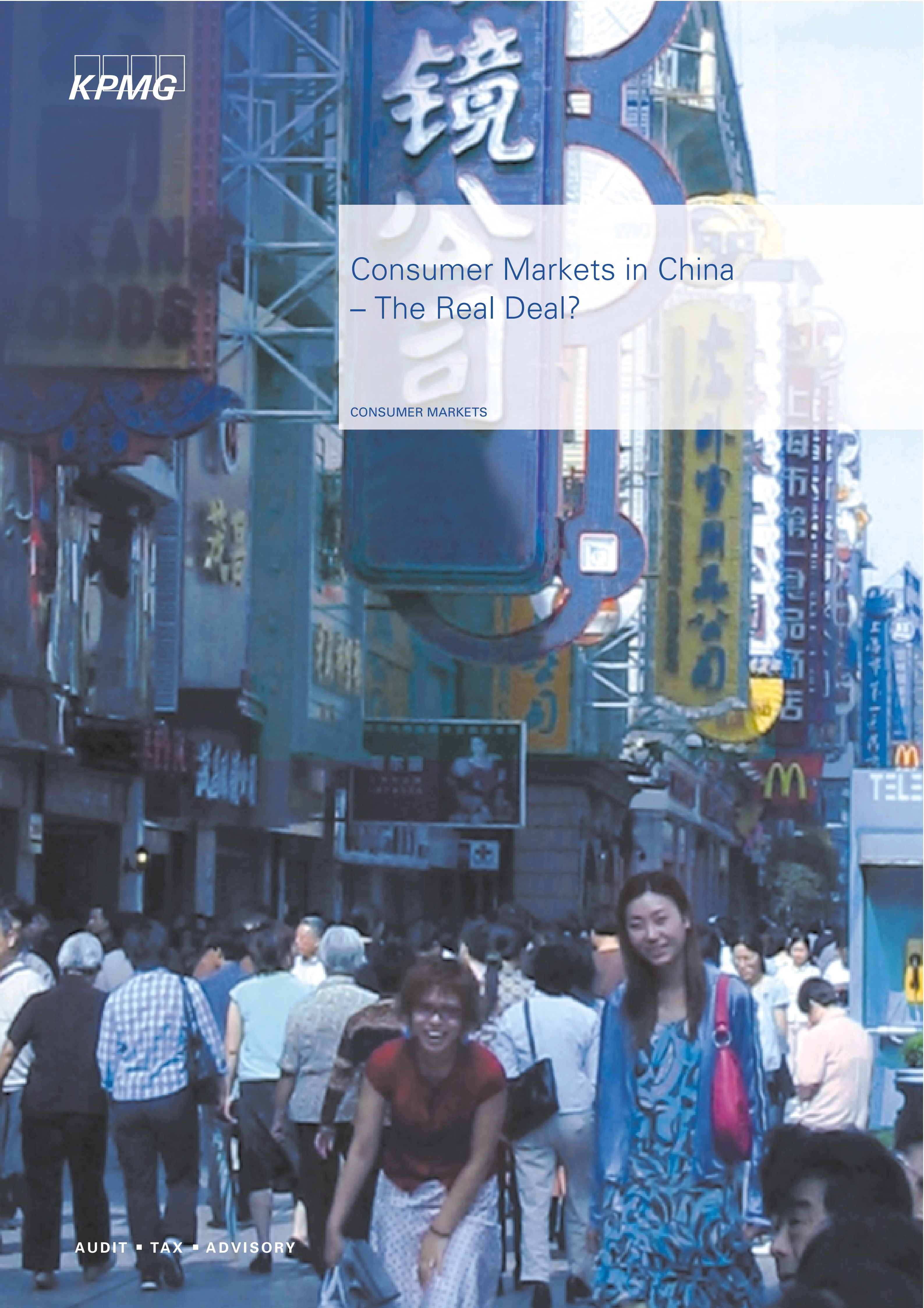

KPMG

Consumer Markets in China – The Real Deal?

CONSUMER MARKETS

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Changing China

Investment in China has been a key global trend since the early 1990s and it is growing in popularity year-on-year. Foreign Direct Investment (FDI) flow into China in 2003 reached US$57 billion. (Source: United Nations Conference on Trade and Development)

- The admission of China to the World Trade Organization (WTO) in 2001 signalled the growing maturity of this market and is expected to further increase the investment opportunities. Of the companies interviewed in the recent survey of consumer businesses commissioned by KPMG's Global Consumer Market (GCM) and carried out by TNS (KPMG GCM survey), 73 percent agreed that FDI in China would increase, post-WTO
- A further 68 percent of interviewed companies believe Chinese exports would increase due to the lifting of restrictions
- In 2003 real GDP growth in China was an impressive 9.1 percent (Source: Economist Intelligence Unit)
- Although no one doubts the opportunities, there are real risks involved. There are signs that the Chinese economy is overheating. The government has recently warned the business community to "stop investing blindly" in "redundant and haphazard" projects.
- Looking beyond the trends and figures, if there is one truism about China it is that it is a unique business environment. It remains a communist country politically, but one with a dynamic economy, a combination no other country has ever achieved.

Investment Options

One of the first investment decisions when looking at China as a potential market is deciding where to invest. There are specifically designated areas, these include Special Economic Zones (SEZs), Economic and technological development zones (ETDZs), and New and High-Technology Development Zones (NHTDZs). In addition there open coastal cities, coastal zones, open inland cities and so on.

It is essential to get the correct advice in order to distinguish between the different incentives on offer for each area. Another key decision is selecting the appropriate business structure, Start-ups, joint ventures and equity partnerships all have their pros and cons. It is vital to take independent advice and listen to, and learn from the acquired knowledge of experienced companies.

Routes to Market

One of the greatest challenges facing potential investors is deciding how to approach the market. Certain companies elected for a national, full-on approach as it is effective in other markets. In China, however, the best method tends to be organic – growth is gradual and builds upon local experience and knowledge.

Macroeconomic Trends

In a such a complex market getting a handle on the macroeconomic trends of its economy and its various sectors is essential. Fortunately, this information is available. The difficulty is judging its quality as Chinese data varies significantly. It is vital to use independent information to get the best picture.

Key facts on China 2003

- Population **1281.0m**
- Population growth **0.72%**
- GDP per capita **US$1,090 (2003)**
- GDP growth **9.1% (2003)**
- Trade balance **US$44.7bn**

(Source: EIU, CIA Workbook)

GDP – composition by sector

- Agriculture **15.4%**
- Industry and construction **51.1%**
- Services **33.5%** (2002)

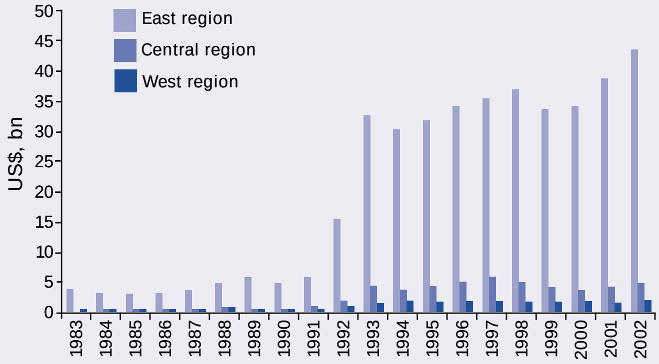
(Source: EIU, Viewswire)

- Inflation (12 month average) **1.2%** (2002)
- Exports of goods and services as % of GDP **26.9%**
- Top 3 export markets **US, Hong Kong, Japan**

(Source: fDi magazine January 5, 2004)

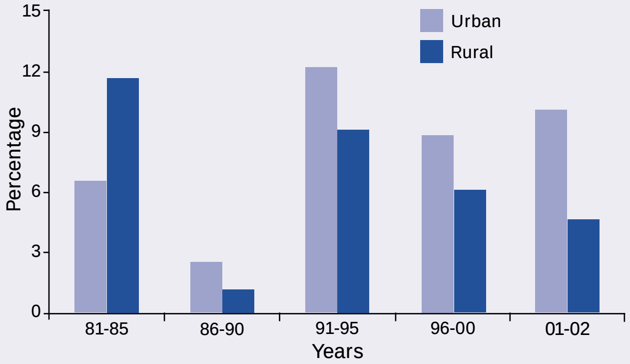
China produces 50% of the world's cameras, 30% of air conditioners and TVs, and 25% of washing machines.
(Source: ADB Annual Report 2004 and Nick Debnam, KPMG in Hong Kong)

FDI inflows into China by regions, 1983-2002 (1995 US$, bn)



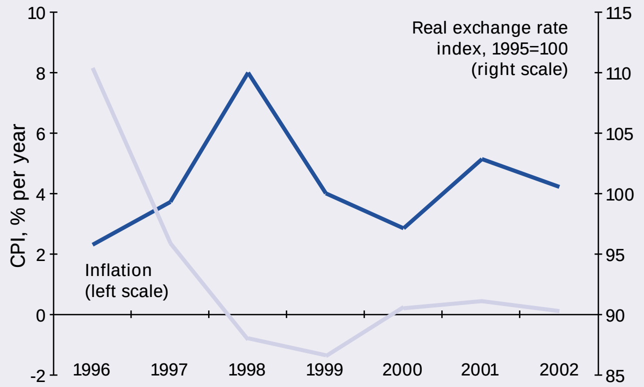
Source: *China Statistical Yearbook*, various years

Annual average per capita income growth, 1981-2002 (%)



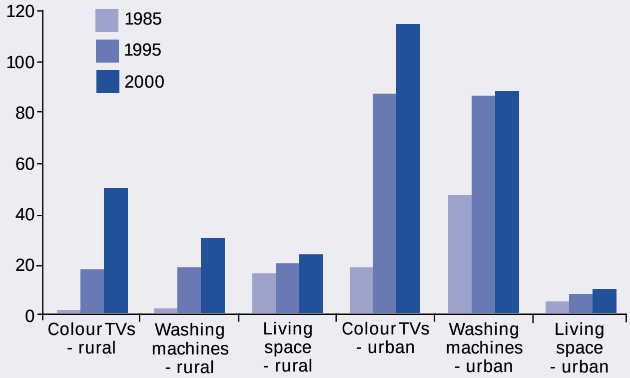
Source: *Household survey data, National Bureau of Statistics*, various years

China Inflation Rate, 1996-2002



Source: *World bank*

Living conditions, 1985-2000



Note: Consumer durable per 100 households and net living space per capita index
Source: *China Statistical Yearbook*, 2001

The Chinese consumer examined

Chinese consumers have had more false assumptions made about them than almost anywhere else in the world. One common illusion is that all Chinese people are frantic to acquire Western brand goods. The next widely-held assumption is the notion that there is no one Chinese market; rather there are many Chinese markets.

While both of these assumptions merit value, both require qualification. In the first example, it was true that Chinese consumers were once avid for Western goods. Now, however, they are demonstrating increasing resistance to paying, what in Chinese terms, are premium prices for products that they can buy locally.

In the second instance the assumption is true, but is still not fully understood. There are a variety of different consumer profiles in China – the difference between urban and rural consumers, for example, is huge. Investors into China should therefore make themselves aware of the size of the "available" market for their products, rather than the national one. A large American mobile phone company began in China in 1987 and is now the biggest foreign company there. However, growth is now levelling off with market penetration of only 20 percent – suggesting that 80 percent cannot afford mobile phones.

According to Tom Stanley, Director, KPMG Transaction Services in Hong Kong, "brewing is a good example of the challenges facing consumer markets (CM) investors in China. On the face of it, China should be a very tempting target for Western brewers as beer is a popular drink throughout the country. In fact, however, there are hundreds of local and regional breweries in China. In practice it has proved extremely difficult to establish a national brand profile."

"People from Hong Kong come here thinking it's all China – one market so they know it. But they really don't."

President, Alcoholic Beverages (In China)

Entering the market

China has insisted on the joint venture/partnership structure for much of the time that Western investment has been permitted. The costs of managing the conflicting goals of the local joint venture (JV) partner have frequently exceeded the benefits of getting the local expertise. Whirlpool, for example, invested almost US$150 million in various projects in the early 1990s. Most of these ventures have been shut down.

In recent years, however, government insistence on JVs and partnerships has changed. CM companies are able to set up on their own. This avoids the pitfalls of relying on a partner who may not be all they claim to be. Securing the services of advisers who can give accurate profiles of possible JV partners in these instances is essential.

Other structures for entering the Chinese marketplace might include:

- Wholly foreign-owned enterprise (WFOE). This requires no Chinese partners and has become less restrictive post-WTO. WFOEs are popular with investors.
- Representative office

Expanding your business

"In China, always get second opinions. Do not depend on a single source of information for anything"
Executive Director, Retail (In China)

42 percent of the companies quoted in the KPMG GCM survey state that they are open to mergers and acquisitions (M&As) in China. These are the tried-and-true expansion methods in the West. They apply in China also, but require caution. Due diligence and validation standards in China are improving – but from a very low base. It is not unknown in China for local descriptions of plant, resources, operating companies and even ownership details to be very inaccurate.

The situation is improving, but any expansion strategy in China must include provision for thorough, reliable, due diligence. Failure of the due diligence process is a "key concern" in M&As in China, according to 55 percent of the companies on the KPMG GCM survey.

Making money

"Many companies make the mistake of bringing in second-rate products thinking China is only a developing country and consumers won't mind"
President, Automotive (In China)

When the Chinese market first opened up, companies and investors lined up to be the first to exploit the new opportunity. Years later, and in many cases the "gold" has yet to appear. This was mainly due to false expectations, based on a failure to appreciate that China is a unique place – and it is unique for more than the fact that it has a huge population. Some saw the Chinese as a passive market willing to take anything offered.

Distribution and logistics

One key issue that is often forgotten in initial investment enthusiasm is the distribution and logistics challenges posed in China. China is nearly always regarded in terms of the size of its population. Less understood is the fact that geographically China is the third largest country in the world and it encompasses practically every kind of geographical area and climate range. Such a combination of size and climate would challenge any logistics system. In China it was compounded by the system itself.

Until the 1990s the majority of Chinese firms relied on their own staff for logistics. They used their own trucking fleets and warehouses. There were no highways and rail conditions were poor. As many products were locally sourced, the basic nature of the logistics industry was not regarded as a major problem. Matters are improving and massive road construction schemes are underway. Logistics in China are, however, still a key challenge to any nationally-focused commercial strategy.

"Unless you have something super-unique like IKEA, the same offering won't work everywhere in China"
GM, Alcoholic Beverages (In China)

Pricing

Getting the price right is essential. A large Scandinavian furniture retailer, that enjoys success in China, priced a table at 299 renimbi. It sold 300 a month. When the product was repriced at 69 renimbi it flew out of the stores at 10,000 a month. The company stated that under the new pricing, "we found volumes we have had no experience of before as a company." Pricing accurately matters in China – getting it right depends on a thorough knowledge of the market.

Coping with counterfeiting and piracy

One of the most serious business issues in China is intellectual property rights (IPR). Protecting brands, patents and copyrights has been a huge issue impacting on foreign investment in China. The belief that IPR infringement poses a "significant threat" to business in China is cited by 82 percent of respondents in the KPMG GCM survey.

"Every year 25 percent of our business is eaten away by counterfeits"
President, FMCG (In China)

The piracy rate in China, according to one copyright industry association, remains one of the highest in the world (over 90 percent). On average, 20 percent of all consumer products in the Chinese market are counterfeit (Source: US Embassy Beijing). If a product (foreign or local) sells well, it is likely to be illegally duplicated.

Much of this problem originally stemmed from a different cultural view on individual achievement rather than from inherent illegality. In China it was customary for any new ideas, or technologies to be used for the common good, so there was no concept of intellectual theft. This view is changing however and the authorities are now taking the problem seriously.

China now has a patent and copyright law, but enforcement is still an issue. Simply understanding which IP agency has jurisdiction over an act of infringement is complex. Jurisdiction is diffused throughout many government agencies and offices, with each typically responsible for the protection afforded by one statute or one specific area of IP-related law. There may be geographical limits or conflicts posed by one administrative agency taking a case involving piracy or counterfeiting that also occurs in another region.

There is no simple answer to IP infringement. According to the KPMG GCM survey the best way to combat this problem is by being proactive rather than reactive, for example, audit suppliers and product design innovations.

The most prominent mistakes made when investing in China

1 Failure to appreciate the differences in the Chinese market. The greatest growth in Chinese consumer markets is in the cities that range from 500,000 to three million. Companies that focus solely on the largest, high profile coastal sites may miss out.

2 Failure to appreciate the ferocity of domestic competition. Before 1949 the Chinese were known for entrepreneurship. Since 1978 these trading talents have been reviving and local companies will go head-to-head with foreign concerns. Education is no longer a strait-jacket on domestic Chinese enterprise. Bill Gates has commented, "The talent of Chinese software engineers is unbelievable, I can't believe how effective they are." (BBC)

3 Failure to get independent assessment of business risks. Investment information can be difficult to get and may not be reliable. It is therefore vital to obtain independent advice from professionals experienced in China before making important strategic decisions.

> "Down the retail chain it's all about relationship. Small retailers function based on relationship"
> **GM, FMCG (In China)**

4 Failure to appreciate and understand cultural differences. In China many common Western cultural and economic paradigms do not apply. The area which creates the greatest cultural confusion for Westerners is "Guanxi" (pronounced gwan see). This refers to doing business through value-laden relationships. One implication of Guanxi is that business negotiations can take longer and be more complex than they may at first appear. For example, in China a contract might be signed to humor the Western guest and extend the relationship. Further concessions and negotiations may be expected afterwards. Contracts are certainly not worthless in China, but their significance is not as great as they are in the West.

Regulatory and compliance

The regulatory environment in China has improved and accession to the WTO has been a particular boost. Surprising gaps still exist however. For example, there is no comprehensive bankruptcy law to protect businesses, although one is in draft. It can also be very difficult resolving contract disputes through the courts.

Taxation

Tax regulation, particularly concerning foreign workers, is improving. Enforcement is also becoming far more rigorous as KPMG in Hong Kong's Peter Kung points out, "this country has a vast population, so it is able to employ a million tax officers." Anyone planning to export from China should be aware that the exports might be subject to VAT in China because most exports are not zero-rated.
The Chinese tax system is extremely complicated, full of reliefs and pitfalls. There is plenty of opportunity for efficient tax planning, but once again quality, independent advice and local knowledge is essential.

Sourcing in China – A changing picture

Sourcing has become one of the country's big growth areas. Concentrated on the coast the products sourced tend towards the traditional low-value items such as clothing and toys.

There are signs that higher-value goods are also now starting to make an impact. 73 percent of those questioned in KPMG GCM survey now source finished goods, as opposed to parts from China. The trademark "Made in Hong Kong", subsequently "Made in China", no longer denotes inferior quality. On a recent visit to China, Giorgio Armani was so impressed by the quality of a US$21 fake Armani watch he bought in Shanghai, he decided to start producing in the country. (Source: *South China Morning Post*)

This improvement is largely due to two factors. Firstly, the long established nature of many Chinese manufacturers means that they are well attuned to Western business expectations regarding ethics and quality control. Secondly, many of the factories are equipped by and belong to foreign concerns and use the latest plant and equipment.

These improvements explain the KPMG GCM survey finding which showed that about 45 percent of the companies questioned claim to source over half of their requirements from China.

Possible pitfalls
While sourcing from China is well established there are still pitfalls. Legal enforcement of agreements can be an issue, as can corruption and logistics.

The Current Scene

Political
The news coming from China is, as ever, mixed. The government is determined to concentrate on domestic commercial development. Virtually every major international crisis has seen China comment, but not commit itself – a practically unique stance for a permanent member of the UN Security Council and one of the world's great powers.

Not even the continuing dispute over the status of Taiwan has been allowed to rock the boat.

Stability both in domestic and internal relations has been the hallmark of current government policy in China and seems likely to remain so for the immediate future. The selection of the Prime Minister, a technocrat with a reputation for pragmatism and caution has sent a very positive signal.

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Company performance
This year has seen consumer companies continue to flourish in China. The KPMG GCM survey found that across the board companies are optimistic about their future business prospects.

Problems of course remain, but it is noticeable that many businesses are adopting a more Chinese-focused approach to their operations. There are fewer ex-pats and the concept that Chinese workers needed foreign managers has gone.

Regulation and IPR enforcement are all improving areas, nevertheless China, at least for the foreseeable future, will remain a challenging market.

Summary
Whatever else has been exaggerated or misunderstood about foreign businesses investing in China, the opportunities for consumer businesses are there, and are continually increasing.

However it is essential to see beyond the hyperbole to develop the correct investment strategy. Statements such as, “If your business isn't making money in China, it probably wouldn't make money anywhere else” (attributed to the President of a large Japanese car manufacturer) sound exciting and dramatic, but create an impression of a never-ending boom.

However gold rushes have a tendency to turn into gold busts and, to get maximum value out of China's Consumer Markets, foreign companies must:

1 Invest in in-depth research

2 Evolve effective business strategies to cope, as far as possible, with the unexpected

3 Use independent advisers on the ground who live in, and know China.

Contact us

Nick Debnam
Asia Pacific Chairman,
Consumer Markets
Telephone : +852 2978 8283
nick.debnam@kpmg.com.hk

Peter Kung
Head of Tax,
Consumer Markets, China
Telephone : +852 2826 8080
peter.kung@kpmg.com.hk

Stephen Mercer
Partner,
Consumer Markets, Shanghai
Telephone : +86 (21) 6288 1899
stephen.mercer@kpmg.com.cn

David Ko
Partner,
Consumer Markets, Beijing
Telephone : +86 (10) 8518 9234
david.ko@kpmg.com.cn

Tom Stanley
Director,
Strategic and Commercial Intelligence, China
Telephone : +86 (21) 6288 3051
thomas.stanley@kpmg.com.cn

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