2010 DOING BUSINESS IN CHINA:A SURVEY OF EUROPEAN COMPANIES

Juan A. Fernandez Per V. Jenster Nicolas Musy

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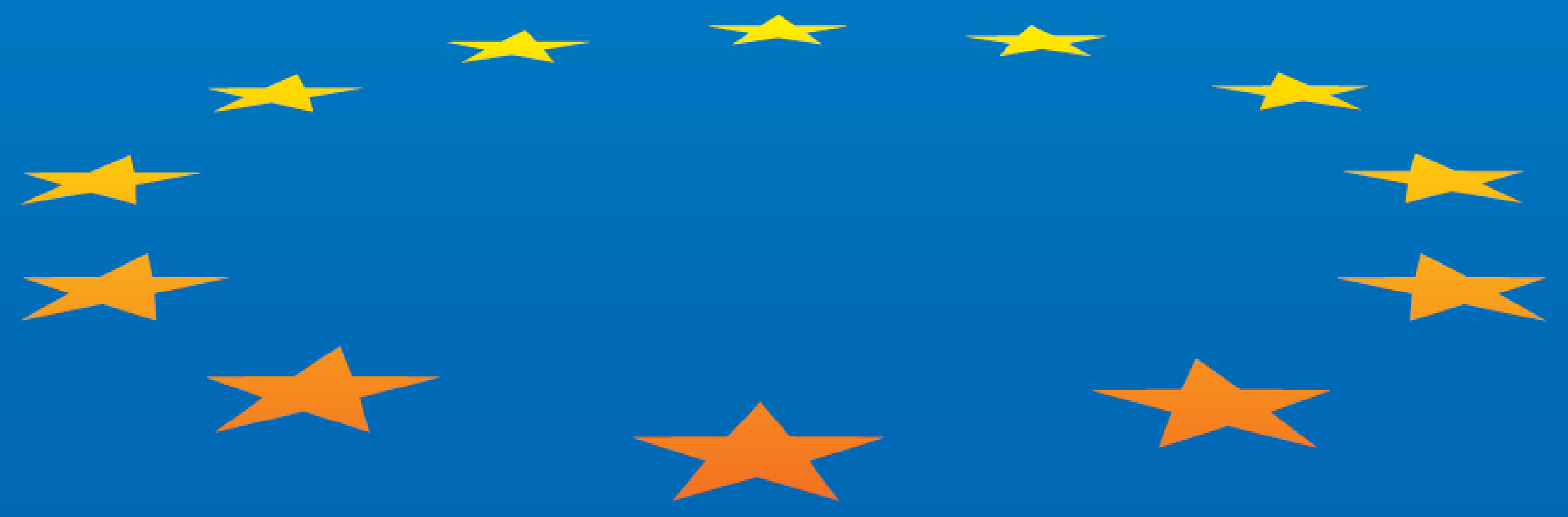

CEIBS
CHINA EUROPE INTERNATIONAL BUSINESS SCHOOL
The Spanish Center of Entrepreneurship

CH-ina

Prof. Fernandez earned his Ph.D. from IESE (Spain) in 1997. He is currently teaching at the China Europe International Business School (www.CEIBS.edu), located in Shanghai, China. He is frequently invited to give presentations on how to manage business enterprises in China to leading multinationals and has recently given presentations in China, South Korea, Vietnam, Japan, Spain, Italy, France and the UK. His work has been published in Harvard Business Review (Spain), Business Week-China, Organizational Dynamics, Business Strategy Review, and the Asian Case Research Journal. He has written four books. The first one, CHINA CEO published by John Wiley & Sons (2006), is based on interviews to 20 CEOs of multinationals in China. His second book, China' s State Owned Enterprise Reforms: an Industrial and CEO Approach, was published by Routledge (2007). The third book CHINA CEO: A Case Guide was published by John Wiley (2007). His fourth book CHINA ENTREPRENEUR was published in Jan. 2009 by John Wiley. This last book is based on interviews to 40 entrepreneurs from 25 different countries.

Dr. Jenster is Professor at China Europe International Business School specialized in Strategic Management and Entrepreneurship. Prof. Jentster also has an appointment at Copenhagen Business School, and was formerly with IMD, Switzerland. Prior to joining IMD, he is a consultant and board member to a number of international firms. He has published more than 135 books, articles and case studies on management issues. Recent publications include Strategy in Practice, Børsen 2003. The same publisher launched Strategy in Knowledge Intensive Firms (transl.) in late 2004. His book with David Hussey, Insourcing/Outsourcing: Marketing and Selling Solutions has been published in early 2005. Managing Market Intelligence, Jenster, et al. CBS Press, 2009. The Dragon on Fire: Experiences from Chinese Entrepreneurs w/ Juan A. Fernandez (Eds.), CEIBS Press (2009). A new case study coauthored with Juan A. Fernandez, Chinese Entrepreneurs: The Lesson from New Wave, supported by CEIBS and Spanish Center Entrepreneurship has been launched in early 2010. The Business of Wine: A Global Perspective w/ David Smith et al, CBS Press, June 2008. Strategy Execution: Passion and Profit, Jenster, et al. CBS Press, 2007. Study on the Future Opportunities and Challenges in EU-China Trade and Investment Relations 2006-2010, EU Commission 2006, he was the team leader for Report to the EU Commission and chosen as Highly Commended Award Winner at the Emerald Literati Research Network Awards for Excellence 2009.

Nicolas Musy has a MSc. Physics Engineering from Swiss Federal Institute of Technology (www.epfl.ch), Lausanne. He was First alumni award winner for demonstrating exceptional entrepreneurial spirit. Exclusively involved in trade, investment, strategy and project management in China since 1986, he has been residing in the Shanghai area since 1988. He has developed and successfully implemented strategies for over 50 Western companies and institutions and is the Project Manager and co-owner of the first Swiss industrial SME in China. In charge of Swiss-Chinese relations for the Swiss Federal Institute of Technology, Lausanne, he has developed the Swiss Center Shanghai concept and implemented it. He is also a Member of the Swiss Center Shanghai Board, and Vice-President of the Swiss Chinese Chamber of Commerce in China.

2010 Doing Business in China: A Survey of European Companies

Juan Antonio Fernandez Per V. Jenster Nicolas Musy

China Europe International Business School
The Spanish Center of Entrepreneurship

Introduction and Acknowledgments

We are honored to have the privilege to write the introduction to this 2010 report based on a survey of European companies in China. The idea for this survey was initiated by Nicolas Musy, president of CH-ina, a consulting firm operating in China since 1996. We wanted to thank all who have helped on this paper, including the very important contribution of Alain Kaiser, marketing specialist who worked on the design and preparation of the final publication under both Musy and my supervision, and that of Jon Goldberg, who helped us with the final stage of the publication. We are also grateful to Xue Meng, Research Assistant in CEIBS, and Sofia Galante, Wei Li Huang and Mandy Zhang, MBA students in CEIBS, as well as Christine Zhao, for their contribution towards editing and finalization of graphs in this paper.

We are glad to be able to finally present the results of our first survey to the general public. Our intention is that this report based on the surveys may become a yearly publication and a regular source of information for European companies operating in China or planning to do business with this country.

This report is organized into five sections as follows:

1. Research Methodology
2. Demographics and Companies Information
3. Business Activities
4. Business Climate
5. Success Factors Analysis

We received a total of 136 responses, mostly from GMs of European subsidiaries in China. The sample is divided into two major groups, service and manufacturing companies, with a subdivision between B2B (Business to Business) and B2C (Business to Consumers).

In section two, we cover the main areas of activity of the organizations represented within the sample: production, sourcing, distributions and logistics, sales, marketing, research and development and intellectual property.

The last section of the report identifies the three main concerns European companies have, namely: finding and hiring talent; the global economic slowdown; and unclear, changing, and/or inconsistent laws and regulations. At the end of this section, the report concludes with an analysis of key success factors of doing business in China.

This report also incorporates excellent contribution from a number of experts who we would like to also thank for sharing their analysis of 2009 and predictions for 2010. These experts are (in alphabetic order):

- Bin Xu, Professor of Economics and Finance, Chair of the Department of Economics and Decision Sciences, China Europe International Business School (CEIBS)
- Ceballos Baron, Miguel, EU Counselor, Trade and Investment, Beijing Office
- Dan Zhu, Managing Director, Shanghai Rainbow Consulting Co. Ltd.
- Fernandez, Juan Antonio, Professor of Management, China Europe International Business School (CEIBS)
- Musy, Nicolas, General Manager, CH-ina
- Slusiewicz, Gene, Supplier Quality & Global Sourcing Manager, The PAC Group,

China operation

- Sunyer, Luis, consultant and lawyer, Guangsheng & Partners

We would also like to thank the various European Chambers of Commerce for connecting us with their members and CEIBS for supporting this research

Finally, our gratitude goes to the institutions that provided their support to this survey and to the executives that took the time to fill in the questionnaires. This publication would have not being possible without them.

Thank you to all.

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Contents

Opinion Article

SOME REFLECTIONS ON CHINA'S DEVELOPMENT

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Gordon G. Chang, in a book written in 2002, predicted the imminent implosion of China's economy and political system. History has proved him wrong. Eight years later, China is still continuing on its unstoppable march from the third world to the first world. In his book, Chang has pointed out that that the only thing that can save China from collapsing was political reform. That prediction was also wrong. China has not changed its political regime, proving that it is possible for this country to have economic development without deep political reform. The book by Gordon Chang shows how difficult it is to make long term predictions about China, even if by the best prepared minds. One thing we can be sure, however, is that China has had amazing success in the last 25 years and most probably will continue this way. It is true that China faces many challenges (environmental pollution, poor-rich divide, etc), but many of these problems are the result of the success of its economic policies, instead of their failure.

The results obtained by the Chinese economy in 2009 are envious to most. While many countries' economies contracted, China's economy expanded; and while trade in general declined, China gained market share. China has several factors in its favor and the Chinese government uses them wisely. Most advantageous may be its vast size. China is not only a continental country - Canada and Australia are also continental countries - but it is also a continental economy. Few countries combine both conditions, India, the United States and somehow the EU, not as a country but as an economic union.

As a continental economy, China possesses important advantages (de Burgh, 2006): an immense domestic market in which local companies can grow rich with experience before launching themselves into the world, a growing middle class which will demand better and

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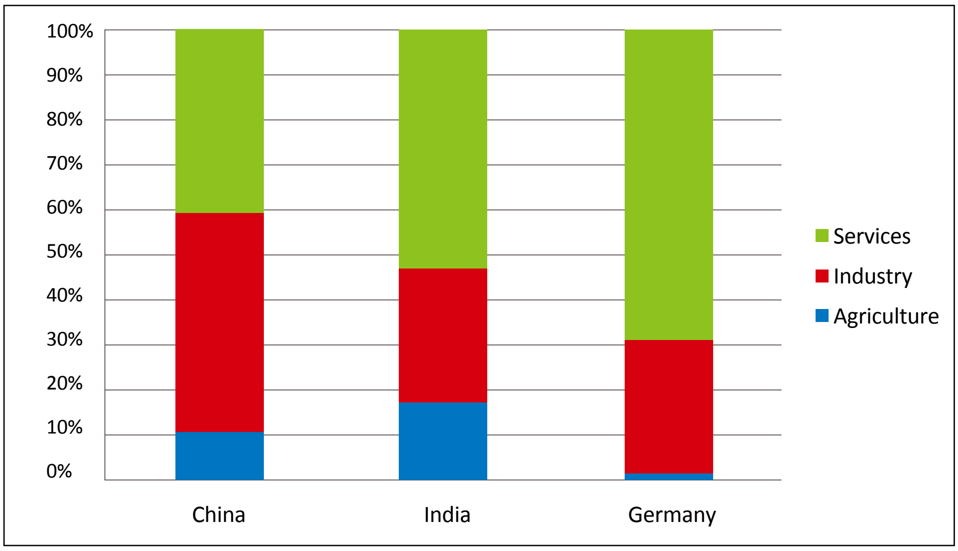
more sophisticated goods and, lastly, an almost unlimited supply of cheap labor still for many years to come while their education level is also increasing.

With these advantages China can compete and specialize in great variety of businesses. As Shenkar (2005) indicates, “the coexistence of cheap labor with increasingly abundant skilled personnel defies common assumptions on national competitiveness as a case of “either or” and underlies China’s strategy of sustaining its dominance in labor-intensive industries even as it enters technology-intensive realms.” This advantage in manufacturing can be appreciated when we compare India and China’s breakdown of GDP, as we can see the enormous weight of industry in the case of China compared to the case of India, where services represent the biggest portion of GDP. It is also interesting to observe how these two countries compare to Germany, the biggest economy in the EU. As China is the biggest source of manufactured goods in the world and also subcomponents that many countries need to stay competitive, the world economy certainly needs China.



Source: The Economist, Pocket World in Figures 2010

GEOPOLITICS 101

The Merriam-Webster Dictionary defines geopolitics as the study of the influence of factors such as geography, economics, and demography on the politics and especially the foreign policy of a state. In this sense China is redefining the world economic scenario. Khana (2008), in his excellent book The Second World, identifies three world super powers: USA, EU and China. He says that the EU is easily the most popular and successful empire in history, for it does not dominate, it disciplines. Europe offers deep reform and economic association with its union. The United States offers military and regime protection and aid, while China offers full-service and conditionally-free relationships. He then uses a well-known line from The Prince where Machiavelli asks if a leader should be loved or feared. Machiavelli says that although love is a more attractive means, at the end the bonds of gratitude are abandoned when self-interest calls; thus the "dread of punishment" makes fear a stronger instrument of control than love. Taking the long view, America is decreasingly loved and increasingly feared, Europe is increasingly loved and decreasingly feared, and China is increasingly both loved and feared, concludes Khana.

China's strategy is to build economic bonds with any country. Regardless of who is in power, China will do business with them. An example of this can be seen in Africa, where China is gaining terrain to other economic powers. Michel and Beuret (2009) explain how the Chinese, "…are willing to make long-term investment in infrastructure projects and industry where Western investors would want quick returns." They quote Ousmane Silla, Guinea Minister of Mines, who when asked about the Chinese said, "… they are the only ones who offer us 'package' deals or turnkey contracts: a mine, a hydroelectric dam, and a refinery – all financed by the China Exim Bank, which is paid in alumina. The operation doesn't cost us anything but generates tax revenues, jobs, infrastructure, and energy. When we ask Alcoa for the same thing, they say that their business is aluminum, not hydroelectric dams."

The Chinese are providing an example of economic development to the world and how to use soft power to gain influence. Whether we agree or not with their political system, we have to recognize the intelligence of their leaders. China is posing new challenges to all economies, whether developing or developed.

So how can we respond to that? De Burgh (2006) says that flexible economies do not necessarily need to fear change, but "countries in direct competition with China, lacking that flexibility, will suffer". The development of China is generating problems but also opportunities. In this scenario, some countries will win while others will lose. Hopefully, Europe will stay on the winning side. An example to follow is given by the European companies that believe in China and do business here. This survey's main purpose is to share some of their experiences to you.

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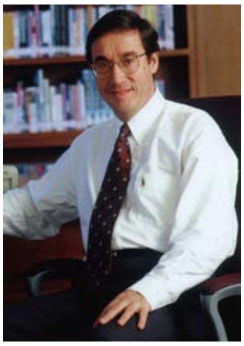


Prof. Fernandez earned his Ph.D. from IESE (Spain) in 1997. He is currently teaching at the China Europe International Business School (www.CEIBS.edu), located in Shanghai, China. He is frequently invited to give presentations on how to manage business enterprises in China to leading multinationals and has recently given presentations in China, South Korea, Vietnam, Japan, Spain, Italy, France and the UK. His work has been published in Harvard Business Review (Spain), Business Week-China, Organizational Dynamics, Business Strategy Review, and the Asian Case Research Journal. He has written four books. The first one, CHINA CEO published by John Wiley & Sons (2006), is based on interviews to 20 CEOs of multinationals in China. His second book, China's State Owned Enterprise Reforms: an Industrial and CEO Approach, was published by Routledge (2007). The third book CHINA CEO: A Case Guide was published by John Wiley (2007). His fourth book CHINA ENTREPRENEUR was published in Jan. 2009 by John Wiley. This last book is based on interviews to 40 entrepreneurs from 25 different countries.

CHAPTER I

I Research Methodology

This report is the first of a series that will take place every year. It is based on an online anonymous questionnaire answered by the General Managers of branch / subsidiary / sister companies of European Companies established in China. The responses were received during the seven week period from 1st September to 16th October 2009. The survey was designed by Alain Kaiser & Nicolas Musy from CH-ina and Prof. Juan Fernandez from the CEIBS. The invitation to participate in the survey was done by e-mail through the different chambers of commerce or commercial offices listed in the acknowledgment. The SwissCham also contacted personally, by phone, their members to get more participants, which was a rewarding process and this boosted its number of participants.

This report has the following intention:

1. Identify the key success factors and concerns for doing business in China
2. Identify the strategies used by European Companies in China (that may lead to success in China)
3. Identification of trends, crisis influence and environmental factors
4. Present recommendations for EU managers and academics

The survey was conducted so that only questions relevant to each participant's activities were shown to the responder. In this way no time was lost and no flawed answer was given - each question was only answered by the right people to ensure that the value of the answers were the highest possible.

In some instances there were not enough responses to make an adequate analysis. In these situations the data were not analyzed separately.

This report is different from other reports in four main aspects:

1) The participants are European companies and 85% of the persons who answered the questionnaire are CEO's/General Manager.
2) The answers are analyzed from three different angles:
a. between Manufacturing and Service companies, themselves separated in B2B and B2C when possible or when there is a notable difference in answers
b. between Small and Medium sized Enterprises (SMEs) and Bigger Enterprises (BEs)
3) Successful companies and Less successful companies as determined by whether they are meeting 90% of their planned strategic objectives.
4) The survey looks at how these companies are organized along with how they operate, and if what they are doing provides them with the desired results.
5) The survey looks at success factors of running a business in China.

Because 78% of the respondents have been working in China for more than 2 years and 42% longer than 5 years, coupled with the fact that 85% of them are CEO's, the results of this survey are highly consistent and of very high quality.

The aim of this report is to first understand how European companies are operating in China, then to find what the most common difficulties are, and finally to find what factors plays the most critical part for successful business in China.

1 Definitions and Abbreviations

B2B	Business to Business: Equipments / Components / Consumables sold to other businesses
B2C	Business to Consumer: Consumer Goods and Pharmaceuticals whose end-users are individual buyers
BE	Bigger Enterprises: companies that have more than 500 employees worldwide.
SME	Small and Medium Enterprises: companies with less than 500 employees worldwide
Less successful companies	Companies meeting less than 90% of their planned strategic objectives
Successful companies	Companies that are meeting 90% or more of their planned strategic objectives.
N (on charts)	This represents the number of respondents to that question on the Survey. Some respondents did not answer some questions and, further, not all respondents were asked all questions.

CHAPTER II

II Demographics and Companies Information

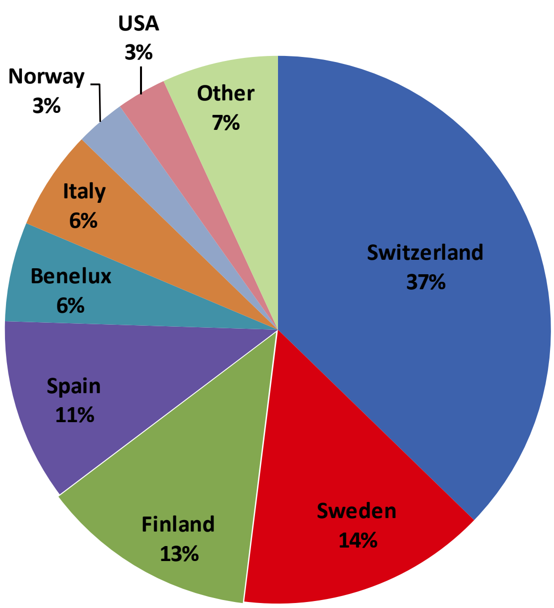
This section defines the sample of companies that responded to the survey.

This section is divided into the following sub-sections

1 Overview

As seen in the chart below, a little more than one third of the companies are from Switzerland and a little less than a third are from Scandinavia (Sweden, Finland and Norway). The high percentage of Swiss companies is most likely due to the active participation by the Swiss Chamber of Commerce which called all its member companies to participate in the survey. Even if the survey was targeted to European countries, a few companies from other countries participated due to word of mouth interest in the survey. All in all, the majority of the 136 participants come from European countries.

Chart II.1.1 - In what country is the global headquarter of the company? N=136

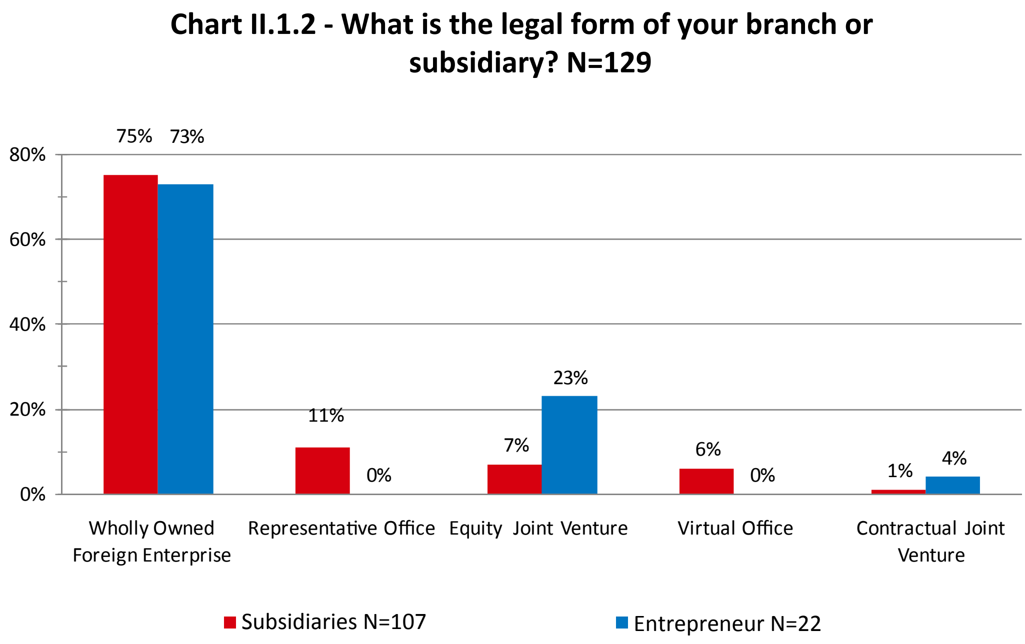


The division by job function for the people having answered the survey is: CEO / General Manager for 85% of respondents, R&D Center manager for 4%, and other functions for the last 11% (including Asia Managers, regional VP's, VP's and Department heads). Of all the respondents, 78% have been working in China for more than 2 years and 42% longer than 5 years. For their experience in Europe, 83% have been working more than 5 years and 57% more than 10 years. It can be seen from these percentages that it is mostly persons with good experience of both China and Europe that answered the survey.

The types of companies they are managing breakdown into subsidiaries / branch / sister companies of European Companies for 83% of respondents and entrepreneur[1] companies for 17%. The legal form in China of most of the companies is "Wholly Owned Foreign Enterprise" (WOFE), as shown in the chart below. From here on, we will consider entrepreneur companies as Subsidiaries in the terminology, unless otherwise noted.

[1] Entrepreneur companies are companies started in China by European people alone as a WOFE or as a JV.

What is the legal form of your branch /subsidiary?



The number of employees in the China branch of the companies surveyed is still quite limited. For the respondents, 24% have less than 10 employees, 54% have less than 50 employees, and 81% have less than 251 employees. Worldwide however, only 42% have 500 or fewer employees. In some comparison charts, when we will look at Small and Medium Enterprises (SME) compared to Bigger Enterprises (BE), we are defining SMEs as having fewer than 500 employees and BEs as having more than 500 employees.

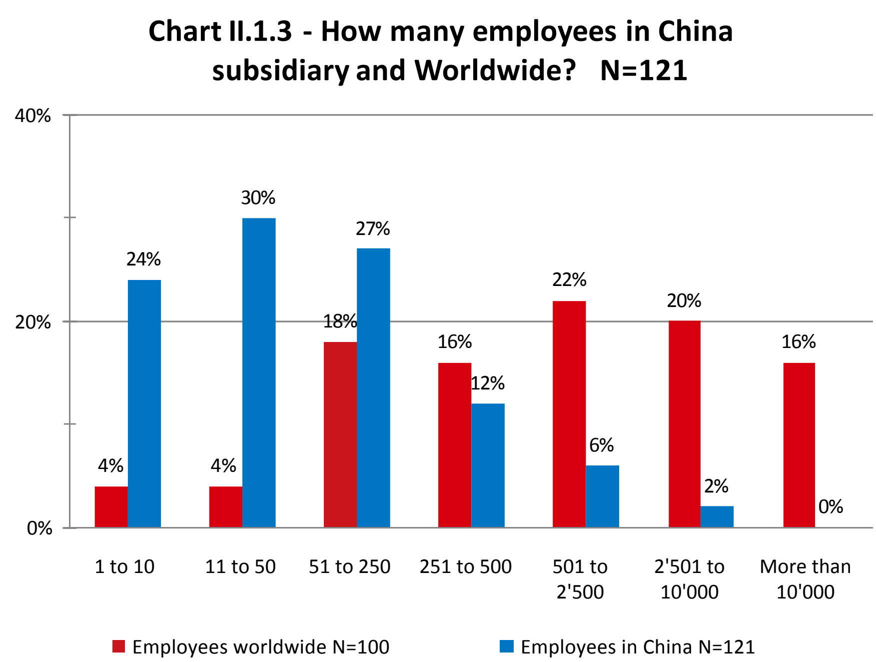
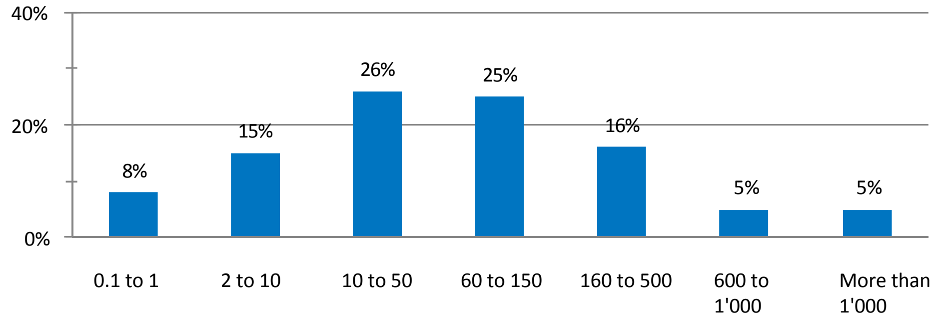


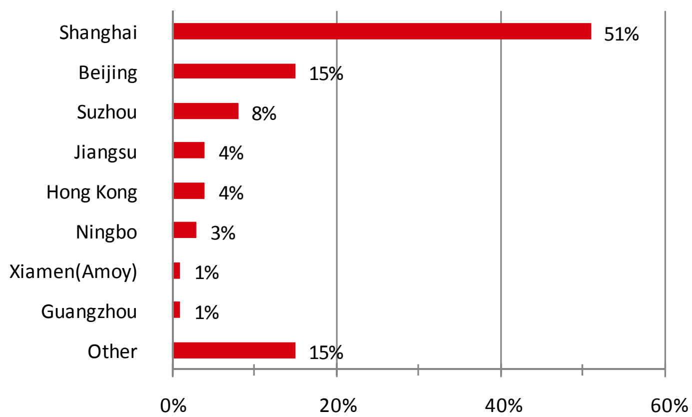
Chart II.1.4 - What is the revenue of your subsidiary (in million RMB)? N=111



The answer as to why these companies are still small can be found by looking at the length of time they were active in China. Indeed, two thirds of the companies surveyed were set-up in China only after China signed the WTO agreements in December 2001. Since then there has been a steady increase in their revenues every two years. In this regard, 2009 should have been a big year, but due to the timing of our survey we cannot make any assumptions, other than because of the global financial crisis, as to why the growth was so low.

Half of the companies in the survey are located in or around Shanghai. Following Shanghai are Beijing, Jiangsu province, and Suzhou. Shanghai comes in first as it is the economic center of China. Beijing comes second because it is the capital and the location of the central government. Suzhou/Jiangsu comes in third and fourth, respectively, as they are the convenient and developed, yet cheaper alternatives to Shanghai.

Chart II.1.5 - Where is the subsidiary located? N=136



Others: Chongqing， Dalian， Hangzhou， Hebei， Jiangmen， Jiaxing， Qingdao， Shenzhen， Taizhou， Tianjin， Zhejiang， Zhenjiang， Zhuhai, Unknown

2 Type of Activity

For the purpose of simplicity, the companies surveyed have been divided into industry sectors and consumer segments.

All surveyed firms have been categorized as in either manufacturing or services industries. Within each industry two general segments will be analyzed: the Business-to-Business (B2B) and the Business-to-Consumer (B2C) segments.

Survey results are summarized and analyzed according to the following classification and order:

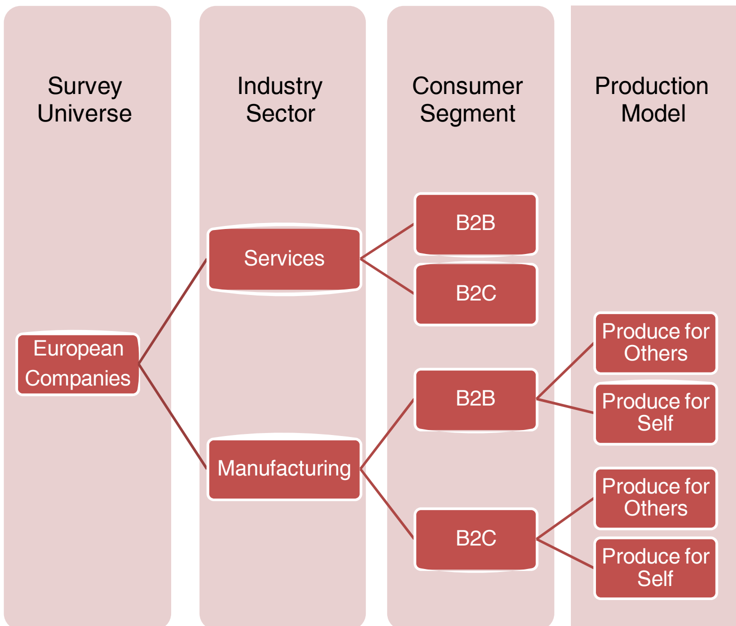
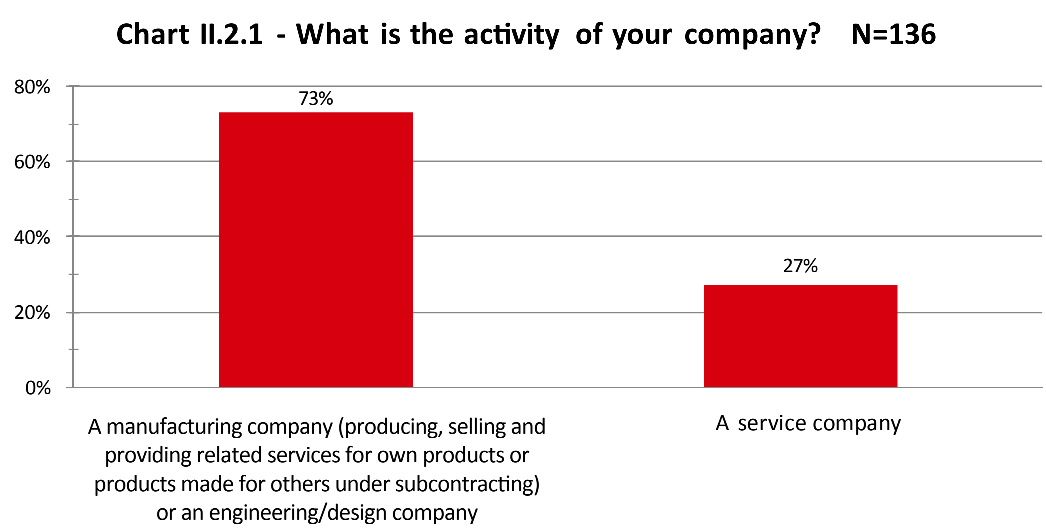


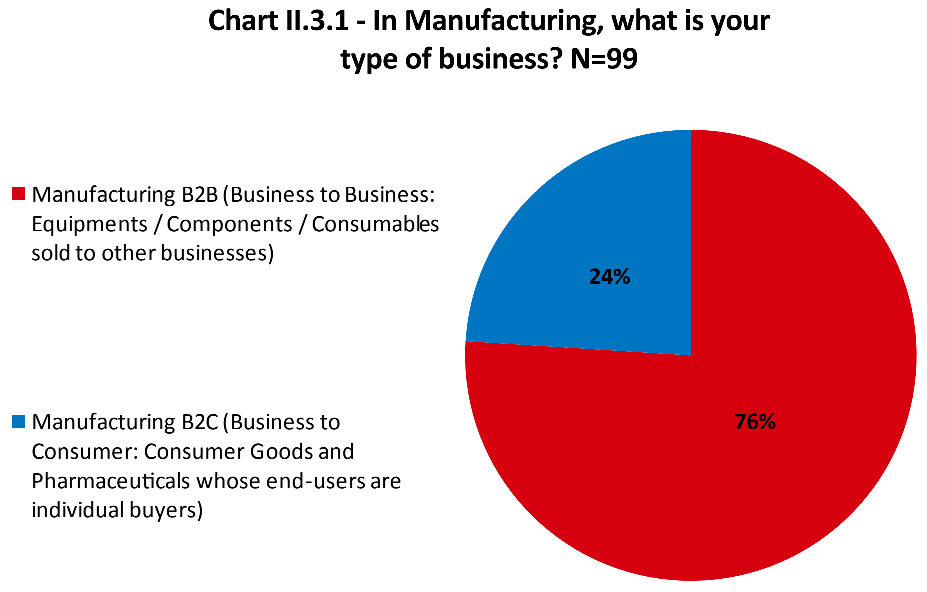
Figure II 1 Survey results division

In our sample, the industry types were broken down into manufacturing (73%) and services industries (27%).

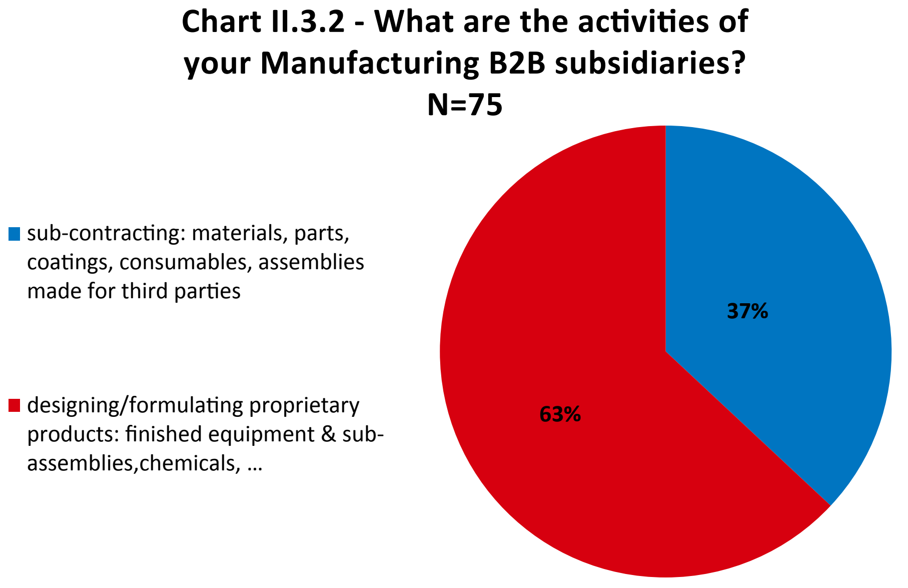


3 Type of Business and Industry: Manufacturing

Three fourth of the manufacturing companies are into the business to business (B2B) industry and just one fourth into the business to consumer (B2C) products.



The B2B companies are, for more than one third, only producing products for others, while the rest are designing their own products. The industry breakdown is as follows.



In addition to the industry types listed below a number of other possible choices were included but not selected by any of the respondents. The number of participants to this question is quite low as more than one third of the companies did not want to answer this question.

Chart II.3.3 - B2B: What is the main industry of the subsidiary? N=47

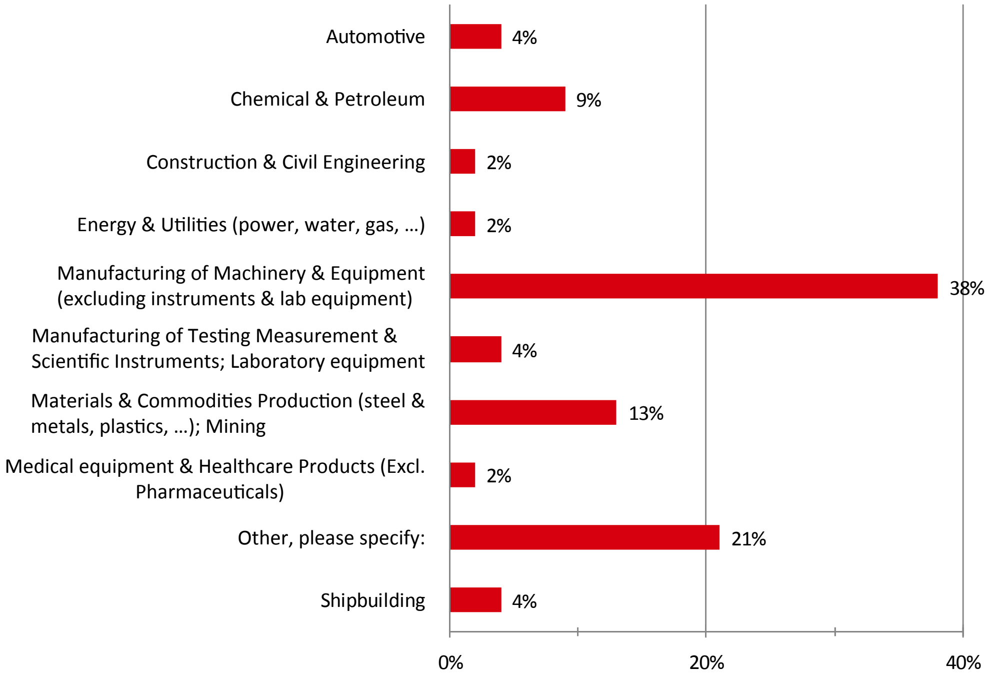
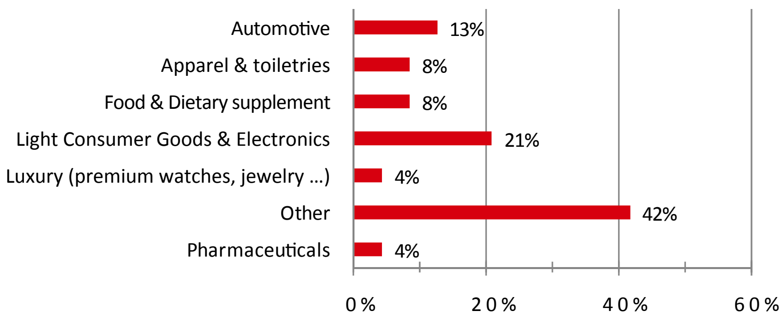


Chart II.3.4 - B2C: What is the main industry of the subsidiary? N=24



4 Type of Business and Industry: Services

The relation between B2C and B2B in Services companies is exactly the same (3 to 1) as for the Manufacturing companies. Because there were too few respondents there is no breakout by industry type for B2B Services companies.

Chart II.4.1 - What are the activities of your Services B2C subsidiary? N=38

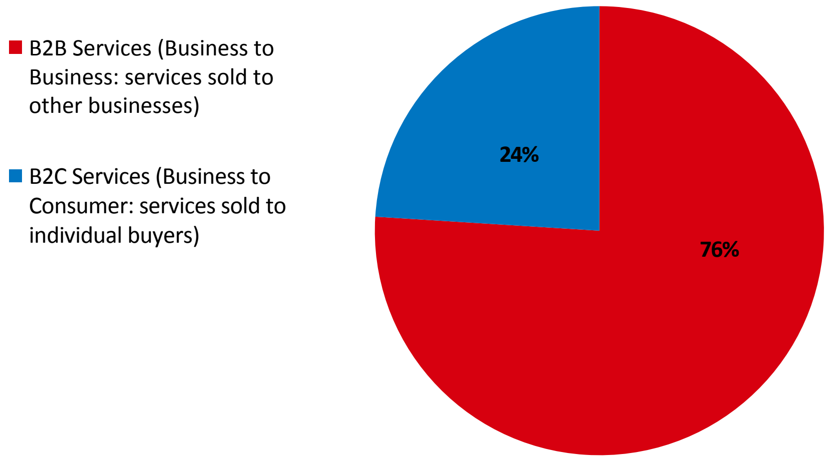
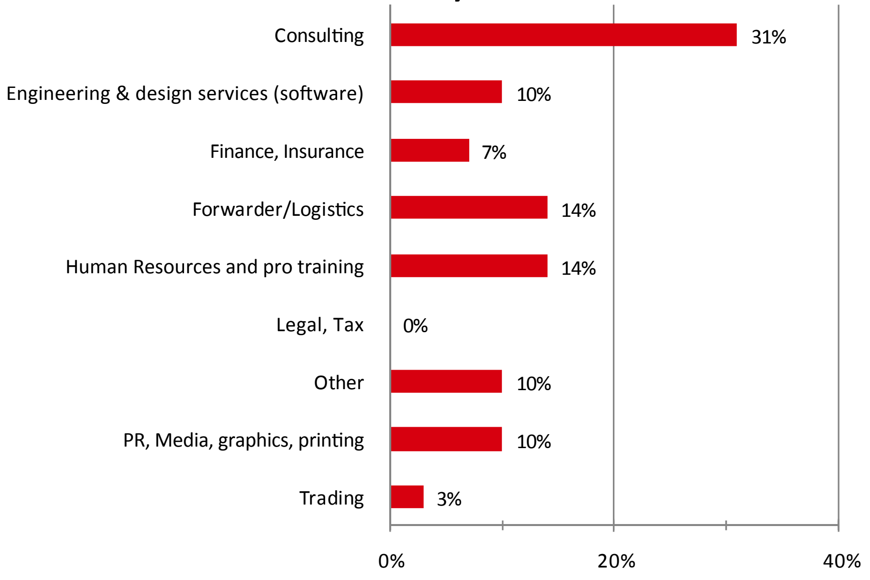


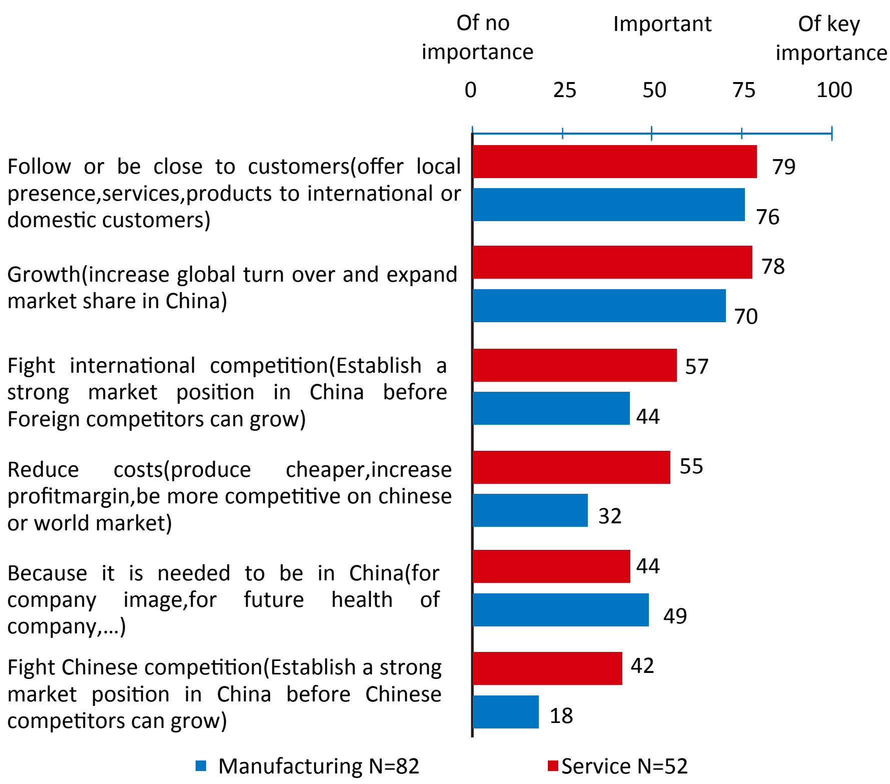
Chart II.4.2 - B2B: What is the main industry of the subsidiary? N=29



5 Reasons for Activity in China

There are two main reasons for companies to come to China, be it in the services or manufacturing industries. Firstly it is to follow customers. And, secondly, it is a strategic decision towards company growth. Reducing costs was only a concern for 32% of the services companies, as opposed to 55% of the manufacturing companies.

Chart II.5.1 - Reason for activity in China N=107



The survey also gives some insights into entrepreneurs' reasons for starting a business in China. Mainly they are attracted by the features of the Chinese market: plenty of opportunities still available due to the development stage of China and also the size of its market. Secondly, are the financial reasons.

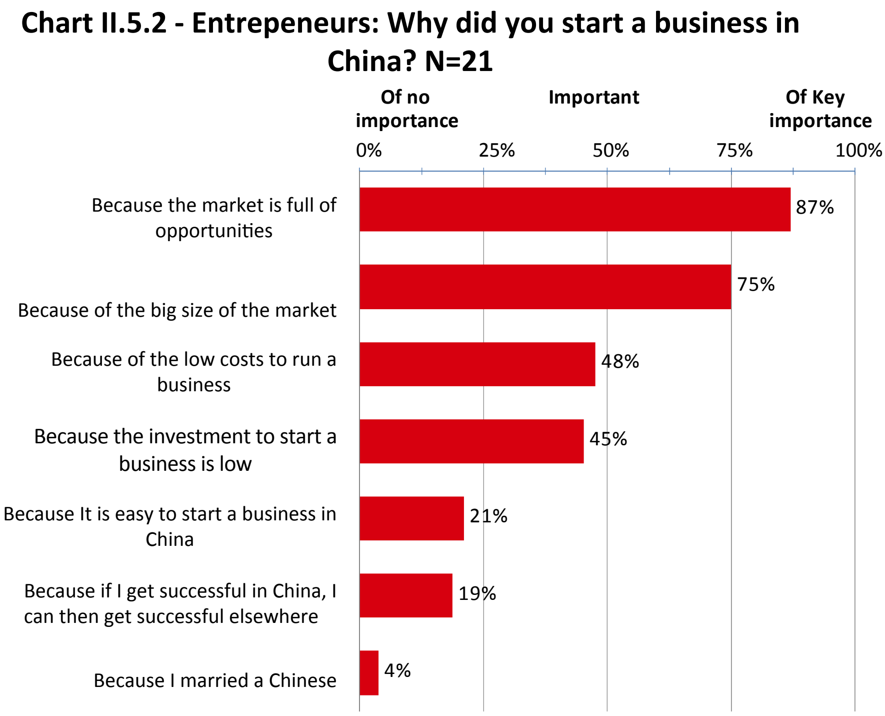


Chart II.5.2 - Entrepeneurs: Why did you start a business in China? N=21
Of no importance
Important
Of Key importance
0%
25%
50%
75%
100%
Because the market is full of opportunities
87%
Because of the big size of the market
75%
Because of the low costs to run a business
48%
Because the investment to start a business is low
45%
Because It is easy to start a business in China
21%
Because if I get successful in China, I can then get successful elsewhere
19%
Because I married a Chinese
4%

Opinion Article

EU-CHINA TRADE RELATIONS AFTER 2009

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With an 8.7% GDP growth in 2009, China has become the third largest economy in the world after the European Union and the United States, surpassing Japan for the first time. After ten years of continuous export growth, the year 2009 marked the first year where China experienced a significant decrease in exports and decline of its trade surplus with the rest of the world. Despite the export decrease, however, China has maintained its second-place rank as world exporter, just behind the European Union but well ahead of the United States. The EU is still, and by far, China's first trade partner and its main external market, absorbing around 20% of its exports; and EU exports to China, although of less importance in absolute value, show that China remains the largest export growth market for EU products. The trade and investment flows between the European Union and China have not been immune to the impact of the financial crisis of 2008-9, however the slowdown in trade and investment flows in 2009 was a temporary one and we are already seeing a rebound in 2010 with positive trade growth, although possibly not as strong as it was in 2007.

According to Chinese official figures, China's exports rose in December 2009 for the first time in 14 months, with a 17.7% increase in exports and 55% in imports as compared to the same month a year earlier. This figure, while positive, also reflects a very low base for comparison: exports in December 2009 were at a very low level. More important is the overall figure for the whole of 2009, with imports decreasing by 11.2% from 2008, but with a 5.1% increase over 2007. Year 2009 concluded with total export decline of 15.9% and 1.3%, respectively, when compared to 2008 and 2007. Trade surplus in 2009 totaled 196.07 bn USD, which is 34.2% and 24.8% less than that of 2008 and 2007, respectively.

After years of continuous trade flow increases between the EU and China, in my view there are seven lessons that we may be able to draw from the decline of trade in 2009.

Lesson 1: Trade has a dramatic multiplying effect where a slowdown in the overall

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economy and in particular, consumer demand, provokes a larger decline in trade flows. In a more integrated world economy with large production chains, a drop in demand for a given product affects all the intermediary production, causing export and import decreases in each country where different components parts are made and assembled before final assembly and shipping to end consumers.

Lesson 2: The vulnerability and dependency of the Chinese economy on exports was greater than expected. Economists have debated in the past about the weight of exports in China's GDP. Some considered it to be overestimated at times, due partly to the share (around 50%) of processing trade involved in the whole export sector. High trade figures do not necessarily indicate a high contribution to GDP growth as a large part of trade was processing for small value-added activities. The structure of some Chinese sectors made them more exposed to the economic slowdown. In China there are thousands of companies oriented towards exports, many with a hundred percent of their production dedicated towards overseas countries, and many of them oriented towards one market only. A dramatic decline in a market that absorbs the total production of a Chinese factory has immediate repercussions, forcing many companies at the beginning of the crisis to close down, provoking a larger effect in the Chinese economy than initially predicted.

Lesson 3: Low end and cheap products where China enjoys a big market share such as textiles, clothing, and footwear were more resistant to the slowdown. There was a normal product substitution effect in some sectors of the EU market to the benefit of cheaper products originating from China, alleviating to some extent export declines in other products, such as capital goods, machinery and equipment.

Lesson 4: EU exports into China were also affected but to a lower extent, proving that the quality and competitiveness of many EU products make them attractive even in periods of economic crisis. It also proves that the majority of EU exports into China are consumed by the Chinese market, not to be re-exported. This evidence is shown by the collapse of exports from Hong Kong, Taiwan, and Japan into China, exports that, to a large extent, are part of a large assembly line where China is the last stop before export to consumption markets. The relatively sustained consumption level in China has favored the structure of EU exports directed to Chinese consumers. With an increase of 40% of car production and sales in China, European car parts manufacturers have found in China an expanding market while the EU and US markets for car parts have languished.

Lesson 5: Even in the context of the current recession, the EU has not resorted to protectionism. The European Union has never used anti-subsidies measures and has not used the Safeguard Clause to stop imports in any sector. Furthermore, the European Union has made a very moderate use of Anti-Dumping measures, with only five new investigations launched in 2009, a figure similar to previous years. The total protectionist measures in force currently apply to less than 1% of EU's total imports from China, which is still far too small to have any significant macroeconomic effects.

Lesson 6: Despite the crisis, demand was kept at strong levels due to the "safety belts" in place in all Member States of the European Union, i.e. the stimulus packages and the coordinated response to the crisis. The European economic policies sustaining domestic demand during the crisis have also indirectly sustained Chinese exports into EU markets.

Lesson 7: On the investment front, European companies remain an important investor in China and in spite of the crisis, no important EU company has withdrawn from China; on the contrary, many have increased their investment. As for Chinese companies investing abroad, there are many positive developments. In the second quarter of 2009 we saw increased activity by Chinese companies investing abroad, with important acquisitions and investments made, thanks to a weak US dollar and many Western companies in need of fresh investments. It is likely this trend will continue or even accelerate in 2010, increasing the presence of Chinese companies in overseas markets and helping many companies to overcome financial difficulties. While most of these investments took place in the energy and mining sectors, it would be positive to see new Chinese investment also flowing in the manufacturing, financial and services sector. This year the EU is poised to welcome the largest volume of Chinese investment ever and, indeed, is already witnessing this phenomenon. The European Union has no restrictions to foreign investment by law and our market is the largest consumer market with 500 million citizens with a high average level of consumption. Combined with a dense infrastructure and skilled work force, the EU should be an attractive destination for Chinese investors. Some are already there and others are preparing their projects which will materialize in 2010.

The New Year 2010 and the Chinese Year of the Tiger offer new hopes of a sustained recovery in our trade flows. The European Commission economic forecast is positive for the whole year, and although we will have to face an increased level of unemployment, the solid and strong economic foundation of the European economy will boost trade as soon as the EU enters into positive growth territory. Higher levels of economic growth in China in 2010 is definitely good news for European exports. The consolidated presence of EU business in China, with a good knowledge of the Chinese market and a competitive level of products, is an opportunity for EU companies to benefit from the increasing Chinese demand while other markets remain weak.

Miguel Ceballos was born in Santander (Northern Spain) in 1967. He studied Law in the Universities of Cantabria (Spain) and Liege (Belgium), where he graduated in 1990. After accession to the Bar Association he completed his studies with a MA in international Relations at the University of Barcelona and a research on the EU law making process at the University of Cambridge (UK). His first working experience as a lawyer at the Bank of Madrid (a subsidiary of the Deutsche Bank) made him discover the world of finance and business. In 1993 he joined COFIDES, the Spanish Agency for Foreign Investment until he was called by the European Commission in April 1994. Miguel Ceballos has worked in several European Commission departments as a lawyer first, and thereafter in Technical Assistance programs for the (at the time) candidate countries and Balkan region. In 2001 he joined the unit for Intellectual Property, new technologies and government procurement in the Directorate General for Trade and was immediately associated to the WTO negotiations of the Doha Development Agenda (launched in December that year). In 2005 he was appointed Deputy Head of Unit responsible for communication and relations with the European Parliament in the DG for Trade, giving him the opportunity to work closely with the EU Trade Commissioner Peter Mandelson's spokesperson and Cabinet. His responsibilities in the DG for Trade provided him with a solid experience in Trade negotiations, both bilateral and multilateral. He has represented the EC at several WTO working groups and Committees. He has taken active part in bilateral negotiations on FTAs with Chile, Mercosur, the Gulf Cooperation Council, Turkey and Syria. He has negotiated agreements for tariff reduction in key IT and high-tech products. Since September 2006 he is the Head of the Trade and Economic section at the Delegation of the European Union to China. He co-ordinates a team of more than twenty people working in close cooperation with Chinese authorities, EU member States and European business to improve market access conditions and facilitate trade and investment in China.

CHAPTER III

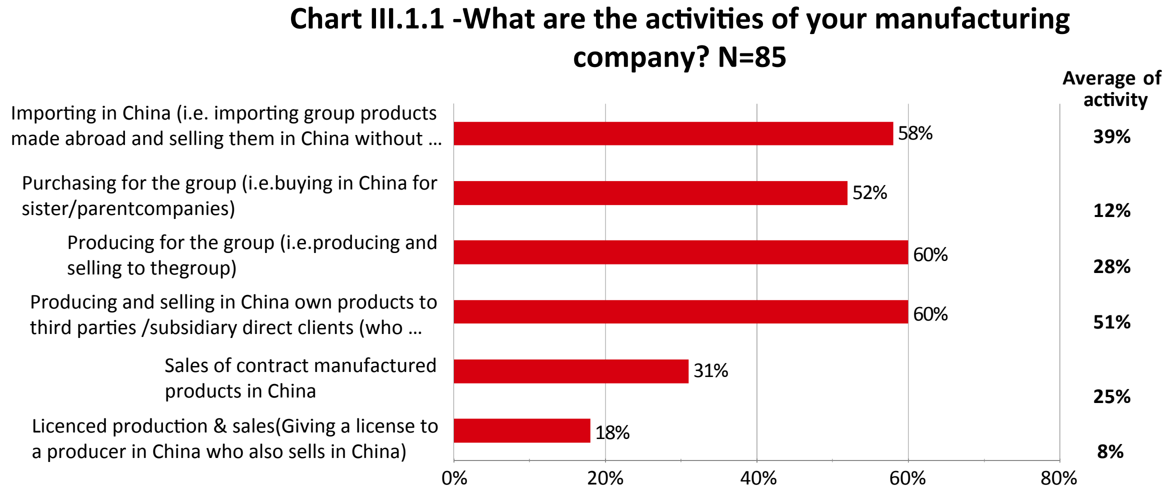
III Business Activities

This part is subdivided by different company activities. The survey was conducted so that only the questions relevant to each participant's activities in China were asked. Therefore, for example, companies in the services industries were only asked questions about distribution and logistics (relevant to one fifth of them), sales and intellectual property. We will therefore first review the activities done by manufacturing companies and then we will go through each activity one by one in following order: production, sourcing, distribution & logistics, sales & marketing, research and development, and finally intellectual property.

This part will be divided in the following sub-sections:

1 Overview

For the manufacturing companies, we can see that there are almost as many companies importing finished products from their group as producing for the group and producing their products for their own sales. Sourcing for the Group follows closely behind and it is done by a little more than half of the companies. However, the relevant percentage of those activities in regards to all their activities in China is not the same. Since multiple answers were possible, the "Average of total activity" the number of selections of a particular activity out of all the activities in China. Finally, only few companies (15%) engage in one single activity.

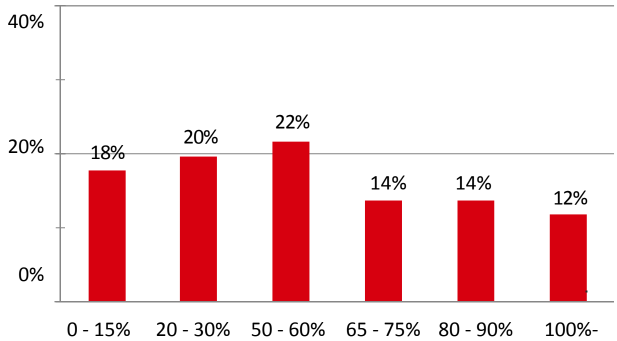


The following charts attempt to give some insight into the other activities performed by manufacturing subsidiaries in China. Each chart breaks down each activity by the percentage allocated to it by each surveyed company. For example, the 100% of Importing in China group represents 58% of the total respondents to this section.

Producing and selling own products to direct clients in China

Based on their response, producing and selling in China through China subsidiaries their own product is the main activity of these companies. Of the respondents producing for the Chinese market 64% are selling over 50% of their total Chinese output to the Chinese market.

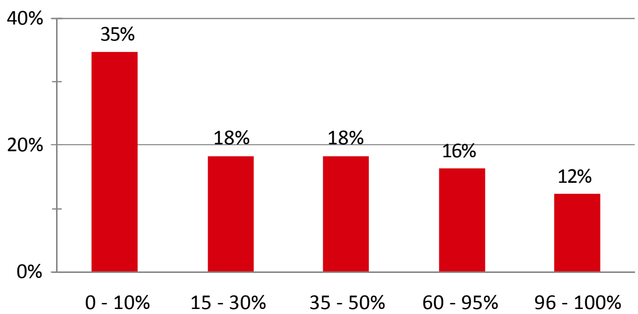
Chart III.1.2 - Producing and selling - Percentage of subsidiary activity? N=51



Importing in China finished Group products

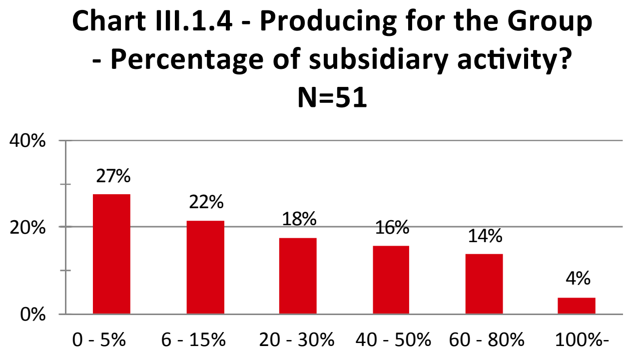
This category of respondents shows that a very small percent are importing goods into China to sell. For 53% of those importing, it represents less than 30% of their activities. Only a very small percentage of the companies surveyed report that greater than 95% of their activities revolve around importing products.

Chart III.1.3 - Importing in China - Percentage of subsidiary activity? N=49



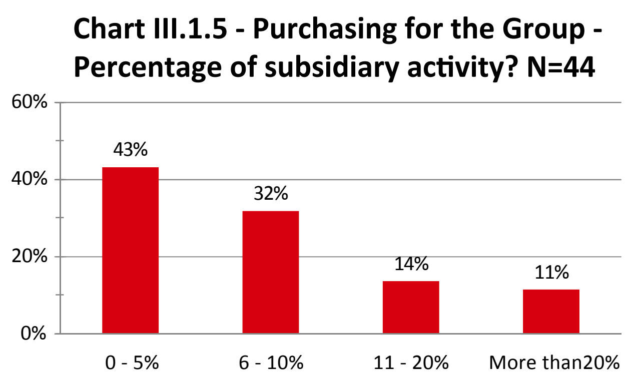
Producing for the Group

Of those producing for the Group, more than 2/3 generate less than 30% of their activity producing for the group. And only 4% dedicate 100% of their activity for the group.



Purchasing for the Group

Only a very small part of those companies who purchase for the Group consider it a large part of their activity. 89% rate it less than 20% of their activity in China.



Opinion Article

2009 YEAR LEGAL DEVELOPMENTS AND FUTURE EXPECTATIONS

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People's Republic of China as an important player in the international economy has not escaped from the global financial downturn that has been shaking and still hitting most of the countries in the world. In accordance with what has been the general understanding of the nature of the global financial crisis, China has also followed the path of setting in place stimulus packages intended to smooth the drainage of liquidity in the financial system, to boost internal consumption and to keep the economy rolling. As a consequence, measures addressing this target have become an important part of the legislation issued in Year 2009. This body of regulations can be characterized by an increase in protectionism and a slowdown of the process of opening the economy, which shall be judged as a negative both for China and the global economy. No less important however, legislative activity unrelated to the stimulus package has also been issued and approved by Chinese National and Local authorities, as we can see next.

From the point of view of legislation activity, the year 2009 was very productive, though it did not drawn as much attention as in the year 2008, when regulations closer to the general public, such as Contract Labor Law and new Enterprise Income Tax Law, became effective.

In regard to these two important regulations, 2009 was the year of full implementation, consolidation and clarification of many of their provisions. Indeed, a number of regulations have been issued by the State Administration of Taxes during 2009 with the common goal of implementing the anti-avoidance principles set forth in Enterprise Income Tax Law. In this sense we can find, among many others, the "Notice of Interpretation and Determination of Beneficial Owner under Tax Treaties" (国税函2009 No. 601), that focus on taxation on passive income received by entities or structures outside of People's Republic of China settled in low taxation regions from entities or structures in mainland China. Beneficial tax treatment based on double taxation agreements between China and such regions for corporations under

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this situation may be at stake after the implementation of this Circular.

Another example would be the “Circular Strengthening the Tax Administration of Equity Transfers by Non-resident Enterprises” (国税函No. 698), related to the situation of share transfer of Companies owning Chinese entities, by which Chinese local tax authorities will be entitled to request from the transferor detailed information, by doing this targeting the taxation of capital gains generated in this type of transactions. This particular regulation has brought concerns about the legitimacy of Chinese Government to extend its jurisdiction to tax transactions that happen outside their borders.

In Labor Law field, as mentioned earlier, 2009 was a year of clarification of Labor Contract Law provisions, effective from January 2008. However, in terms of Social Welfare there were some interesting activities, especially in the local area of Shanghai, among which I would like to mention one small local regulation that will have important impact in the calculation of social cost of employees by foreign enterprises. I am referring to the “Circular about the Issues of the Participation of the Immigrant Working Staff in Shanghai in the Basic Endowment Insurance Plan for Shanghai Urban Employees”, issued by the Human Resources and Social Security Bureau of Shanghai on July 12th 2009. According to this new rule, employees from areas outside of Shanghai – i.e. those whose “hukou” does not belong to Shanghai, that meet certain conditions may participate in the Shanghai medical insurance, work-related injury insurance, maternity insurance and unemployment insurance. For companies based in Shanghai, this will represent an increase of social cost of employees from out of this area, whose hiring costs were traditionally lower if compared with those belonging to Shanghai.

Also in regard to Social Welfare, it is worth to mention the “Notice of Several Issues on Foreign Employees in Shanghai Participating in Social Insurance”, issued by Shanghai Municipal Bureau of Human Resource on October 10th, 2009, by which eligible foreigners can benefit from an extension of the right of social insurance coverage.

Going back to the National level, in the financial field, it is important to refer to the “Measures for the Administration of Pilot RMB Settlement in Cross-border Trade”, issued by the People’s Bank Of China jointly with several Ministries on July, 1st 2009. Under this small but important regulation, Chinese Government is setting up a testing program by which a number of selected enterprises in also selected mainland cities and regions, will be allowed to settle payments in RMB – the Chinese national currency, with enterprises located in Hong Kong and other regions outside the Chinese borders. This regulation is regarded to be the first step towards the internationalization and full convertibility of the RMB.

Foreign companies operating in the tourism sector have reasons to celebrate a further step in the opening of this economic sector to foreign investment. This has happened through the new “Regulations on Travel Agencies”, which came into effect on May 1st, 2009, issued jointly by the State Council of the People's Republic of China and the China National Tourism Administration. These new Regulations, which revise the “Regulations on the Management of Travel Agencies” that were passed in 1996, allow the establishment of wholly foreign owned enterprises travel agencies, eliminate restrictions for setting up branches by foreign invested travel agencies, and lowers thresholds for the establishment of travel agencies and their branches.

In the field of Company Law, it is important to mention the approval of the long expected Implementing Regulations of Partnership Law, passed by November 25th, 2009, which will be effective March 1st, 2010. They have been long expected considering that Partnership Law was approved on August 27th, 2007, however it could not be put into practice due to the lack of implementing regulations, a situation very common in China. These new regulations introduce a different way for foreign companies to enter into the Chinese market, other than through wholly-owned enterprises scheme or the joint-venture model, and it is particularly interesting for venture capital and private equity firms.

Other important legislative activities in 2009 were:

- New Patent Law of the People's Republic of China adopted in December 27th, 2008, that introduced changes to the patent regime that will mostly affect life sciences companies, genetic resources based patent, compulsory license, parallel import and exception.
- The Insurance Law of the People's Republic of China, as revised and adopted at the 7th session of the Standing Committee of the 11th National People's Congress of the People's Republic of China on February 28th, 2009, had a significant impact on the investment in, and the operation of insurance companies and insurance intermediaries in China.
- The Tort Law of the People's Republic of China, promulgated on December 26th, 2009, that shall come into force on July 1st, 2010, aimed to protect the legitimate rights and interests of parties in civil law relationships.

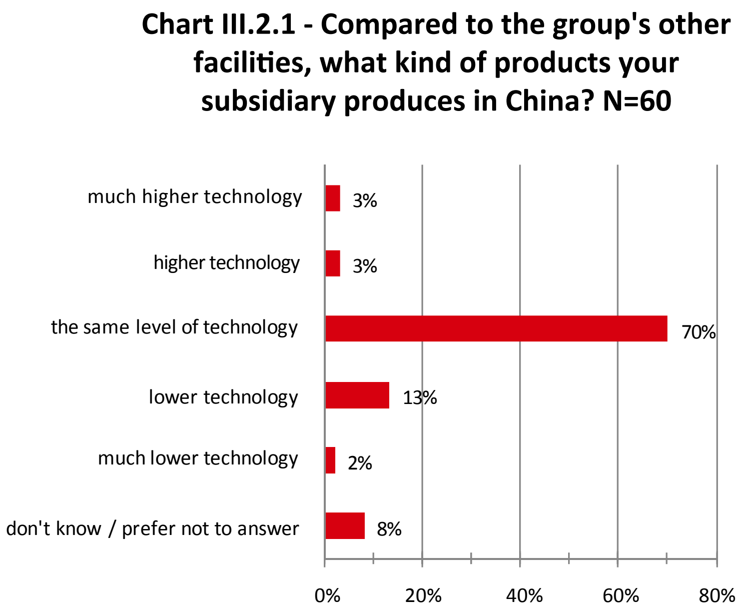
In conclusion, in spite of increasing protectionist measures to combat the economic downturn, almost silently and unnoticed, 2009 witnessed not only a further step in the process of modernization and opening of the Chinese market to the foreign investors, but also the preparation of Chinese economy for the next level, which is the full integration in the financial markets, setting the basis of its future dominance in the global economy. This is the trend that hopefully will prevail in the near future.

Mr. Luis Sunyer is a legal, tax and accounting advisor specialized in Chinese practice. Since 2005 Luis has been providing consultation services for foreign companies investing in People's Republic of China in these three areas. Luis works now as associated lawyer in Guangsheng and Partners, Shanghai office, since 2008. At the same time, going beyond the legal field and taking advantage of his expertise in Chinese tax and accounting issues, he is now developing his own business, focusing in corporate internal organization, specifically in the financial, administrative and human resources areas. Luis also enjoys spending part of his time working as a lecturer in a program jointly organized by Fudan University and Instituto Tecnológico de Monterrey. In 2005, Luis has received his MBA degree by China Europe International Business School (CEIBS, Shanghai). Since then he has been working in different companies and projects in People´s Republic of China, including the international Law Firm DS Avocats. Prior to coming to China, ha has been working in Mecalux, S.A., a Spanish listed multinational company, where he became familiar with financial, legal and organizational issues of companies expanding abroad.

2 Operational Activities

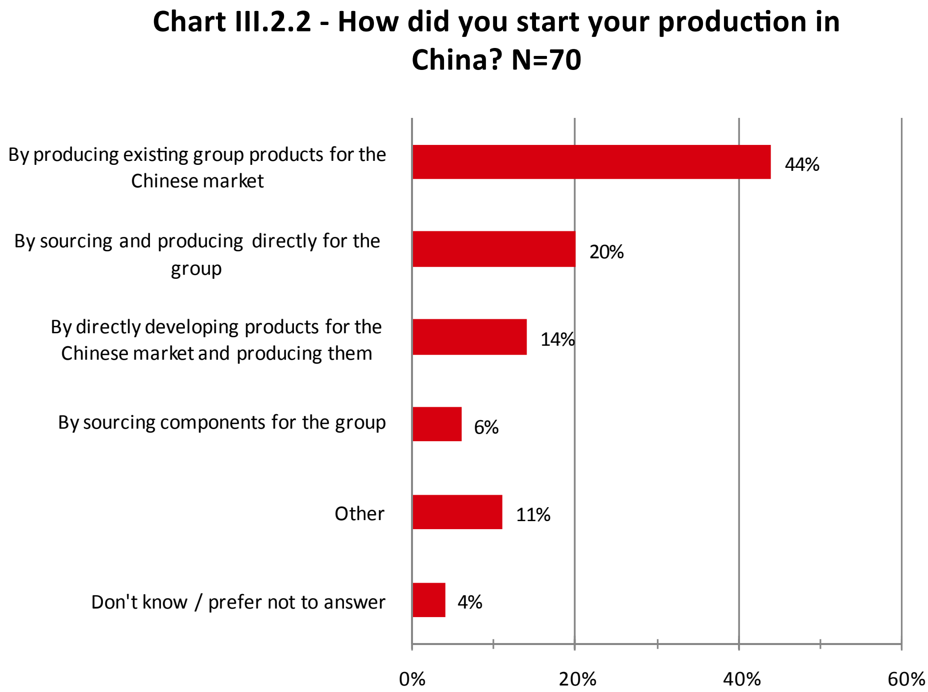
2.1 Production

With companies focused on production, it is important to understand with what level of capability they are producing. As shown in the graph, most of the surveyed companies are able to produce products with the same level of technology as in their other production plants outside of China.



Secondly, more than two fifths started their production with existing products, but targeting the Chinese market. R&D has played an interesting role in this as these numbers are very similar to companies which had some R&D done in China even if they sell the "same" products[2]. Sourcing and producing directly for the group is the second most common way to start production.

[2] See Chart III.2.1- Compared to the group's other facilities, what kind of products your subsidiary produces in China?



Of the companies that produce the same types of products in China as elsewhere, their products represent a fairly high percentage (71% on average) of their turnover. Indeed, two-thirds generate more than 60% of their turnover based on same types of products and 42% generate more than 80% of their turnover. This means China is just another production base for them and that products are generics made in China, for China. However it will be demonstrated in the R&D part that most of the companies surveyed are applying minor adjustments to their products.

Of the respondents, 43% are also producing products which are exclusively produced in China and intended for the world market. But, as the second graph shows, for the majority of these producers this is a small part of their production, as it counts for 20% or less of their turnover for 50% of the companies.

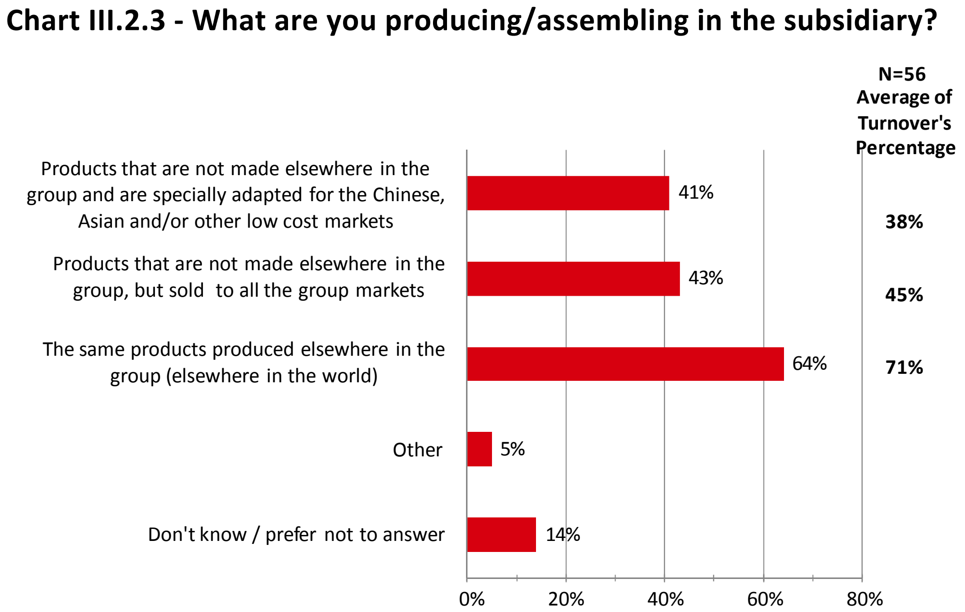


Chart III.2.3 - What are you producing/assembling in the subsidiary?
N=56
Average of Turnover's Percentage
Products that are not made elsewhere in the group and are specially adapted for the Chinese, Asian and/or other low cost markets
41%
38%
Products that are not made elsewhere in the group, but sold to all the group markets
43%
45%
The same products produced elsewhere in the group (elsewhere in the world)
64%
71%
Other
5%
Don't know / prefer not to answer
14%
0%
20%
40%
60%
80%

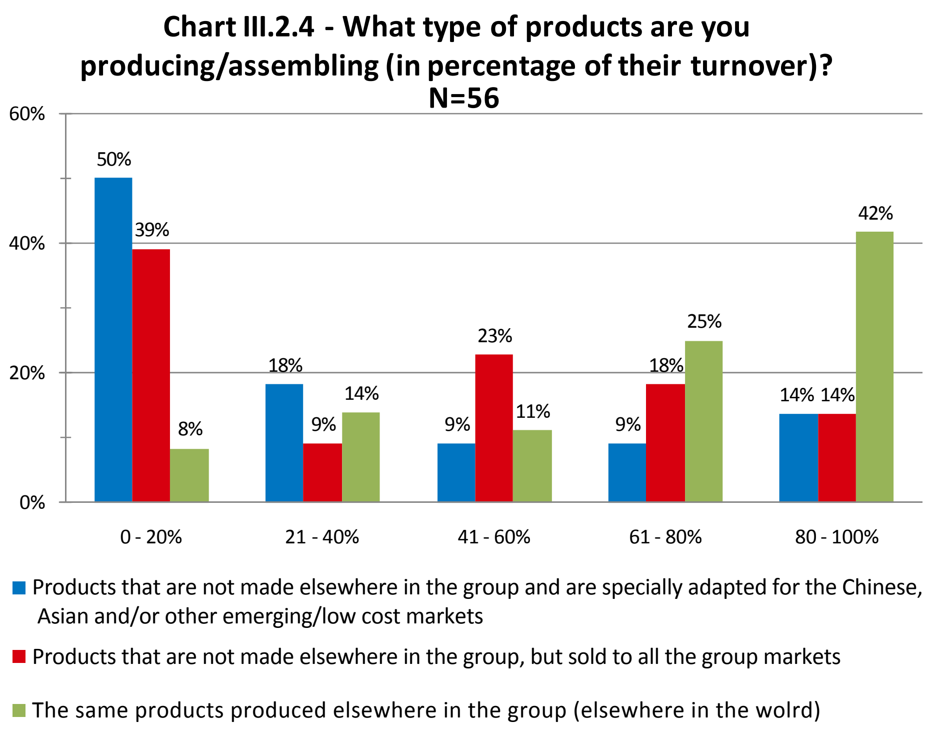


Chart III.2.4 - What type of products are you producing/assembling (in percentage of their turnover)?
N=56
60%
40%
20%
0%
50%
39%
8%
18%
9%
14%
9%
23%
11%
9%
18%
25%
14% 14%
42%
0 - 20%
21 - 40%
41 - 60%
61 - 80%
80 - 100%
Products that are not made elsewhere in the group and are specially adapted for the Chinese, Asian and/or other emerging/low cost markets
Products that are not made elsewhere in the group, but sold to all the group markets
The same products produced elsewhere in the group (elsewhere in the wolrd)

In your subsidiary, what are you producing/assembling in percentage of your turnover (multiple answers possible)?

Almost half of the companies are importing parts or modules that are then used in their production. For most it only accounts for a small part of the total product cost. For those importing most of the product, they are mostly just assembling their products. The main reason given for the import of parts or modules is the lack of technological capability and secondly, the fact that they are just assembling. It is interesting to note that the fear of IP loss if produced in China is not of great concern to the companies.

Chart III.2.5 - Are you buying completed parts/modules that are produced elsewhere in the group outside of China? N=65

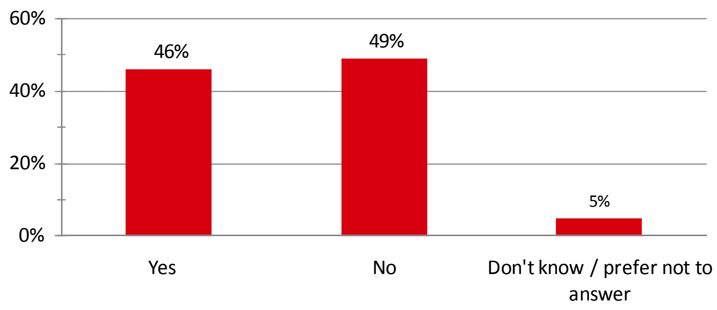
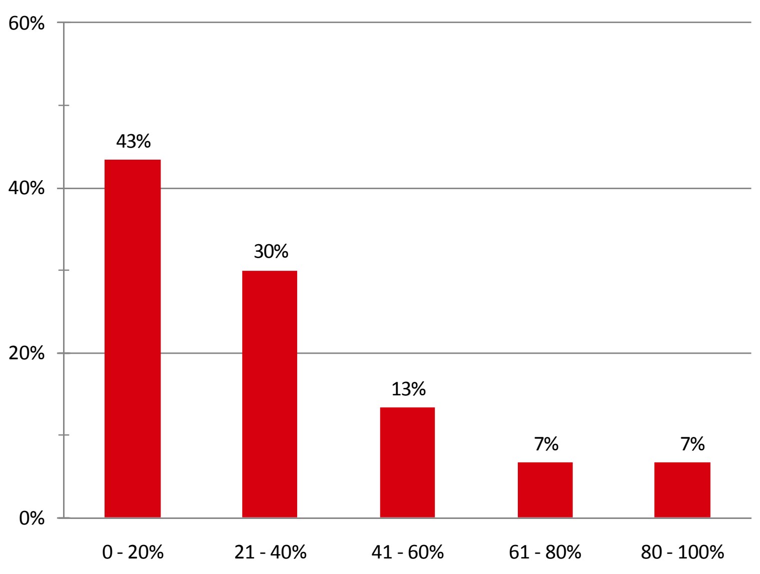
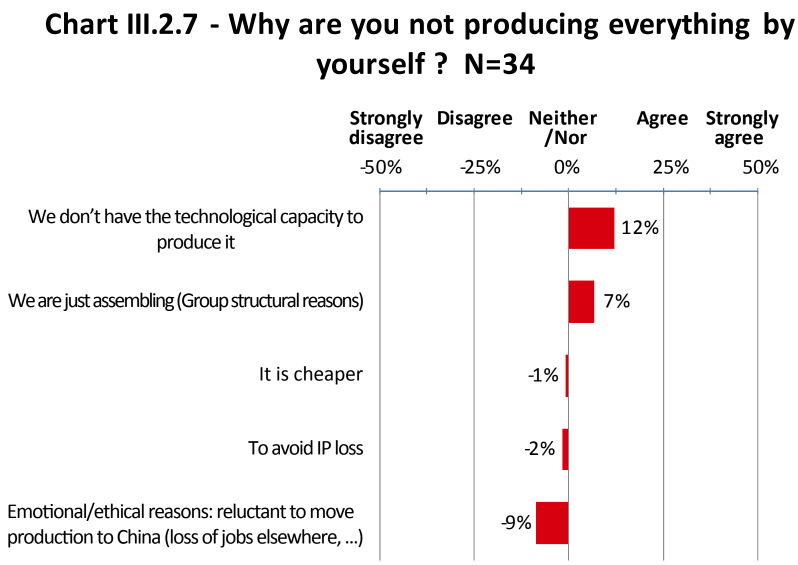


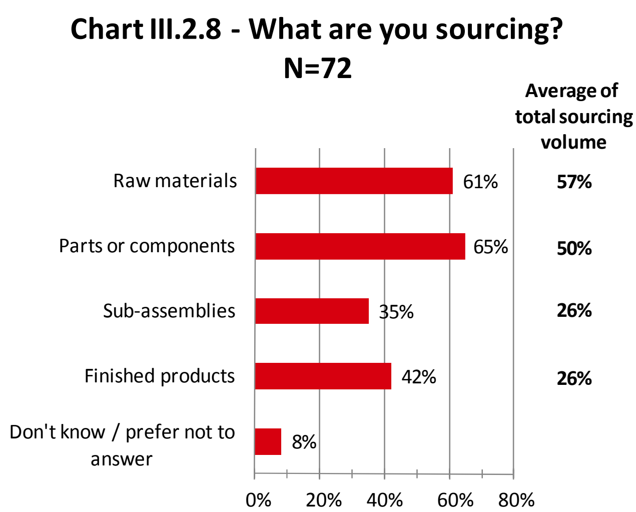
Chart III.2.6 - What is the relationship between imported parts/modules percentage compared to total material costs: N=30





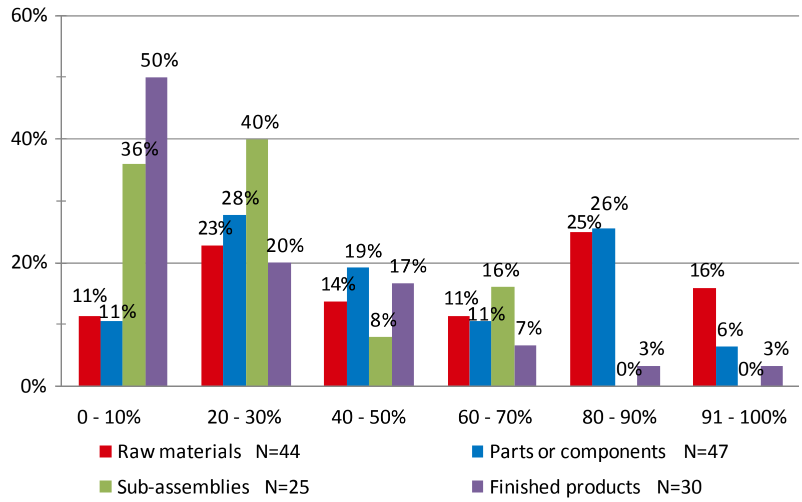
2.2 Sourcing

Most companies are sourcing raw materials and/or raw components. But still, 42% are sourcing finished products and 35% sub-assembled products.



The percentage of each of these relative to total sourcing volume concurs with the preceding findings. One can also note that for sub-assemblies[3] and for finished products, the percentage of total sourcing volume is more on the low side of total sourcing volume as opposed to raw materials or parts & components where it is more consistent across the range of respondents.

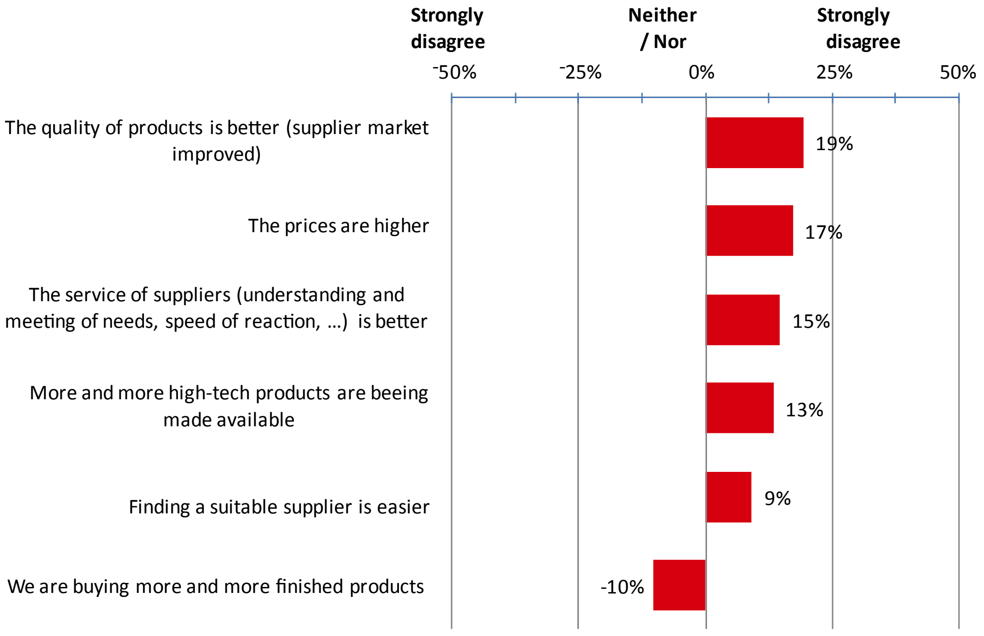
Chart III.2.9 - What percentage of total sourcing volume hold the different types of sourcing? N=72



The environment for sourcing is getting better but at the same time, the prices are getting higher. However with global financial crisis, there should still be a span of time where the prices will stay the same or even decrease.

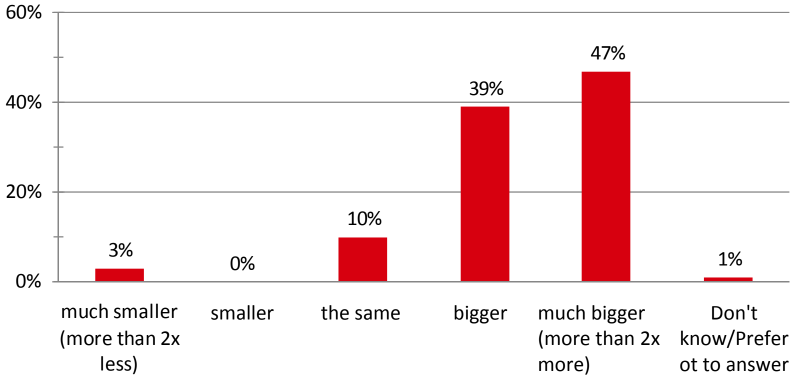
[3] Sub-Assemblies are pre-assembled parts which are further assembled into a finished product

Chart III.2.10 - Compared to 3 years ago, do you agree with the following statements about sourcing? N=77



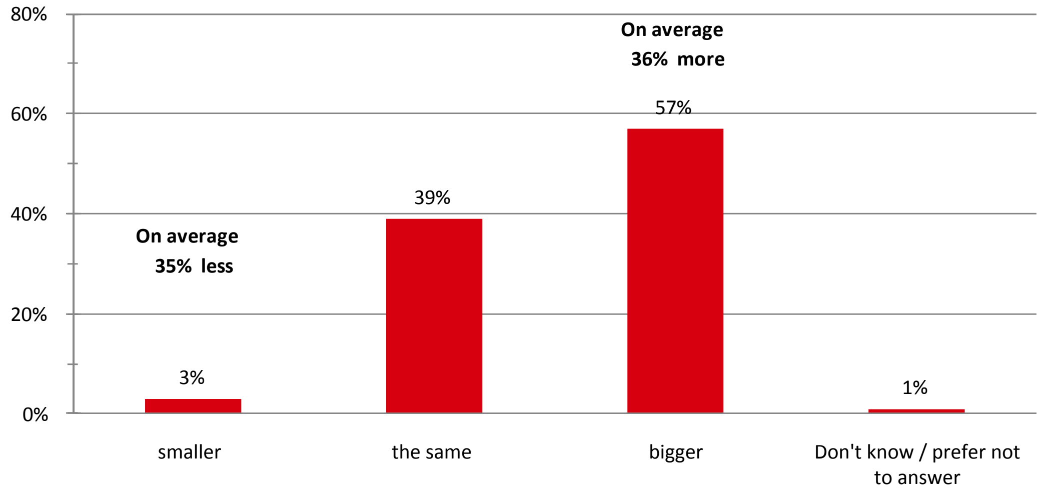
Therefore for most of them, they are sourcing more than in the past.

Chart III.2.11 - Compared to 3 years ago, what volume in quantity are you sourcing in China? N=77



For 2010, the volume sourced is expected to be higher for three fifth of the respondents with an average of 36% bigger volume compared to 2009. For the rest of them, they will source the same quantity as in 2009.

Chart III.2.12 - In 2010, compared to 2009, what volume in quantity are you planning to source from China ? N=69



2.3 Distribution and Logistics

Distribution of goods in China is an interesting topic, and China is believed to have some of the best infrastructure for its economic development stage. There are three main ways European companies organize their distribution.

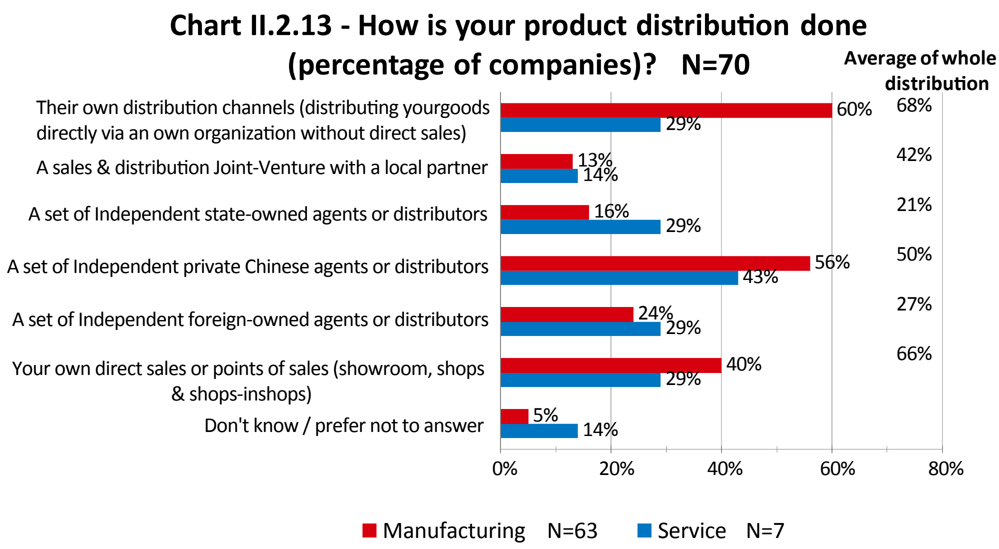
a) The most common way is through "own distribution channels" without direct sales. Of the companies using this channel, 44% use this channel exclusively.

b) The second way is to use a set of independent private Chinese distributors. In this case, companies use them either as the main distributor or just as a small part of their distribution.

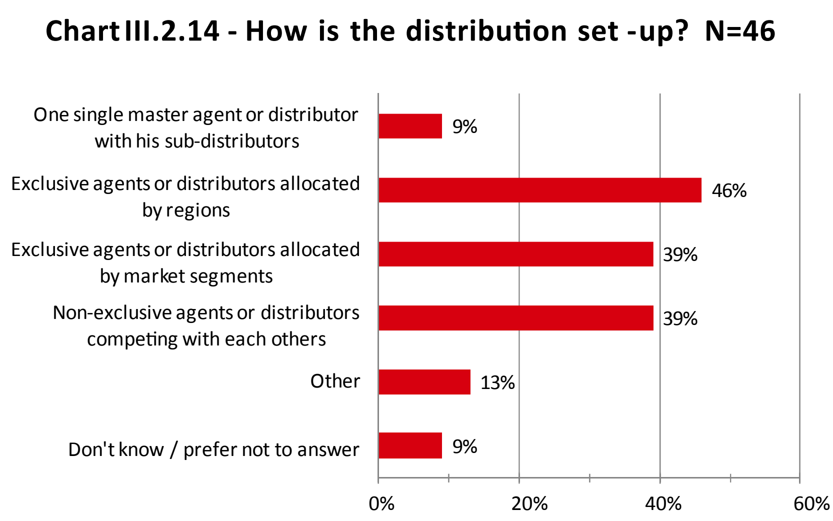
c) The third way is the use of direct sales. The majority distributes this way. In fact, 25% responded that they use it as a sole method of distribution and 63% use it for more than 70% of their distribution.

The other methods of distribution usually only count for a small part of total distribution network.

From this sample, differences between B2B and B2C companies were minimal.

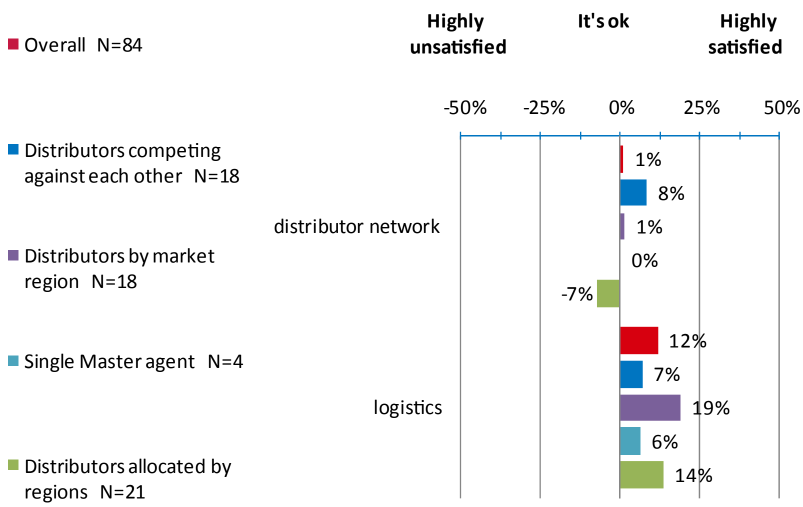


If they are using any kind of independent set of agents or distributors, they were asked how those were set-up. The size of China makes it hard to rely on just one distributor and this graph shows this fact. For most product categories there are very few distributors covering the whole country. If an exclusivity agreement has been made, agents or distributors are allocated by region or market segment. If non-exclusive, agents or distributor are allowed to compete amongst each other.



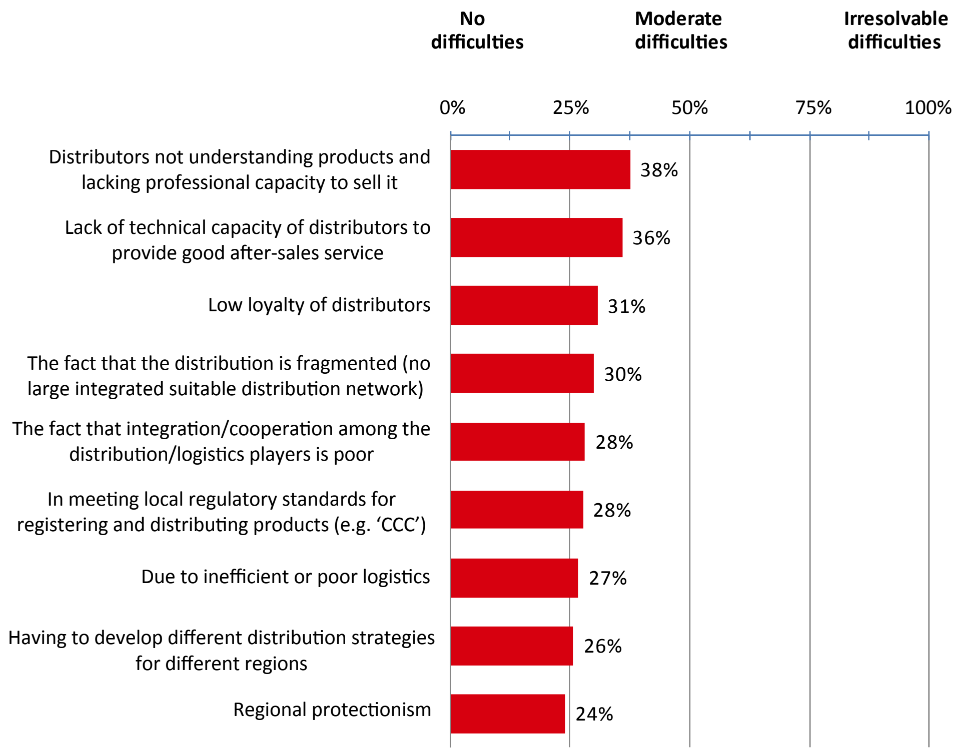
Concerning the level of satisfaction with distribution, it seems that there is still room for improvement, but, on average, there seems to be no major problems. No correlation has been found between a certain use of distribution network and the level of satisfaction. However, those relying on “an independent set of agents or distributors who compete amongst each other” report a higher level of satisfaction than the rest of the patterns. This is especially true compared to those respondents that have distributors allocated by region. These respondents are the most unsatisfied with their set-up.

Chart III.2.15 - Are you satisfied with distribution networks and logistics ? N=84



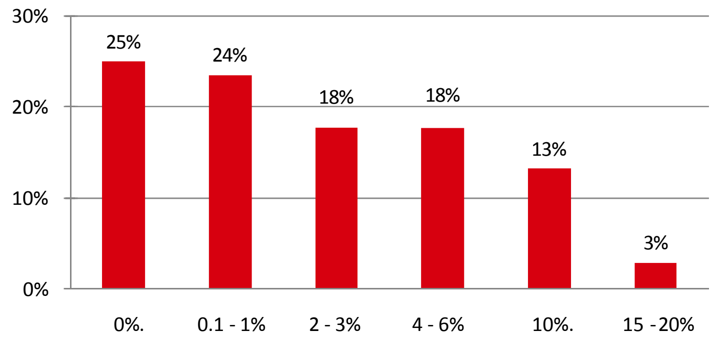
The distributors’ room for improvement mainly lies in their ability to understand the products, to sell them professionally, and to use technical knowledge to provide good after-sales service. Another difficulty is to ensure the loyalty of their distributors.

Chart III.2.16 - What are your difficulties with distributors? N=80



Finally losses due to distribution or logistic problems remain low for the majority of our sample. Still, 15% of them suffer heavy losses of 10% or more.

Chart III.2.17 - What are your losses due to distribution and logistics problems (in % of value of distributed goods)? N=68



Opinion Article

OPINION ARTICLE: HAMMERING THE SUPPLY CHAIN

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In 2008, I wrote an article titled, "7 Hammers on China's Competitiveness." These hammers reduce China's competitiveness in the global market place as compared to other low-cost countries. They are:

- RMB currency appreciation
- Raw material cost increases
- VAT drawback policy changes
- Annual salary increase expectations of the Labor force
- New Labor Laws
- Uniform Environmental Regulation conformance
- Price of Oil affect on transportation

Global demand dropped so dramatically in early 2009 that it completely overshadowed all the effects of these hammers. In 2009, most of the detrimental effects of these "hammers" were suspended, stabilized, or even improved slightly. China's domestic demand, with the help of the Government's financial stimulus package, and policy changes stimulated the economy effectively to avert the serious impacts felt by many Western Countries. Allow me to review each of the changes seen in 2009 and provide 2010 predictions. I will also comment on China's stimulus package itself.

RMB appreciation – 2005 through 2008, the RMB appreciated an average of 5.5% per year. In 2009, the RMB remained pegged at 6.83 RMB/$. Because the dollar value has drop against other major world currencies this past year, I see renewed pressure for the RMB to appreciate again in late – 2010, although at a more reasonable 3% per year rate.

Raw materials – This is a globally equal commodity for most products such as stamped

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or cast parts. China has no major advantage or disadvantage for most raw materials as compared to global competitors. China's huge demand for raw materials, however, tends to drive the prices of many of these materials. Prices for most raw materials dropped in early 2009 because global consumption dropped. Now, as China's construction and manufacturing engines began to roll again in late 2009, commodity prices are expected to rise 10-15% in 2010.

VAT policy – In 2008, the amount of VAT rebate given on some low value-add exported commodities, such as simple castings, was reduced or cancelled altogether. In 2009, this policy was reversed to help distressed China exporters of such products. I believe that at least for 2010, this more favorable VAT rebate policy will remain in place.

Salary increase expectations – In the past few years, Chinese employees expected up to 10% salary increases per year. They could easily seek more lucrative salaries at other companies. In 2009, many companies reduced their labor cost by:

- Trimming their staffing levels by 5-20%
- Or instituted across the board salary reductions of 10-25%
- Or ran their manufacturing operations 2- 3 weeks a month and shut it down 1-2 weeks per month.

Most staff accepted such concessions for the sake of their company's survival and opportunities elsewhere were extremely limited. Now, many companies are hiring again but only to replace some (not all) of the positions cut last year. In 2010, I predict a lot of secret interviewing for potential jobs at companies offering better salaries again, especially by employees that sacrificed part of their income in 2009.

Hiring practices in 2010 - In the past, when China's growth was going strong, HR was tasked to quickly hire people with the skills and experiences needed immediately to perform urgent tasks. Candidates' motivations and alignment with company's culture was not a priority. The crisis served as a good excuse to release marginally contributing employees. In 2010, HR managers will be more selective on who they hire. One executive said it best…" we came to China not because of its low labor cost but because of its huge talent pool, so we can choose the very best." Technical skills can be taught to talented people but personal motivation and deep rooted habits are impossible to change.

Labor policy - In 2008, a new labor policy was instituted to assure that employees received their full social benefits. Some campus style (on-site living accommodations) manufacturing operations paid less than their fair share of benefits to their employees. This was a significant cost increase to those operations. More stringent dismissal guidelines were part of this new policy as well. In 2009, as most companies downsized their staffs to survive, enforcement of this policy was overlooked. As business improves in 2010, I predict renewed threats of enforcement of these labor policies.

Uniform Environmental regulations – Prior to 2008, meeting global environmental standards was enforced only at JVs and foreign owned enterprises. By mid 2008, this policy was uniformly applied and audited at all China based companies. 2009 saw continued application of the law although audits were conducted only sporadically. In 2010, I predict even more "Green" initiatives to be instituted as the Government attempts to become viewed as more global environmentally sensitive.

Hybrid and electric cars are not cost competitive with traditional fossil fueled vehicles (including CNG) because their volumes are too low to benefit from economies of scale. If the China Government mandated that 750,000 – 1,000,000 cars be produced with these new technology propulsion systems, the price of those vehicles would drop to make this technology affordable to the global masses. With such an edict in 2010, China could become the world's leader of such vehicles within 2-4 years.

Price of oil's affect on shipping – When oil reached \$140/barrel in 2008, there were many that said the world is no longer flat. In 2009, the price of oil stabilized in the \$60 to \$80 range. Although oil's price may creep higher in 2010, I doubt it will exceed \$100/barrel, creating the scare we saw during the summer of 2008. Regardless, even at higher prices, people need to think of more creative ways to package products for shipment to better utilize sea containers' space and weight restrictions.

China's stimulus package was targeted primarily for infrastructure projects such as:

- Deep water port improvements and expansions
- Rail system networks from the Coast to China's Interior, where the Government is pushing more companies to settle to improve employment, wages, and skills
- Continued the "Next 25 Cities" improvement projects for housing for the masses
- Agriculture equipment and facilities improvement
- Lower taxes for purchased small cars, again primarily for people living in China's interior Provinces.

These effectively re-invigorated the economy to the point that by the end of 2009, China's GDP approached 9% after dropping to below 6% earlier in the year. These Logistic Improvement Projects are preparing China's export driven businesses to be more effective to meet future global requirements when the world's recovery finally takes hold. Vital food and water projects are targeted to meet and sustain the masses needs.

In 2010, I see continued focus on lower income, affordable, housing projects for the masses while controls are implemented to prevent a higher end, speculative, housing bubble. I expect continued Government support of infrastructure, agriculture efficiency improvement, and related projects but maybe not in the form of another stimulus package but in some other form of favorable incentives in 2010.

China's various Regions felt the crisis differently. The North and Middle Coastal Regions of China felt a production dip but domestic demand and the stimulus projects reduced much of the impact by the end of the year. The Interior of China is primarily agriculture and raw material sources so the crisis had minimal impact there. South China, home to most manufacturing industries for global export was hardest hit. 30,000+ factories closed leaving millions of workers without jobs. Although export has recovered 20-35%, this Region saw more than a 50+% drop so they are still far from full recovery. The surviving companies have become more scrupulous with their financing, resources, and inventories. Many don't even order raw materials or build product without a PO in hand or an order to ship product. Hopefully they have learned to become more efficient (better through-put) and more quality minded for what they produce.

Although China's labor cost is facing challenges from other low cost countries like Vietnam, Thailand, India, and Eastern Europe, China will still remain the "factory of the world" because of its low overhead and economies of scale. It will continue to attract foreign companies, looking not only to purchase products from China export but continued investment in facilities in China to share in satisfying its growing domestic demand in 2010 and beyond.

Quality of China produced goods has always been a concern to foreign consumers but that is changing quickly. As domestic consumers' demand for products which meet international standards for quality and performance increases, this will drive local producers to improve their image from one of purely "lowest cost' to that of "value"…good quality, fast to production, at a reasonable, globally competitive, price.

I wish you good fortune and the greatest success in 2010.

Mr. Slusiewicz has 32 years of experience within GM and Delphi in Process Engineering and Supply Chain Management, specializing in Best Cost Country Localization initiatives, Global Souring, Supplier Development, Plant and Product Start-ups, and Project Management.

Originally from the United States, Mr. Slusiewicz has spent the last 14 years supporting operations in Australia, China, Indonesia, Thailand, India, and Korea. His diversified experience enables him to be very effective at project execution and identifying companies' synergies.

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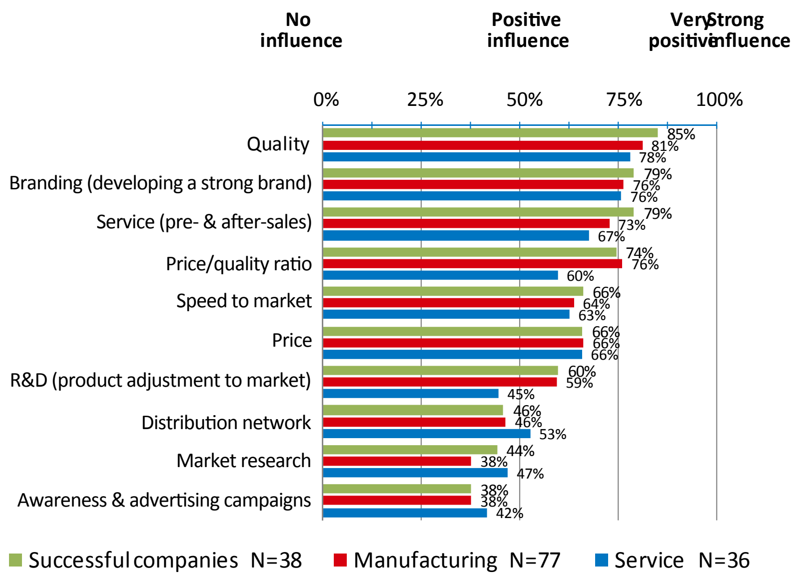
3 Communication Activities

3.1 Sales

The main factors with a positive influence towards sales are Quality, Branding, Service (pre & after sales), and the Price/Quality ratio. As shown in the following graph, these factors are thought to be even more important for successful companies (without comparing with less successful ones). Surprisingly, awareness and advertising campaigns is ranked the lowest. This fact is likely due to the way Chinese society works by guanxi (a Chinese term for closely-built interpersonal relationships) and trust, where branding is caught in the middle of complex relationships.

Looking at the data, successful companies rated Quality (4.3 of 5), Branding (4 of 5), and Service (4 of 5) as the factors having the most positive influence on their sales.

Chart III.3.1 - Which factors have a positive influence on your sales?N=113



The target customers of most companies within the survey lie in the middle to high-end segments. As the low-end segment is held firmly by the Chinese companies, it would be difficult to compete against them in them. This breakdown can also be explained by the fact that these companies' products tend to also be of higher technological standards as western economies are more developed.

Whether in services or manufacturing industries, the surveyed companies' biggest market segment is the high-end, backed only by little of the middle and/or low-end segments.

Chart III.3.2 - Which segments are you selling?
N=79

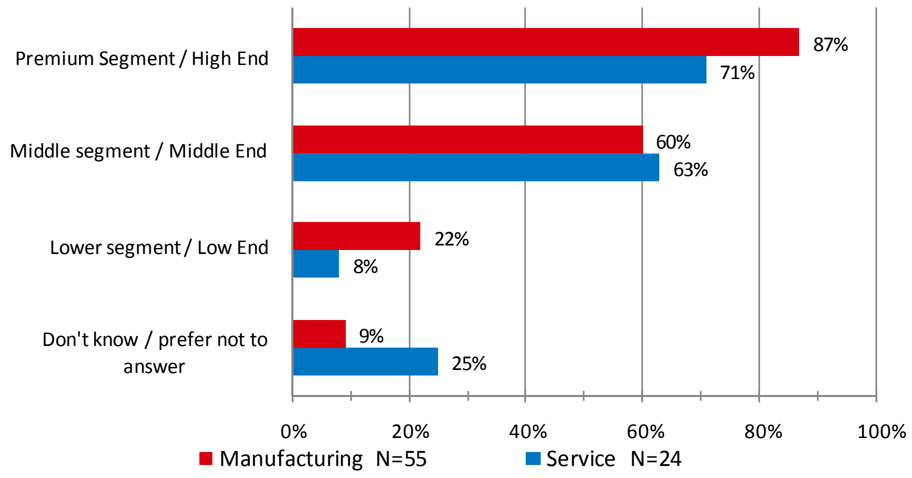
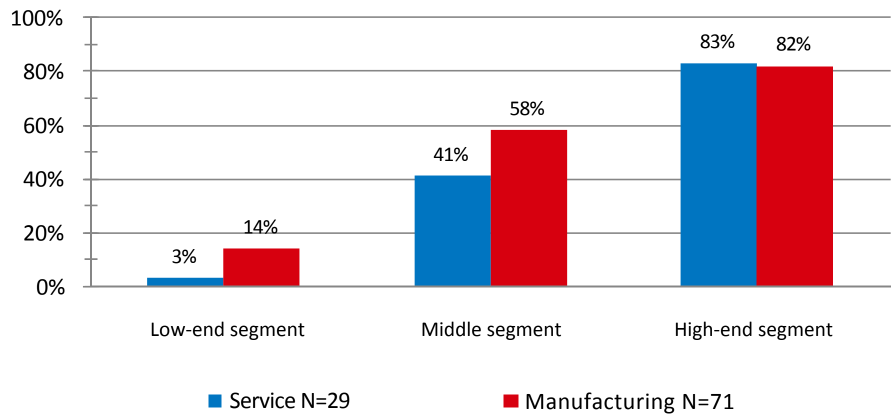


Chart III.3.3 - In the future, you plan to sell more to who? N=100

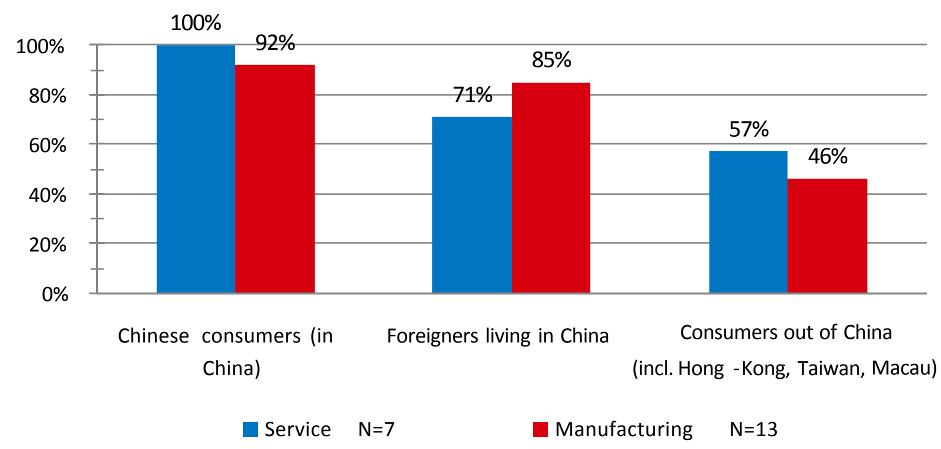


Respondent companies are selling to a broad range of consumers.

For B2C businesses, the majority sells to Chinese consumers in China. For manufacturing companies 92% sell to Chinese consumers, and these sales represent a large percentage of their turnover. For services companies, all of them sell to Chinese consumers, but on average 60% of the revenue comes from Chinese consumers. For both manufacturing and services companies the amount sold to foreigners in China is quite low.

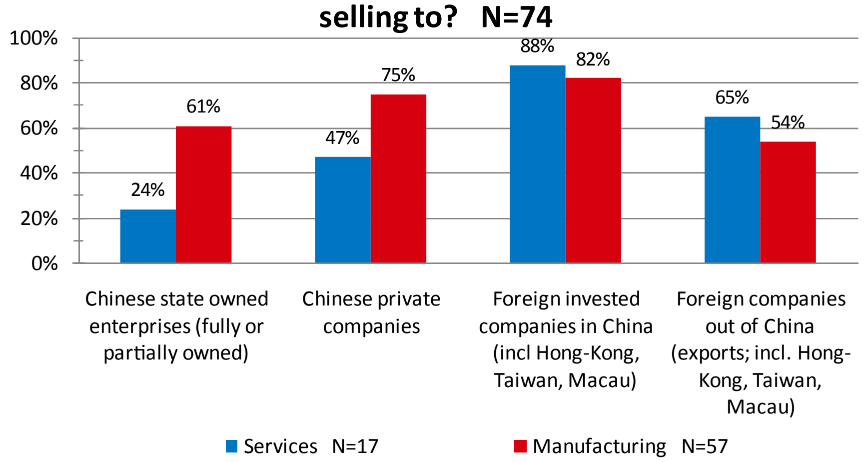
Only about half of the companies surveyed are selling to consumers outside of China. For manufacturing companies these revenues are a small share of their total sales, but for services companies selling outside of China around 60% of their revenue is generated from those sales.

Chart III.3.4 - B2B: To which consumers are you selling to? N=20



For B2B businesses, only manufacturing companies are selling a significant amount to State Owned Enterprises and Chinese private companies. For manufacturing companies, the revenue split between the various consumer types is fairly evenly-spread. For a few of the respondents a significant portion of their sales were to foreign invested enterprises, which would indicate that these respondents are very new in the market and/or have been set up to target existing customers in China.

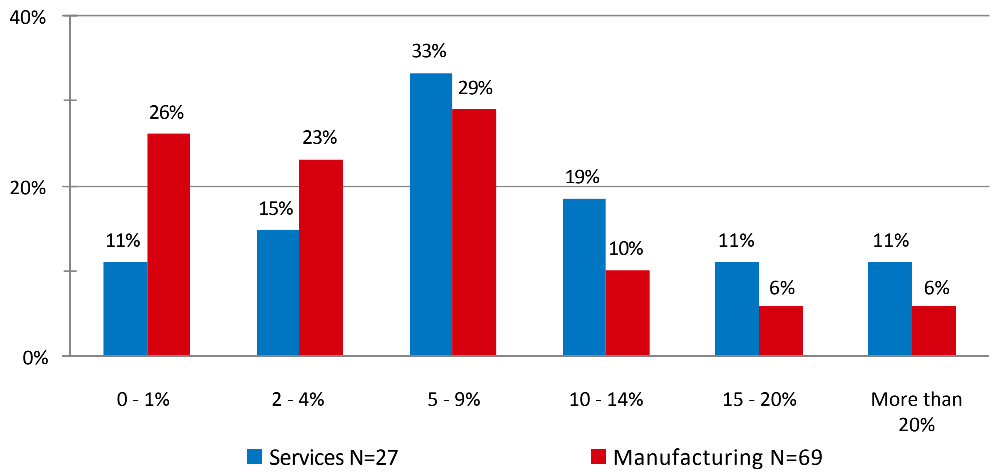
Chart III.3.5 - B2C: To which consumers are you selling to? N=74



3.2 Marketing

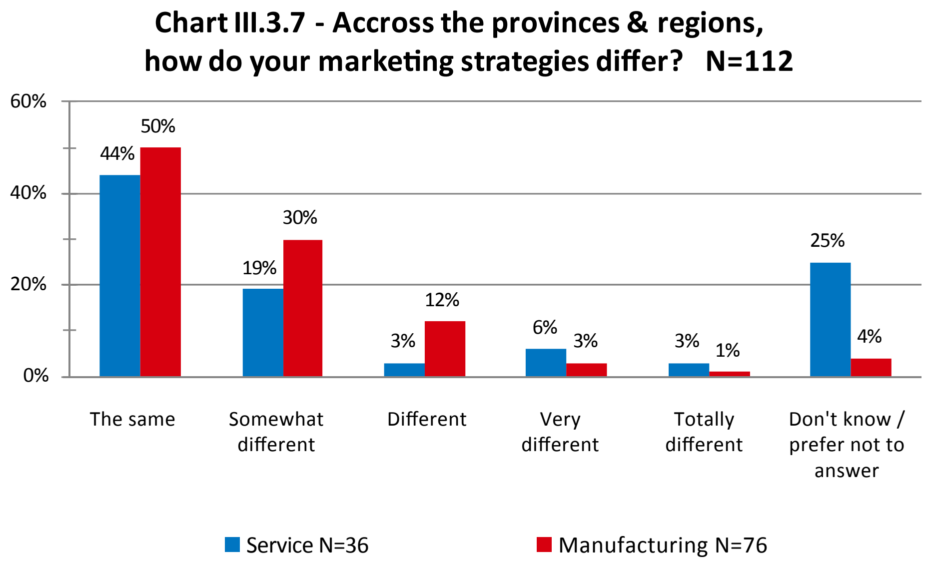
Of the services companies surveyed, 22% spent more than 15% of their turnover on marketing, whereas only 12% of the manufacturing companies surveyed spent over 15% of their turnover on marketing. A recent study by the Chief Marketing Officer (CMO) Council showed that only 14% of their surveyed companies spent more than 16% on marketing as percentage of turnover[4], indicating that services companies are having to spend significantly more on marketing to enter the Chinese market.

Chart III.3.6 - What percentage of your subsidiary yearly turnover is spent on marketing, promotion and awareness? N=96



As China is a huge country and every province can be considered as a single European country, marketing strategies can also be different among various regions. However, as the below chart explains, most respondents are still applying the same strategy across regions. Looking at differences between B2B and B2C companies, it is mostly the B2C companies that apply different strategies.

[4] Improving Marketing Yield, Visibility and Process, CMO Council 2009

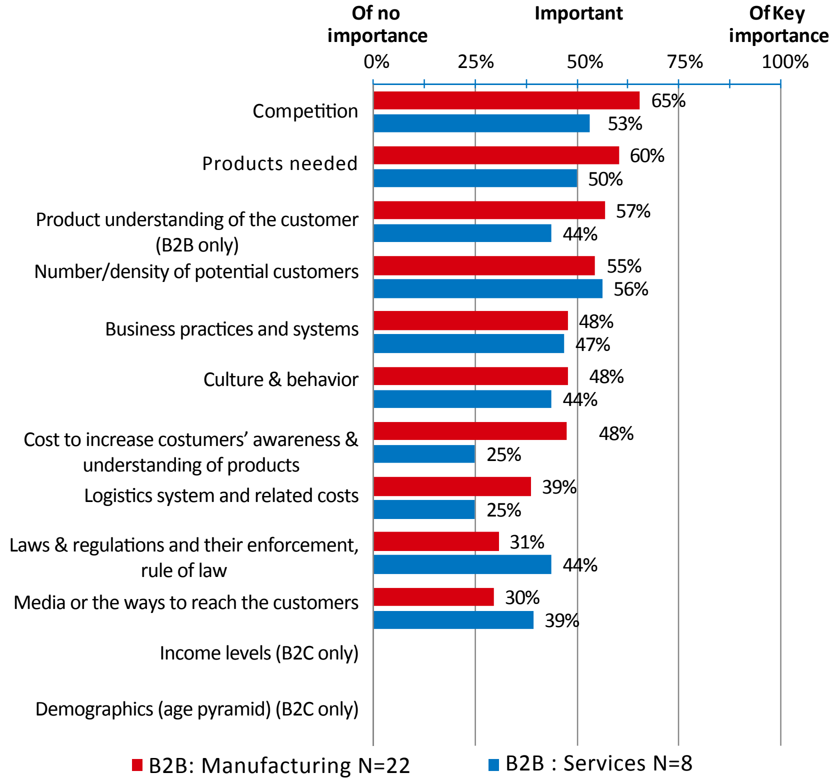


The following chart takes a look at the reasons why some companies choose to apply different marketing strategies. Because there are few B2C companies having different strategies, no differences were made between services and manufacturing B2C companies.

For B2B manufacturing companies, the presence of competition in the region is the primary factor of importance for adopting different marketing strategies across provinces. This stands in comparison to B2B services companies, where competition is only a secondary factor of importance, with the density of potential customers being the primary factor. This is not to say that density of potential customers is not important for B2B manufacturing, as it is currently ranked as the fourth major reason for different strategies. As products needed in different regions vary, so can the marketing strategy, and hence products needed is the secondary factor of importance for B2B manufacturing companies, with product understanding of the customer being the tertiary factor of importance.

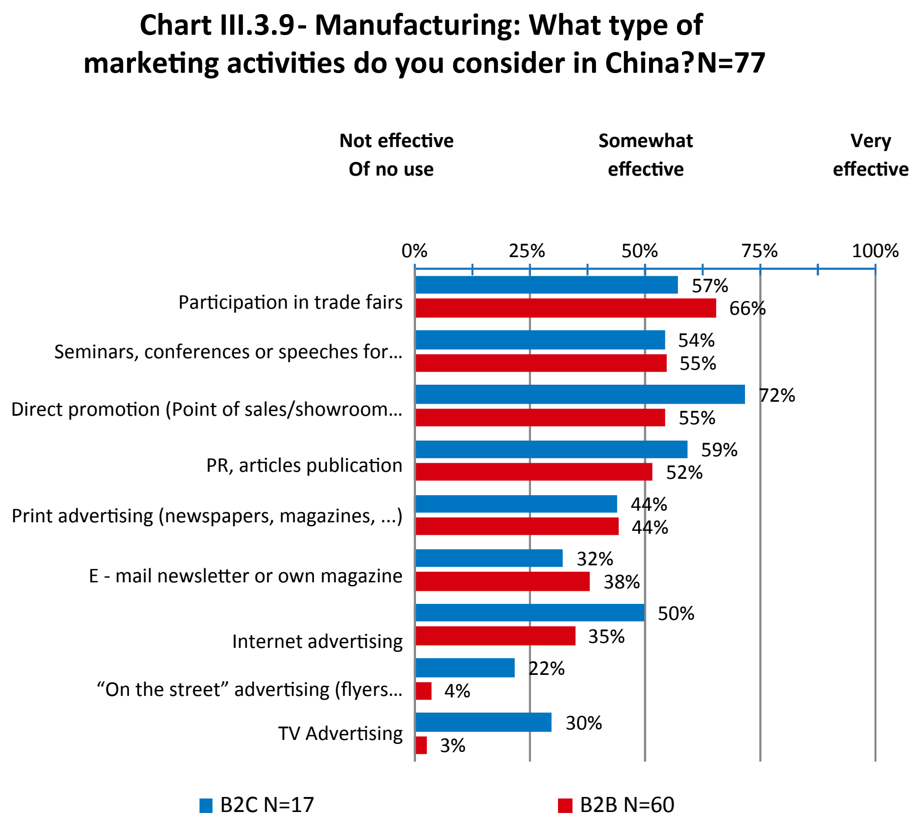
For B2C companies, the reasons for difference in marketing strategies across provinces are less clear, and they rate the business practices and systems as the most important factor, followed by the products needed, and the competition.

Chart III.3.8 - How important are the following factors on the difference in marketing strategies accross the provinces & regions? N=44

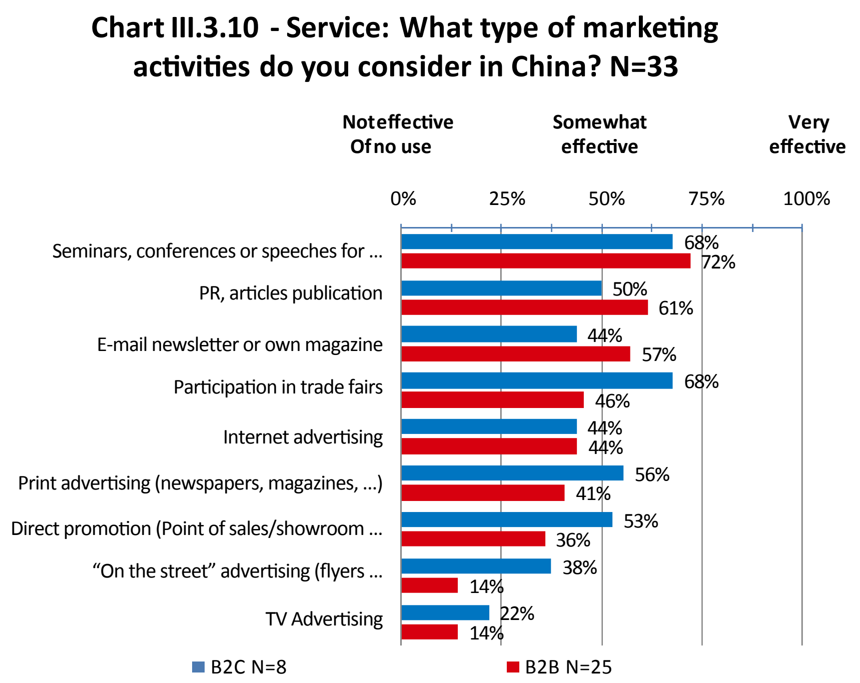


Looking at the different marketing activity types by effectiveness for manufacturing B2B, trade fairs are the most effective way to increase awareness of people. Seminars, direct promotion and PR follow thereafter in terms of second most effective ways to promote products and brands.

For B2C companies, direct promotion is the best way, with PR and articles publication being the second best. Interesting to note, Internet advertising is apparently working quite well for these companies as it ranks as fourth most effective way to advertise their products, just behind participation at trade fairs and seminars.



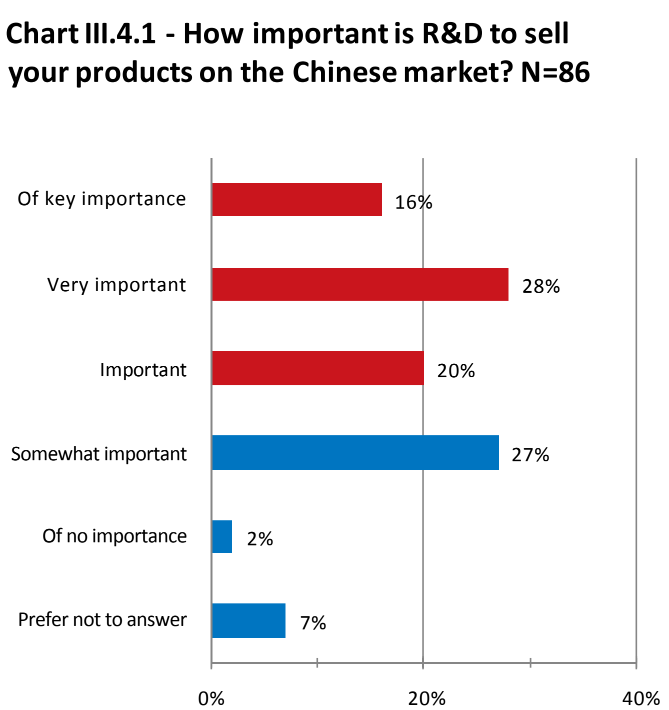
Both B2B services companies as well as B2C services companies consider seminars as the most effective marketing technique. Interestingly, however, B2B services companies do not rate trade fairs as very effective. PR, publications and e-mail newsletter are also considered moderately effective ways to raise awareness for B2B companies. B2C companies favor more print advertising, direct promotion and PR as second most effective marketing activities.



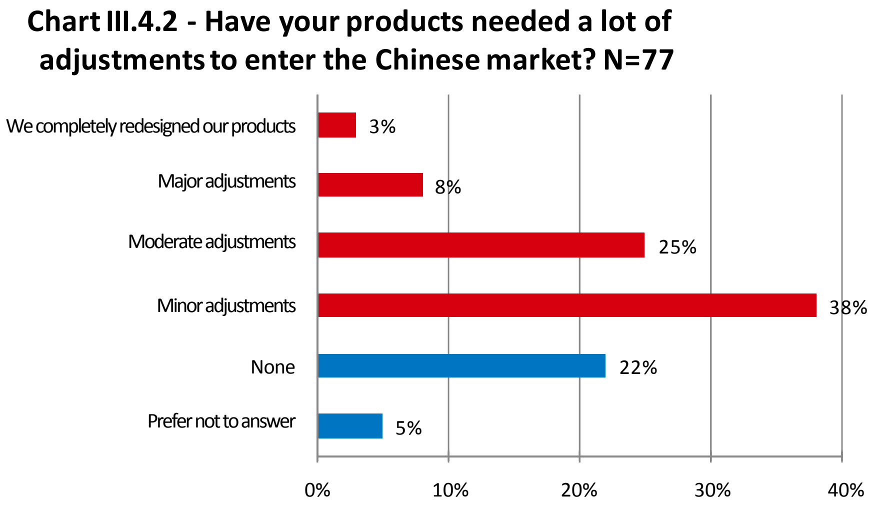
4 Intellectual Activities

4.1 Research and Development

R&D is considered by more than two thirds of our sample as "important" or "greater than important". The reasons behind this can probably be found in the fierce competition in China (see Concerns) and in the understanding of the Chinese market.

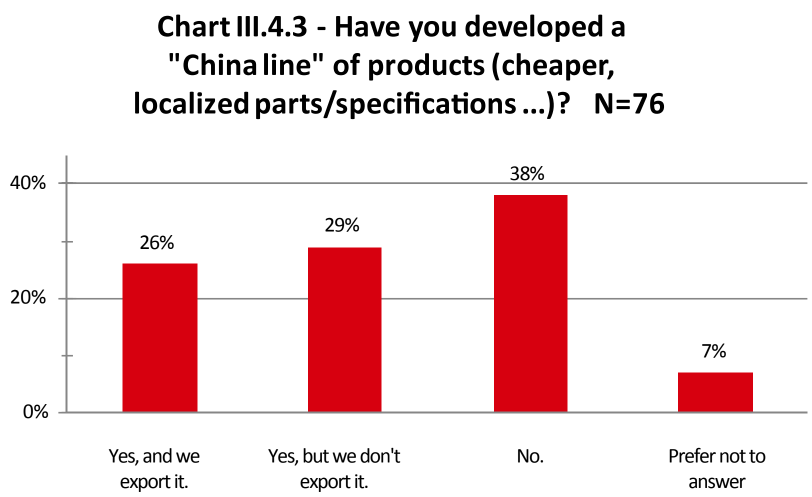


For three fourths of our sample, some amount of R&D has been done before selling their products on the Chinese market. Most of them just make minor adjustments on the surface when adapting their products to the Chinese market, but, one third of those surveyed actually

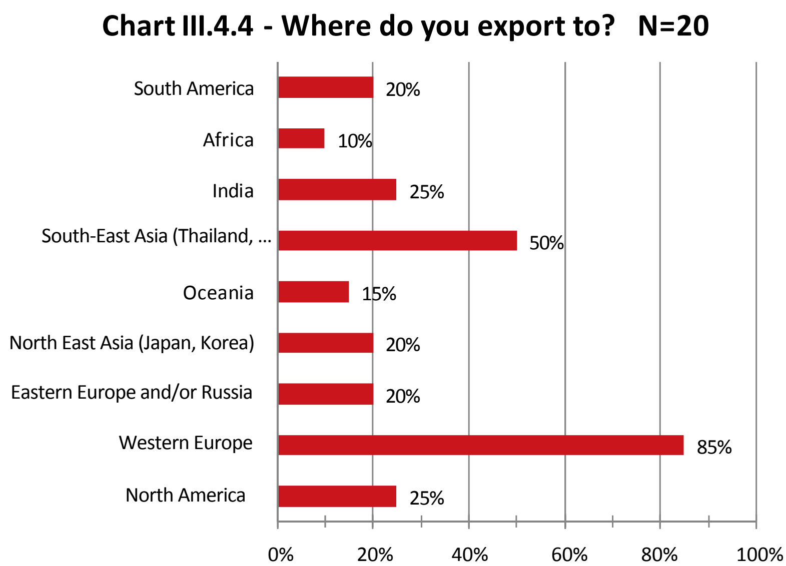


go deeper by making modifications specifically for the Chinese market.

Going one step further, 55% of those surveyed even developed new lines of products targeting not only Chinese market (29%), but even for other markets (26%). This shows the availability of quality components for cheaper prices, even for higher end products (cf. "In what segments are they selling").

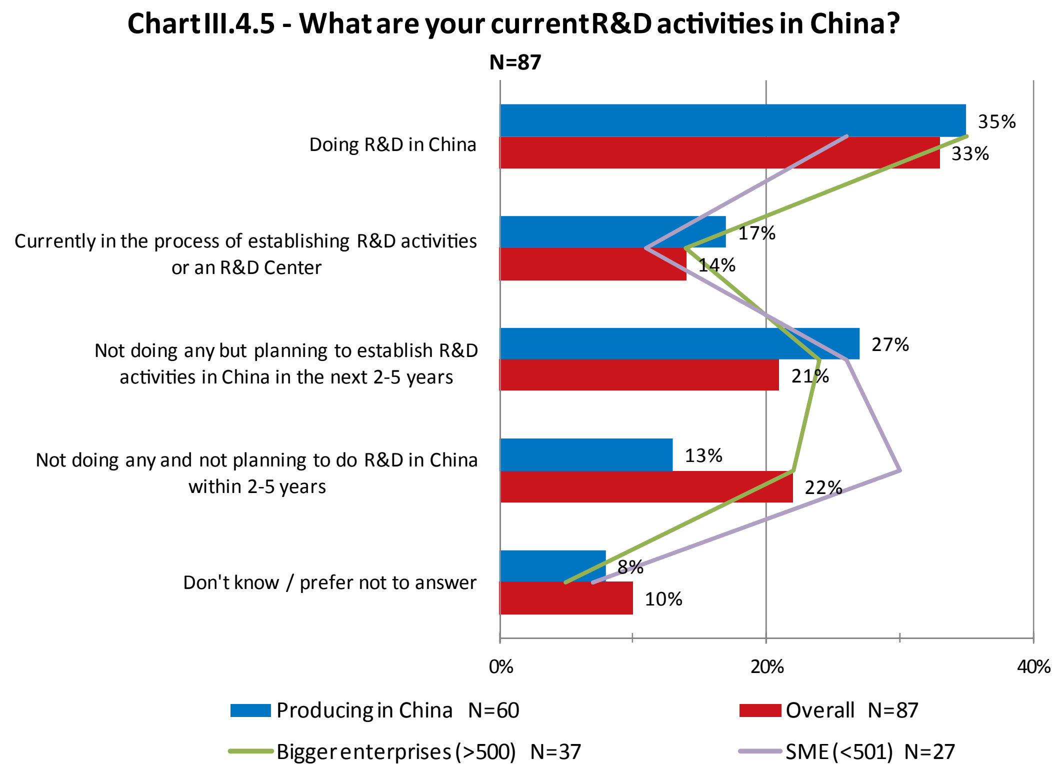


Companies' "China line" is exported to Western Europe in the first place (85% of respondents), with South-East Asia being second (for half of the respondents). This localization is mostly endeavored by the BEs (63%) and can be seen by the reach of their R&D activities in China (cf. "what market for their R&D"). The same can be said for SMEs and Western Europe (100% export to Europe and their R&D are for global activities).



One third of the sample is already doing R&D in China and another third is in the process of establishing R&D activities or planning to do so in the near future. This leaves just a minority of companies not taking the chance to do R&D in China. When looking at companies already producing in China, these numbers are even slightly higher.

Comparing BEs with SMEs, it can be seen that it is mostly the BEs that are doing R&D.

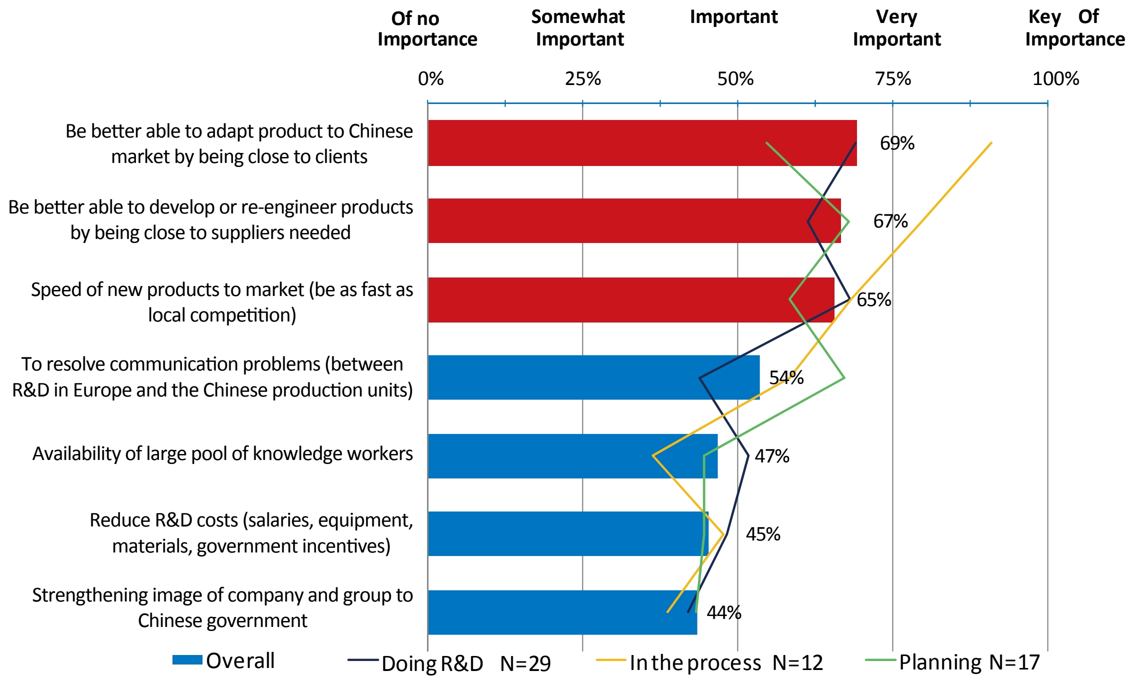


There are three main reasons why companies do R&D or want to do in China: better ability to adapt the products to the market, better ability to develop or re-engineer products by being close to suppliers, and faster execution.

The chart shows that the frequency and importance of communication problems seems to be on a rise.

The difference between BEs and SMEs can be found in two answers. Firstly, the SMEs consider the reduction of the R&D related costs as a much more important factor than BEs. Secondly, the availability of a large pool of knowledge workers is not really of importance to the SMEs.

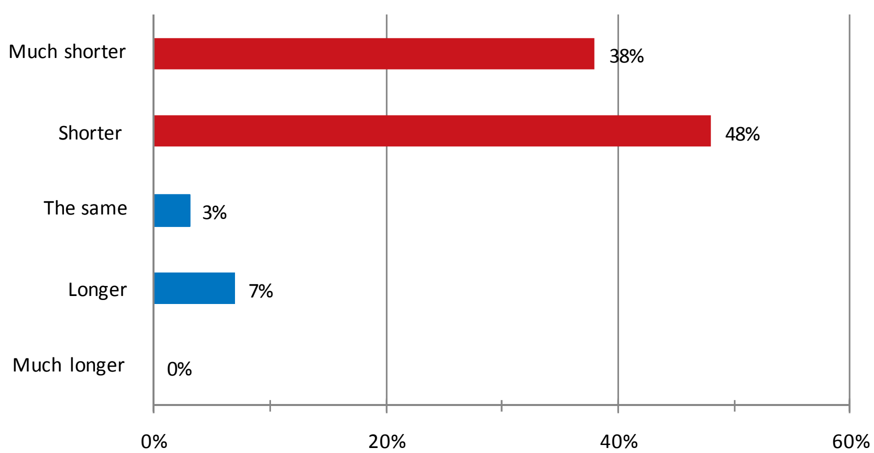
Chart III.4.6 - How important are the following reasons for having opened or planning to open an R&D unit or center in China?N=53



The third most important reason why companies are setting up R&D in China is the speed to market and faster execution. This can be related to how organizations interact with their suppliers. The following chart shows that the companies currently doing R&D feel that their lead time from suppliers is shorter in China than in Europe, which can help with faster product development and production.

Chart III.4.7 - Compared to Europe, what is the usual lead time until delivery from suppliers?

N=29



The target markets of the R&D operations are clearly different between SMEs and BEs. SMEs tend to go global whereas BEs tend to go regional for R&D.

Chart III.4.8 - For what markets are or will your R & D activities be for? N=53

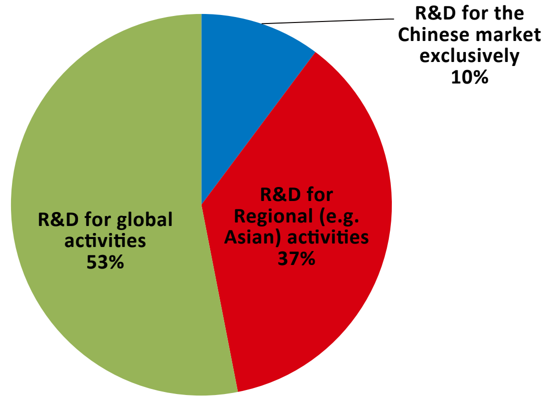


Chart III.4.9 - SME: Target markets? N=17

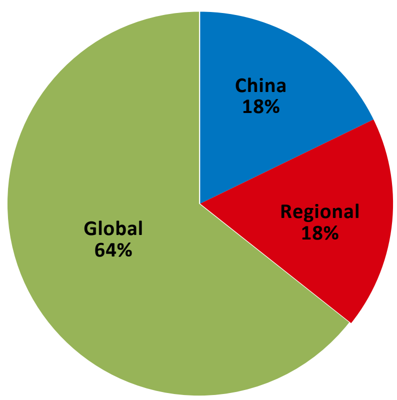
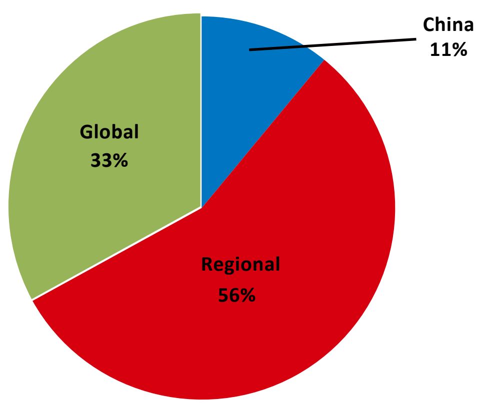
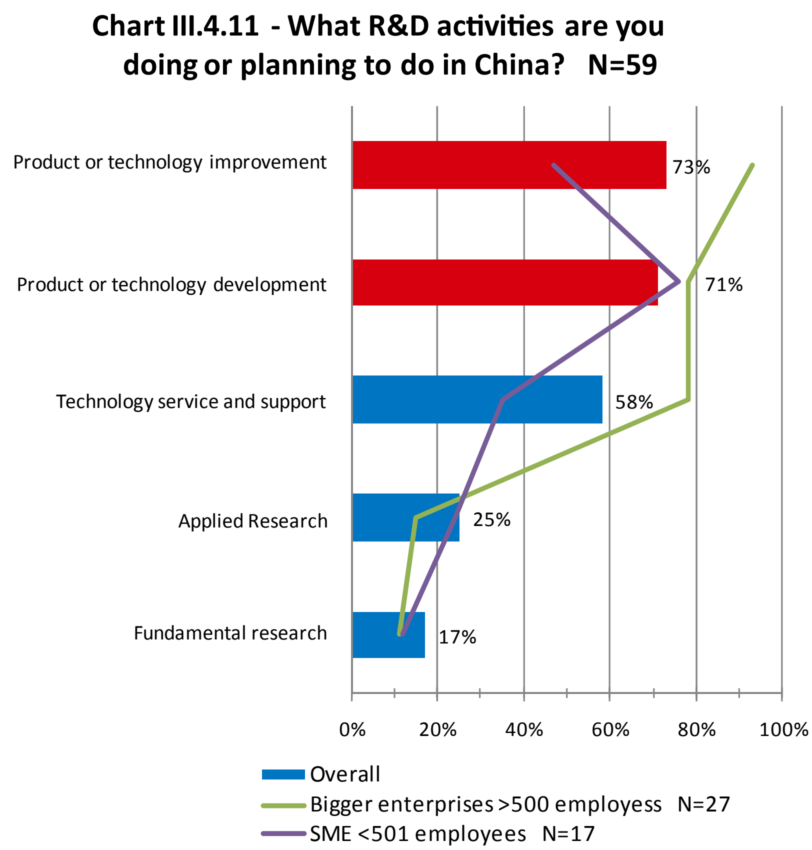


Chart III.4.10 - Bigger companies: Target Markets? N=27

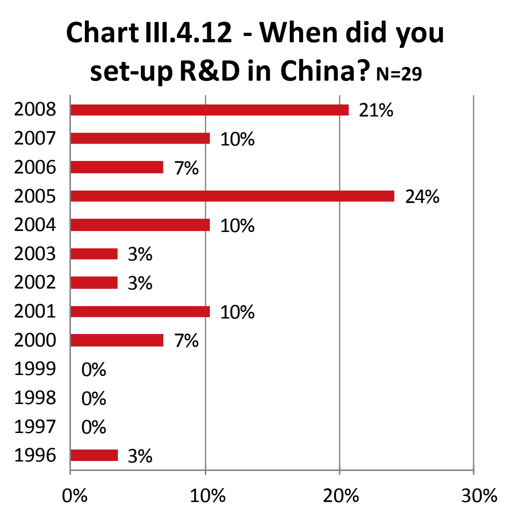


There are mainly three types of R&D that are conducted in China: 1.) product or technology improvement, 2.) product or technology development, and 3.) technology service and support. However a few companies also do, or will be doing, applied research and fundamental research.

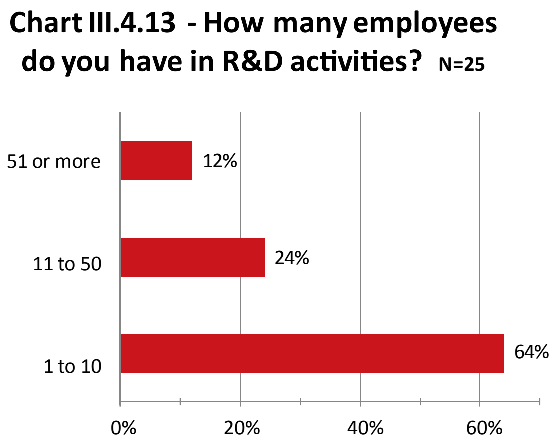
The chart also shows that the specific aim of the SMEs is mostly to develop new products and less to improve older ones or provide technology service and support. This finding corroborates with the target region of their R&D: the world.



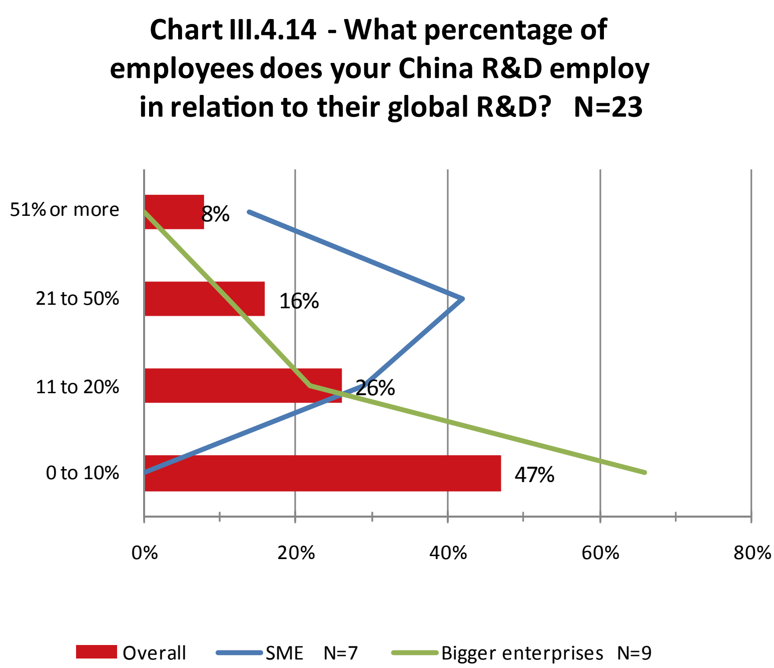
R&D activities were for the most part set up after the WTO agreement in 2001, with a big peak in 2005 and 2008. As the operations are still quite new, this would in part explain their small size (cf. next graph).



The R&D activities of our sample are still very small as two-thirds of our sample employ less than 10 people in R&D.

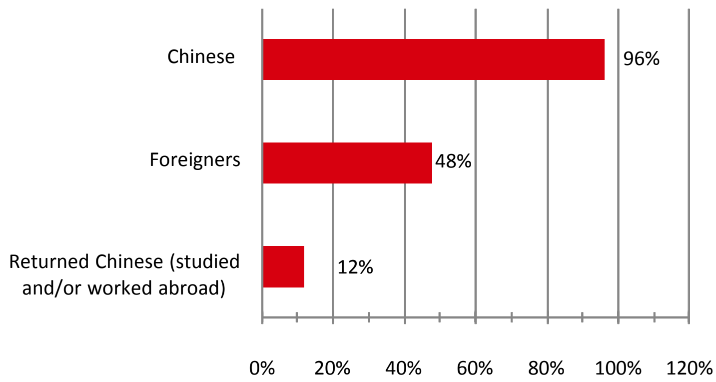


In relation to their global R&D activities, half of our sample has their China R&D employees count for 10% or less of global total. But herein shows another big difference between SMEs and BEs, as this proportion appears to be correct for BEs, but for SMEs, their R&D activities in China actually account for a good portion of their global R&D activities.



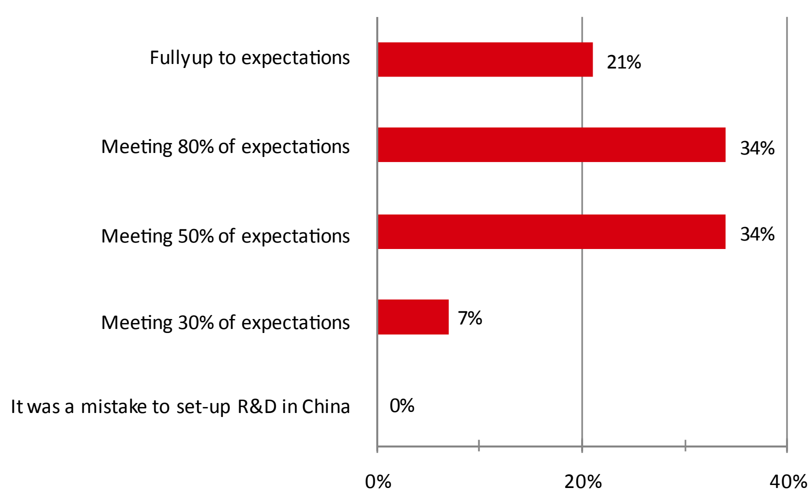
Looking at the origin of the staff for their R&D operations, almost all companies take advantage of the abundant local population, but half of them still hire some foreigners. However, the Chinese employees consist of more than 90% of the whole R&D staff for three-fourth of our sample, with foreigners or Returned Chinese being only a minimal part of R&D staffs.

Chart III.4.15 - Where is the staff of your R&D facility from? N=25



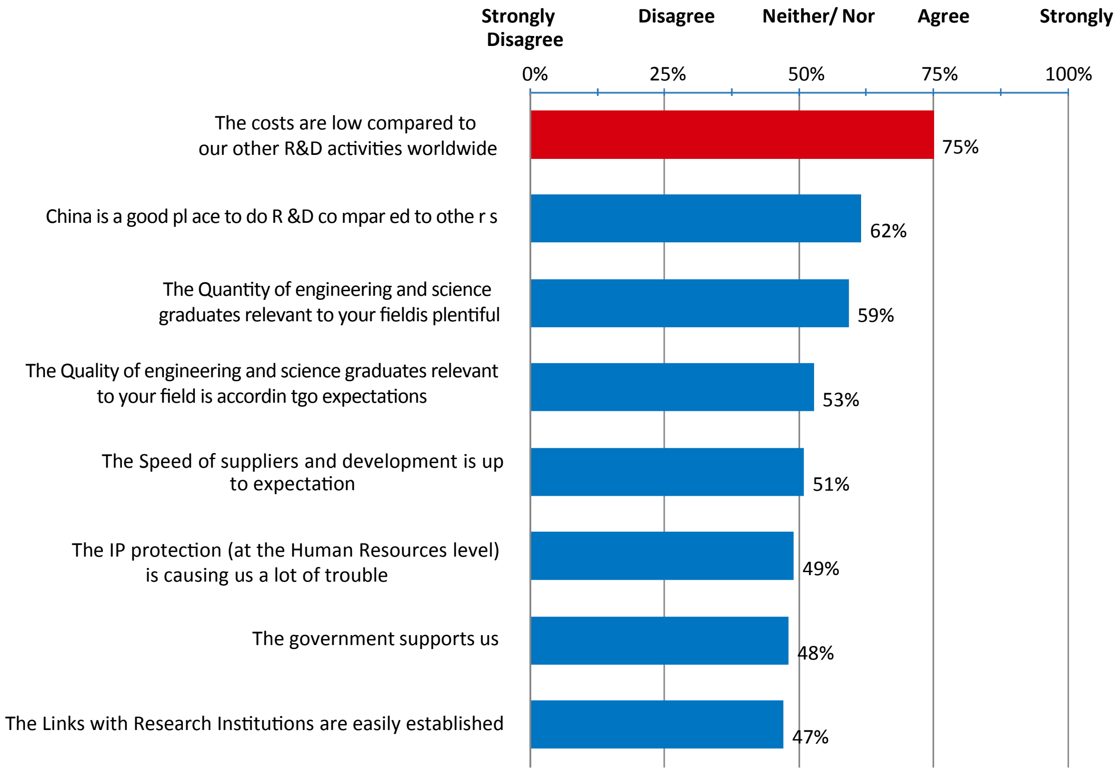
Two-fifths of our sample has met 50% or less of their initial expectations for their R&D activities, which alludes to the difficulty in managing R&D operations in China. A brief interview with a few companies who took part in the survey showed that there are mainly two kinds of difficulties: external – represented by the customers; and internal – represented mostly by the staff and their difficulty to adapt either to international business practices for Chinese, or to local conditions for foreigners.

Chart III.4.16 - How do your R&D activities meet your initial expectations? N=29



When conducting R&D in China, those surveyed think that the costs here are low compared to their other R&D activities Worldwide and therefore rates China as a good place for R&D by comparison. Reasons for this are likely the plentiful quantity of knowledge workers and almost-up-to-expectations quality of work. It appears that problems related to IP and human resources are not of real concern. Finally, it appears that links with local institutions are not as easily established.

Chart III.4.17 - How do you rate the following statements describing R&D environment in China? N=29



Establishing links with research institutions seems to be an interest only of BEs. Indeed, only 17% of BEs do not consider building links worthwhile, whereas almost 90% of SMEs are not interested generally in building links. Among the good portion of BEs who has developed links with research institutions, most of them think the links are extremely useful to them.

Chart III.4.18 - Have you developed links with Research Institutions in China? N=29

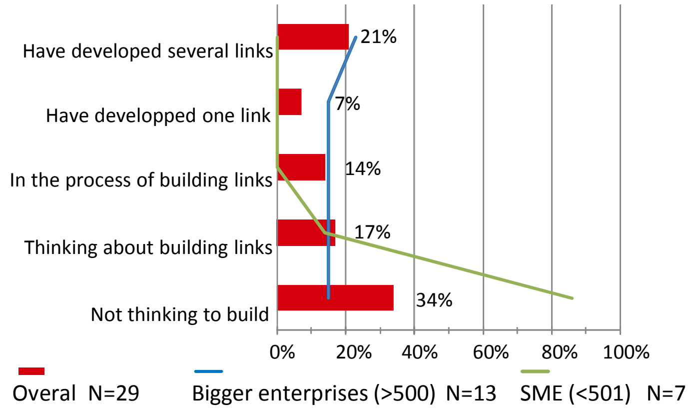
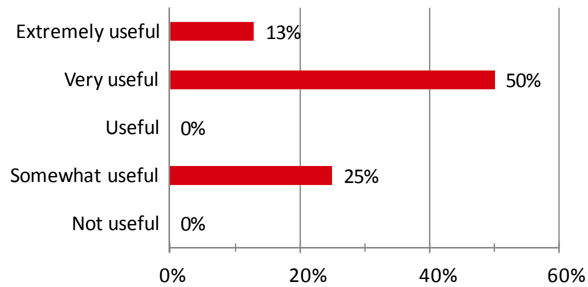


Chart III.4.19 - How are these links useful to you? N=8



The R&D intensity[5] of our sample is quite high, with an average spending of around 8% of total turnover (without the 100% research center). But taken separately, BEs and SMEs exhibit quite different patterns and this may be somehow related to the importance of worldwide share of R&D activities. For BEs, the intensity with an average around 4% is on the lower side of the spectrum, yet still quite high compared to European averages (2.7% according the "European Industrial R&D Scoreboard 2008"). In the future, none has indicated any plans to decrease R&D activities. Especially of note is that 91% of BEs plans to increase activities/intensity as opposed to only 43% of SMEs. The rest plans to stay with the same intensity.

[5] R&D spending as a percentage of Turnover

Chart III.4.20 - How high is your current R&D intensity in China (percentage of R&D spending/turnover)? N=21

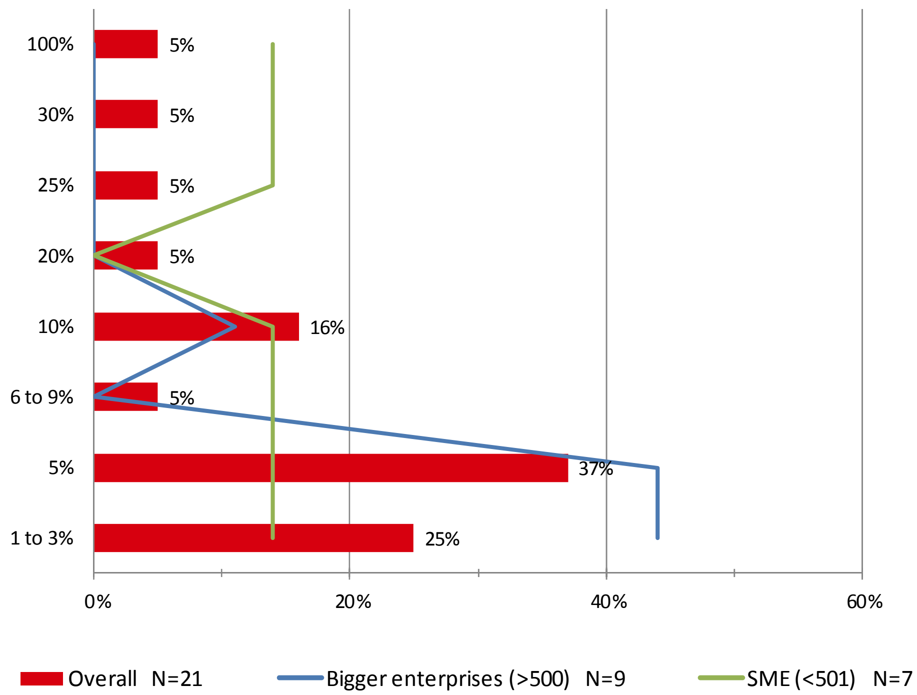
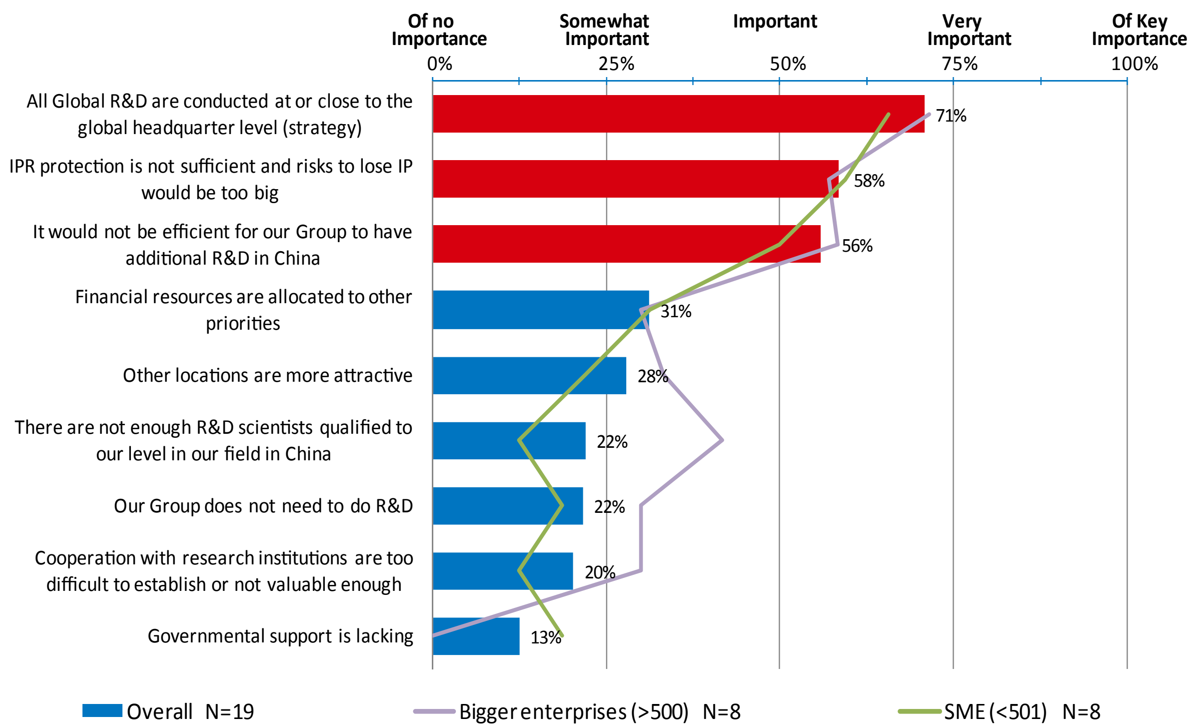


Chart III.4.21 - Why have you not set up and are not planning to set up R&D activities in China? N=19

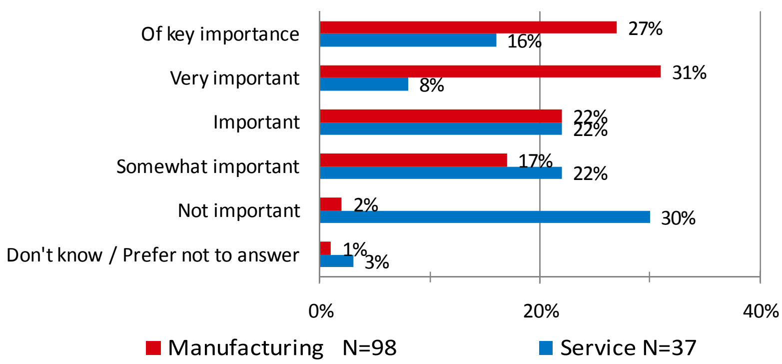


There are three main reasons why companies do not want to establish R&D in China, two of which are strategic reasons and one being the fear of loss of IP. The IP loss fear, however, is not that well founded as we will observe in the section on Intellectual Property. The main strategic reason is that companies conduct R&D close to their headquarters and the other reason is that it would be superfluous for them to have a separate R&D center. BEs have another concern, however, as they fear that there are not enough qualified scientists available

4.2 Intellectual Property

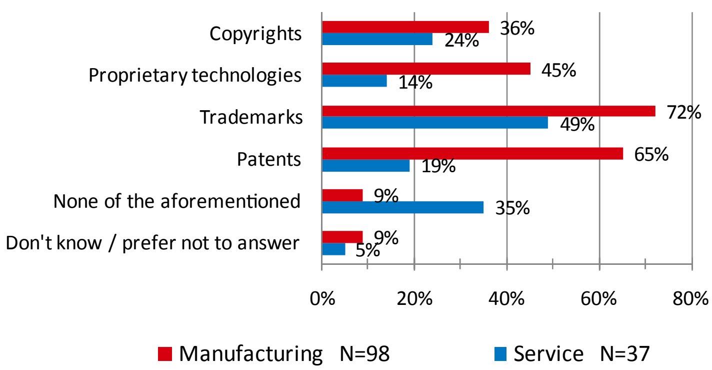
While IP is important for most of the manufacturing companies, it is less so for services companies.

Chart III.4.22 - How important is IP (intellectual property) to your business? N=135



Most manufacturing companies register some trademarks, patents or copyrights in China,

Chart III.4.23 - What type of IP do you own? N=136



but one-third of services companies do not register any.

When owning proprietary technologies, companies seem to think that the registration of patents, trademarks or copyrights is less important when compared to other factors. In particular, they rated the overall quality advantage to be of key importance, whereas they rated making technology difficult to copy, and its marketing and brand building as the second and third most important factors, respectively.

For most of the manufacturing companies, their IP has sometimes been infringed on in the prior years. Only one-fourth of the B2C and 17% of the B2B manufacturing companies have had their IPs infringed often. B2C companies seem to have reported more IP infringements. Saying IP infringement is a big problem, however, may be going too far, as some other charts further on will demonstrate (in this section and in the concerns section).

For services companies, IP is less often infringed on and only very few report it to happen often or more.

No correlation has been found between SMEs and BEs, and among all the range of company sizes, repondents seem to be hit by infringement the same way.

Chart III.4.24 - When owning proprietary technologies, how do you rate the following elements? N=47

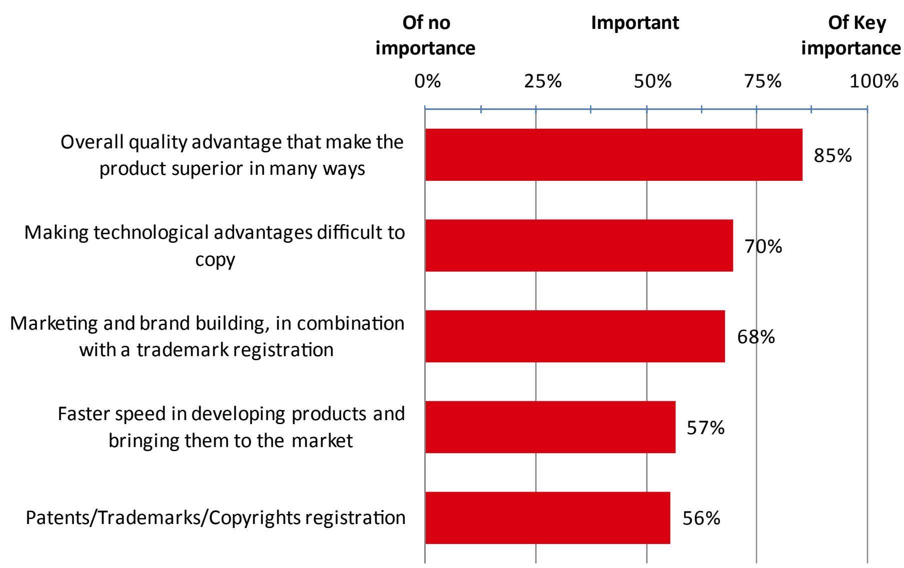


Chart III.4.25 - Manufacturing: How often has their IP been infringed in the past year: N=98

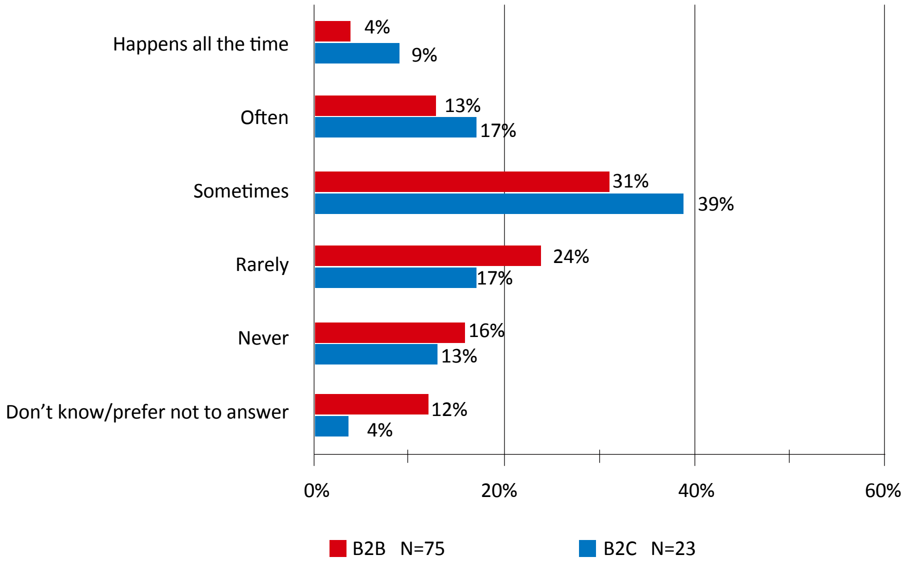
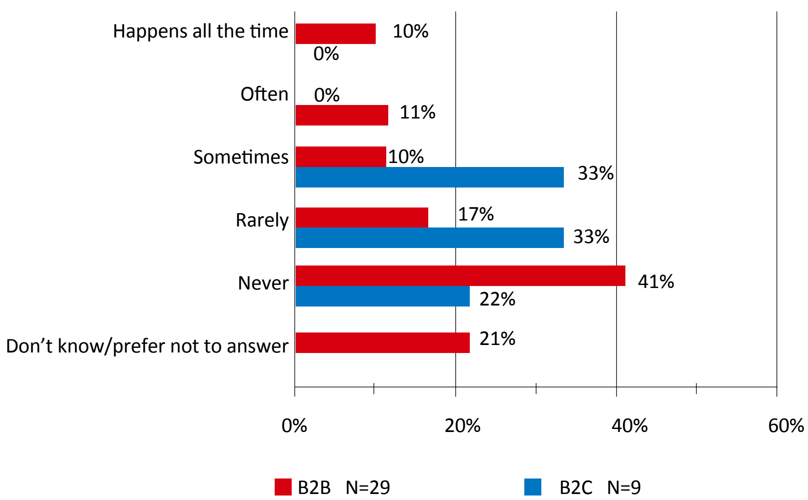


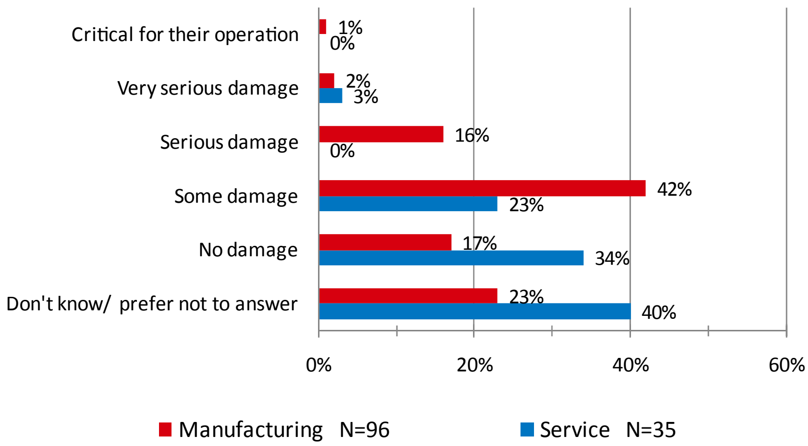
Chart III.4.26 - Service: How often has their IP been infringed in the past year: N=38



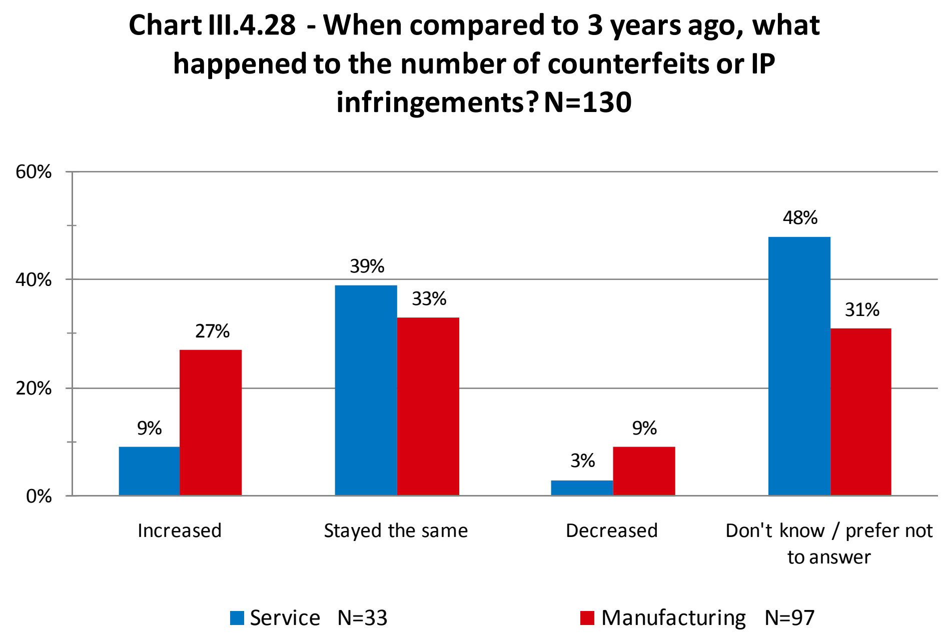
How often has your IP been infringed in the past year (counterfeit products, disclosure of know-how/commercial secrets, patents or trademark infringement)?

The previous charts showed that while infringement happens, it does not happen too often. The next chart shows that the damages caused by IP infringement were not critical against their operations, reinforcing again the fact that IP infringement is not as much of a problem as many may think.

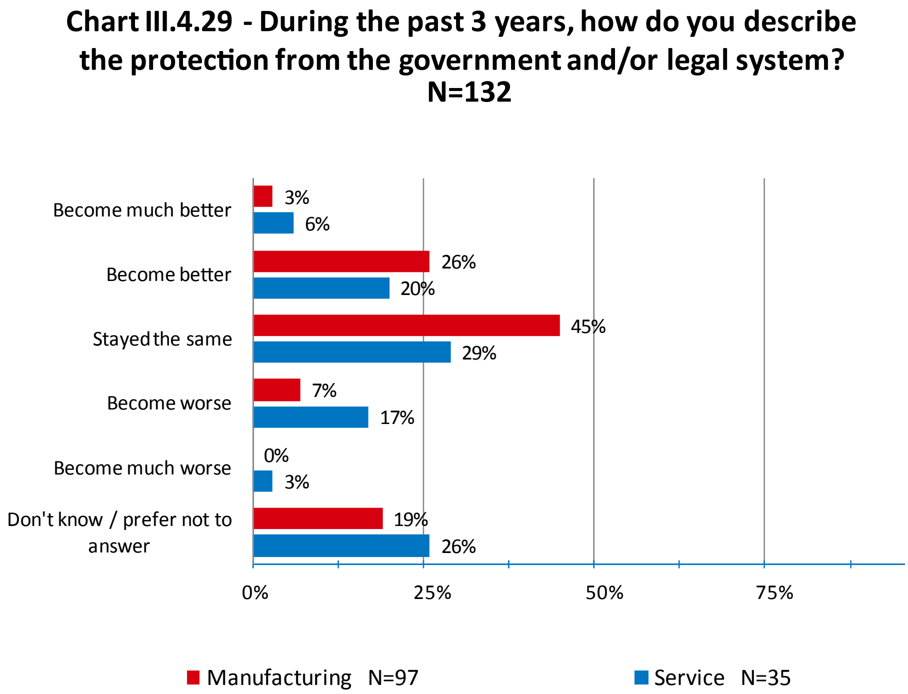
ChartIII.4.27 - What is the extent of damage caused by IP infringement originating in China for your subsidiary? N=131



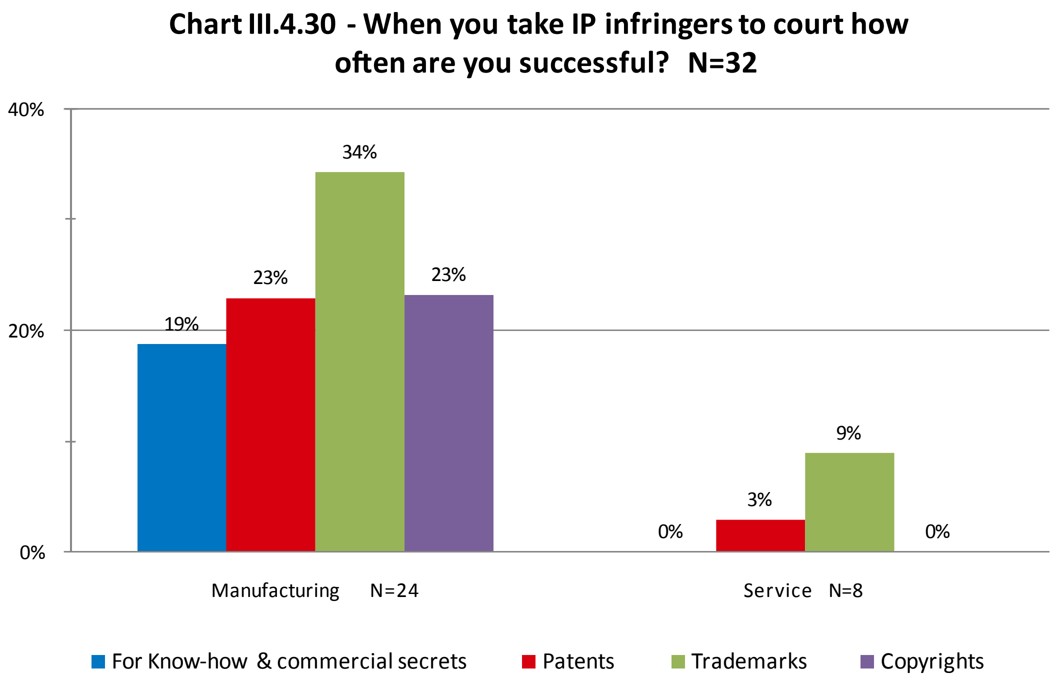
According to our sample, the number IP infringement cases has stayed the same or has even increased compared to three years ago. It is unclear as to the exact reason for this increase, but the increase may be explained either by the fact that infringements are more common as companies become more well-known, or by the fact that the companies are more aware of the infringements.



However, those surveyed think that the protection from the legal system has stayed the same or even became better. This does not contradict the other findings, but merely indicates that as more issues occur, there are more standard ways of dealing with them through the court.

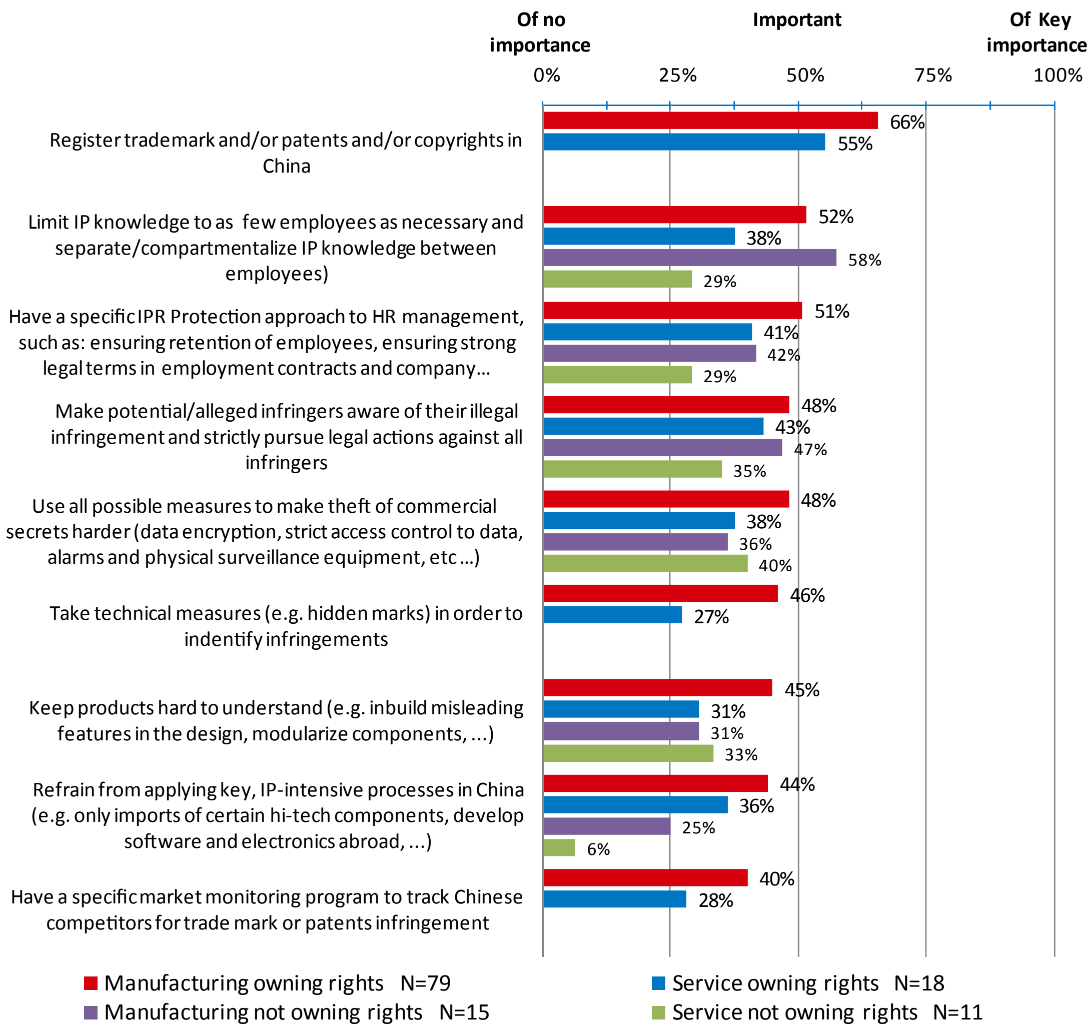


When asked if they had taken legal actions against infringers, around one-fourth of the manufacturing and one-tenth of service companies answered yes (30% manufacturing and 20% services companies answered no, the rest didn't answer). However, when they rated the success of their actions, it became obvious that there have little successful cases, as shown in the chart below. Most success was observed in Trademark cases.



Finally when asked what is the most effective way to prevent IP loss, registering patents / trademarks / copyrights turns out to be the most effective. Limiting the IP knowledge to a few employees is the second most important thing to prevent IP loss for companies owning rights, while being the most important for companies not owning rights. The third most important practice surprisingly is IP protection approach to human resources management. It should be noted that all factors listed afterwards are all somewhat important.

Chart III.4.31 - How do you rate the following measures to prevent IP loss? N=123



Opinion Article

THE COUNTRY WHERE TRAINS LEAVE EARLY

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In recent months, when taking the new high speed trains from Shanghai, I noticed that the train left the station at least 1 minute early, every time. And, when the train leaves, the platform is empty: every passenger is always on the train early as well…

The whole country seems to be participating in China's big catch-up. Over 42 high-speed train lines (8,000 km of track for 350 km/h speeds and 5,000 km at 250 km/h) are under construction. These lines were planned for completion in 10 years, but when the financial crisis hit, in order to generate employment, the plans were moved forward to finish them all by 2012! Over 100,000 workers alone are assigned towards building the 1,500 km Shanghai-Beijing line, which will cut transportation time from 12 hours to under 5 hours, making the train trip competitive with flying, while saving considerable amounts of fuel.

By 2020 China plans to build 3 times more nuclear power plant than the rest of the whole world combined: that is close to one new plant per month.

BYD, a 20 workers only battery making company in 1995, employs over 130,000 people today and produces hybrid cars with exclusive battery technology. After receiving an investment of USD 250M from Warren Buffet's Berkshire Hathaway fund on March 1st, the battery-turned-electrical car maker just signed another deal with Daimler Benz to co-produce a small e-car for the China domestic market.

The Chairman of "Build Your Dream" - which BYD stands for - intends to live by his company name and become the biggest world car producer. Only 47 years old, he may well succeed given the push that China exerts on its market towards switching to electrical vehicles. 13 cities have been earmarked for complete electric conversion of public transportation (including taxis). Incentives for private buyers of gas efficient cars are also under discussion at the central government level.

These outstanding examples illustrate how far China has come in the last 20 years, from

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producing the world's plush toys and t-shirts, to developing its own top of the line technology.

True, China has an old tradition for invention (most famous among its discoveries are the compass, printing press and the gunpowder) and the Middle Kingdom was also the world's innovation center until Europe took over during the Renaissance. Still, this development did not happen without considerable underlying efforts.

Led by engineers[6], China's government has planned the country's move into development of the technologies that power China. There have been many considerations: 2,000 relevant civil servants participated in the drawing out of the plan. In addition to the obvious economic interest of owning the technological added value, they concluded that China's development problems will need homegrown solutions. Indeed, no other country faces challenges of the type and magnitude that China must deal with: if only to fulfill the aspirations of a billion people hoping to enjoy western standards of living in the foreseeable future.

Approximately the size of the USA, China hosts four times as many citizens though a third of the country is barely inhabitable. As a result, its environment is already strained to the limit. To deal with such issue, a project is under way to divert water from the Yangtze River 1,000 km to the North, to compensate for the fast depleting water tables there. Just as well, China will be the first country to install a 1M Kilovolt line needed to transfer electricity from the west, which is rich in hydropower, to the coast which uses it. And these are just few of the examples of gigantic projects that China undertakes that most of us never hear about.

China's drive to become an innovator has been formalized in the National Science & Technology Plan which started on January 1st, 2006 and is set to end in 2020. Within these 15 years, the plan's objective is to render the country capable of fulfilling its own needs in a range of key technologies. 16 national projects are specifically defined, including the development of CNC machine tools. The fields of "new energy, new material, biomedical, IT and advanced manufacturing"[7] have been singled out for accelerated development. From 1.5% of GDP used in R&D in 2005, now the target is to reach 2.5% in 2020, the level of Germany.

The emphasis on the development of universities and research may be the most important effect of the plan in the long run. Top overseas Chinese scientists are offered to come back and enter Chinese universities with more funds, means, and students than they have in the West. Besides, every year 6,000 of the nation's top PhD students receive a scholarship to study abroad. Upon completion they have an obligation to return and work for China's government. They will become the researchers, labs and universities leaders of the next decade.

To spur innovation, researchers have a variable pay system according to performance. They are encouraged to build start-ups and allowed to own a majority of the ventures they start based on their discoveries.

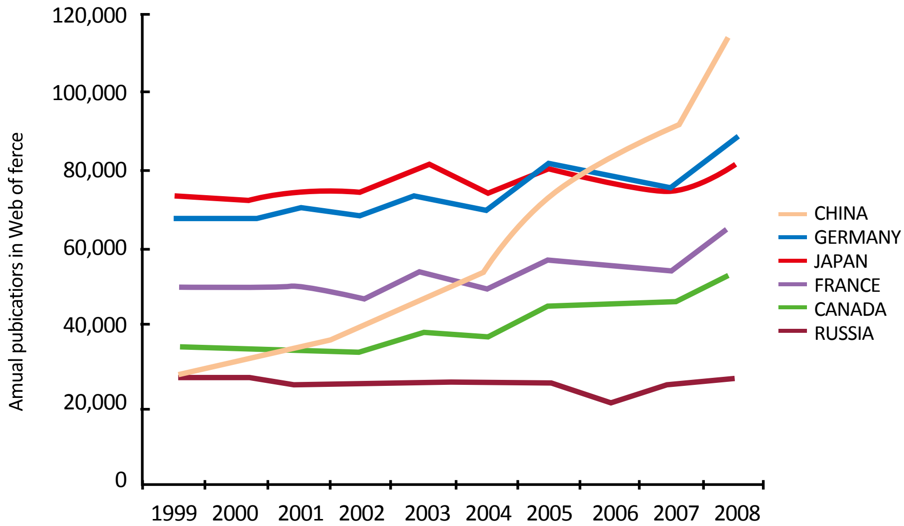
Results are already coming in. In terms of scientific production, China is now second

[6] 7 out of 9 top leaders of the country (Standing Members of the Communist Party Politburo) are engineers and Hu Jintao's moto "Build a Harmonious Society through Scientific Development" says it all.

[7] Wen Jiabao's speech to the National People's Congress, March 7, 2010.

to the USA even though the number of papers originating in China is only a third of those written by US researchers. The impact of Chinese research and its quality is still moderately lower but consistently growing; and in some areas, China is dominating world research. In the field of material sciences, China publishes over 20 % of the world's important scientific articles and over 30% in the sub-fields of metallurgy and crystallography.

Annual Publications in the Web of Science
Thomson Reuters Research 2009



Chinese students are getting stronger too and winning international competitions. Last February, Shanghai Jiaotong University beat Stanford to become World Champions in the International Collegiate Programming Contest, among close to 2,000 participating universities[8].

China is only the fifth nation in international patent filing (after the USA, Japan, Germany and Korea), yet Huawei, one of its telecommunication equipment companies was the top patent filer in 2008 and the No. 2 in 2009 (after Panasonic). And, while most country's (and the world on average) registered patents filings rate decreased in 2009, China's rate of patent growth remained around 30%. In comparison, India files less than 1/10th of the number of China's patents.

At current growth rates, China will have caught up with the USA by 2020, both in quantity of scientific production and in patents filing.

But what does this all mean for us, western citizens and companies? And what should we do about it?

The closest example we have of a large Asian country reaching western technological levels in recent history is Japan. They made good machines, watches, cars and became dominant in the range of electronic consumer goods we know. In the 30 years it took Japan

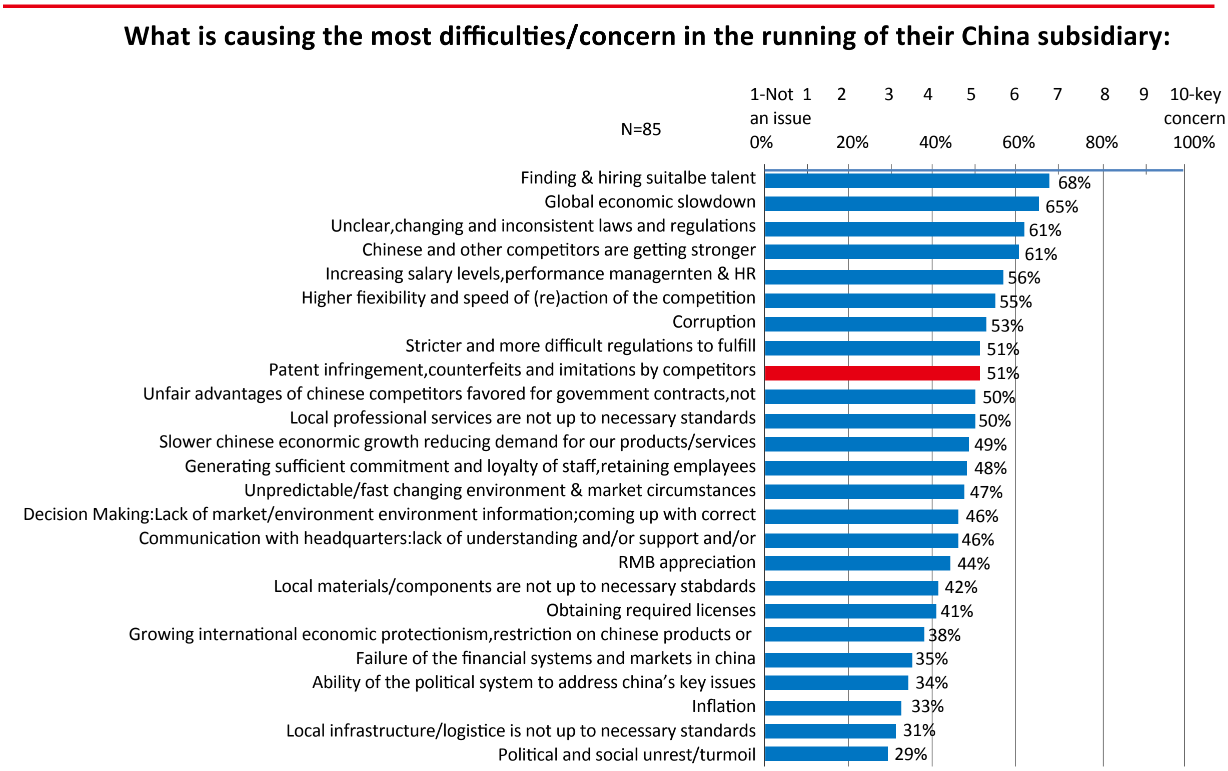
[8] http://cm.baylor.edu/welcome.icpc

to achieve technological excellence in a number of fields, living standards also caught up to make Japan's production costs on a par with ours. Since 20 years ago, we now compete with Japan on a generally even footing.

There are some differences with China's development story, however, and two of them are worth mentioning. On one hand, China is 10 times bigger in population size than Japan. It makes China's development slower and longer. After 30 years of "open-door policy", China still harbors hundreds of millions of unskilled workers and its farmers earn between 60 and 100 Euros per month. Factoring in the productivity improvement that can be achieved with organizational improvement, reduction of wastes and the localization of machinery, it will take another 20-30 years until Chinese costs of production increase significantly faster than in the rest of the world.

On the other hand, China is a much more open market and society than Japan, allowing both a better access to the market for foreigners and a faster assimilation of new technologies. If ever, China will be a faster innovator but a better cooperator.

The Survey results illustrate this last point: Intellectual Property Protection is not a real concern for companies active in China:



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Besides, one third of European companies have established R&D operations in China while another third is in the process or planning to do so.

Indeed, with China on track to develop its own technology intensive products for its own market, foreign companies have realized that they must suit local needs and tastes to sell in China. But not only must international firms develop the right product for a market that starts to serve itself, products must also be offered at competitive prices and with the right service. As a result, tech products more and more often need to be developed to match local production circumstances, so that they can be produced in China at local costs[9].

Still, to participate fully in the Chinese development, we have to make sure we continue to advance the science, develop the technologies and market the products of the future. Particularly, we have to make sure that we sell these products in China as well!

China started on its own race towards innovation on January 1st, 2006. Let's hope that we don't behave like the rabbit of the fable but compete and cooperate from the beginning: in 2020 the outcome of the game will largely be set!

[9] Adjusting products to the market and to the local production circumstances are the two top reasons for companies to do R&D in China.

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Exclusively involved in trade, investment, strategy and project management in China since 1986, he has been residing in the Shanghai area since 1988. He has developed and successfully implemented strategies for over 50 Western companies and institutions and is the Project Manager and co-owner of the first Swiss industrial SME in China.

In charge of Swiss-Chinese relations for the Swiss Federal Institute of Technology, Lausanne, he has developed the Swiss Center Shanghai concept and implemented it. He is also a Member of the Swiss Center Shanghai Board, and Vice-President of the Swiss Chinese Chamber of Commerce in China.

CHAPTER IV

IV Business Climate

This section first looks at what concerns companies the most, and then several of those concerns will be discussed separately to show the trends along with to cover some additional items. After this section we will have a look at the achievements and factors for success based on our sample.

This part is divided into the following sub-sections:

1 Concerns

1.1 Top Three Concerns

Both manufacturing and services companies share the same top 3 concerns in the same order.

1. Finding and hiring suitable talent
   Finding suitable talent has been a concern for a long time now and it still stays at the top of the concerns for foreign companies.
2. The global economic slowdown
   This is a direct result of the crisis. How long will this stay a concern is another matter.
3. Unclear, changing and inconsistent laws and regulations
   China is still in a development process, therefore laws and regulations are strictly controlled according to China's needs, since in order to control its development, Chinese laws may be prone to change unexpectedly so as to favor some particular aspect of development.

1.2 Other Concerns

The fourth, sixth, and ninth concerns for manufacturing companies are related to competition, which is therefore considered as substantial threats to them. For service companies, competition is of less concern as they are only ranked as the 11th, 13th and 15th among the concerns.

The fifth concern for manufacturing companies is related to HR and it concerns the increasing salaries and the value for HR costs. Services companies ranked it as an important concern as well but rate it only at eighth place.

The fourth concern for services companies is that the local professional services are not up to necessary standards. Manufacturing companies only rate this as 11th among concerns. It might be strange for services companies to be concerned about this factor as it should be seen as an opportunity to offer better service than them. However, close collaboration with local service companies may be the reason behind this concern.

The last two significant concerns for services companies are related to laws and regulations and are ranked at fifth and sixth position. Fifth is stricter and more difficult regulations to fulfill and sixth is obtaining the required licenses. Manufacturing companies only rate these two concerns at 8th position and 19th position, respectively. Again the reason why services companies are concerned with these two factors is unclear. It is probable that it is because those are the services they are offering to manufacturing companies, and therefore their work is getting harder while for manufacturing companies it stays the same as they are using the services companies to help them (consulting companies accounting for 25% of these results).

Furthermore, IP infringement is not considered as a top concern, being only at tenth rank for manufacturing and last for services companies.

Chart IV.1.1-Manufacturing:what is causing them the most difficulties or concerns in the running of their subsidiary? N=92

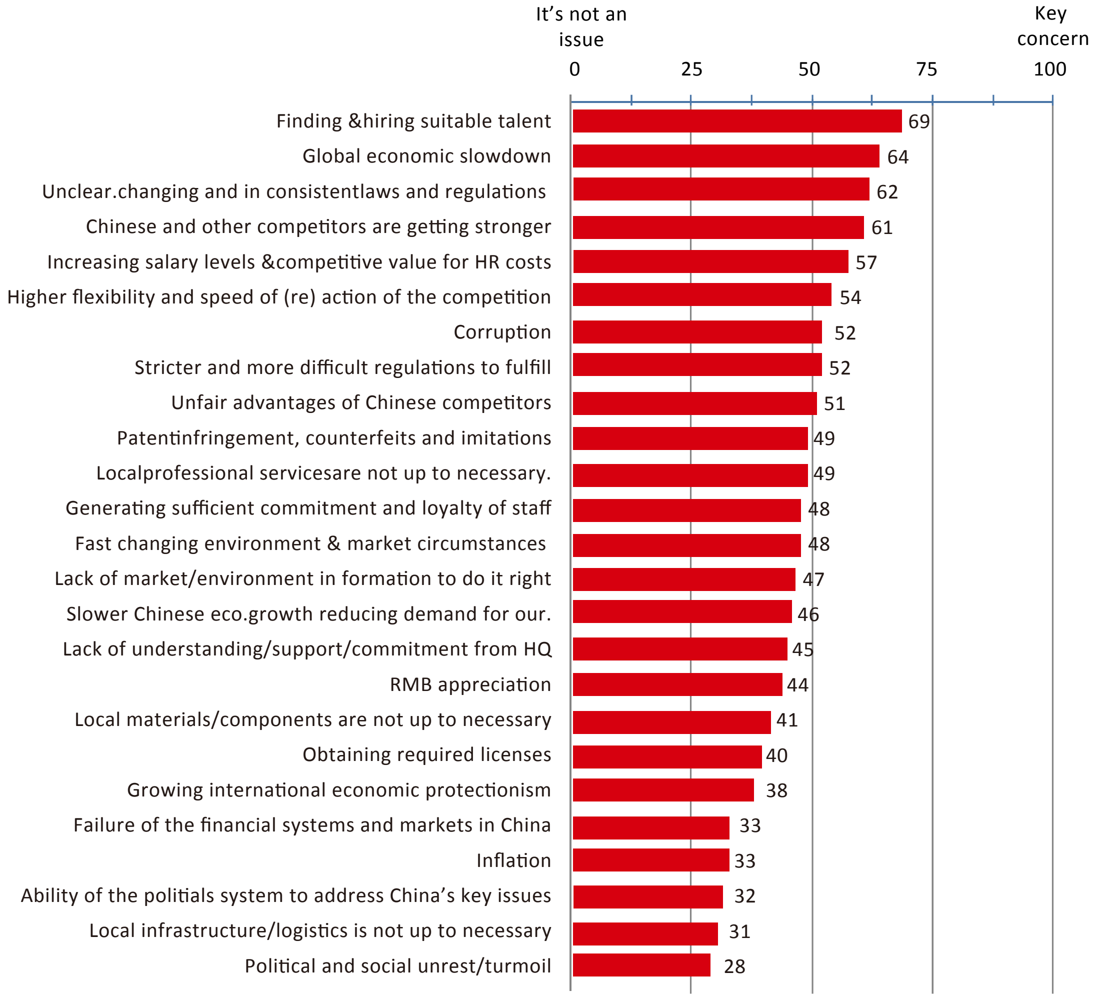
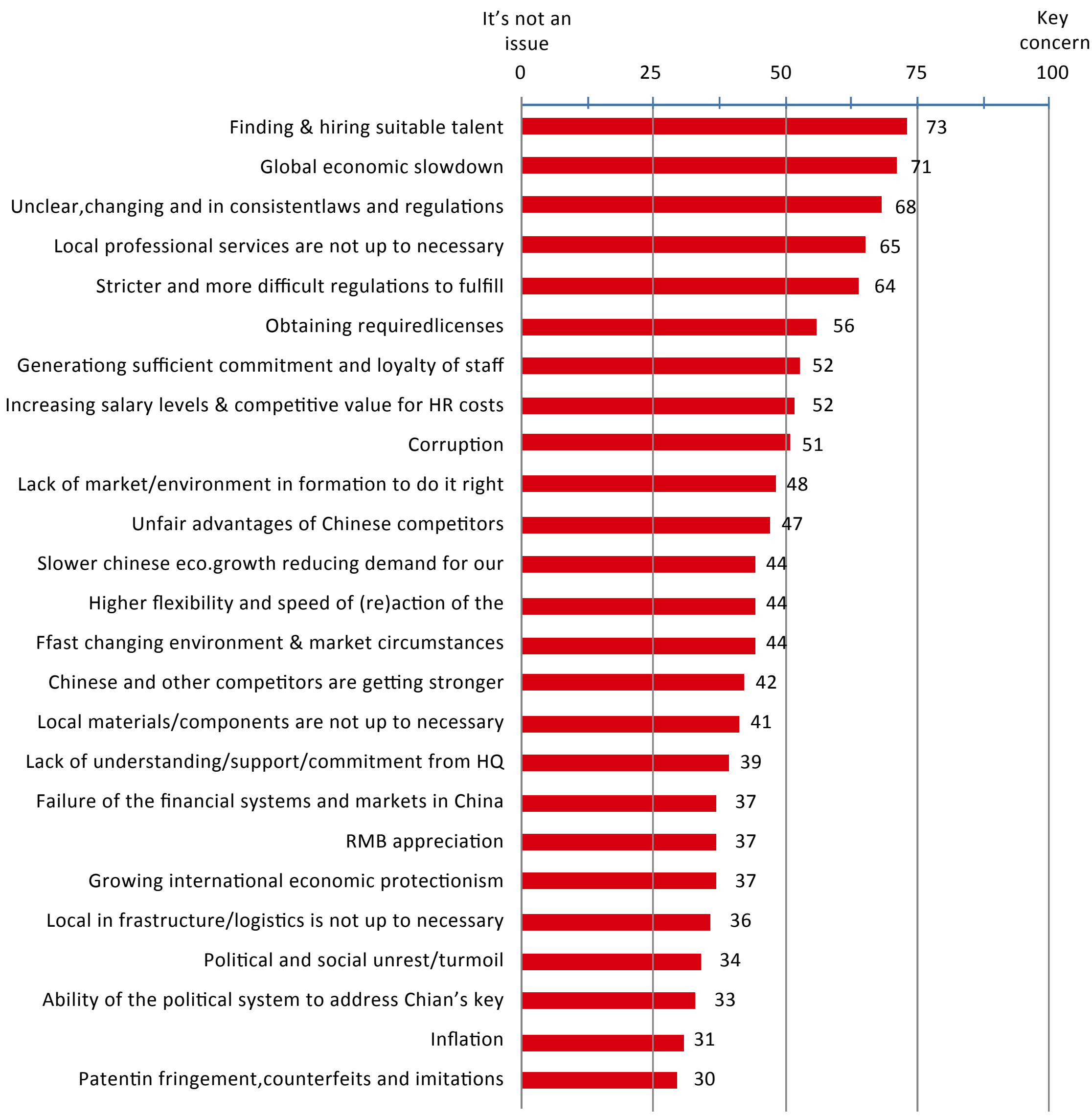


Chart IV.1.2-Service:what is causing them the most difficulties or concerns in the running of their subsidiary? N=36



Opinion Article

THE CHINESE ECONOMY: EVALUATION OF 2009 AND PREDICTIONS FOR 2010

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Evaluation of 2009

It is now a consensus that China has achieved its target of 8% real GDP growth in 2009. In the beginning of 2009, most economists considered it too high a goal to be achieved. There was a good reason for this expert view. China's spectacular economic growth in 2002-2008 was largely driven by export growth at an average annual rate of around 30%. When the global financial crisis deepened in the fourth quarter of 2008, China's exports dropped sharply by 30%, which caused a near-zero quarter-to-quarter growth in China's real GDP in the fourth quarter of 2008 (year-to-year growth was 6.8%). The conventional wisdom is that such a strong downward trend is difficult to be reversed quickly, even if by the iron hand of the Chinese government.

The Chinese government proved that "Impossible is nothing". The government first announced a 4 trillion RMB fiscal stimulus package in November 2008. Then state-controlled banks issued new loans at an unprecedented fast pace, totaling over 9 trillion RMB in 2009. In addition, local governments were given the green light to spend money, and ten industries were selected to be boosted by a national industry revitalization program. With this wide range of actions from the government, the Chinese economy bottomed out in the first quarter of 2009 (6.1% year-to-year growth) and returned to double-digit growth by the fourth quarter of 2009 (10.5% year-to-year growth expected).

While the Chinese economy looks good in GDP growth, it has become more imbalanced and distorted. Before 2009, the Chinese economy was already overly investment-driven; now it becomes even more so. Before the crisis, the large production capacity built by investment could be absorbed by the global market. Now the external demand for Chinese goods is much less robust and it is no longer able to absorb China's excess production capacity any

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more. In the near future of one to two years, the Chinese economy can still rely on increases in government investment to maintain a high growth rate, but this is neither healthy nor sustainable.

So 2009 is both a blessing and a curse for China. On the one hand, 2009 provided China an opportunity to increase its relative power in the world economy. For example, China's banks took the top three spots in the global ranking of banks (Forbes, April 2009). China's stock prices doubled, and China surpassed Germany to become the no. 1 exporter of the world. On the other hand, China's fast recovery turned against itself in that it drove up the prices of natural resources that China imported heavily and also caused other countries to impose more trade restrictions on Chinese exports. The biggest curse is that the short-run success was achieved at the cost of intensifying the distortions in the economy. Before 2009, the Chinese economy had seen a gradual increase in the share by the private sector; this trend was reversed in 2009. Before 2009, the housing prices of Chinese cities had been gradually stabilizing; this desired situation was destroyed and housing prices saw sharp increases in 2009 again. Before 2009, China was on the track to reduce its external imbalance (too much trade surplus) by appreciating its currency and reducing tax rebates to exporting firms. Now RMB is effectively pegged to the U.S. dollar and tax rebates to Chinese exporting firms have been resumed.

In any case, the V-shaped recovery of the Chinese economy is good news for businesses in China. Although there are serious structural problems in the Chinese economy, which were further intensified by the anti-crisis policies in 2009, they do not present an immediate threat to most businesses in China. Nevertheless, for those companies that have a long-term interest in the Chinese market, it is important to develop a perspective on the Chinese economy in a longer time horizon.

Predictions for 2010

As we have learned from experiences of the past, in particular from 2009, the outlook of the Chinese economy is largely driven by government policies. What kind of policies will the Chinese government implement in 2010? Without answering this key question, one would not be able to predict the Chinese economy correctly.

The Chinese government stated that it will maintain a "proactive" fiscal policy and a "moderately loose" monetary policy in 2010. It is expected, however, that China will adjust its policies in 2010 in certain ways and at certain chosen times. Because the global recovery will be slow, China will still need fiscal expansion to maintain its economic growth and employment. The fiscal stimulus package of 4 trillion RMB is for two years and the money will continue to be spent in 2010. The Chinese government has a relatively low debt-GDP ratio of 20%, and government tax revenue increased by 30% in 2009, so there is still enough room for further government spending.

China's monetary policy is expected to be tightened. The amount of new bank loans issued in 2009 was extraordinarily high (exceeding 9 trillion RMB), which led to sharp increases in housing prices in China's cities. The real estate sector is a major source of revenue of local governments, and hence there exists great resistance against policies aiming to cool down the real estate market. However, housing price is also a very sensitive social issue. When the increase of housing prices exceeds certain limit, the central government will act to contain the increase. Although CPI inflation is expected to be low (below 3%) in 2010, China's central bank, the People's Bank of China (PBoC), has emphasized the need to manage inflation expectations before it materializes. All these suggest that China's monetary policy will be tightened in 2010. As to the timing and the magnitude of China's policy adjustment in 2010, it will depend largely on the degree of recovery of China's exporting sector. If China's exports recover faster than expected and by a larger amount, the Chinese government is likely to carry out its monetary tightening (or so-called exit strategy) at an earlier time and by a larger magnitude.

The degree of China's export recovery will also be an important consideration in China' s adjustment of its exchange rate policy. If China's exports recover strongly, the Chinese government may consider adjusting its RMB policy. However, since the global market is not likely to recover strongly in 2010, the likelihood that the Chinese government allows RMB to appreciate in 2010 is rather small. China has accumulated 2.3 trillion U.S. dollar foreign exchange reserves. To alleviate the inflationary pressure it brings, the Chinese government may speed up the process of financial opening to encourage more overseas investment by Chinese citizens and Chinese companies.

As discussed earlier, China's anti-crisis policies in 2009 intensified the structural problems underlying the Chinese economy. Although the structural problems do not present an immediate threat, they constitute risks to the medium- and long-term future of the Chinese economy. Year 2010 may be viewed as a starting point of China's transition towards a new "steady state". For the next ten years, we may envision two extreme scenarios. The best scenario is that China finds a way to moves up in the ladder of economic development with more income and a better safety net for ordinary people, more private consumption, an upgraded production and export structure, a larger service sector, a more efficient financial sector, a more balanced external account, and a more flexible exchange rate. The worst scenario is that China continues with the resource-intensive investment-driven growth model, an inefficient financial sector, a rigid exchange rate, an increasingly imbalanced external account, and with asset price bubbles building up, which will eventually lead to a hard-landing and a prolonged period of stagnation. Neither of these two extreme scenarios may actually occur, but they serve as useful references for us to formulate a long-term view about China's future.

To summarize, we expect that China will continue its fiscal stimulus policy in 2010 but will tighten its monetary policy to cool down the real estate market and reduce inflation expectations. The Chinese economy is expected to grow at around 10% in 2010. We believe that 2010 will be a critical year for the Chinese government to initiate post-crisis policies towards building a new economic model for China. Companies with a long-term interest in China should keep a watchful eye on these policies.

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Dr. Xu's current research focuses on the global and Chinese economy, multinational enterprises in China, and trade and finance issues of emerging markets. He has published extensively in both international and Chinese journals, and is the author of International Trade (Peking University Press, 2009). Dr. Xu is associate editor of the Journal of International Trade and Economic Development, board member of the Asia-Pacific Trade Seminars, and principal investigator of a research project funded by National Natural Science Foundation of China.

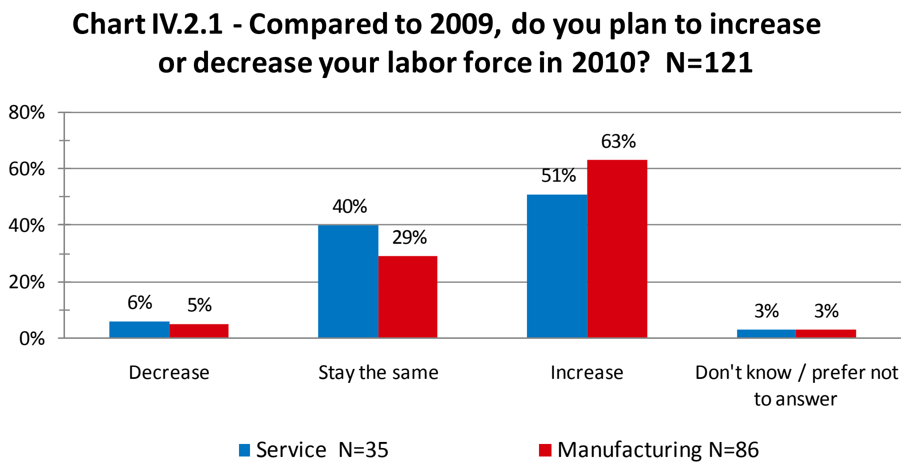
Dr. Xu teaches macroeconomics and international finance at CEIBS. He has been invited to give speeches to senior executives from multinational enterprises including Barco, Bosch Rexroth, HSBC, IBM, Rabobank, Sandvik, Schindler, and Swiss Re, and lectures to Executive MBAs from IESE Business School, Danish Leadership Institute, Kyiv Mohyla Business School of Ukraine, and Rotterdam School of Management. Dr. Xu is the recipient of the 2009 CEIBS Teaching Excellence Award.

2 Trends

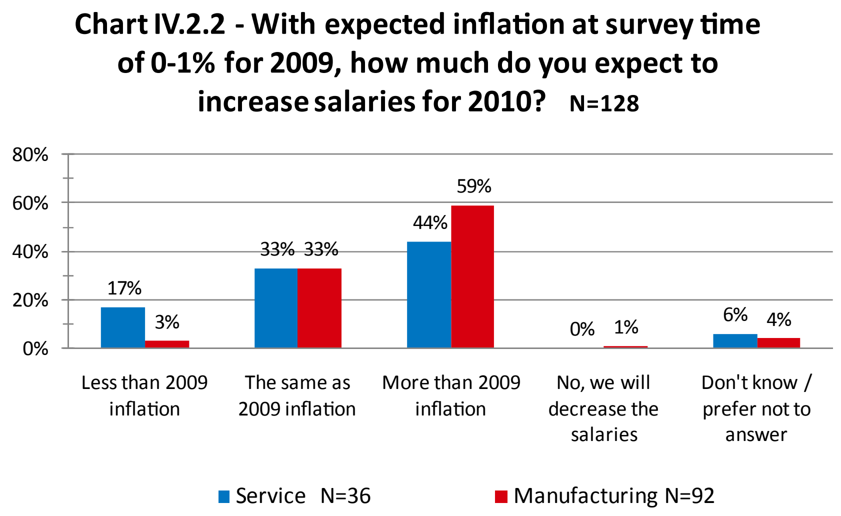
2.1 Human Resources

Identified in the top concerns of companies: human resources is a key to success

The top concern of surveyed companies is finding and hiring suitable talents. And, as shown below, most of the companies will increase their labor force in 2010, especially those in manufacturing, hence why hiring is a key concern. Most of the companies plan to increase their labor force at a rate of 0-20% (50% for manufacturing, 30% for services). However 30% of the services companies plan to increase their labor force aggressively at a rate higher than 80%.

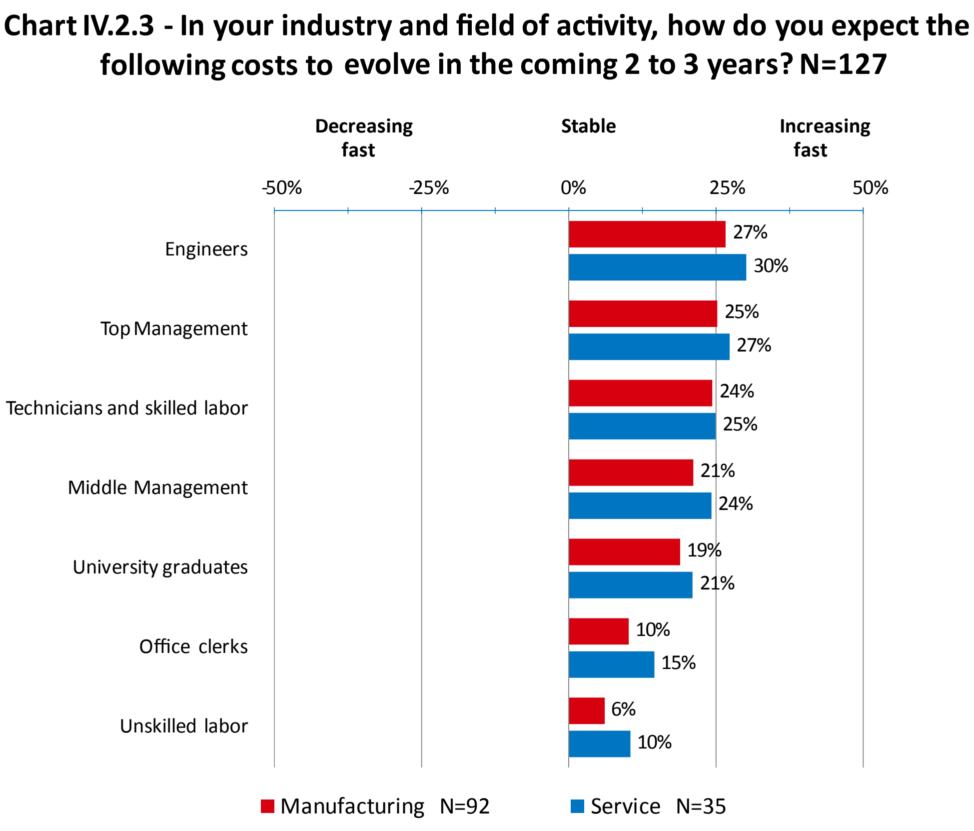


The increase of salaries ranked at the 5th and 8th positions. As show in the chart below, half of the services companies and one-third of the manufacturing companies will increase their labor force salary levels by 0-1%. Almost none plans to decrease salaries. The rest will all increase salaries more than 1%. For this group, the expected increase is between 4-6% for half of the services companies and two-third of the manufacturing companies. Only very few will increase less than that (10%). The rest of the companies plan to increase them at a rate of



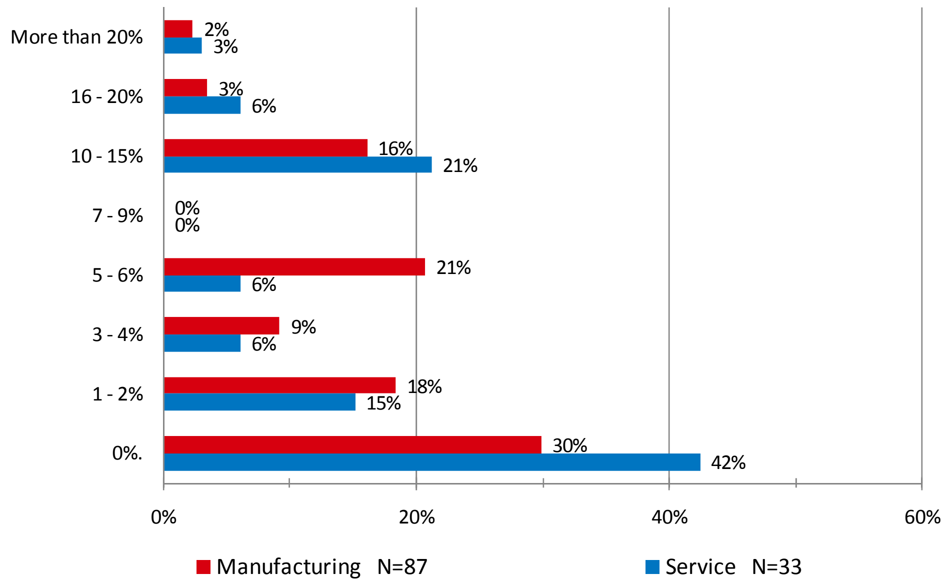
10% on average.

To further identify what kind of labor cost is increasing the most, we asked respondents how they expect the following costs to evolve. The top positions to increase in cost are Engineers, Top Management and Technicians/Skilled labor, respectively. Unskilled labor and office clerk positions should see their salaries relatively stable.



When asked about unwanted employee turnover, the majority of respondents indicated it was still quite low. Almost 60% of services companies and 50% of manufacturing companies have 2% or less unwanted employee turnover. However, 20-25% of the surveyed companies have an unwanted employee turnover rate greater than 10%.

Chart IV.2.4 - For 2009, what is your estimate of unwanted employee turnover (as a percentage of total number of employees in your subsidiary)? N=120



2.2 Economic Crisis

The second top concern by companies, the economic slowdown, was benchmarked by looking at its impact on sales.

Firstly, looking at local sales, the biggest groups expect to increase their sales in 2009 as compared to 2008 and this is especially true for half of the manufacturing companies. For most companies, this increase is about 1-20%, but some are even confident in doubling their sales. One-fourth expects the same sales volume. Finally, less than one-third of service companies and less than one-fifth manufacturing companies expect lower sales volume, estimated by most to be approximately 1-20% lower.

Chart IV.2.5 - Compared to 2008, the sales to clients located in China for 2009 are expected to be? N=113

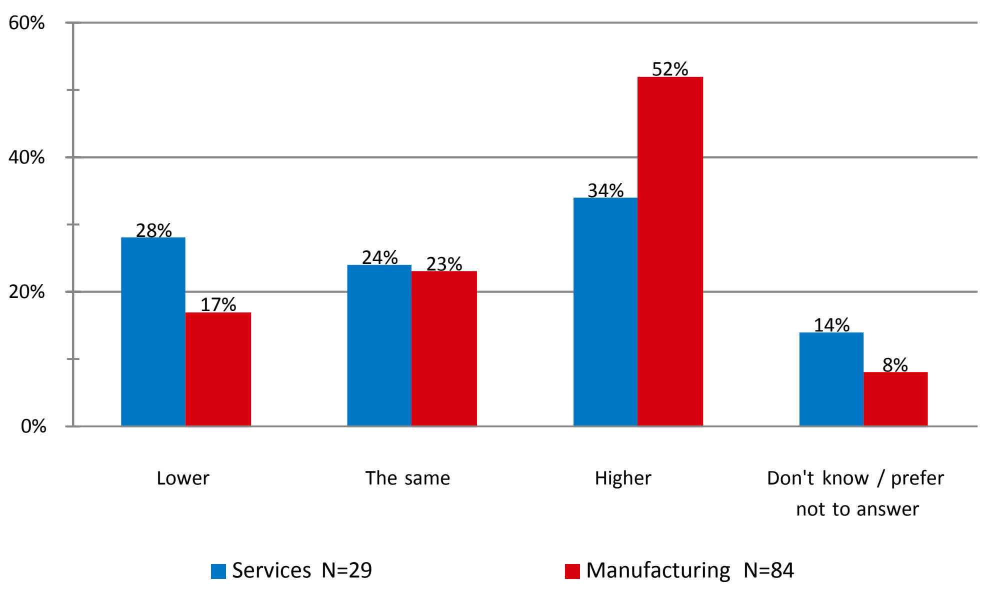
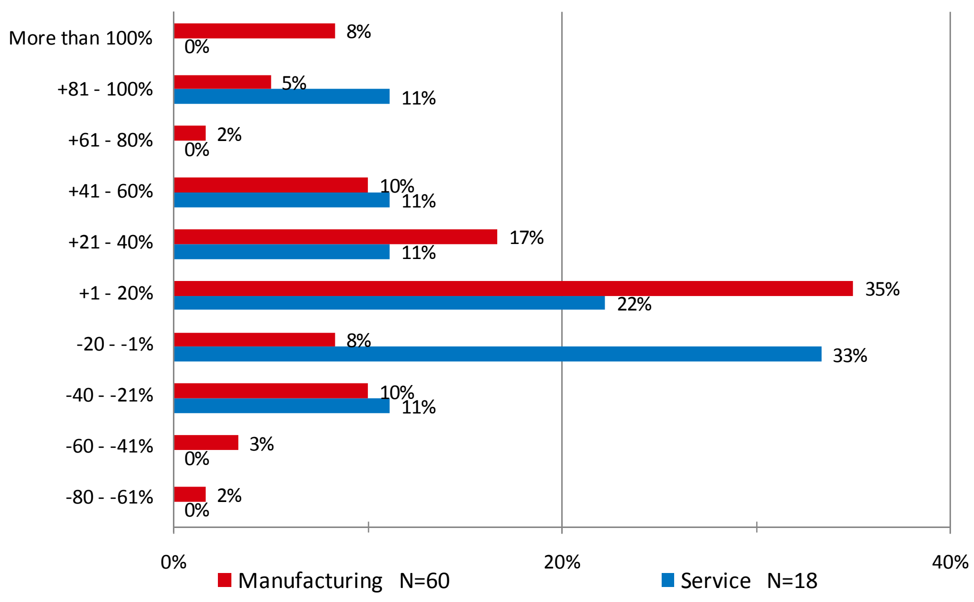
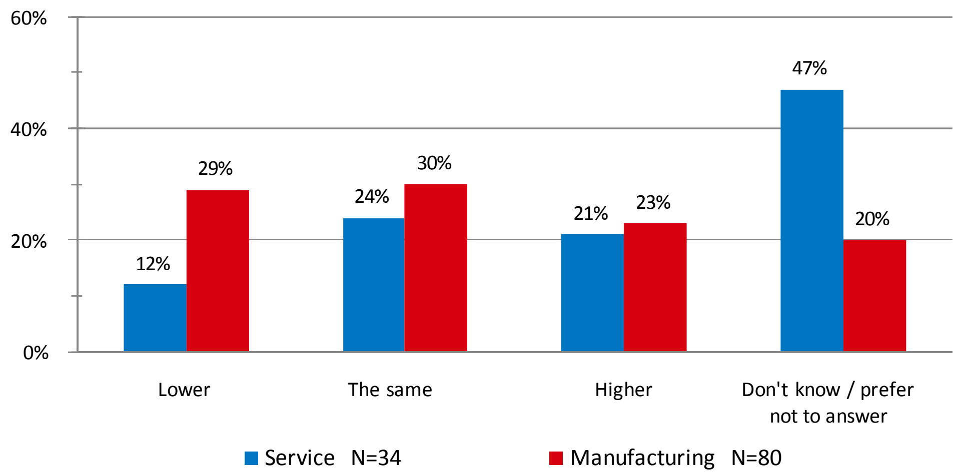


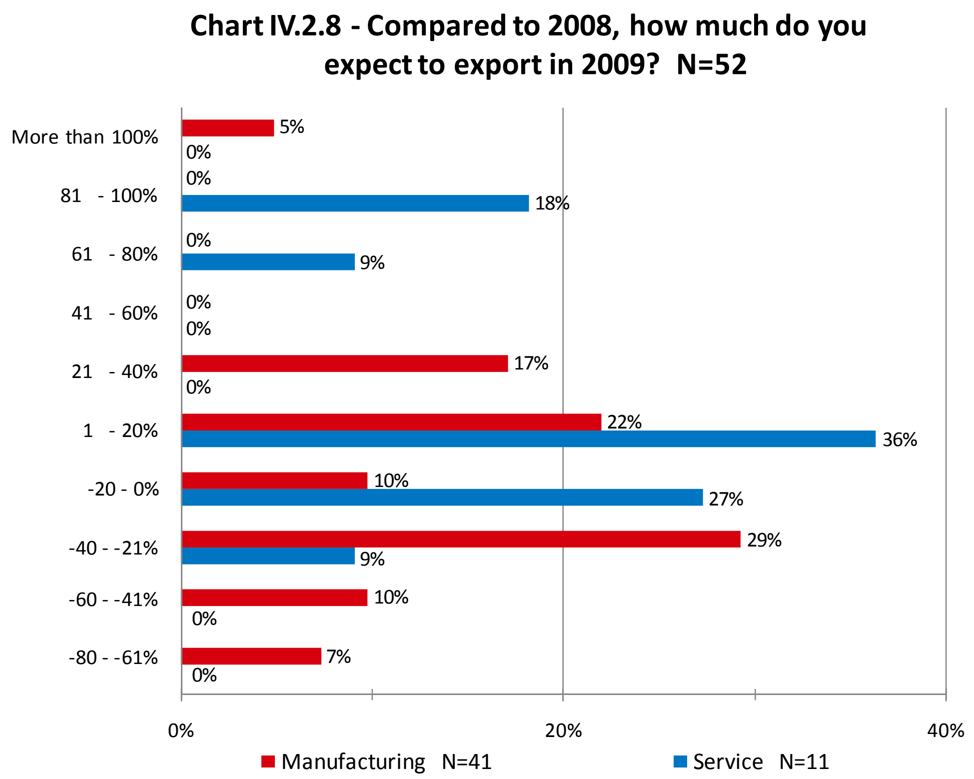
Chart IV.2.6 - Compared to 2008, how much do you expect to sell to clients in China in 2009? N=78



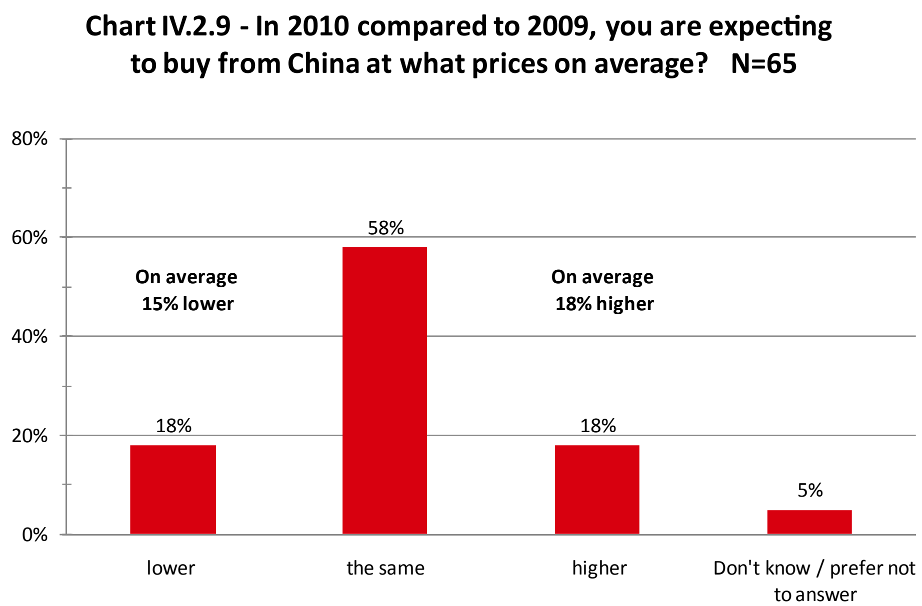
Secondly, exports are a good way to see how other countries influence companies operating in China. The results are more mixed this time, however. The first thing we can see is that a high rate of services companies, as well as manufacturing companies, did not answer either because they do not export services or products, or because at the survey time, they did not know how the rest of the world is going to recover. For the services companies who did answer, the outlook is more on the positive side. As for manufacturing companies, it is quite well distributed but when looking more closely we can see that among those expecting lower exports, most expect a decrease of 20-40%, which is quite high. From this, it is apparent that services companies were more positive for 2009 as compared to manufacturing companies.

Chart IV.2.7 - Compared to 2008, how much do you expect to export in 2009? N=114





Among the concerns of the respondents, inflation and appreciation of RMB were rated very low on the list. For the most part, respondents that are sourcing from China thought prices would stay the same in 2010.

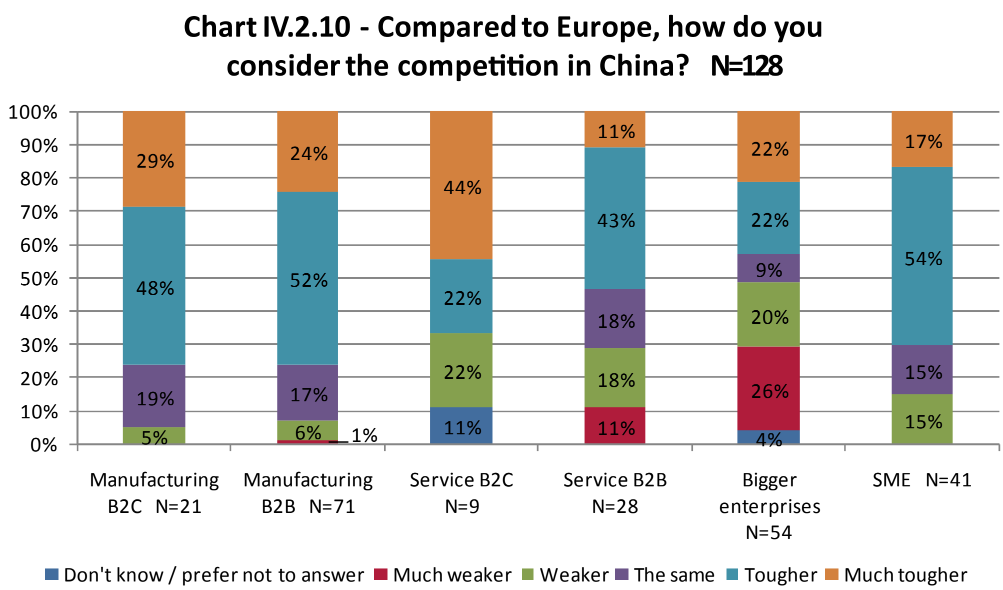


Regarding the impact of the economic crisis of 2008-9 on the sales sector, we can conclude that the services companies surveyed experienced the most negative effect upon their local sales, whereas the manufacturing companies experienced the most negative impact in their export sales. However, most companies felt confident in the success of their business in 2010, and in the next five years.

2.3 Other Trends (Competition, IP, Investments)

Competition is rated as quite a serious concern, especially for manufacturing companies. The following chart shows how respondents rate the competition in China in comparison to Europe.

For most of manufacturing companies the competition is tougher or much tougher than in Europe. For services companies it is less the case, especially for services B2B companies.



In comparison to IP infringement, most companies consider competition as a tougher concern. A small percentage of manufacturing companies and SMEs do, however, suffer more from IP infringement.

Chart IV.2.11 - Do they suffer more from the honest competition or from IP infringements? N=129

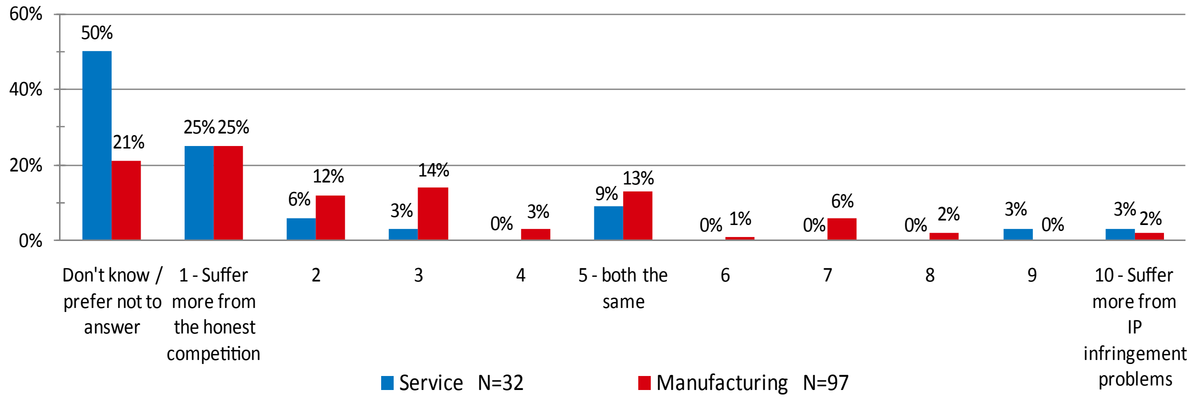
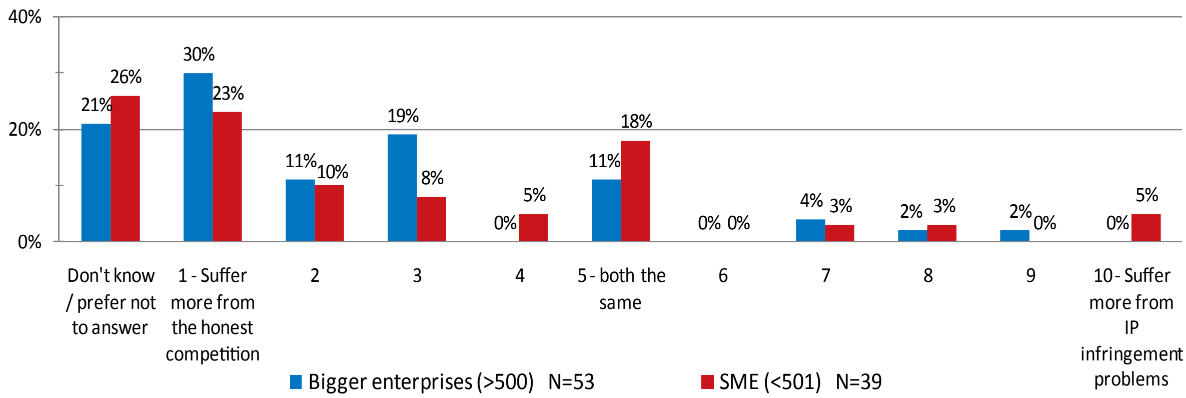
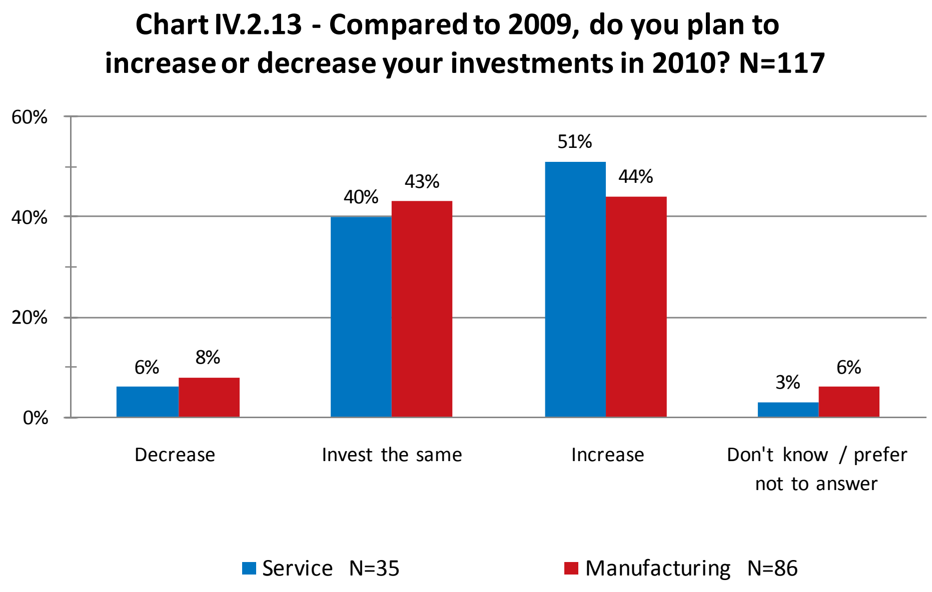


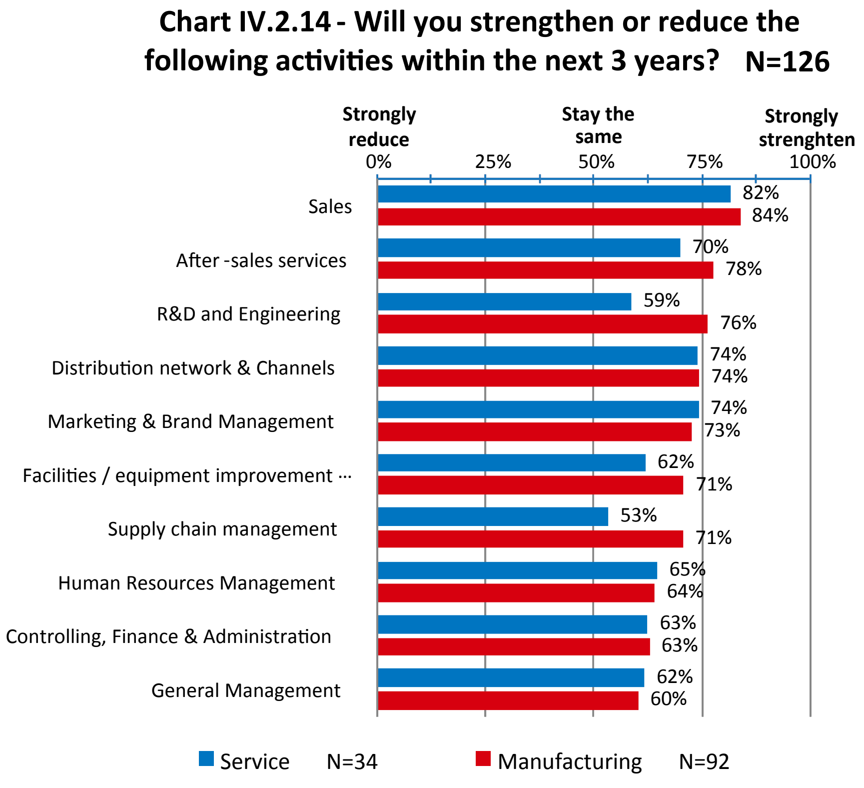
Chart IV.2.12 - Do they suffer more from the honest competition or from IP infringements: N=92



Surveyed companies plan to invest the same or increase their investments for 2010. This makes sense as most surveyed companies' operations in China are still quite small while the market is very big. For most, the increase in investment will be between 0-20% and around a third will invest more than that.

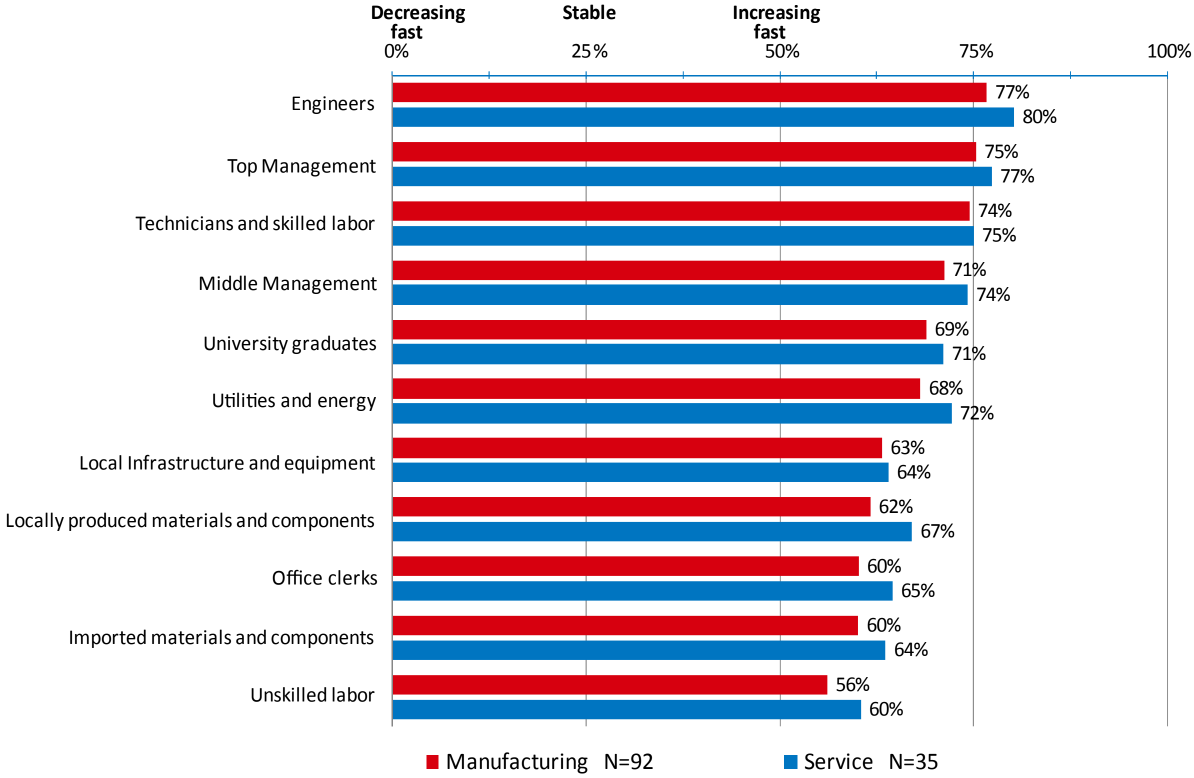


In the near future, they will strengthen all their activities and especially sales, after-sales services, R&D, distribution networks and Marketing/Brand management.



Regarding the costs, they foresee that it is the personnel costs and the "utilities and energy" costs that will increase the most in the following years.

Chart IV.2.15 In your industry and field of activity, how do you expect the following costs to evolve in the coming 2 to 3 years? N=127



2009- 2010 HUMAN RESOURCES TRENDS

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China faces some of today's most complex Human Resources challenges to be found anywhere in the world. In a country of 1.3 billion people, there is a constant shortage of skilled labor and managerial talents. In the meantime, there is an oversupply of university graduates. For example, the country's workforce is growing at 11% per year with 10-12 million urban jobs being created annually; an estimated 30% of university graduates still cannot find a job. Other challenges include widening income gaps (urban Chinese earn more than three times as much as those in rural areas), increasing differences in skills and qualifications, as well as growing regional disparities. A future concern is that China's workforce is expected to start shrinking after 2015 due to the rapidly rising numbers of elderly people and the decreasing number of working age citizens. By 2050 it is expected that close to a third of China's citizens will be over 60: three times the current proportion in that age bracket[10].

2009 Evaluation

2009 saw an unprecedented global economic slowdown. For the Chinese economy, which has mainly been built on export-driven instead of domestic consumption that has grown at double digits in the past 30 years, this is the first time ever for people and organizations to witness and go through a drastic climate and expectation changes.

- Shanghai, China's locomotive in economic growth and development, had its first negative growth in the first quarter in 2009.
- In South China, where most labor intensive industry are being fueled by unskilled migrant workers, 20 million people lost their jobs and had to head back their inland homes.
- More than 6 million university and college graduates joined the already tightened labor market. By adding 30% of the unemployed graduates from 2008, there were in total

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[10] European Business in China Position Paper 2009/2010

10 million educated young people who were expected to find a job in the gloomy 2009. According to official statistics, only 70% of this population managed to find a job despite various stimulus package initiated by the government.

- The Chinese government put forth a stimulus package worth RMB 4 trillion to generate domestic demand and create jobs in infrastructure projects.
- Due to demand stimulus, the Chinese economy growth came back to a plus 8% for the 2009.
- Most employers had to make adjustments at the company level to respond to declining demand for their goods and services. They also had to adjust both their compensation strategies & tactics to meet headcount and budget goals. Most companies chose to have hiring freeze, variable salary (i.e. Bonus) reduction, forced unpaid leave, and lay-off of some of the extra managerial functions due to slowing down of the business.
- The Chinese government called for industry restructuring in response to the changes due to the slowing down of the export driven manufacturing industries, where most of them were in overcapacity. We have seen a shift of manufacturing plants moving to inland provinces where land and labor are more competitive. As a result of such industry restructuring, some of the factories in coastal cities were forced to close down. Labor disputes also increased significantly.

Overall, 2009 is a year of tremendous challenges for HR. Compared to past years' challenges in attracting and recruiting people, this year laying off people and factory closing have been the main theme for most HR practitioners. The other emphasis was on performance management with the aim of striving for efficiency.

With the Labor Contract Law (LCL) in effect as of Jan.1, 2008, which set standards for mandatory labor contract laws, layoff and severance payments, more power were granted to China's state-sanctioned labor union. Implementation rules of the LCL were later issued on Sep.18, 2008, which had helped to clarify points of the law that raised concerns earlier, but left most other employment areas unclear. The new Meditation and Arbitration of Labor Disputes Law, effective on May.1, 2008, softened the requirements for employees to file claims and thus provides the basis for enforcing the newly granted rights. It also led to an increase of labor arbitration and the burden of proof is widely shifted to the employer.

The Chinese government has continued its efforts in creating a "social security system with Chinese characteristics" aiming to offer universal coverage by 2020. This system covers work related injury insurance, old-age pensions, unemployment insurance, maternity insurance and medical insurance. Though a uniform social framework will have a positive effect on the long-term labor development in China and fully support China's efforts in achieving a sustainable social security system, the immediate result for employers were an increase of overall labor cost in combination of a weak market demand in the middle of a global recession.

Driven by cost, a further localization at upper management levels was also deployed. Shanghai and Beijing have seen more expatriates repatriation. Labor disputes between employer and expatriates were also commonly seen due to disagreement in contract termination. Most international schools saw a significant drop in student numbers of expatriate children.

The total economic climate also brought psychological shock and attitude change in the Chinese labor market. For people who have never seen recession but only growth before, they have started to value job stability for the first time, which lead to change in job searching behavior and career anchoring. For the past 15 years, fortune 500 companies used to be the first choice for university graduates. In 2009 we have seen the most-sought-after candidates choosing to work for Chinese state-owned enterprises and government agencies. Registration for civil servant assessment and selection also hit a record high.

2010 Trend

With the effect of the RMB4 trillion stimulus package, the Chinese economy is expected to grow at 9.4% in 2010. We have seen a recovery in certain industry sectors, i.e. strong growth in the automotive industry is an example. In 2009 China has taken over US as the largest car manufacturer in the world with a total annual production number of 13.5 million cars. The Chinese government has also identified 10 industries for stimulation: steel, automotives, ship building, petrochemical, textile, light industrial, nonferrous metal, equipment manufacturing, electronic Information, logistics, etc. Out of the 10 chosen industries with the exception of logistics, 9 other industries are all in manufacturing, which will be set as the economic growth engine.

It is clear that the Chinese government will focus on growing domestic market by accelerating the urbanization process. In the coming years, there will be 300 million people turning into urban residents. Demand for such group will pull economic demand from all directions. In the meantime, investment will also be increased in education, health care, and social security and insurance for reaching a more harmonious society to ease tension due to increasing disparity between the rich and the poor. Some industries which had traditionally been monopolies are also opening up as opportunities for foreign and private investors, such as finance, railway, road transportation, telecom, power & utilities. With the call of building Shanghai into an international financial centre by 2020, a series of opening activities will be rolled out, such as getting foreign listed firms listed in the China A share market. This could help MNCs raise money more easily in China for funding its further China penetration.

In 2009 with Chinese car manufacturers' acquisition of Volvo and Hummer, we can also see a trend for more Chinese companies to "go abroad". By going to Europe and US, most companies aim for building international market share and acquiring branding and innovation know-how, while going to Africa and Latin America are more aimed for resources, supply, and trade.

With the above mentioned business trend, we will see the following HR trend emerging:

- With the trauma caused by economic crisis, "emotional healing" is expected by most Chinese employees since this was their first encountering with any form of economic recession. Therefore, a clear message on future business direction and roadmap from MNCs' headquarters or China headquarter will be greatly appreciated.

- Retention is on top of agenda in the minds of most business leaders and HR practitioners. Most companies will identify their core talents and provide them with retention schemes to secure the sustainability of the China organization's growth. Due to size and opportunities in the China market, often core talents are also more motivated, even enthusiastic about being entrepreneurs themselves, which make retention strategy and solution even more challenging. Bold and Creative career path and reward strategies will be appreciated. This requires HR and senior management to think "outside the box" instead of just preaching existing global practices and policies.
- Thanks to the initiation of China-wide inter-province transfer on personal pension and medical insurance funds beginning in 2010, we could see a more free flow of local talents in the China market. This could help ease shortage in demand for experienced employees.
- A new round of recruiting, both for entry levels and specialized experts will be common after 2009's slowdown. After 2008-9's head count and hiring freeze, most MNCs have now loosen up their recruitment policies. We have already seen a recovery in the search industry since the second half of 2009. However, a more professional approach in talent selection has been called into attention for better match between candidate's capabilities and employer's expectations.
- In the financial industry, we will see more talent in-flow from US and Europe into China due to Shanghai's ambition to be a global financial centre by 2020. Naturally this could also trigger a demand of experienced professionals; salary increase will also be natural due to supply and demand mismatch.
- Large investment of training and development budget will again be back in the budget. This is due to lack of professional training by the Chinese universities. With the past years' popularity in MBA and EMBA diploma education, we now see a trend of global leading business schools teaming up with leading Chinese universities and MNCs on targeted topics for specialized industry professionals and captains, such as Supply Chain Management, Growing Service Industry, etc. Often the programs are short in duration (between 1-2 weeks), but content rich, with faculties that are jointly formed from academic professors and industry opinion leaders.

Dan Zhu is a specialist in Talent Selection and Organization Development. Since 1998 she has been working with Western & Chinese companies on talent identification, leadership development and organizational effectiveness projects in China.

As founder and Managing Partner of SRC, a leading China HR specialist in Talent Selection & Leadership Teambuilding, she has personally assessed thousands of executives, both Chinese and Western, in the past 10 years. Via insightful findings from her Sino-Western leadership benchmarking, Dan has also coached many Western executives during their China postings.

Dan holds an MBA from Nyenrode Business Universiteit, the Netherlands and Master of Education from Emory University, the USA. She teaches Cross Cultural Leadership and Human Resources Management in **Nyenrode's** MBA / Executive programs and **China Executive Leadership Academy Pudong (CELAP,** a national institution supervised by the central government's Organization Department, specialized in training senior leaders in government and top executives, with a focus on social improvement and economic development), **Rochester-Bern** EMBA Shanghai Module, **Fudan Olin** EMBA, **Shanghai University** EMBA/MBA, etc.

In May 2004, she served as Board member of the Benelux Chamber. Since 2007, she works jointly with the Dutch Consulate Shanghai on China Communication & Talent Selection Know-How for visiting delegations. Since 2008 she serves as the Vice Chair of the European Chamber's HR Forum in Shanghai. She has played a key role in organizing the European Chamber's annual HR Conference, where hundreds of industry leaders and HR practitioners meet and discuss hot issues on HR trends and best practices.

CHAPTER V

V Success Factors Analysis

This part will be divided in the following sub-sections:

1 Overview

Because the survey took place after the crisis, during a period of recovery, the following results can be seen as a consequence of the crisis and as a projection of the future recovery.

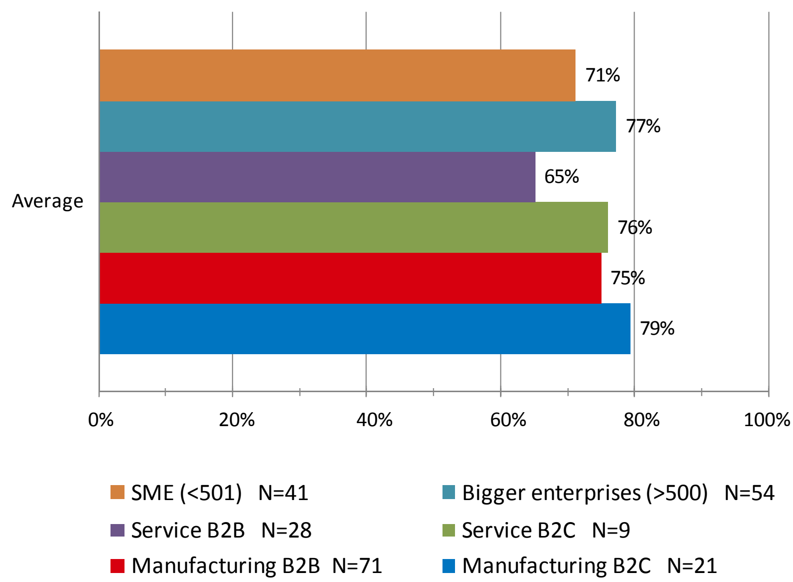
To evaluate success, a subjective question was asked to see if companies were meeting their planned strategic objectives. By doing this we rate the past history of the companies. No time frame was set so that it could be interpreted in general. We then looked through all different categories to see what type of companies were the most successful. Two charts were then made to interpret the results: a chart with the average strategic objectives met and another with the detail. After that, to evaluate the future success of the companies, we asked if they were confident about the future. Therefore, it establishes a comparable measure of success, taking into the consideration the past and the future expected success.

2 Past Success: Strategic Objectives Met

For the average chart, looking at company's business types, it is the B2C sector that shows the most success in both manufacturing and services categories. B2B companies lag slightly behind, especially in the services industry. However, with an average of 74% of planned strategic objectives met, we can say that companies are quite successful in China.

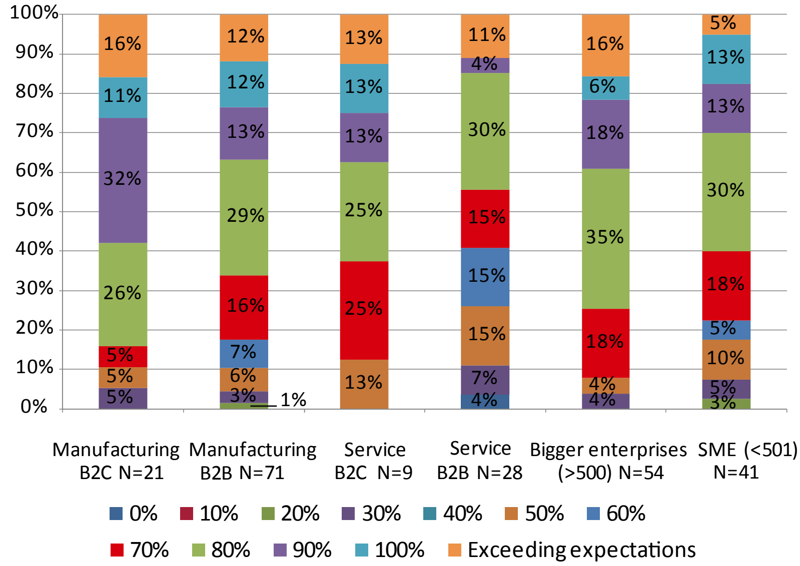
If examining by business size, BEs have higher success rates than SMEs.

Chart V.2.1 - To what level is your subsidiary meeting the planned strategic objectives? N=128



When examining in detail it becomes even more apparent that the Manufacturing B2C companies are the most successful, with 59% of them achieving 90% or more of their planned objectives, followed by the group of BE achieving it for 40% of companies. Both of those groups have 16% of companies exceeding expectations. The services B2B companies are by far the least successful group, achieving less than 70% of objectives for 41% of the companies, and only 16% were able to achieve 90% or more. BEs are also far more successful than SMEs.

Chart V.2.2 - Is the subsidiary meeting their planned strategic objectives? N=128

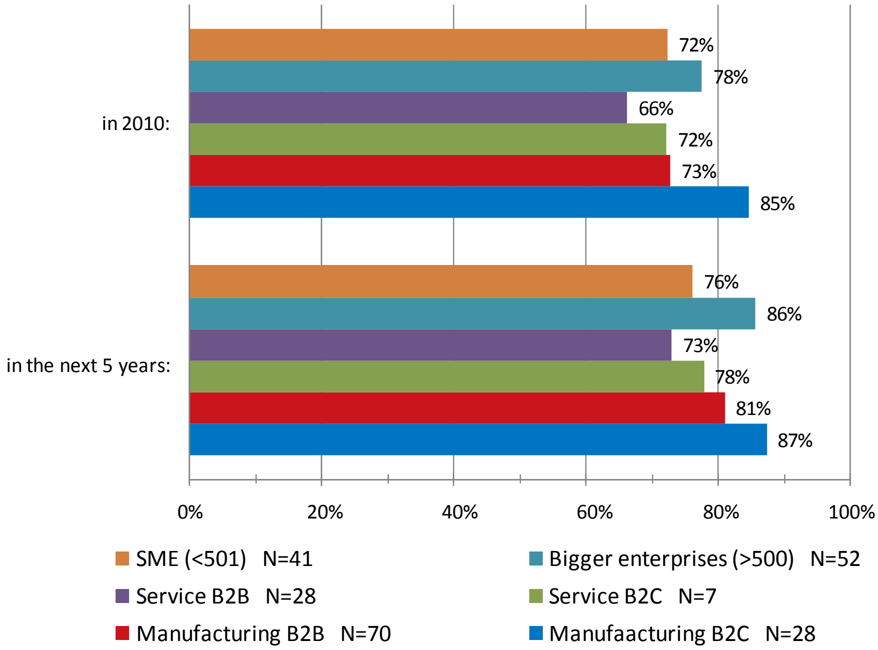


3 Confidence about the Future

Complementing the information about the strategic objectives met, the following chart shows how companies rate their confidence levels about their future for China operations, according to their current success. Indeed, the results follow the same pattern as the precedent charts. Manufacturing B2B companies ended being the most confident, with BEs being a close second.

It should be noted, however, that since the survey took place in the early period after the crisis, the outlook for 2010 turned out less optimistic as compared to confidence levels about the next five years. It is still quite positive, however, with an average of 74% of companies confident in having successful business in 2010. For the next five year the average goes up to 80%.

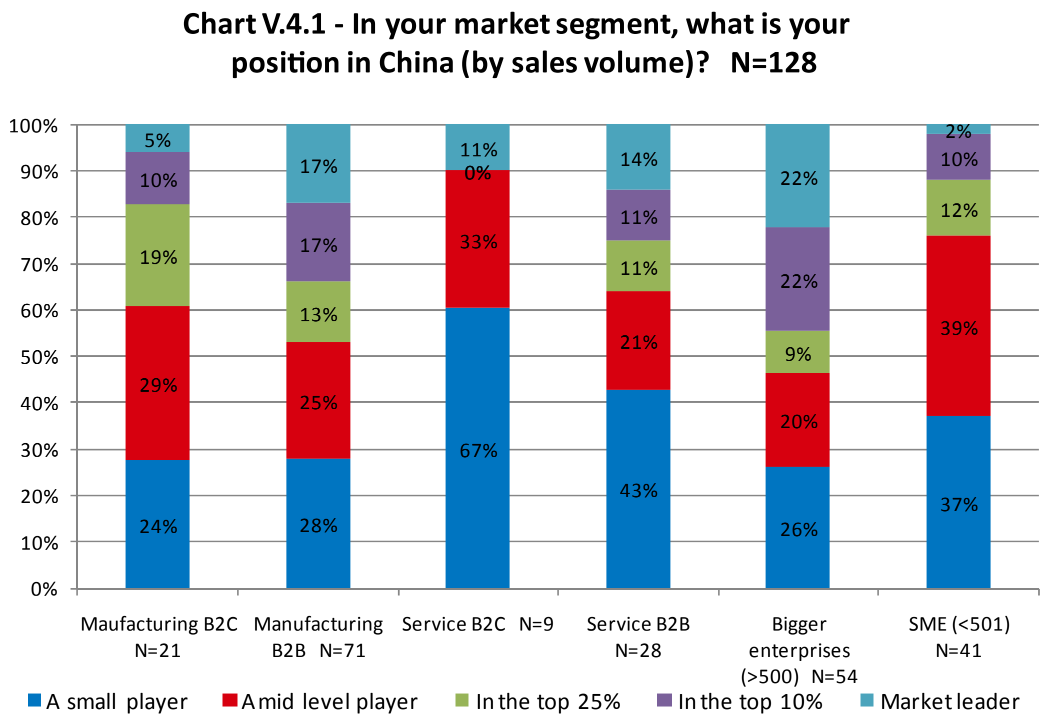
Chart V.3.1 - How confident are you in the ability of your China operations to do successful business?N=125



4 Market Position

Finally, to review if success is linked with market position, the companies were asked what market position they were holding.

From the following chart, no finding can be made in relation to the previous charts. However, Manufacturing B2C companies fighting in the lower shares of the market are quite successful. Services B2B companies that scored the worst, in terms of planned objectives meeting, has all the market shares of the spectrum covered, with an emphasis on small market share. Hence in conclusion, market share and success do not seem to be linked.



Finally, if looking at competition strength, it turns out that Manufacturing B2C companies in China experience tougher competition than in Europe (please see Chart IV.2.10) . Surprisingly, for Services B2B companies this competition is thought of, in general, to be tougher, but less so than how Manufacturing B2C companies rate their competition. The success of this category is therefore related neither to the market segment nor to the competition (subjectively speaking for our sample).

5 Factors of Success

Companies were asked to rate the importance of 40 factors for successful operation in China. These factors were grouped into 6 categories to help identify the key categories for success. Below is a list of the categories with their factors.

Table 1 Factors for Successful Operation in China

Organizational strength	1	Action Plans	Human Ressources	1	HR Management
	2	Chinese partner (if Joint-Venture)		2	Adapted performance & incentive systems
	3	Efficiency of subsidiary operations		3	Localization of the management
	4	IP and Know-How Management & Protection		4	Quality and qualification of the management team
	5	Outsourcing non-core operations		5	Sense of belonging and emotional attachment to the company
	6	Quality control & Production Management		6	Strong company culture & values
	7	Sourcing & Supplier Management	Other Resources	1	Finance availability
	8	Strategy & Concepts		2	Management Support from group
	9	The type of subsidiary legal form		3	Technical Support from group
	10	Well developed and strictly enforced systems & processes	Understanding of environment & network	1	Market/Competitor/Consumer behavior knowledge/research
	11	Well prepared and enforceable contracts with all stakeholders		2	HQ understanding of subsidiary environment and flexibility in adapting to local ways
Products or Services	1	After-Sales support		3	Knowledge/understanding of the relevant laws/regulations
	2	Brand Strength (positioning and awareness among clients)		4	Relationships & Network/ Guanxi
	3	Company Reputation and Image		5	Understanding of the local business ways
	4	Competitiveness of product: Quality + Service /Price Ratio		6	Understanding of traditional Chinese culture (and Chinese language) by foreign managers
	5	Distribution Channels/Network	Understanding of environment & network	1	Availability of qualified human resources
	6	Local product development (R&D), local adjustments to market		2	Location Cost levels / Efficiency advantages Ratio
	7	Marketing & Sales		3	Proximity to clients/potential clients
	8	Proprietary technologies, strong IP		4	Proximity to suppliers
				5	Rule of laws (knowledge of legal system)
				6	Support from government (favorable policies and problem solving)

Going further, the detailed results for different companies and categories will be analyzed, but below are the aggregated answers from all companies surveyed. Human resources factors are regarded as the most key for achieving success in China, followed closely by products/services and the understanding of the environment.

Those three categories show that it is the people, with the right product, image and distribution, with the knowledge of a very special environment that makes up the most important categories of factors to have success in China.

By comparing overall results between successful and less successful companies as defined by the methodology at the beginning, there is little difference but higher ratings on every category from successful companies. Also the other difference is that successful companies put products/services as the most important category of factors, whereas the less successful companies rated the understanding of the environment & network as more important than products/services.

Chart V.5.1 – All Companies: Factors of success by category: N=127

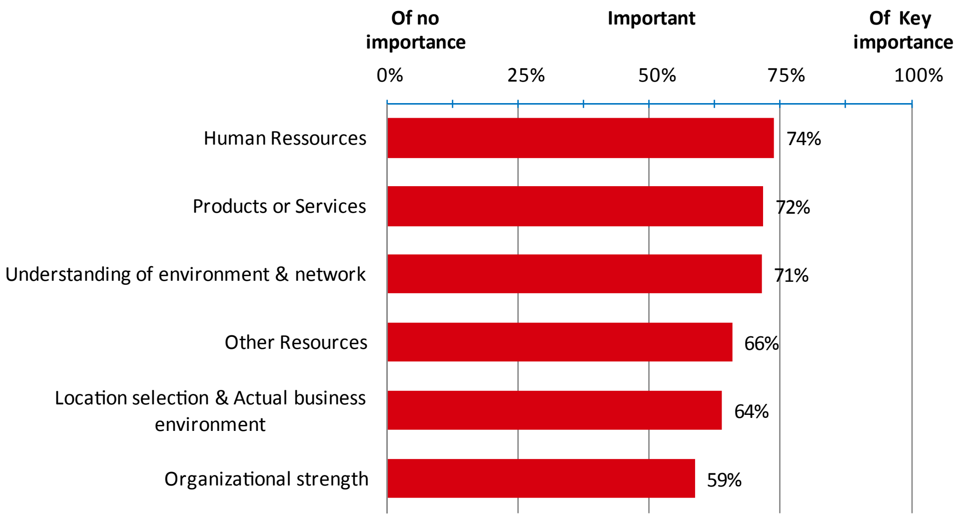
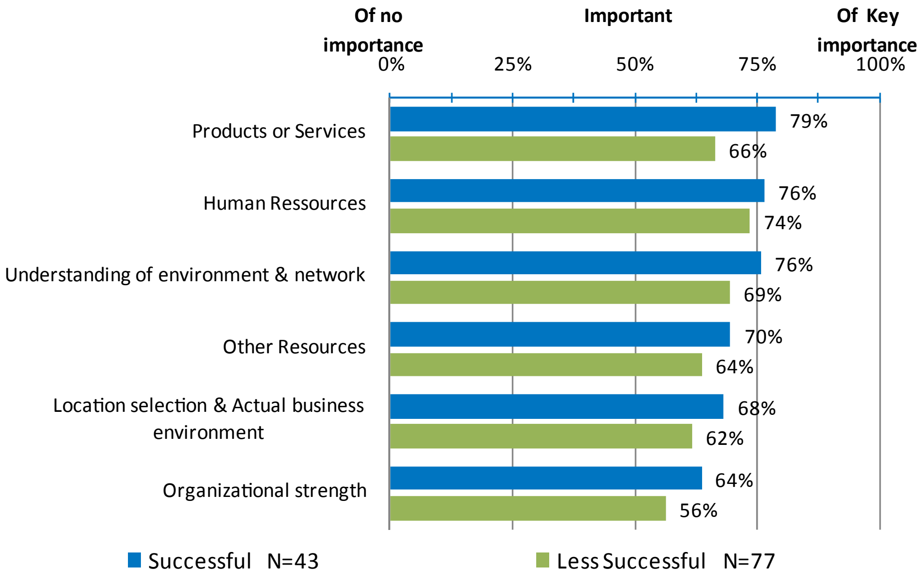
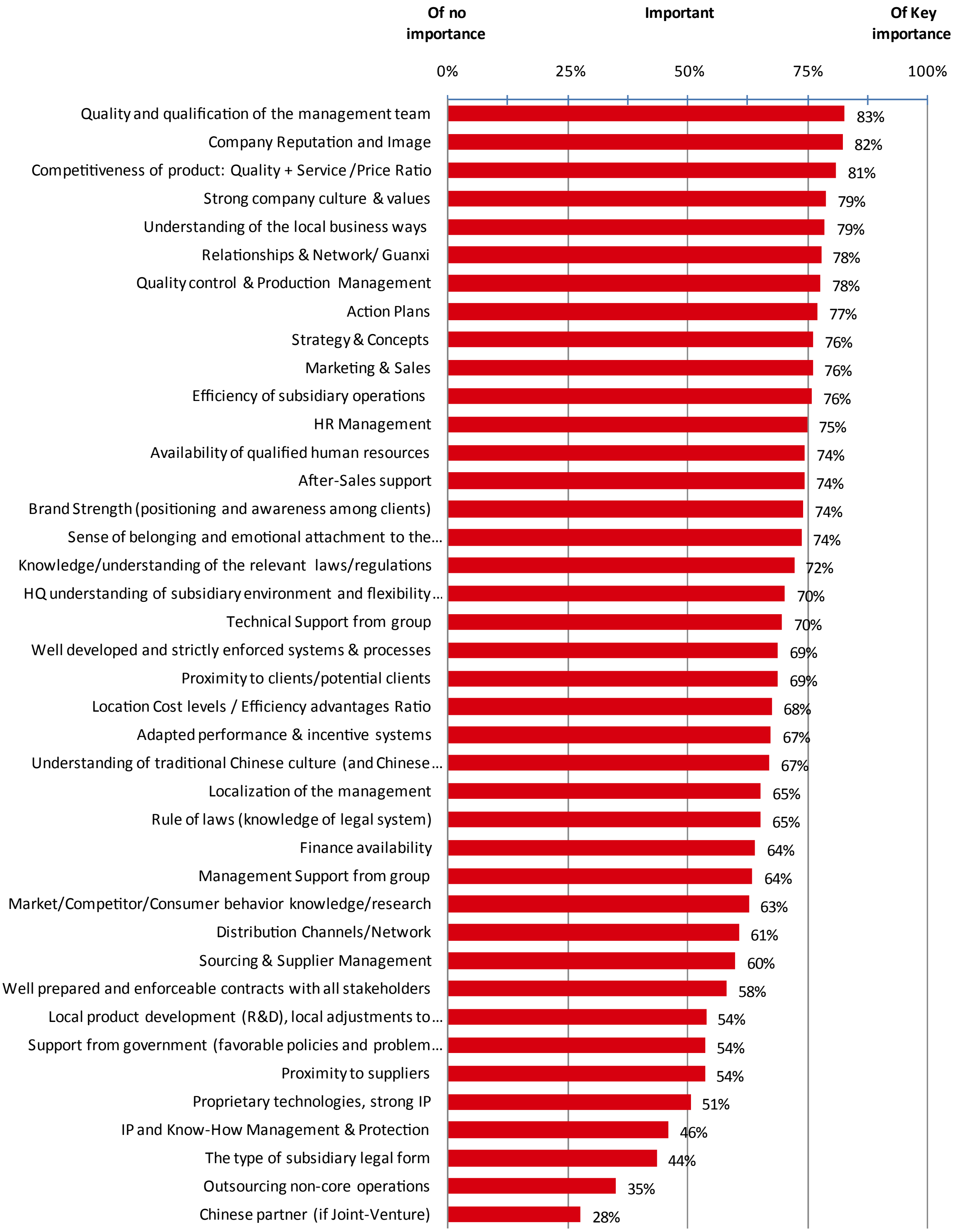


Chart V.5.2 – Factors of success by category (Successful vs. Less successful companies): N=120



Below contains the list of all individual factors making up the aggregate. It is to be viewed as an average opinion by the general managers of the subsidiary companies within our sample. Moreover, opinions would be naturally expected to vary, depending on each manager's type of business, industry and company, and their activities (importing, production etc.).

Chart V.5.3 – All companies: How decisive are these factors for your company's success in China? N=127

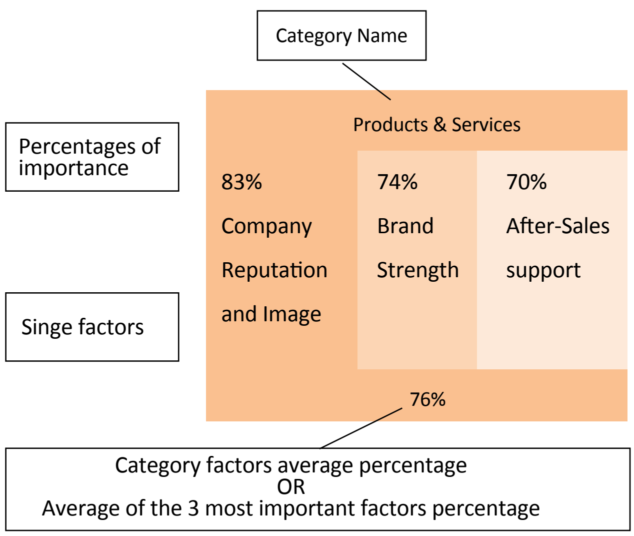


You will find in below Chart V.5.5 a further break-down of the success factors as seen by our respondents. Due to the large size of the chart, we provide a summary table of the three highest rated factors of each category. However, as it may interest some readers, the charts for each individual factor of each company's categories are to be found at the end of this report.

We provide two types of tables prior to explaining the differences. The first table will show the categories in the order from most important to less important by taking into consideration the average of all the factors included into the category (for example "Organizational Strength" has 11 factors and "Human Resources" has 6 factors). The second table will only take into consideration the average of the three most important factors of each category. By doing this it will reveal different perspectives about the results and the 18 most important factors for success in China.

In order to simplify your reading of the chart V.5.5, below is the explanatory legend :

Chart V.5.4 – Legend for Success Factor Analysis



Reading the columns from left to right, we list the top three factors from most important to least important. Please be reminded to look at the percentage at the bottom of each category with these charts: a high difference between categories means that a category is much more important than the other (in above case the one with the highest percentage is the most important).

In "factors of success resume (1)", both types of tables are placed side by side for easier comparison purposes. There are three groupings: all the companies, successful companies and less successful companies. By comparing across these categories, we can see that the "other resources" category is overrated and organizational strength is underrated when looking at all the factors of each category. Another finding is that almost all of the groups rate the same three top factors for each category even though their respective position might be interchanged.

Lastly, "location selection & business environment" and "Other Resources" seem to be the least important categories in attaining success.

For the other categories in "factors of success resume (2.1 & 2.2)", "organizational strength" is the most important for manufacturing companies. For bigger companies it is "human resources", and for smaller companies it is: "understanding of environment and network".

Chart V.5.6 – Factors of success resume (2.1)

By the average of all factors of each group of success factors

	No 1 Group of success factors	No 2 Group of success factors	No 3 Group of success factors	No 4 Group of success factors	No 5 Group of success factors	No 6 Group of success factors
Maufacturing B2C N=21	**HR** 84% Strong company culture & values 83% Quality and qualification of the management team 77% HR Management 76%	**Products & Services** 84% Company Reputation and Image 82% Brand Strength 82% Competitiveness of product 76%	**Understanding of Environment & Network** 86% Understanding of the local business ways 77% Relationships & Network/ Guanxi 76% HQ understanding of subsidiary 76%	**Location selection & Business environment** 78% Availability of qualified human resources 76% Proximity to clients/potential clients 75% Cost levels / Efficiency advantages Ratio 68%	**Other Ressources** 75% Technical Support from group 66% Finance availability 61% Management Support from group 68%	**Organizational Strength** 86% Quality control & Production Management 83% Strategy & Concepts 81% Action Plans 64%
Manufacturing B2B N=71	**HR** 81% Quality and qualification of the management team 75% Strong company culture & values 72% Sense of belonging and emotional attachment to the company 72%	**Products & Services** 87% Competitiveness of product 81% Company Reputation and Image 76% Marketing & Sales 70%	**Other Ressources** 76% Technical Support from group 67% Management Support from group 64% Finance availability 69%	**Understanding of Environment & Network** 75% Relationships & Network/ Guanxi 74% Understanding of the local business ways 70% HQ understanding of subsidiary environment 69%	**Location selection & Business environment** 72% Availability of qualified human resources 69% Location Cost levels / Efficiency advantages Ratio 65% Proximity to clients/potential clients 62%	**Organizational Strength** 80% Quality control & Production Management 78% Efficiency of subsidiary operations 76% Action Plans 60%
Service B2C N=9	**Understanding of Environment & Network** 96% Knowledge/ understanding of the relevant laws/regulations 94% Relationships & Network/ Guanxi 94% Understanding of the local business ways 85%	**HR** 89% Strong company culture & values 85% Quality and qualification of the management team 79% Sense of belonging and emotional attachment to the company 80%	**Location selection & Business environment** 86% Availability of qualified human resources 85% Proximity to clients/potential clients 83% Rule of laws (knowledge of legal system) 77%	**Products & Services** 86% Company Reputation and Image 81% Competitiveness of product 75% Marketing & Sales 68%	**Organizational Strength** 82% Quality control & Production Management 80% Efficiency of subsidiary operations 79% Well prepared and enforceable contracts with all stakeholders 63%	**Other Ressources** 68% Finance availability 63% Management Support from group 57% Technical Support from group 63%
Service B2B N=28	**HR** 87% Quality and qualification of the management team 84% Strong company culture & values 75% Sense of belonging and emotional attachment to the company 74%	**Understanding of Environment & Network** 81% Relationships & Network/ Guanxi 80% Understanding of the local business ways 71% Knowledge/understanding of the relevant laws/regulations 69%	**Location selection & Business environment** 74% Availability of qualified human resources 66% Proximity to clients/potential clients 65% Rule of laws (knowledge of legal system) 61%	**Products & Services** 83% Company Reputation and Image 74% Brand Strength 70% After-Sales support 58%	**Other Ressources** 59% Finance availability 53% Management Support from group 49% Technical Support from group 54%	**Organizational Strength** 82% Action Plans 67% Efficiency of subsidiary operations 65% Quality control & Production Management 50%
Bigger enterprises (>500) N=54	**HR** 89% Quality and qualification of the management team 83% Strong company culture & values 82% Sense of belonging and emotional attachment to the company 80%	**Products & Services** 85% Company Reputation and Image 85% Competitiveness of product 79% Marketing & Sales 72%	**Other Ressources** 77% Technical Support from group 73% Management Support from group 63% Finance availability 71%	**Understanding of Environment & Network** 79% Understanding of the local business ways 77% Relationships & Network/ Guanxi 72% HQ understanding of subsidiary environment 71%	**Location selection & Business environment** 79% Availability of qualified human resources 67% Proximity to clients/potential clients 66% Location Cost levels / Efficiency advantages Ratio 64%	**Organizational Strength** 86% Action Plans 83% Strategy & Concepts 82% Quality control & Production Management 62%
SME (<501) N=41	**Understanding of Environment & Network** 82% Relationships & Network/ Guanxi 79% Understanding of the local business ways 74% Knowledge/understanding of the relevant laws/regulations 72%	**Products & Services** 80% Company Reputation and Image 78% Competitiveness of product 75% After-Sales support 69%	**HR** 76% Quality and qualification of the management team 75% Strong company culture & values 66% Sense of belonging and emotional attachment to the company 67%	**Location selection & Business environment** 73% Proximity to clients/potential clients 72% Availability of qualified human resources 66% Location Cost levels / Efficiency advantages Ratio 63%	**Other Ressources** 63% Technical Support from group 62% Finance availability 53% Management Support from group 59%	**Organizational Strength** 78% Quality control & Production Management 71% Efficiency of subsidiary operations 70% Strategy & Concepts 55%

Chart V.5.7 – Factors of success resume (2.1)

By the average of the 3 most important factors of each group of success factors

	No 1 Group of success factors	No 2 Group of success factors	No 3 Group of success factors	No 4 Group of success factors	No 5 Group of success factors	No 6 Group of success factors
Maufacturing B2C N=21	Organizational Strength 86% Quality control & Production Management 83% Strategy & Concepts 81% Action Plans 83%	Products & Services 84% Company Reputation and Image 82% Brand Strength 82% Competitiveness of product 82%	HR 84% Strong company culture & values 83% Quality and qualification of the management team 77% HR Management 81%	Understanding of Environment & Network 86% Understanding of the local business ways 77% Relationships & Network/ Guanxi 76% HQ understanding of subsidiary 80%	Location selection & Business environment 78% Availability of qualified human resources 76% Proximity to clients/potential clients 75% Cost levels / Efficiency advantages Ratio 76%	Other Ressources 75% Technical Support from group 66% Finance availability 61% Management Support from group 67%
Manufacturing B2B N=71	Products & Services 87% Competitiveness of product 81% Company Reputation and Image 76% Marketing & Sales 81%	Organizational Strength 80% Quality control & Production Management 78% Efficiency of subsidiary operations 76% Action Plans 78%	HR 81% Quality and qualification of the management team 75% Strong company culture & values 72% Sense of belonging and emotional attachment to the company 76%	Understanding of Environment & Network 75% Relationships & Network/ Guanxi 74% Understanding of the local business ways 70% HQ understanding of subsidiary environment 73%	Location selection & Business environment 72% Availability of qualified human resources 69% Location Cost levels / Efficiency advantages Ratio 65% Proximity to clients/potential clients 69%	Other Ressources 76% Technical Support from group 67% Management Support from group 64% Finance availability 69%
Service B2C N=9	Understanding of Environment & Network 96% Knowledge/understanding of the relevant laws/regulations 94% Relationships & Network/ Guanxi 94% Understanding of the local business ways 95%	Location selection & Business environment 86% Availability of qualified human resources 85% Proximity to clients/potential clients 83% Rule of laws (knowledge of legal system) 85%	HR 89% Strong company culture & values 85% Quality and qualification of the management team 79% Sense of belonging and emotional attachment to the company 84%	Products & Services 86% Company Reputation and Image 81% Competitiveness of product 75% Marketing & Sales 81%	Organizational Strength 82% Quality control & Production Management 80% Efficiency of subsidiary operations 79% Well prepared and enforceable contracts with all stakeholders 80%	Other Ressources 68% Finance availability 63% Management Support from group 57% Technical Support from group 63%
Service B2B N=28	HR 87% Quality and qualification of the management team 84% Strong company culture & values 75% Sense of belonging and emotional attachment to the company 82%	Understanding of Environment & Network 81% Relationships & Network/ Guanxi 80% Understanding of the local business ways 71% Knowledge/understanding of the relevant laws/regulations 77%	Products & Services 83% Company Reputation and Image 74% Brand Strength 70% After-Sales support 76%	Organizational Strength 82% Action Plans 67% Efficiency of subsidiary operations 65% Quality control & Production Management 71%	Location selection & Business environment 74% Availability of qualified human resources 66% Proximity to clients/potential clients 65% Rule of laws (knowledge of legal system) 68%	Other Ressources 59% Finance availability 53% Management Support from group 49% Technical Support from group 54%
Bigger enterprises (>500) N=54	HR 89% Quality and qualification of the management team 83% Strong company culture & values 82% Sense of belonging and emotional attachment to the company 85%	Organizational Strength 86% Action Plans 83% Strategy & Concepts 82% Quality control & Production Management 84%	Products & Services 85% Company Reputation and Image 85% Competitiveness of product 79% Marketing & Sales 83%	Understanding of Environment & Network 79% Understanding of the local business ways 77% Relationships & Network/ Guanxi 72% HQ understanding of subsidiary environment 76%	Location selection & Business environment 79% Availability of qualified human resources 67% Proximity to clients/potential clients 66% Location Cost levels / Efficiency advantages Ratio 71%	Other Ressources 77% Technical Support from group 73% Management Support from group 63% Finance availability 71%
SME (<501) N=41	Understanding of Environment & Network 82% Relationships & Network/ Guanxi 79% Understanding of the local business ways 74% Knowledge/understanding of the relevant laws/regulations 78%	Products & Services 80% Company Reputation and Image 78% Competitiveness of product 75% After-Sales support 78%	Organizational Strength 78% Quality control & Production Management 71% Efficiency of subsidiary operations 70% Strategy & Concepts 73%	HR 76% Quality and qualification of the management team 75% Strong company culture & values 66% Sense of belonging and emotional attachment to the company 72%	Location selection & Business environment 73% Proximity to clients/potential clients 72% Availability of qualified human resources 66% Location Cost levels / Efficiency advantages Ratio 70%	Other Ressources 63% Technical Support from group 62% Finance availability 53% Management Support from group 59%

Chart V.5.8 – Bigger companies: How decisive are these factors for your company's success in China? N=54

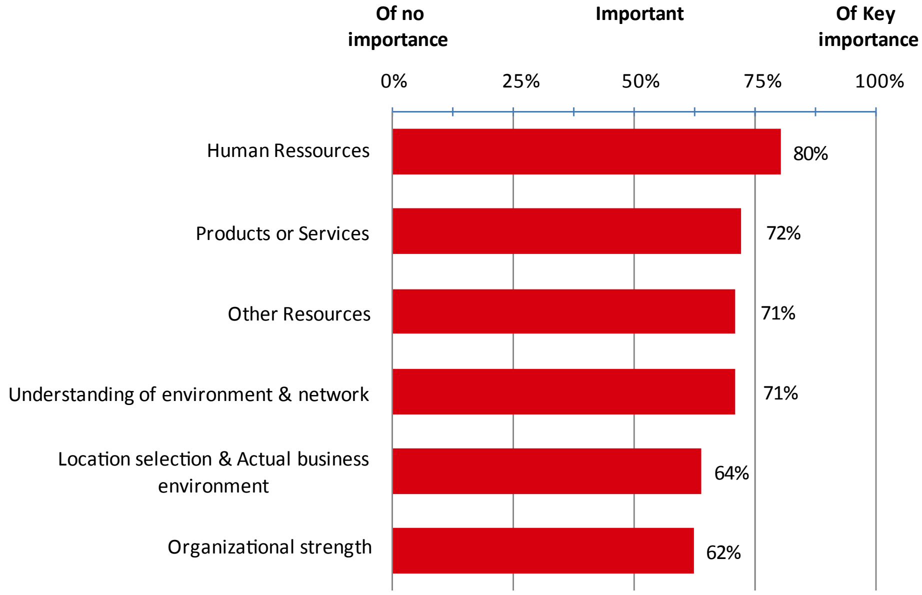
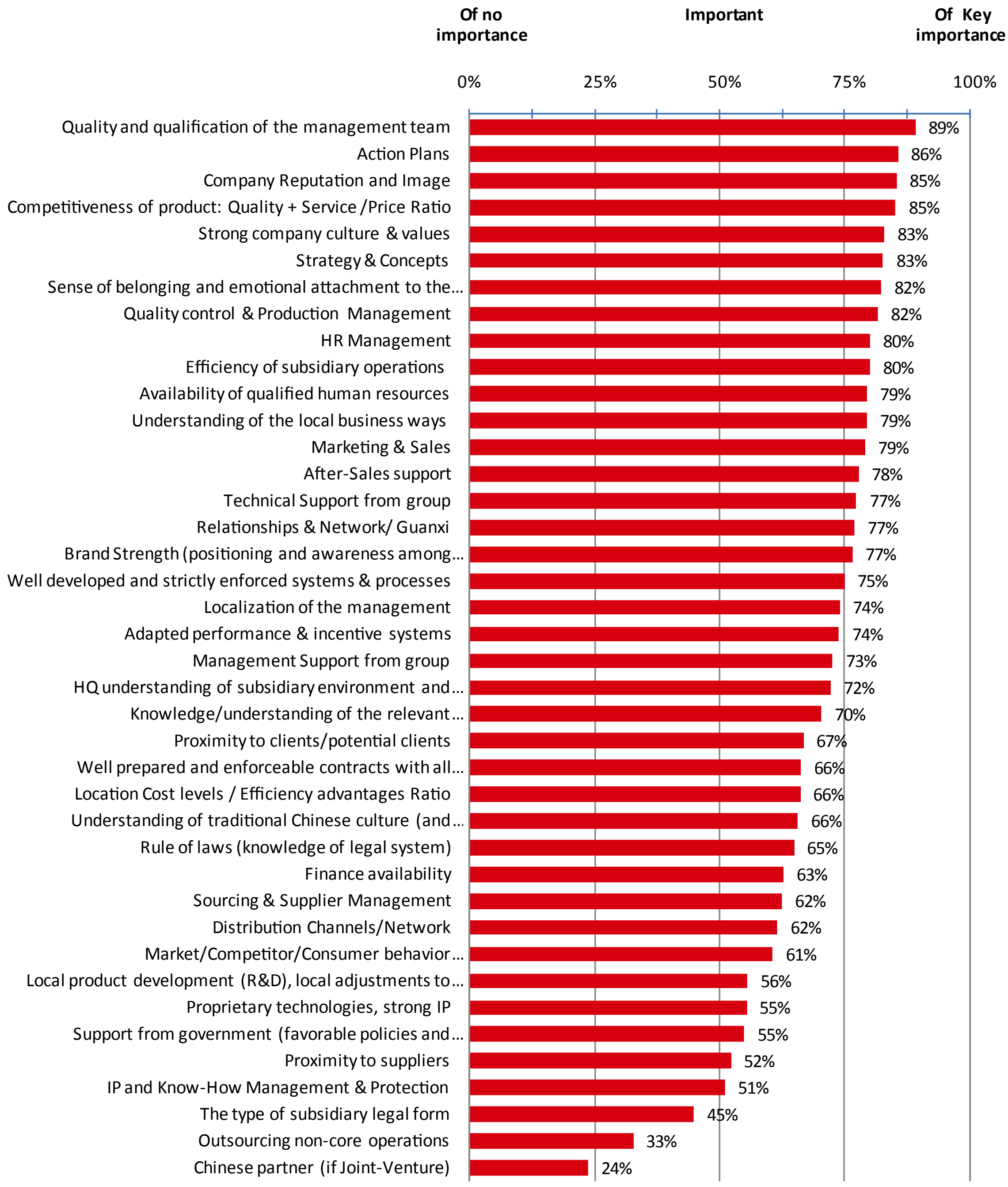


Chart V.5.9 – Bigger companies: Factors of success by category? N=54



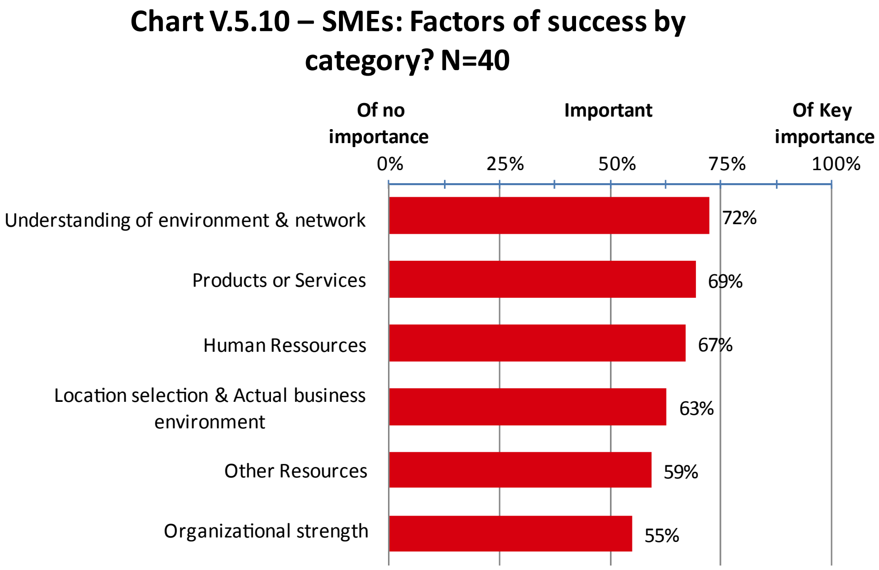


Chart V.5.10 – SMEs: Factors of success by category? N=40
Of no importance
Important
Of Key importance
0%
25%
50%
75%
100%
Understanding of environment & network
Products or Services
Human Ressources
Location selection & Actual business environment
Other Resources
Organizational strength
72%
69%
67%
63%
59%
55%

Chart V.5.11 – SMEs : How decisive are these factors for your company's success in China? N=40

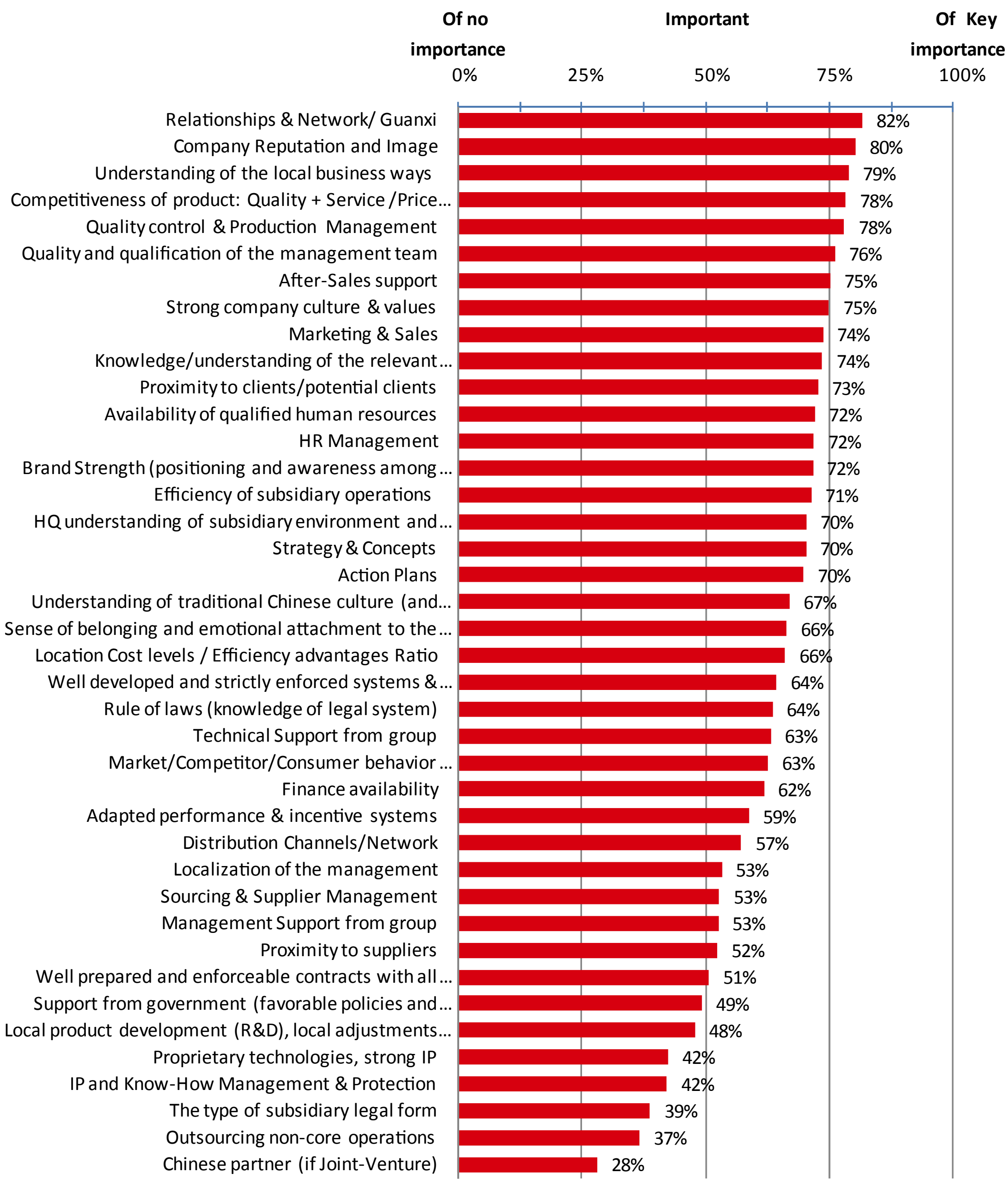


Chart V.5.12 – Successful companies: Factors of success by category? N=43

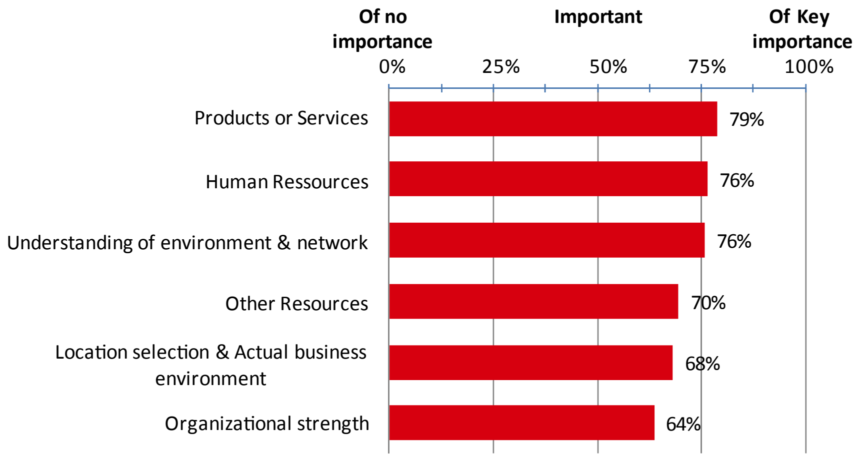


Chart V.5.13 – Successful companies: How decisive are these factors for your company's success in China? N=43

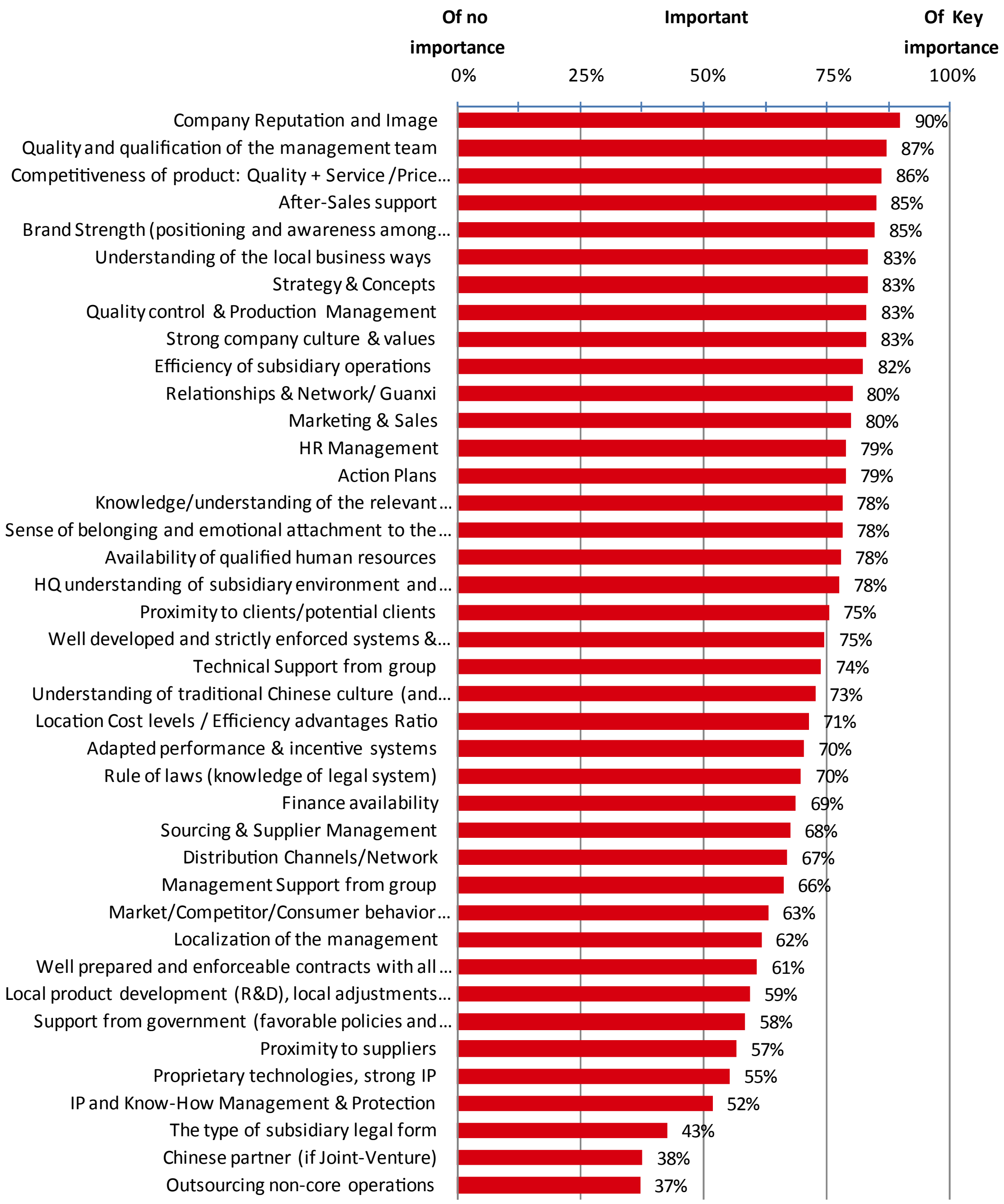


Chart V.5.14 – Less successful companies: Factors of success by category? N=77

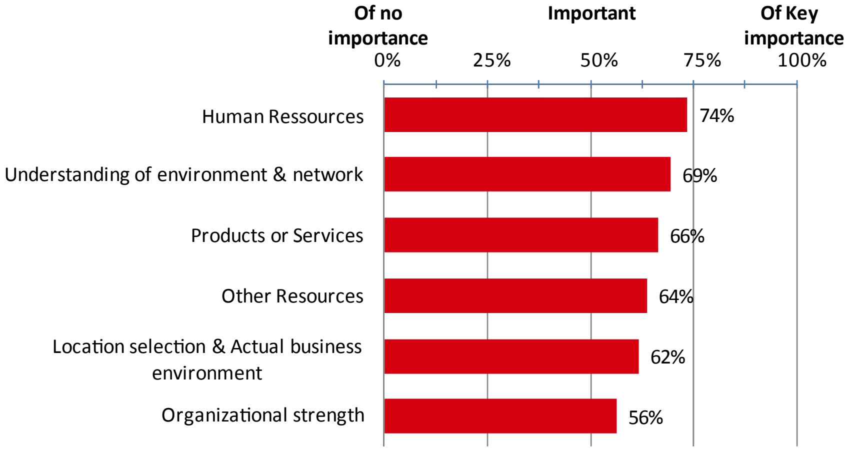
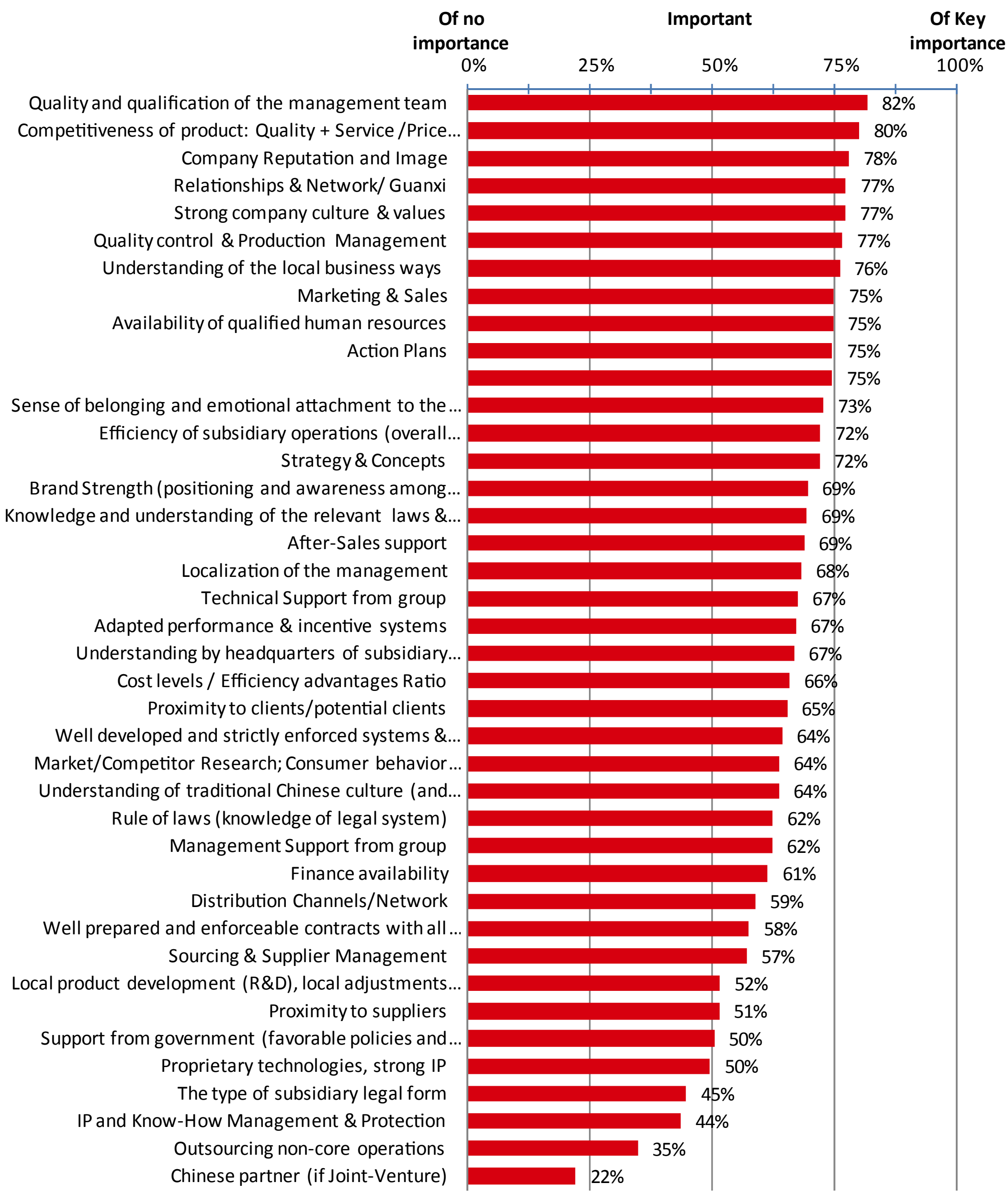


Chart V.5.15 – Less successful companies: How decisive are these factors for your company's success in China? N=77



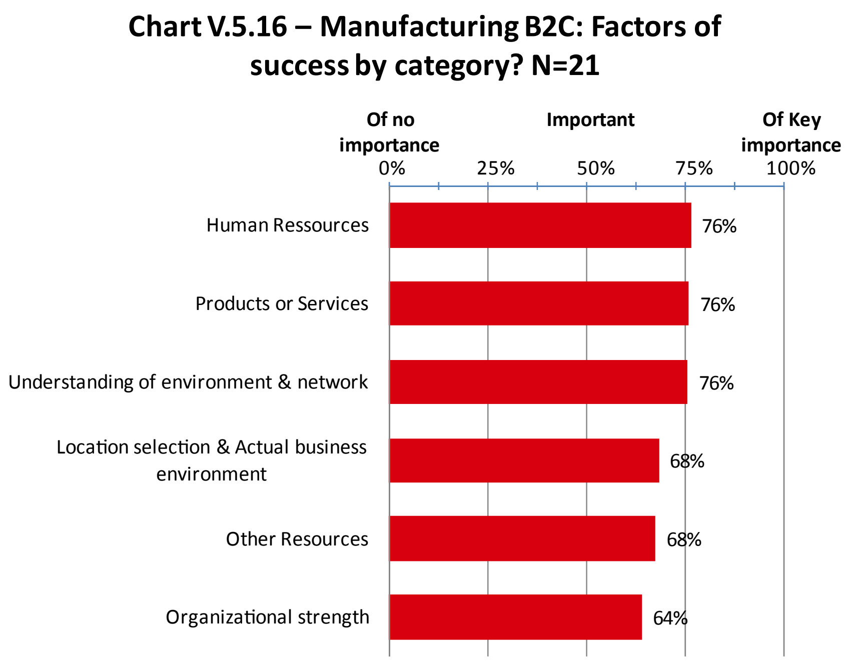


Chart V.5.16 – Manufacturing B2C: Factors of success by category? N=21
Of no importance
Important
Of Key importance
0%
25%
50%
75%
100%
Human Ressources
Products or Services
Understanding of environment & network
Location selection & Actual business environment
Other Resources
Organizational strength
76%
76%
76%
68%
68%
64%

Chart V.5.17 – Manufacturing B2C: How decisive are these factors for your company's success in China? N=21

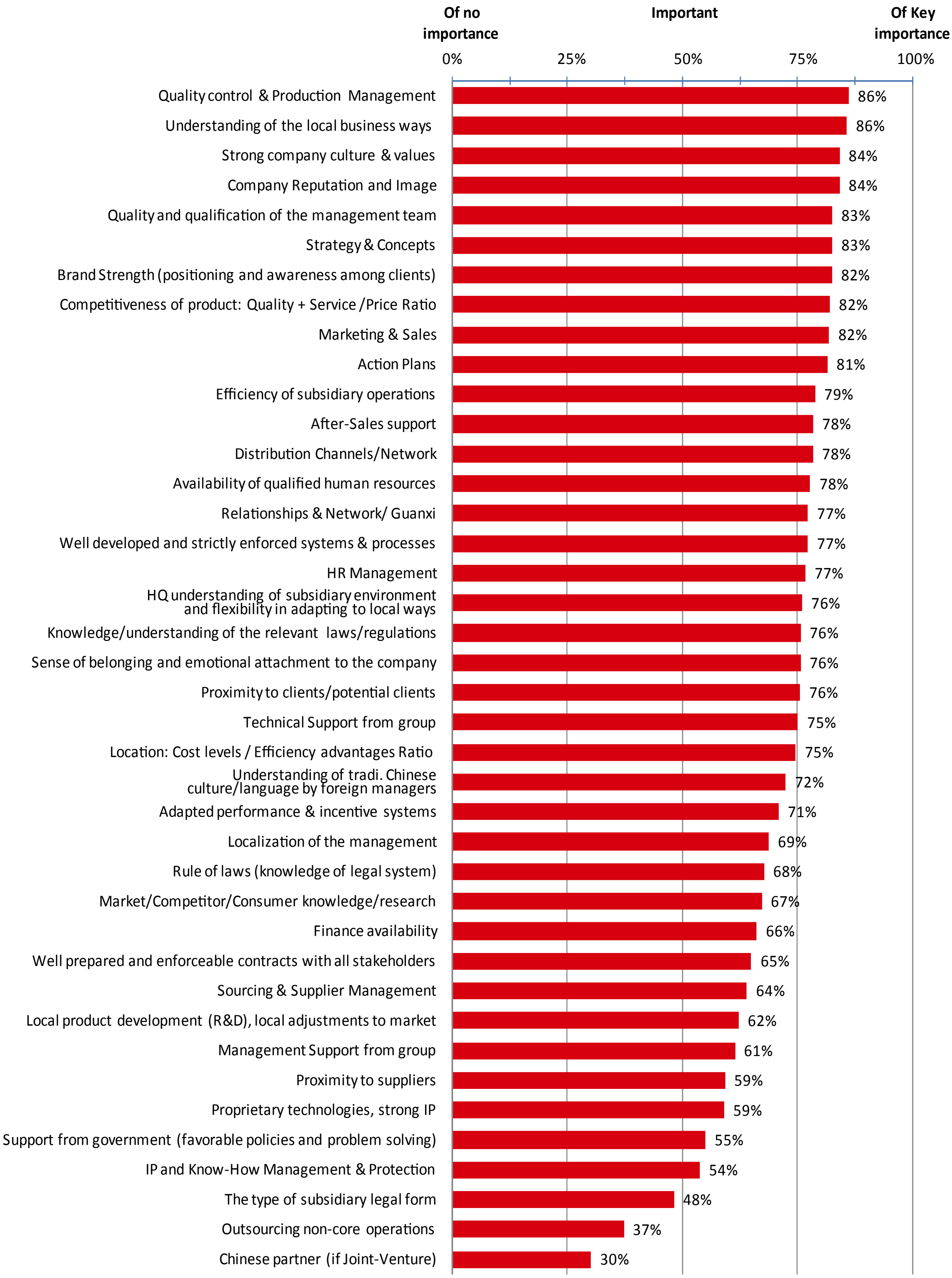


Chart V.5.18 – Manufacturing B2B: Factors of success by category? N=71

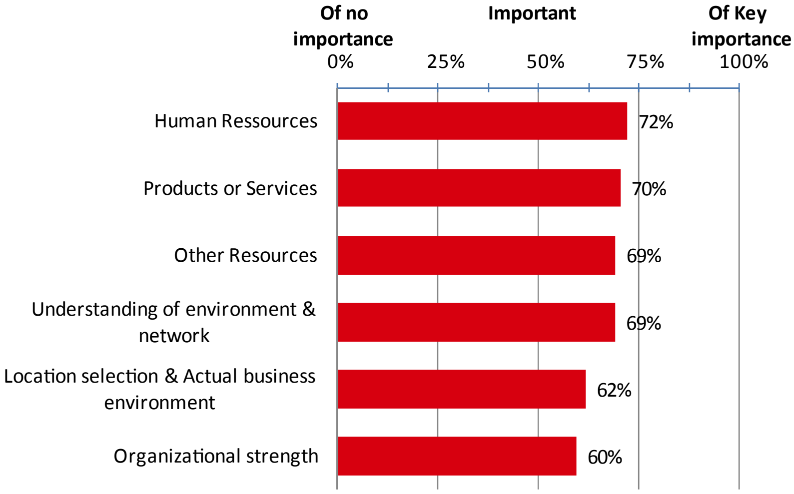


Chart V.5.19 – Manufacturing B2B: How decisive are these factors for your company's success in China? N=71

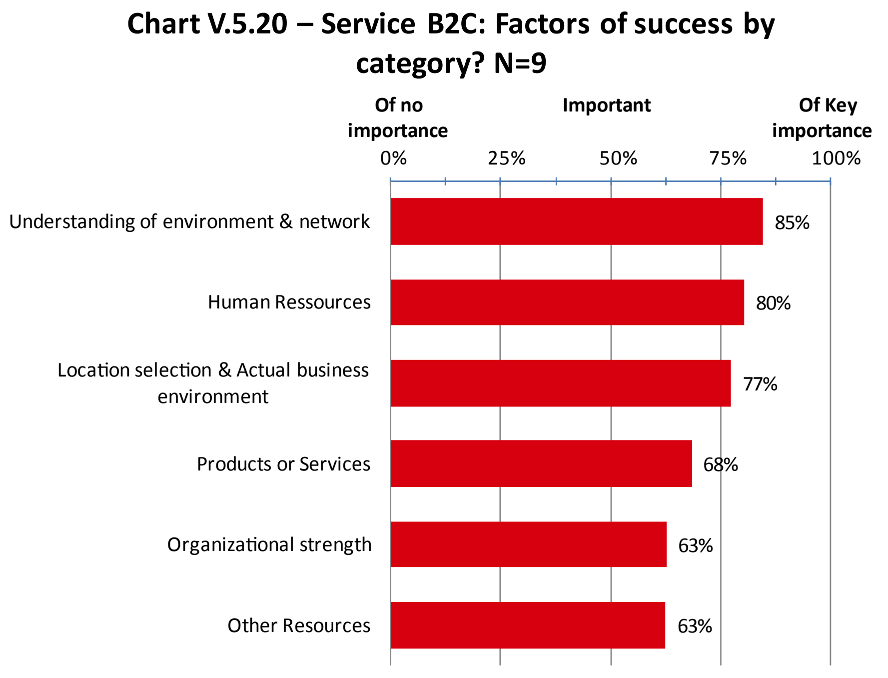


Chart V.5.20 – Service B2C: Factors of success by category? N=9
Of no importance
Important
Of Key importance
0%
25%
50%
75%
100%
Understanding of environment & network
85%
Human Ressources
80%
Location selection & Actual business environment
77%
Products or Services
68%
Organizational strength
63%
Other Resources
63%

Chart V.5.21 – Service B2C: How decisive are these factors for your company's success in China? N=9

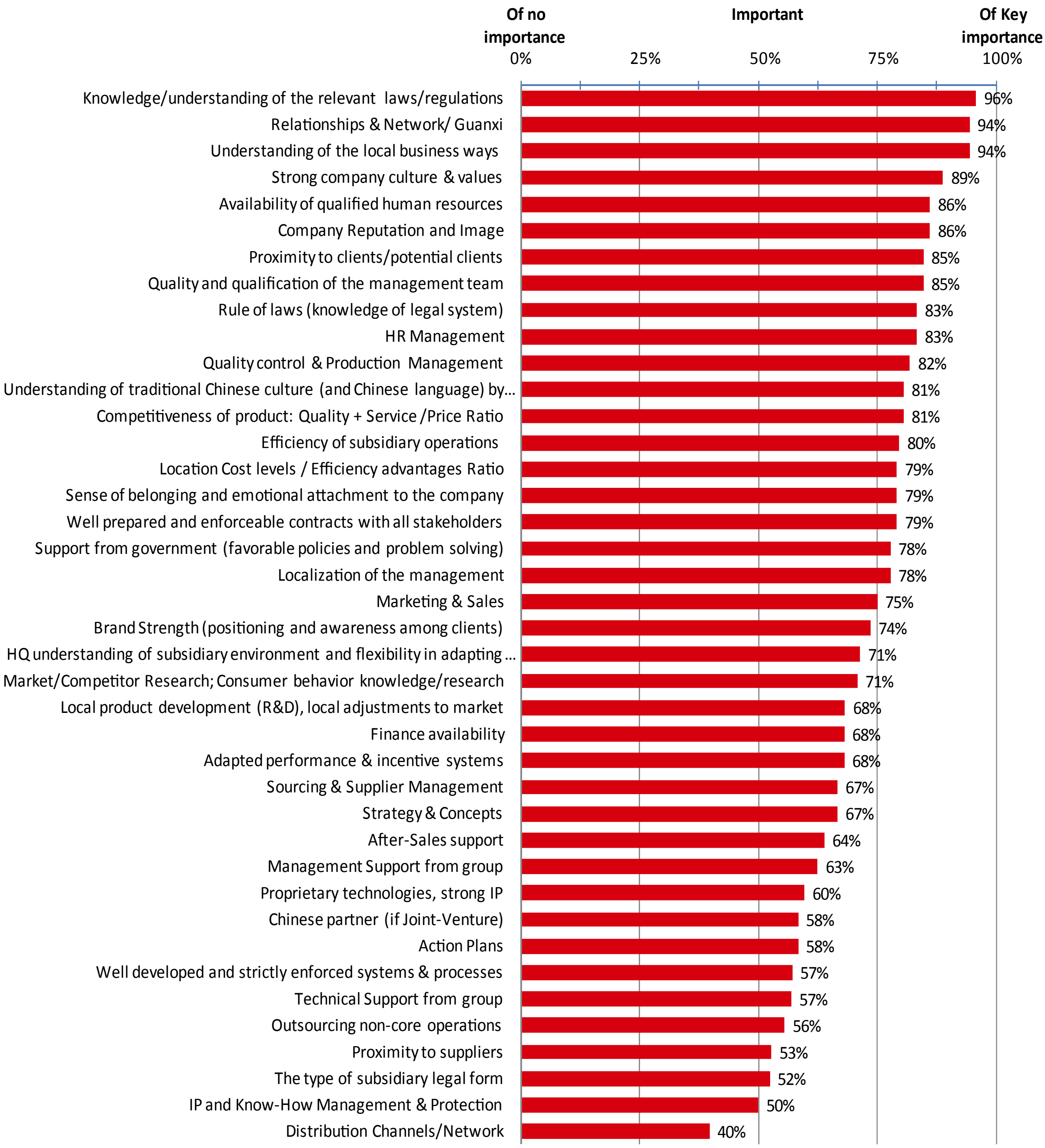


Chart V.5.22 – Service B2B: Factors of success by category? N=27

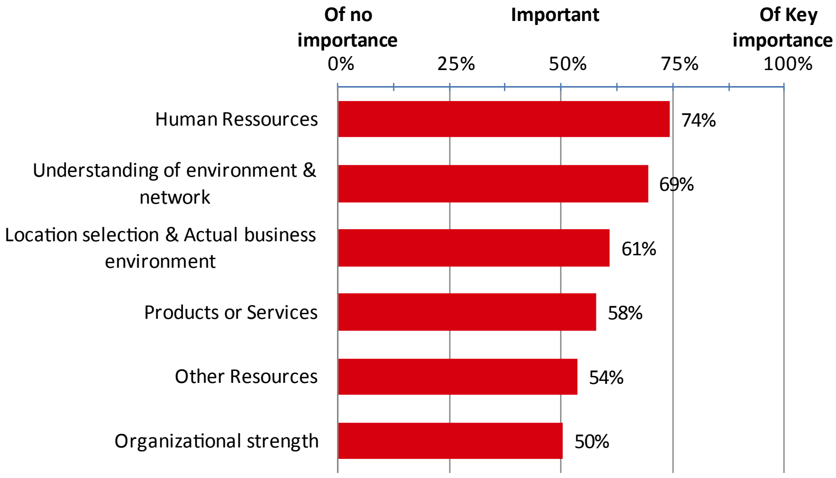
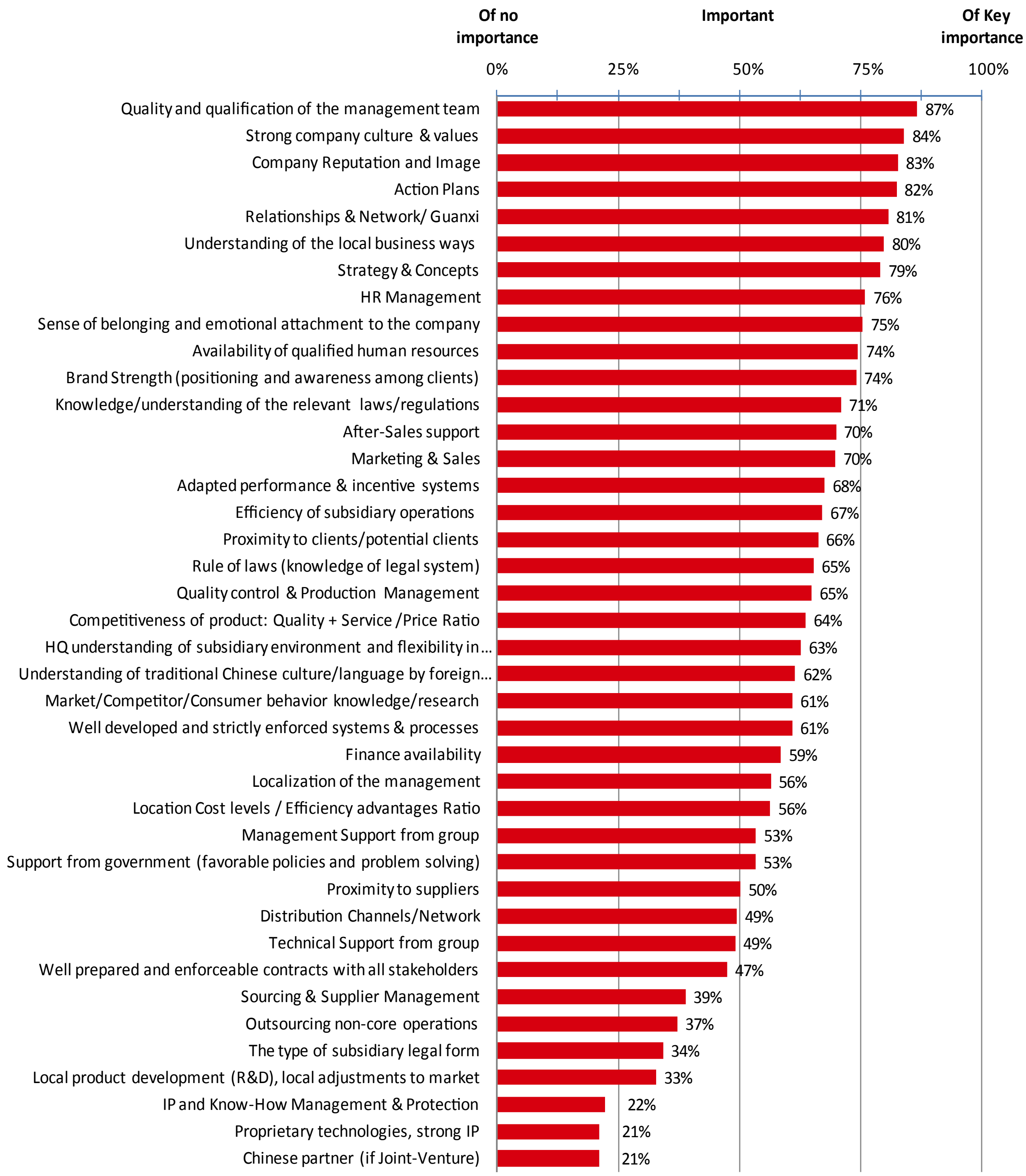


Chart V.5.23 – Service B2B: How decisive are these factors for your company's success in China? N=27



CONCLUSION: THE 2010 EUROPEAN COMPANY SURVEY

China is clearly seen as the land of opportunity, but many European firms have also chosen to invest in China for other reasons. Firstly, the most sited reason for European firms to expand in China is to follow or be close to current customers, just as offering local presence, service and products to their international as well as local customers. The grand opportunities promised by China have also created a sense of urgency with firms hoping to gain an early mover advantage, and possibly to establish strong market positions in China before losing the upper hand to other foreign competitions. Finally, some firms, particularly manufacturing organizations, want to establish a strong market position in China before Chinese competitors can grow in Europe.

Another category of European firms in China has been established by Entrepreneurs who see the big market with many opportunities, the low initial investment and operational costs as catalysts for starting businesses in China.

Most firms are involved in both selling own products produced in China or imported from subsidiaries abroad, as well as exporting products produced in China. Most of the firms producing in China consider the technology used as being on par with similar facilities abroad. Exclusive distribution is used by a majority of foreign firms and most seem to be reasonably satisfied with the level of performance. When they face difficulties it is mostly due to lack of technical understanding or sufficient level of professionalism by the distributor. However, low loyalty and lack of focus also seem to be a strong source of dissatisfaction.

It is not surprising that most firms emphasize Quality, Branding and Service as important dimensions upon which they compete. However, speed to market and positive price/quality ratio, together with China specific products are seen as important competitive dimensions.

Generally, European firms target middle-to-high end segments, and most do not anticipate that this will change in the future. For firms that are both targeting Chinese and foreign customers, many do see differences across regions and provinces – both in terms of products needed, competition and business practices. These findings are also consistent with other research sources, and thus, should highlight the challenging choices of European firms as they define and execute business strategies in China.

Many firms still emphasize trade fairs, seminars, direct promotion and PR as important vehicles to reach customers. The latter two are particularly important to consumer-focused firms who also are avid users of internet advertising.

Two thirds of European firms consider R&D important to their success in the Chinese market and most firms say they have had to make adjustments to their product offering for the Chinese market. More than half of the firms have developed a "China Line and half of these even export these products outside of China, both back to Europe and also to South-east Asia.

Over half of the European firms are either doing R&D in China or in the process of establishing such activity. An additional 20-27% are considering establishing such activities within the next 2-5 years. The most important reasoning is to be better able to adapt products to the Chinese market, do re-engineering of products, increase speed of adaptation, and to resolve communication gaps. The availability of a large pool of knowledge workers is also mentioned amongst 50% of the firms, as are the greater cost efficiency. Firms also feel it enhances their image by conducting R&D in China. Most firms feel, however, that their Chinese R&D activities only partly fulfill their initial expectations. These firms feel that links to academic institutions are important and most feel these are useful. To most manufacturing firms, intellectual property rights are very important to their business, and a majority is ensuring their rights, whether these are copyrights, proprietary technologies, trademarks or patents. At the same time half of these firms site that infringements are taking place.

For both European manufacturing and Services firms, the biggest concerns are finding and hiring suitable talents as well as increasing cost levels and loyalty, unclear, changing and inconsistent regulation and the general uncertain global slowdown. Yet, most firms expect their labor force to increase, but the pressures on salaries will persist, especially for educated staff.

European firms also mostly expect their investments to increase in 2010 or remain at the same level as in 2009. Firms also expect to strengthen their sales, distribution, marketing and after-sales activities, as the overwhelming proportions of companies remain very optimistic about the future.

As European firms look towards the decisive success factors for achieving success in China, the primary cause is the quality and qualification of the company's management team and reputation. With competitive product, service and quality, firms point to the softer issues of culture and values as important factors. These are carried by a good understanding of local business practices and far reaching networks and Guanxi.

The 2010 Survey suggests that not only are European firms becoming more firmly entrenched in China, they are also solidifying their understanding of how to become successful here. Whilst they appear to be "going more local", their European management practices and capabilities serve as strengths in their efforts to continuously contribute to Chinese society. As our effort to understand these practices will continue in future surveys, we hope to track the progress of development and discern more refined nuances of best management practices by European organizations in China.

China is growing in complexity. To be successful will be more difficult as the Chinese firms learn and improve their own competitive stances. European companies will face new challenges in the future: an increasingly demanding Chinese consumer, more capable Chinese companies, and a Chinese government interested in supporting Chinese companies with favorable legislation. European companies will likely enjoy benevolent business conditions for some years more; but in the end only the best and most adaptable will survive.

Figures and Charts

II, Part 1

II, Part 2

II, Part 3

II, Part 4

II, Part 5

III, Part 1

III, Part 2

IV, Part 1

IV, Part 2

V, Part 2

V, Part 3

V, Part 4

V, Part5