The New China Story

Short-term Instability, Long-term Strength

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GERMAN CHAMBER of Commerce in China 中国德国商会

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Roland Berger

PREFACE

Multinational companies have built up a strong local presence in China in the past decades. Many of them based their success on the "Old China Story," which was mainly driven by the so-called "Three Carriages" – consumption, investment, and net exports, along with other driving forces such as low labor cost, lax environmental regulations, and high capital productivity.

However, this "Old China Story" is over. Uncertainty and unpredictability have emerged as part of the Chinese economy, and past advantages that contributed to economic growth are disappearing.

On the other hand, bilateral (economic) relations have proven successful, yet controversies continue to emerge in both bilateral relationships and the global context. The bilateral relationship between Germany and China is being reassessed by the German government in all areas as part of its "China Strategy," mainly due to political developments in China in recent years and Germany's "turn of the century" in foreign policy, sparked by the Russian war of aggression against Ukraine. The assessment of China in the triad of the cooperation partner, economic competitor, and systemic rival is now a consensus among political stakeholders in Germany, the EU, and among German businesses. It is equally agreed upon that human rights violations are not compatible with the values of German companies. German companies are considered model companies in China in social responsibility and sustainable business practices. Over one million employees of German companies in China also serve as ambassadors in society for the values German companies represent.

In this context, multinational companies are now discussing the best ways to mitigate risks and better engage in the Chinese market. Combined with Roland Berger's profound strategy consultancy expertise in global markets and major industries, and valuable testimonials from some representative member companies of the German Chamber of Commerce in China, we jointly published this report on the Chinese economy and multinational companies' China strategy, under the understanding that there is a new China story, with a changed political, economic, and social environment.

With this report, we revealed that even though the old China story is over, the fundamentals that have made multinational companies successful in China remain. To better engage in the Chinese market and maintain a competitive edge, it is crucial to develop new business models and mitigate risks to better fit the "New China Story."

There is a famous proverb from old Chinese wisdom – "when the winds of change blow, some people build walls, while others build windmills." Amid the changes and challenges of our time, success will ultimately go to multinational companies that can rapidly transform their engagement models and adapt to the new conditions of the local markets.

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1 A "PERFECT STORM" IN 2022

2022 Was a Difficult Year for China

In 2021, China was the driving force behind the world's economic recovery. However, in 2022, the Chinese economy faced a "perfect storm."

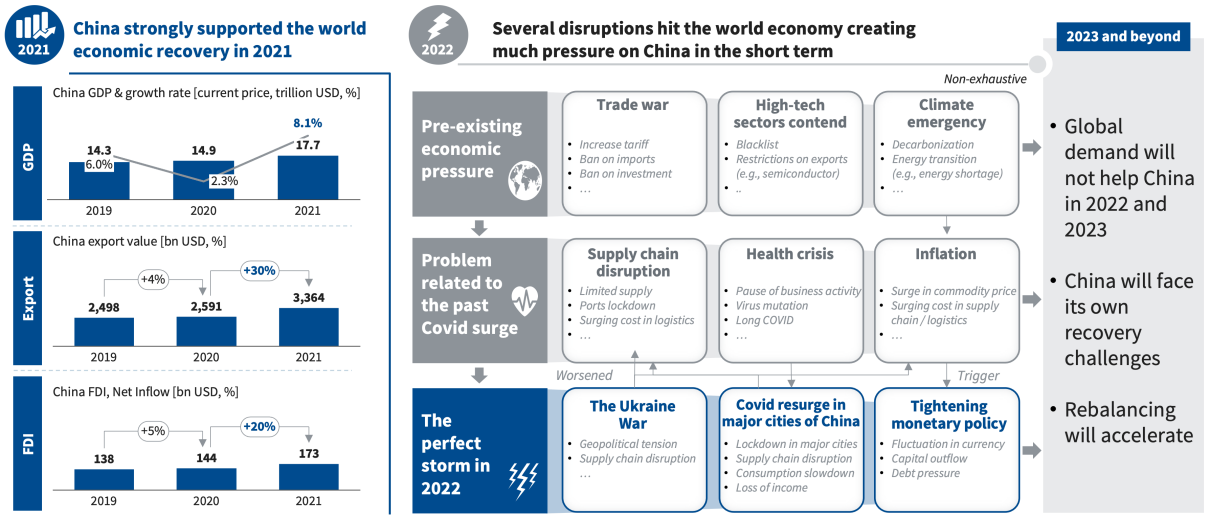
The Chinese supply chain has been critical to the world's economies in meeting the surging demand of the post-Covid-19 period. It showed quite extraordinary resilience in the second half of 2020 and early 2021. In 2021, China's GDP growth led the world with an 8.1% jump, and its export growth hit a new high of 30% versus 2020. It helped finance more investment, especially in automation and robotization, which made China an even more powerful and modernized manufacturing powerhouse with increasing capacity and productivity.

Yet, 2022 was a difficult year. While Covid-19 was still circulating around the world, the Russian war of aggression against Ukraine unleashed a global economic shockwave, only matched by the oil price shocks in the past. Inflation has been on the rise since 2018, followed by the beginning of the trade war between China and the US, and then fueled by logistics bottlenecks and demand surges during and after Covid-19 waves. Inflation received a global boost due to increased energy prices and tightening monetary policies, which caused further pressure on demand. Furthermore, China's domestic demand slowed down significantly due to the stringent Covid-19 lockdown policy.

At the same time, the world has witnessed the acceleration of climate change, with extreme weather during the summer of 2022 causing damage in both emerging and developed economies.

For China, the convergence of all the disruptions and challenges turned into a "perfect storm," adding pressure and raising a debate on the resilience of the Chinese economy.

FIGURE 1.1:
In 2021, China strongly supported the world economic recovery – but 2022 turned into a "perfect storm," with highly uncertain outcomes

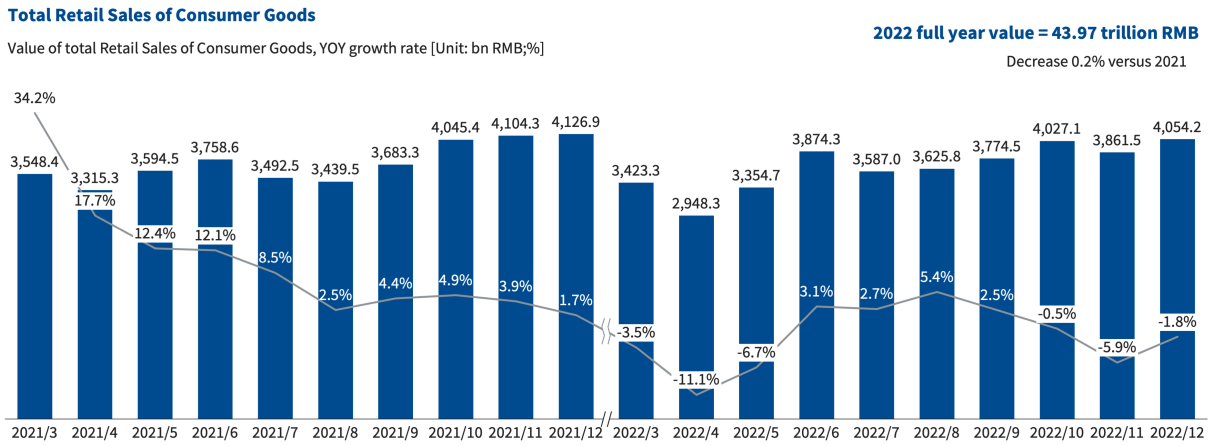


Source: IMF; National Bureau of Statistics of China; General Administration of Customs of the People's Republic of China; Roland Berger

Decline In Consumer Confidence

The stringent Covid-19 control policy inevitably disrupted economic activity, especially consumption. Since the second half of 2021, China has experienced a decline in consumption growth. China's value of total retail sales of consumer goods dropped by 11% in April 2022 compared with the prior year due to the Covid-19 resurgence and lockdowns in major cities. The slump in car sales, for example, was even more dramatic, with consumption plummeting 48% year-on-year in the same month. China's total retail sales of consumer goods in 2022 was ~44 trillion RMB, a decrease of 0.2% compared to 2021. Within retail sales, revenues of restaurants and catering fell by 6.3% in 2022.

FIGURE 1.2:
China also experienced a decline in consumption growth since H2 2021, dropping dramatically in April / May 2022



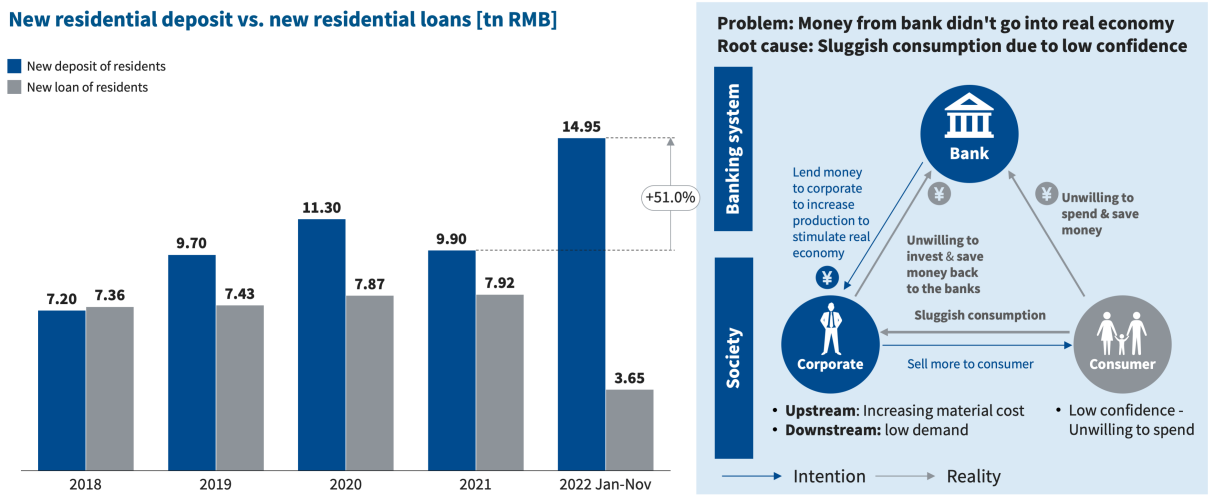
Source: National Bureau of Statistics; Roland Berger

To stimulate economic vitality, China has cut the loan prime rate (LPR) three times since December 2021. The five-year loan prime rate was reduced by 35 points, and the one-year loan prime rate was reduced by 20 points.

Despite these efforts, business activities were not efficiently shored up due to the sluggish confidence in demand. In the first 11 months of 2022, China's incremental household savings have reached 15 trillion RMB, which is already 5 trillion RMB higher than the entire year of 2021. At the same time, the value of incremental household loans was only half of that in 2021.

In response to uncertainties and concerns for the future, people prefer to save more money rather than spend, invest, or take on debt. Boosting consumption has become one of the top priorities for the Chinese government in 2023.

FIGURE 1.3:
China has continuously decreased LPR to stimulate the real economy. However, it did not sufficiently boost the economy due to sluggish consumption in demand



Source: The People's Bank Of China; Roland Berger

2023 Will See a Bumpy Recovery Route

The Covid-19 control policy inevitably disrupted economic activities, especially consumption. Yet some fundamental aspects of the Chinese economy have proven resilient: China's exports remained high in 2022 despite the slowdown in Q3-Q4, and increased by 9% in the first 11 months compared to 2021, which was already an excellent year for export growth. The inflation and currency fluctuation also stayed in a moderate range compared to many other countries, creating a solid foundation for the recovery.

At the end of 2022, China abruptly loosened its Covid-19 control policies and reopened to the world. This new development immediately improved market sentiment. The expected recovery of the Chinese economy will brighten the global economic prospects for 2023.

Yet, things are more likely to get worse in the first few months of 2023 before they get better, considering the surging Covid-19 cases in recent and coming months and referring to the reopening experience of other Asian economies. Therefore, we expect 2023 will prove a bumpy recovery route for China.

2

2 MULTINATIONALS ARE WORRIED ABOUT CHINA

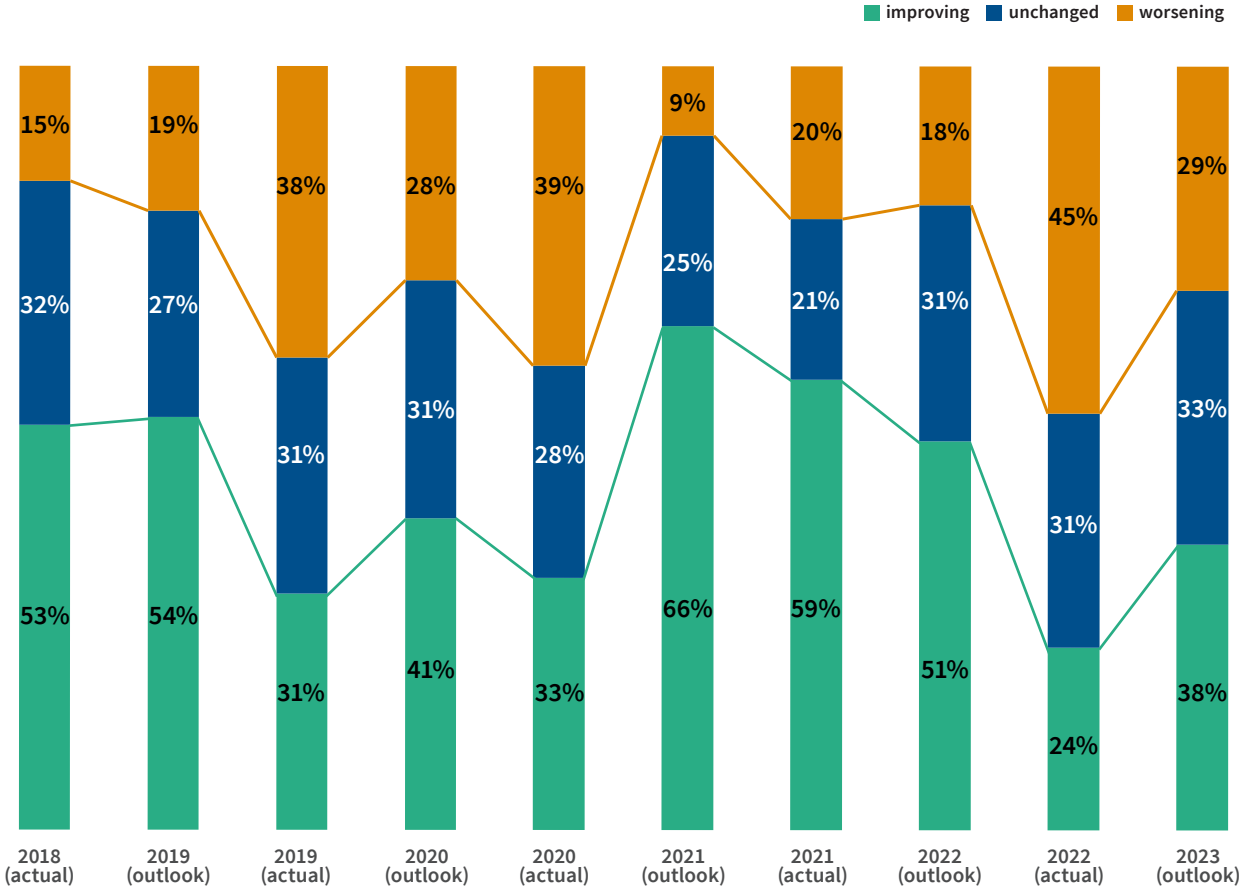
When Covid-19 started spreading across the globe, China's domestic B2B and B2C markets served as additional growth engines for many multinational companies, being relatively protected from Covid-19 waves until early 2022 and generating both volume and profits for some companies.

Heading into 2022, the Zero-Covid response and the ongoing Omicron wave in China have put pressure on markets and company performance, resulting in low business sentiment in the foreign business community.

Business Confidence of Foreign Companies in China Hit Historic Low

In the Business Confidence Survey 2022/23 conducted by the German Chamber of Commerce in China, the business sentiment of German companies reached a historic low amid the continuation of zero-Covid policies and geopolitical tensions. Only 24% of the surveyed companies experienced an improvement in the development of their industry in China in 2022 compared to 2021, while 45% experienced a worsening.

FIGURE 2.1:
Rebound of industry development in 2023 - expectations still not comparable to pre-Covid times
How do you evaluate the development of your industry in China in 2022 compared to last year? And what are your expectations for 2023? (2018: n=420; 2019: n=460; 2020: n=535; 2021: n=587; 2022: n=585)



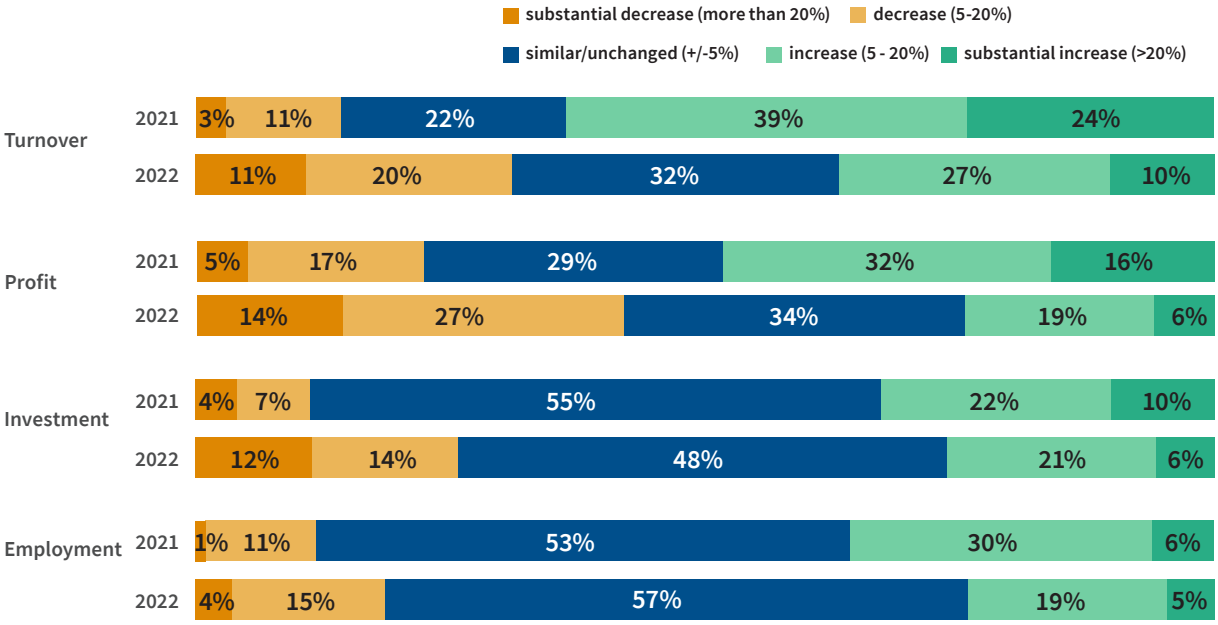
Note: "I don't know" answers excluded

Source: AHK Research and Analysis

Expectations for all four key performance indicators dropped in 2022: turnover, profit, investment, and employment. A larger share of companies reported a decrease, while a smaller percentage reported an increase compared to 2021.

FIGURE 2.2:
Turnover and profits heavily impacted by zero-Covid policy

How do you expect your company to perform in the following areas by the end of 2022 compared to 2021? (2021: n=587; 2022: n=570)



Note: "I don't know" answers excluded

Source: AHK Research and Analysis

In 2022, we could strongly sense that the business confidence in China as a manufacturing base and technology/innovation partner has been called into question, and optimism was afflicted.

"The geopolitical risks have an impact on our investment. For example, we had planned to invest in new production facilities in a neighboring province of Shanghai, but later the headquarters only approved an investment to expand our existing facilities in Shanghai, considering the risk. New investment for a new plant would very possibly be made in favor of a country in ASEAN..."

- Managing director of a leading German industrial system provider.

3

3 THE "OLD CHINA STORY" IS GONE

Uncertainty and unpredictability were never a feature of China's 5-year plans for the economy. This instability has raised concerns among businesses operating in China.

> ***"I have been working for about 30 years. In the past few years, the political instability has created an unstable business environment, which hasn't happened in China since I come here. China had been a stable and reliable place for investment. Our board asked me what was happening in China, as they had no clarity..."***
>
> *- General manager of a leading German industrial tools trading company.*

Looking back at China's core competitiveness in the past decades, it was mainly driven by low labor costs, lax environmental regulations, and high capital productivity, which is still valid to some extent in China's current stage. However, these contributing factors to China's economic growth are slowly disappearing.

In the real estate sector, for example, many enterprises have seen poor cash flow due to the tightened control on loans by the Chinese government since 2020. In 2022, fixed asset investment in real estate fell by 10%. It is expected that real estate in China will take years to recover. The time for property speculation is also gone.

FIGURE 3.1:
The "Old China Story," when China's core competitiveness was driven by low labor costs, lax environmental regulations, high capital productivity, and limited TFP, is over

1) Manufacturing labor costs per hour 2) P_k=Q/K P_k is capital productivity, Q is output and K is capital stock 3) take 2000 china's TFP as 1

Source: Statista; World Bank; Roland Berger

Within this massive development, many foreign companies have built a solid presence in China based on the "Old China Story." Foreign companies enjoyed a combination of labor and capital competitiveness, permissive regulations, and waves of planned boosts in certain B2B or B2C segments.

The change in China's core competitiveness has signaled to the business world that this "Old China Story" is over. Yet we believe the fundamentals that have made multinational companies successful in China remain, augmented by new features, making a whole new China Story possible.

4

4 A "NEW CHINA STORY" IS BEING WRITTEN

4.1 What Is the "New China Story"?

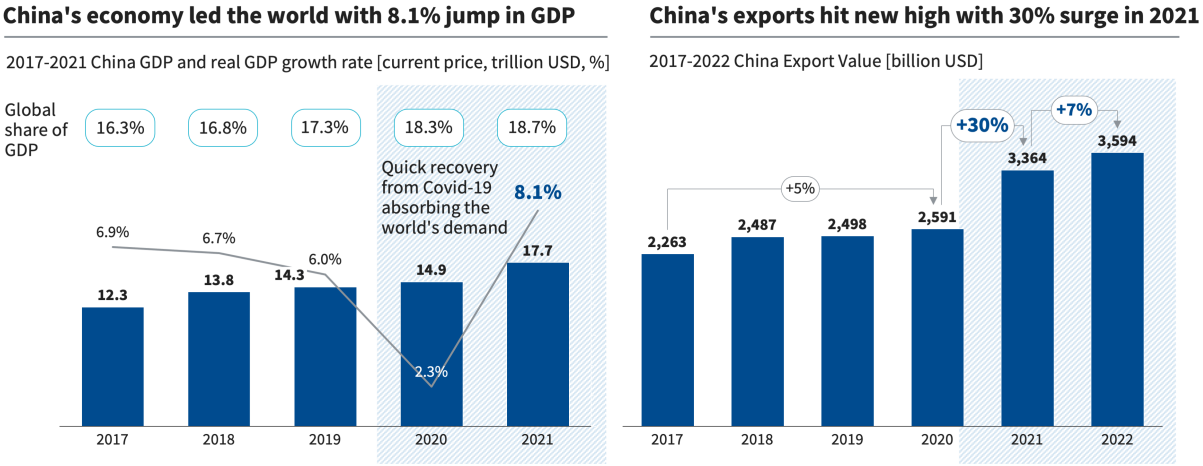
China's Key Fundamentals Remain Resilient

Despite short-term volatilities, the structural foundations of China's success remain resilient and intact in the medium to long term.

On the supply side, the competitiveness of the Chinese supply chain remains, and has even been improved due to the pandemic: Chinese and foreign companies invested heavily to modernize their production systems in 2021, when most of the global manufacturing was still crippled by Covid-19 disruptions.

FIGURE 4.1:
In 2021, China remained the world's manufacturing powerhouse, with 8.1% jump in GDP and 30% surge in exports

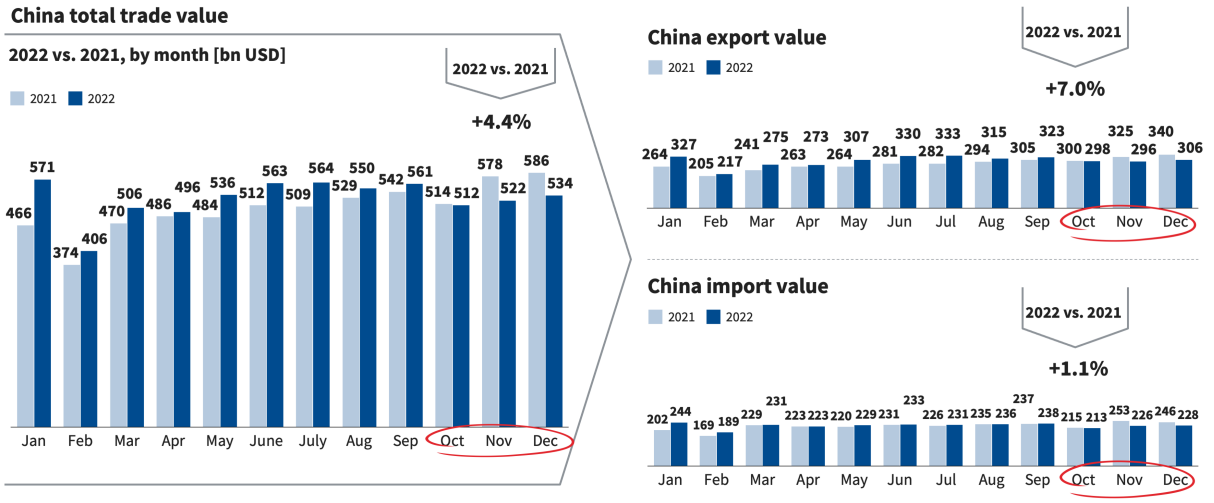
China macro economy performance



Source: IMF; National Bureau of Statistics of China; Roland Berger

The continuous surge in Chinese exports, even in 2022, demonstrates its resilience and competitiveness. Nevertheless, since October 2022, China's exports have slowed down and dropped 8.7% in November compared to 2021, and the slow global demand is expected to continue until 2023. Export may not be able to strongly support China's recovery in the short term. Yet, in the medium to long term, the Chinese manufacturing sector will remain a global force, thanks to enhanced, low carbon productivity and Asia's leverage in the future.

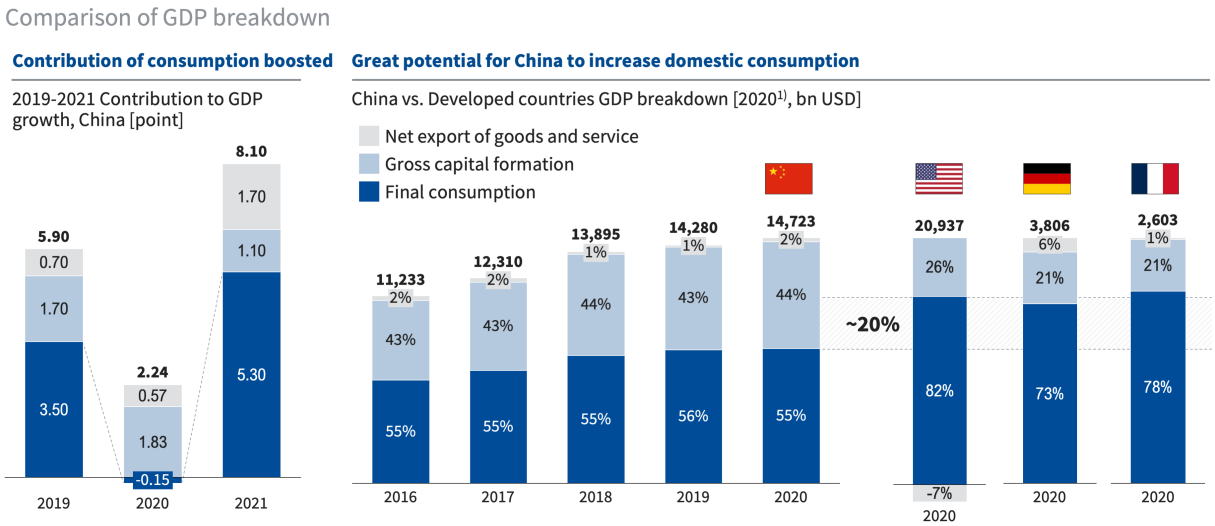
FIGURE 4.2:
China exports remained resilient in the first ten months of 2022, but were hit in November by weakening global demand and covid-19 disruptions



Source: General Administration of Customs of the People's Republic of China; Roland Berger

China has a huge domestic market and the corresponding demand. With 1.4 billion people and a fast-growing middle-income class, as well as per capita GDP now exceeding 10,000 US dollars, China remains one of the world's biggest consumer markets with strong potential. It will also be strongly supported by government incentives, such as the 'Strategic Planning Outline for Expansion of Domestic Demand (2022-2035),' launched at the end of 2022.

FIGURE 4.3:
Domestic consumption greatly contributed to China's economic growth in 2021, and still holds untapped potential

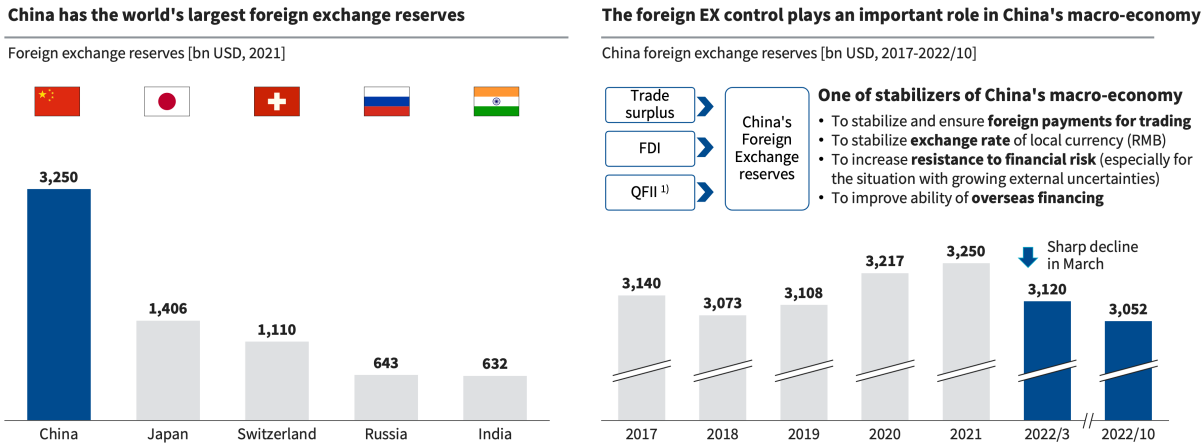


1) 2020 is the latest update by World Bank; 2021 GDP breakdown: Net export (2.5%), Gross capital formation (43%), Final consumption (54.5%)

Source: World Bank; Roland Berger

Furthermore, faced with external instabilities, China has the world's largest foreign exchange reserves, which ensures the stability of foreign trade and investment, and increases resilience to financial risk.

FIGURE 4.4:
China has the world's largest foreign exchange reserves, ensuring stability of foreign trade and investment, and increasing resilience to financial risk



1) Qualified Foreign Institutional Investor

Source: The People's Bank of China; Roland Berger

Decoupling: Limited on the Supply Side, Faster on the Demand Side

We believe that the much-discussed supply chain decoupling will mainly affect the technology sector, as we are witnessing an escalation in the US legislation towards high-tech sectors such as the semiconductor field. In the meantime, there is a certain level of supply chain diversification, triggered by three key factors: First, tightened risk management due to the increasing uncertainties creating supply chain bottlenecks. SecondChina's competitiveness compared to other countries in labor, technology, and infrastructure has decreased its added value. Lastly, economic sovereignty concerns – since the pandemic, more and more countries have put heavy emphasis on economic sovereignty, especially in strategic areas, such as semiconductors, pharmaceuticals, etc.

However, Chinese demand is increasingly decoupled from the rest of the world, demonstrating unique consumption patterns. It includes, but is not limited to, different cyclicity, increasingly localized production, 'Made in China for China,' localized product design and features, unique digital and payment ecosystems, distinct innovation, etc.

While China is developing into a singular market, its size and growth continue to offer opportunities for foreign companies.

"For the next few years, the first thing is strengthening independence and accelerating local decision-making. For example, digitalization is simply more advanced here. China has this new disruptive way of doing business with WeChat, e-shop, and Douyin (TikTok) for marketing and sales activities, which is very different from other markets, including our home market or the US market."

- General manager of a leading German industrial tools trading company.

4.2 Three New Economic Engines

These changes mean that the "Old China Story" is no longer a guarantee of success for multinational companies. As China builds up new economic engines for the future, foreign companies must understand how the country's economy is transforming.

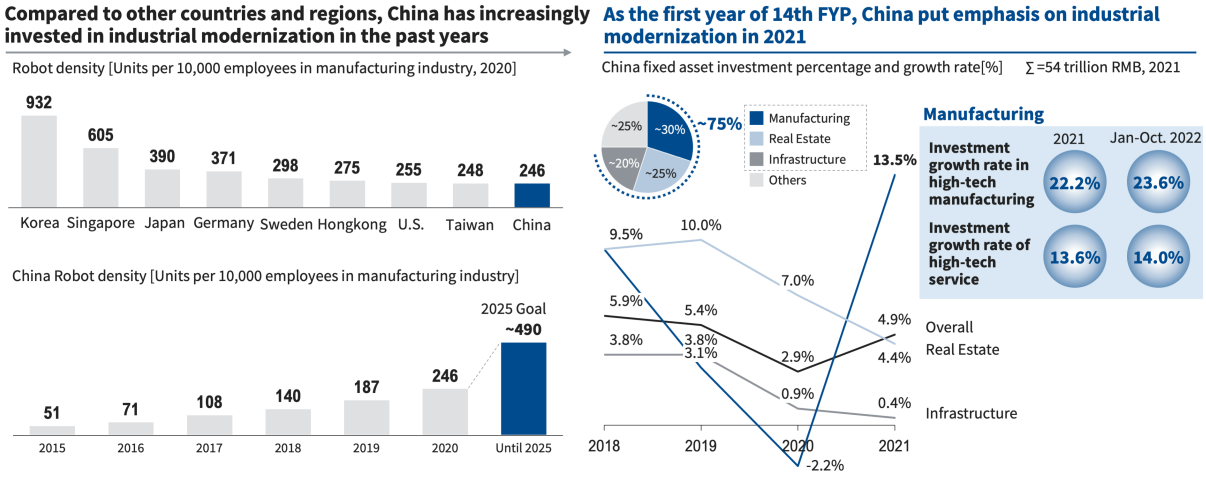
Industrial Modernization

2021 marked the start of China's 14th Five-Year Plan, where an increased emphasis was put on China's industrial modernization.

Manufacturing represents one-third of China's fixed asset investment. Between January to October 2022, manufacturing investment grew by 9.7% - faster than the overall fixed asset investment growth of 5.7%. Out of the manufacturing investment, investment in advanced manufacturing has increased by 24%. China's industrial fleet is becoming increasingly automated, with the ratio of industrial robots installed per manufacturing employee approaching that of Sweden or Germany. Around 70% of the robots installed yearly still rely on imported or foreign design, providing vast market opportunities for multinational companies.

Foreign enterprises thus have a good chance to remain a key contributor to China's industrial modernization, particularly in fields such as industrial automation, robotization, and digitalization.

FIGURE 4.5:
China is accelerating industrial modernization, building up new competitiveness and productivity driven by innovation

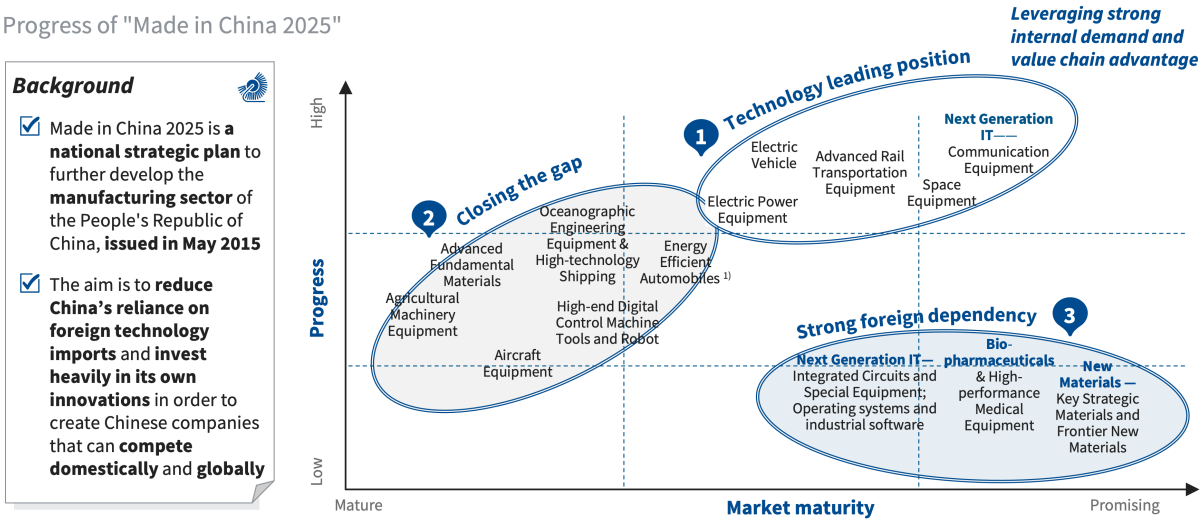


Source: IFR; National Bureau of Statistics of China

In more recently developed industrial sectors, Chinese companies are leapfrogging and gaining leadership positions worldwide, such as in the e-mobility value chain, from chemicals and materials used for batteries to electric vehicles.

The same can be seen for communication equipment, space equipment, and more: unlike the 'Old China Story,' where the global supply chain was driven by China's productivity. In these sectors, the global supply chain will partially be driven by Chinese innovation.

FIGURE 4.6:
Since the launch of "Made in China 2025," China has leapfrogged in many areas through unique advantages, but still lags in several sectors

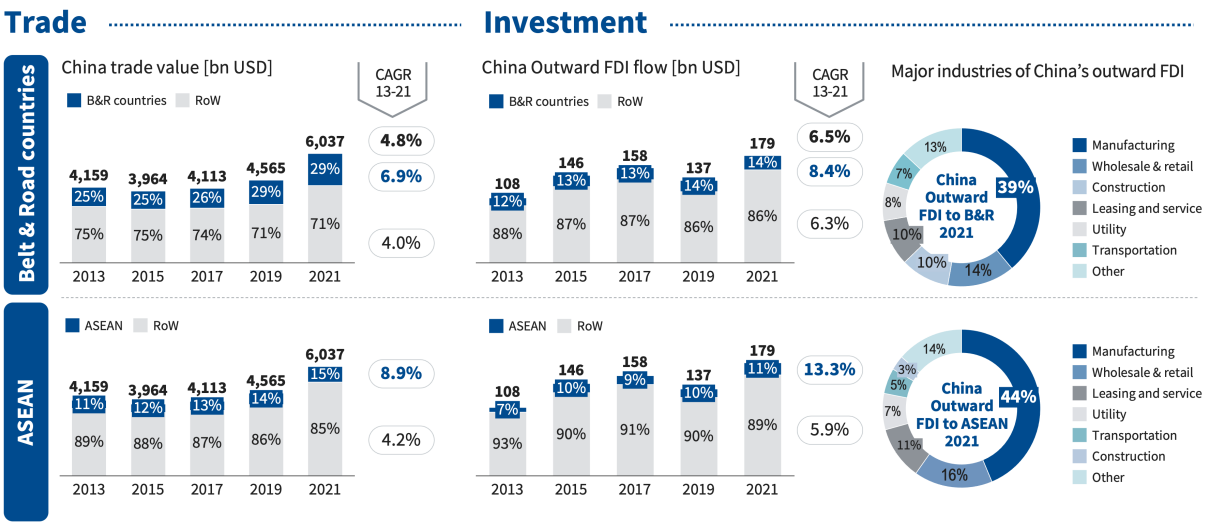


1) Refers to internal combustion engine improvement for CV

Source: Roland Berger

The regionalization of trade is another important aspect of this major transformation and accelerated modernization, which also drives competitiveness. Cumulatively, ASEAN countries have become trade partners to China at an equivalent level to the EU, and surpassed the US. This shift is driven by Chinese and Asian manufacturing companies continuously searching for competitive advantage across the region. It is evident when reviewing the growth rate of Chinese investment in the region and manufacturing dominance. The Regional Comprehensive Economic Partnership (RCEP) treaty will accelerate this trend towards regionalizing trade.

FIGURE 4.7:
China's competitiveness also comes from regionalizing investment and trade



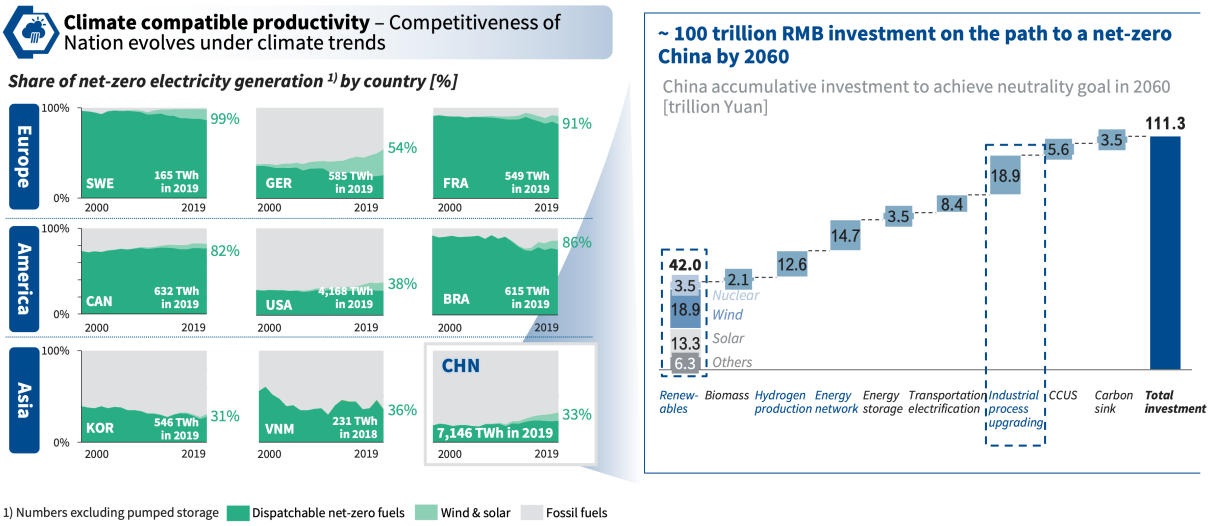
Source: General Administration of Customs of the People's Republic of China; Ministry of Commerce of the People's Republic of China

Low-Carbon Development

The fight against climate change is changing countries' competitive advantage. In recent years, the carbon border adjustment mechanism and various tax approaches have been and will be implemented worldwide. As a key exporter of manufactured goods to the rest of the world, China can keep this position and its growth engines only if it further decarbonizes. A new paradigm for competitiveness addresses the urgent need for climate action, which requires massive investments. Chinese companies will have to accelerate the progress of energy transition and decarbonization to maintain this competitiveness.

China's double pledge to peak carbon emissions by 2030 and reach carbon neutrality before 2060 is the key to maintaining competitiveness, and will drive further acceleration of the modernization process. Currently, China has considerably increased its share of renewable and nuclear electricity. With 33% of its power coming from renewable sources, China fares reasonably well compared to other industrial nations like South Korea, Vietnam, and the US, but falls short compared to Germany.

FIGURE 4.8:
The double pledge to peak and neutralize CO2 is key in maintaining China's competitiveness, and will drive further acceleration of the modernization process



Source: EIA; Goldman Sachs;

While Europe and North America have reached an emission peak, China has yet to do so. Therefore, China has even less time to shift its production model. This will accelerate innovation, and the scope of the change will drive down the marginal cost compared to the rest of the world. This is not a new pattern: we have seen it before with solar PV modules and batteries.

China has unique policies, technology, and natural advantages in the fight against climate change. The long road to carbon neutrality will create abundant opportunities for global cooperation.

Common Prosperity to Fuel Mass Consumption

In recent years, the Chinese government has taken pragmatic and assertive measures to strengthen control over several industries under the guiding theme of "common prosperity." In the short term, these actions have raised concerns regarding China's business environment.

FIGURE 4.9:
In recent years, the government has taken pragmatic and assertive measures to strengthen control over several industries under the guiding theme of "common prosperity"

China's recent actions on oversighting business

E-commerce

E-commerce
- Alibaba was fined $2.75 bn over "choose one from two" feature that barred vendors to sell on rival sites (2021/4)

Food delivery
- Regulator strengthen protection for food delivery workers e.g., insurance (2021/7)

Live-streaming
- Strengthen control on product marketing, language (better mandarin) and dress code

Online Finance
- Set tighter controls on online lending (2020/11)
- Set limits on cross-provincial online loans and capped loans to individuals

Entertainment & Media

Gaming & social media
- New restrictions to limit the time under-18s can spend gaming online (2021/8)
- Introduce "Teenage mode"
- Ensure real names are used in registration before offering gaming services

Celebrity
- Limit huge salaries for TV stars (2022/2)
- Inspect celebrity's tax evasion (2021/2022)
- Crackdown celebrity hype

Property
- Authorities tightened curbs in 2021 on real estate borrowing to prevent any asset bubble, setting caps for developers and banks (2021/7)
- Housing price controlling

Private education
- Ban firms that teach school curricula from making a profit, raising capital or going public (2021/7)
  - Publicly listed tutoring firms saw massive decline after regulations
  - Social media giant ByteDance laid off staff in its education unit
  - Online tutoring company VIPKid stopped lessons by foreigners

Ride-hailing
- The cyberspace regulator in China alleged that data from users was collected illegally by Didi (2021/7)
- A cap will be placed on the percentage that ride-hailing platforms can take from drivers' fees (2021/8)

Key Targets
- Education equality
- Cybersecurity
- Anti-monopoly
- Wage gap
- Spiritual culture
- ...

Chinese government's oversight on business is becoming more pragmatic under the guiding theme of "Common Prosperity"

Source: Roland Berger

While most analysts predicted aggressive tax or redistribution measures, this has not materialized. We believe in a different direction: increasing the size of the domestic market by expanding the middle class. It is not about redistribution or making the wealthy wealthier. Instead, it's about introducing tens of millions of people on the fringe of the lower-middle class into the middle-class group. China's domestic consumption potential remains largely unleashed.

China launched multiple pilot programs, in Zhejiang and other provinces, introducing initiatives to shift the population from rural China into suburban areas and increase their disposable income. For mass-market brands, this trend could bring about numerous opportunities.

FIGURE 4.10:
Zhejiang aims to grow its middle class through increased economic output as part of "common prosperity"

Demonstration Zone for Common Prosperity

1 Central Level — The State Council (May 2021): Supporting Zhejiang's High-quality Development and Construction of a Demonstration Zone for Common Prosperity

2 Provincial level — Zhejiang province (Jul 2021): Implementation Plan for the Zhejiang High-Quality Development and Establishment of a Demonstration Zone for Common Prosperity (2021-2025)

3 County level — Jiashan county (Nov 2022): Construction plan of high-quality development demonstration sites in Jiashan County of Zhejiang in the new development stage

- **Demographic representativeness**: population, size, rural area, county numbers etc.
- **Economic foundation**: GDP, disposable income etc.
- **Acceptance to reform**
- **Future growth potential**

2025 Target	Per capita disposable income	Urbanization rate for the permanent population	Reduce the income gap btw urban & rural residents (Selective)	Percentage of R&D spending	Proportion of middle-class	Reduce the income gap btw urban & rural residents (Selective)
	75k RMB	75%	<1.9	4%	82%	1.55

Key initiatives
- Increasing economic output through innovation
- Deepening income distribution reform
- Achieving public service sharing
- Creating more influential culture
- Building sustainable environment
- Improving digital capability

Key aspects

Emphasizing on building an **innovation-driven** and **modernized industrial system to** increase economic output that drives **GDP per Capita**

Supporting and expanding the **size of the middle class**

Common prosperity

Source: Roland Berger

4.3 China Will Be Back; MNCs Will Stay

Revisions made to the industry catalogue ("2022 Catalogue of Encouraged Industries for Foreign Investment") last year encourage foreign investment in key fields. It covered advanced manufacturing, high-end technology, energy conservation, and modern services, which align with China's priorities.

The country will also support foreign investors in establishing research and development centers in high-end and emerging technology fields. With increasing government support, foreign businesses can play a bigger role in tech innovation and scientific research, sharing global resources, and localizing innovation. If China holds up to its promise of opening up, foreign companies will keep playing an essential role in the Chinese economy.

"We are convinced that China is leading the way in many areas of the sectors that we have involved in. The 'local for local' strategy is not just to serve the local, but also to leverage our competencies and capabilities in China for the global market..."

- Senior vice president of a world-leading German multinational engineering and technology company.

Although China currently faces huge economic challenges and is still lagging in certain areas, we believe that, for most multinational companies, China remains an attractive market, a superior industrial cluster, and an increasingly efficient innovation hub. Even though it is unlikely for China to replicate past booming decades, its key fundamentals remain robust and unique compared to many other markets.

FIGURE 4.11:
China will be back, and multinational companies will stay – based on a "New China Story"

	BEFORE "The Old China Story"	TODAY "Global + Local Turbulence"	TOMORROW "The New China Story"
China's Interests and Intentions	• WTO, reform and opening • Development of China GDP and GDP/capita • "Manufacturing powerhouse of the world"; export driven growth • Foreign innovation, technology and know-how input • Domestic consumption drive • "Waves" driven by Five-Year plan	• 14th Five-Year Plan focus on supply side, industrial modernization, energy transition • Global & local economic crisis looming, no cyclical benefits (different from 2021) • Priority on stability / Zero-Covid policy until Party congress + lead time to new government installed	• **New society**: common prosperity etc. • **Dual Circulation**, increased economic sovereignty and reduction on dependencies • **Industrial modernization and decarbonization**; foreign innovation, advanced technology and know-how input in that context - GDP/capita & new growth engines
Multinational Companies' Interests and Intentions	• Labor based productivity • Permissive regulation (environment, business, tech & IP) • Infrastructure development to empower export machine • Development of dense manufacturing clusters & production systems	• Short-term: very low business confidence • Distrust in stability and predictability of system, casting doubt on resilience • Medium-term increased geopolitical risk on business • Wait & See approach given uncertainty; continued commitment • China still an attractive investment destination (as long as supply chains and consumption rebound in 2023)	• **Too big to miss** – Revenues and profits • **Eco/geopolitical risks** looming in the world; China manageable • Strong resilience of China's industrial clusters; **China for China, China +1 or 2** • **Chinese innovation** attractive • **Localized business models** • **Risk mitigation critical** • Return to **predictability, level-playing field**

Source: Roland Berger

"Our company has been in China for nearly 30 years, and China is regarded as an important market. In the next five years, a 12%-18% annual revenue growth of our business can be anticipated, and with the current global economic context, we believe the local Chinese market has bigger growth potential than other markets in the world..."

- Managing director of a world-leading industrial system provider.

5

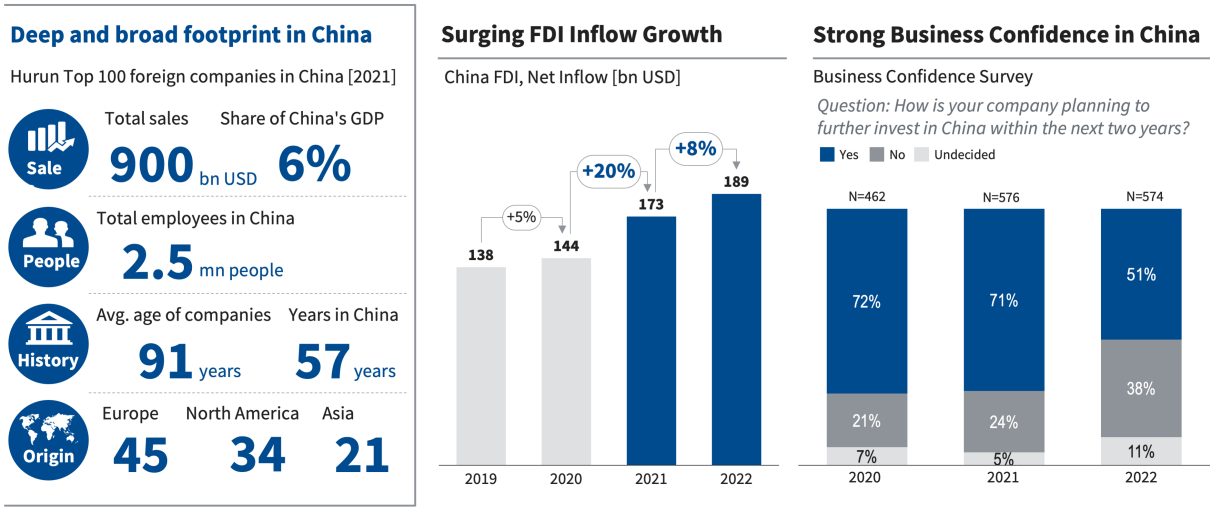
5 HOW CAN FOREIGN COMPANIES ADAPT TO THE NEW CHINA STORY?

5.1 The Foreign Business Footprint in China Remains Broad and Deep

Foreign businesses' footprint in China is broad and deep. Based on a report released by Hurun Research Institute in 2021, the sales of the Top 100 foreign companies in China represented 6% of China's GDP. Among them, 45 companies were from Europe.

In 2022, the foreign direct investment (FDI) into China's mainland was 189.1 billion US dollars - an 8% increase year-on-year. Notably, FDI in high-tech manufacturing surged 58.8% from the same period (January-November) in 2021, while that in the high-tech service sector rose 23.5% year-on-year. During that period, investment from Germany climbed by 52.6%.

FIGURE 5.1:
The foreign business footprint in China remains broad and deep, showing strong confidence in China's economy



Source: Ministry of Commerce of the People's Republic of China; Hurun Report; Business Confidence Survey 2022/23 by German Chamber of Commerce in China; Roland Berger

For most foreign companies in China, decades of development mean that the cost of leaving, scaling down, or even freezing investment in the medium term is too high; yet frequent 'black swan' and 'grey rhino' events make the business environment increasingly unstable. Companies in China are easily caught between urgency and uncertainty.

Adaptation to the "New China Story" is a combination of risk anticipation and mitigation, and occasionally - evolution of the business model.

"China now represents 40% of the total world chemical market. Yet, in 2030, we will be talking about half of the global chemical market in China. I think this trend is unlikely to stop. Also, China aims to achieve 5%-7% GDP growth, which is certainly higher than the worldwide average growth rate. The trend will continue, so the market is here. The question is how to capture market growth opportunities and fend off risks..."

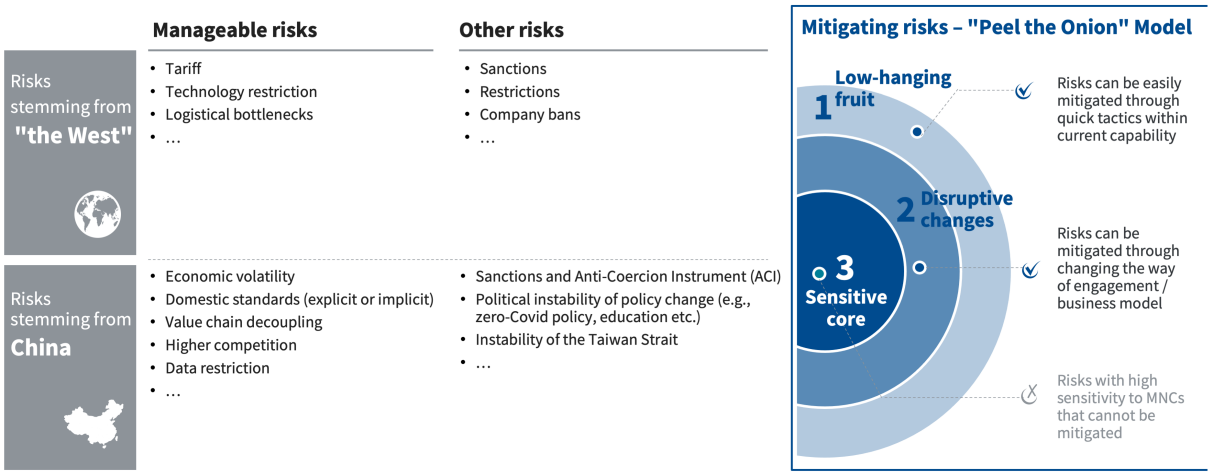
- China president of a world-leading chemical company.

5.2 Risk Anticipation and Mitigation

First, risks must be thoroughly screened and mitigated, and concerns around political and operational issues need to be carefully addressed.
To help multinationals better understand the current situation, we introduced the "Onion Model." The core idea of this model is to provide foreign companies operating in China with an evaluation framework. Through this framework, foreign companies can better recognize emerging and potential risks, evaluating whether these are manageable risks that could be mitigated with tailor-made measures, or unavoidable ones that should be dodged completely (i.e., the "sensitive core" of the onion).

FIGURE 5.2:
Multinational companies face different risks in China; it is crucial to address and mitigate the risks by "peeling the onion"

Multinational companies risks in China – How to address and mitigate the risks



Source: Roland Berger

Multinational companies in China can use the "New China Story" features to screen their operating model and mitigate risks. That being said, companies largely vary in industry, size, product, and technology usage, subjecting them to specific risks. Each company thus requires deep analysis and tailored mitigation measures.

Below are some risks many multinational companies face in China.

- **Compliance with the latest regulations:** the data and cyber-security measures, for example, with some ambiguous phrases open to interpretation, often calls for separating IT systems, functional applications, and data storage. It impacts B2B industrial companies less than B2C companies or companies that provide services to B2C companies, such as software companies.

- **Sanctions:** company and individual constraints and bans, mostly stemming from the US legislation, need to be factored in.

- **Business segments and products with strategic sensitivity:** Companies in specific technology sectors, concentrated sectors, deserve specific attention. This also depends on the nature of local competition.

FIGURE 5.3:
Separate compliance rules for all stages of data management, including collection, processing, storage, and transfer

Compliance principles across the data lifecycle

Data collection

- Informed consent required
- Driver opt-in required for collection
- Biometric info collection only for safety purpose
- Access to sensitive areas such as military mgmt. zones and gov. are not permitted
- Collection granularity (e.g., resolution) of radar and camera should be appropriate

Adjustments to sensor hardware and software required to comply with important data collection restrictions – must be considered in R&D phase through SOP and operations

Data processing

- Sanitization of personal information and important data as much as possible
- Provision of personal information outside the vehicle without personal consent requires anonymization
  - deletion of pictures containing natural persons
  - local contour processing of face information in pictures

Perception and processing algorithm development required to sanitize sensitive information generated from vehicle

Data storage & transfer

- Personal information and important data should be stored in China
- Storage period of data outside vehicle, position and trajectory data cannot exceed 14 days in remote information service platform
- Security assessment by CAC[1)] required for cross-border data transfer for the following:
  - National security, public interest, and legitimate rights and interests of individuals or organizations

Local data storage required and local R&D capability, especially algorithm training based on local data needs, to be established or enhanced given risk of cross-border data transfer

1) CAC: Cyberspace Administration of China

Source: Desk research, expert interview; Roland Berger

FIGURE 5.4:
Multinational companies in China can use the "New China Story" features to screen their operating model and mitigate risks

Checklist for foreign companies on China operation

Checklist / Perspective	☑ Sanction Compliance	☑ Latest Regulatory Compliance	☑ Strategic Sensitivity	☑ Supply Chain Resilience	☑ Local Capability	☑ Risk Mitigation
China	• Trade: Import/Custom restrictions with certain countries, tariffs • Sanctions on individuals (normally less direct impact)	• Cyber Security law • Anti-monopoly Law and Regulations • Anti-Foreign Sanctions Law • …	• Technology sensitivity vs. technology attractiveness (e.g. China catalogue of "welcome" foreign investments • Product / system(data) sensitivity • Local competition – Standard competitors vs. high-profile national / local government sponsored competitors • …	• Logistical constraints (bottlenecks, prices, sensitivity to Covid) • Covid-related restrictions and potential shutdown • Dependence on global flows vs. regional/local supply • …	• Domestic localization of R&D / innovation and operation excellence • Dependence on foreign talent • Connection with Chinese eco-system, e.g., local suppliers, local engineering, software developers etc. • Resilience of local decision making and trust with HQ • …	• IP protection • Organization structure (separation of legacy / more sensitive activities) • Ownership structure (shield-JVs, reverse JVs, stakeholders management, …) • Portfolio evolution by value chain • Exit strategy (partial/total) • …
European & U.S.	• Trade (tariff, import/export bans) • Entity list / company bans • Technology bans • Investment restrictions • Sanction on individuals (normally less direct impact)	• Uyghur Forced Labor Prevention Act (US) • Forthcoming CSRD (EU) • The International Procurement Instrument (EU) • The anti-coercion instrument (EU) • Supply chain legislation				

Source: Roland Berger

Certain risk mitigation measures can be developed: for example, JVs with relevant Chinese partners, local refinancing and financing to transfer some accountability to Chinese shareholders and stakeholders, etc. Decision-making can be increasingly localized in parallel, sometimes with a separation of structures between sensitive and less sensitive businesses, which also helps manage differentiated ownership structures.

5.3 Evolution of Business Model

Increasing local competition has been the focus of attention for many multinational companies operating in China. Local players are often recognized to have more agility, accelerated technological capabilities, cost advantages, and their product quality is quickly improving. Today, many multinationals face great challenges from external risks and local market competition.

To mitigate the risks and strengthen competitiveness, sometimes the business model of multinationals needs to evolve. Here, localization is key: localization of the entire decision-making process, including R&D, production, go-to-market, and deeper connection with Chinese consumers and the local ecosystem, helps adapt to a market that sometimes diverges from European or American practices. With rising competition from local players, multinational companies need to further strengthen their innovation capabilities to remain competitive in the Chinese market.

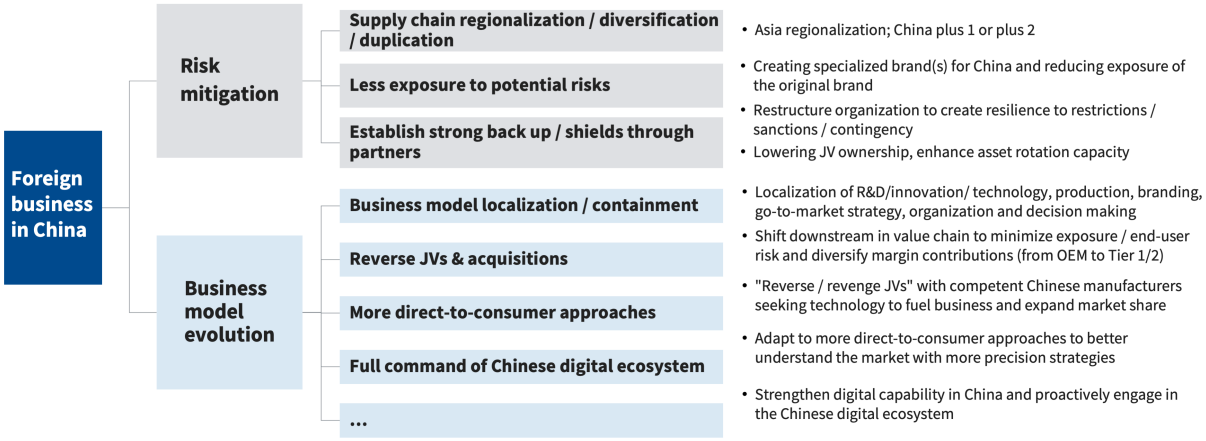
"We have reached an 80% localization rate of our parts in China. For the next step, the keyword is local engineering. We must grow together with OEMs in China. The specification changes a lot during the development, so you must adapt very quickly to the local needs..."

- President of China of a world-leading German automotive supplier.

Some companies choose to isolate themselves from the end-user markets and become tier 1 or tier 2 suppliers. Each of these examples is associated with very specific situations, and there is no one-size-fits-all.

FIGURE 5.5:
Engagement and business models of foreign companies in China are evolving to adapt to the "New China Story"

Measures to better engage in China's development for foreign business (non-comprehensive)



Source: Roland Berger

5.4 Real Client Case of Risk Mitigation

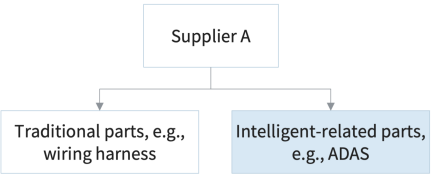
Supplier A is a leading global automotive supplier operating in China that provides traditional and intelligent parts such as advanced driver-assistance systems (ADAS).

In recent years, this supplier has faced challenges in operating environment changes, such as data regulation, investment restrictions, supply chain localization, and government bias for local core technology.

FIGURE 5.6:
Supplier A is a leading global automotive supplier and is facing challenges in operating environment changes

Client background and challenges of operating environment changes

Project background



- Supplier A is a **global leading automotive supplier** providing traditional parts and intelligent related parts like ADAS
- China is continuing to be the **key growth market** for supplier A, accounting for >20% of global revenue and a significant share of profitability

Major changes of operating environment and challenges

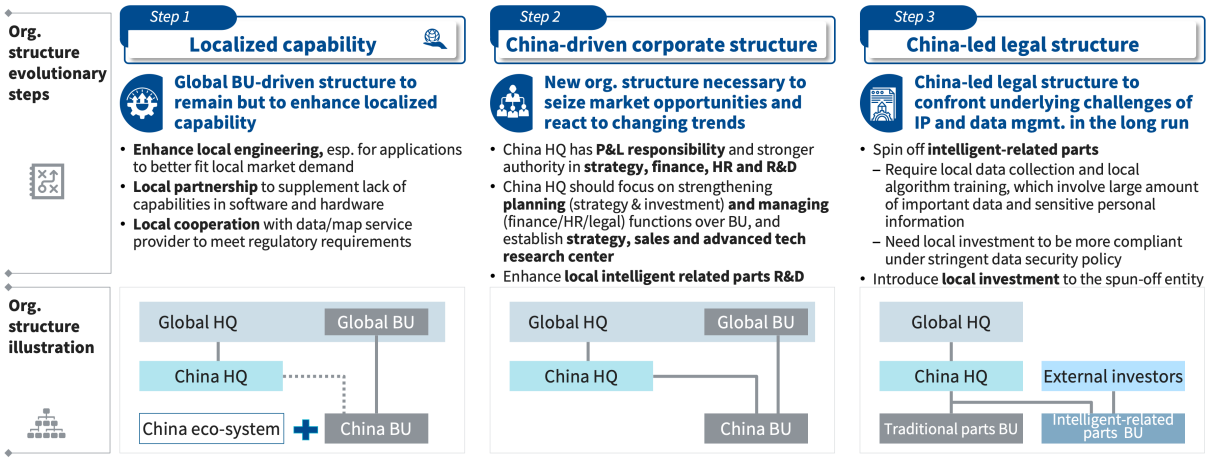
- **Tightening data and privacy rules:** Policies around connected vehicle data management have been intensively released, in which **important data and sensitive personal information** are strictly monitored. The rules would limit the autonomy and flexibility of global R&D for data intensive areas, such as autonomous driving (AD), due to impact of one principle that **local data is for local usage**
- **Investment restrictions for foreign entities:** Currently, sensitive segments, e.g., **mapping and value-added telecom service**, are restricted for foreign investment. Such restriction might limit the development of high-level autonomous driving solution and certain value-added telecom service such as application software of In-Vehicle Infotainment (IVI)
- **Localization of supply chain, incl. IP:** Due to influence of **uncertain environment** (e.g., US-China trade war, Russia-Ukraine war) and normalization of pandemic, supply chain is **gradually shifting from globalization** to **localization model** for safety concern; More **stringent restriction on IP transfer** from the US to China is expected, especially for advanced tech
- **Government bias for local core tech:** China has strong ambition to become a technology-powered country, therefore government **support for local high-tech companies**, such as key suppliers in internet connected vehicles, could be expected. Bias on local companies might make foreign players more difficult due to potential **entry limit, subsidy for local companies**, etc.

Source: Roland Berger

Therefore, to better adapt to local challenges and seize new opportunities, the situation calls for an evolution in supplier A's organizational structure.

FIGURE 5.7:
We suggest supplier A evolves its organizational structure to address local challenges and seize new opportunities in China

Organizational structure evolution



Source: Roland Berger

6

6 SUMMARY AND STRATEGIC OPTIONS

With profound and complex changes in the global environment and increasing competition in the local Chinese market, foreign companies' China operations face growing challenges. Yet China's rapid development and pledge to reopen will bring plenty of opportunities for both Chinese and foreign companies. To better manage risks and seize growth opportunities, it is essential for foreign businesses to understand China's evolution and its unique features.

Doing business in China has undeniably become more difficult for foreign and Chinese companies in recent years, but the fundamentals operating in the Chinese market remain favorable. Adapting operating and business models to the "New China Story" is imperative to cope with the economy's short-term difficulties and turbulent movements.

"It is very clear that our position on China is unchanged. China is a very important market and we will continue to dedicate ourselves to this market. We will continue to follow our strategy in terms of an enhanced local-for-local footprint. There is a fa- mous quote about China saying, 'everything is possible, but nothing is easy.' I trust it summarizes China's prospects quite well. If you are willing to make an effort and address the opportunities in a positive, embracing way, China is still the region and the country that provides plenty of opportunities. We will continue to take those chances for our company in China..."

- Senior vice president of a world-leading German engineering and technology company.

Therefore, the China strategy of foreign businesses needs to evolve accordingly, adapting to the "New China Story" with adjustments to fit companies' unique frameworks. Foreign companies in China can consider three strategic options to stay competitive and achieve sustainable growth in the medium to long term:

- **China-Plus-One strategy:**

Supply chain disruptions and geopolitical tensions saw an increased need for a balance between market potential, cost efficiency, and supply chain resilience. One way to balance those factors is to extend the footprint within the region with the China-Plus-One strategy: remaining in China while engaging within the Asian region. This strategy allows companies to mitigate supply chain risks, especially when operating globally. While the Chinese market has the potential to satisfy one's production capacities, serving the global market from only one facility might be too risky in the future.

While striving for the China-Plus-One strategy might increase the costs in the short and mid-term, it will create more resilience in the future, which can decrease the risk premiums towards investors and customers in the long term. Furthermore, it could serve as a competitive advantage against local competitors, which often have a local footprint only.

Other advantages of the China-Plus-One strategy lie in the opportunity to better serve other local markets, adapt to local requirements and customer needs, and react faster to changing market needs. This would decrease the reliance on a single market and bring new business opportunities in Asia.

Due to the growing Chinese market and rising opportunities, foreign companies are still required to invest in the country to keep up with the market needs and remain significant market players. However, diversification requires significant capital and internal management resources, such as navigating new laws, new markets, and streamlining the business over multiple locations. Therefore, engaging with new markets takes time, and should be done gradually rather than overnight. One possible approach could be establishing a single production first, then extending process capacities until fully operational.

A disadvantage of the China-Plus-One strategy is that, due to the increase in costs (such as capital expenditure costs, management resources, reduction of the economy of scales, etc.), the competitiveness of the Chinese and global markets could suffer. German companies pointed out the risk that local competition would benefit if cost structures were higher (due to the China-Plus-One strategy) for foreign companies in China and globally. Companies must analyze the pros and cons of this strategy to find the right balance between risk mitigation and remaining competitive in China and the global markets.

- **Develop a winning value proposition through innovation:**

Innovation and technological advancement have been key for foreign companies looking to succeed in China in the past decades. By collaborating with local partners that are part of China's innovation ecosystem, foreign companies can stay competitive by optimizing existing products and creating innovative products and services with possible integration into their global portfolios. Faced with rising competition from local players, foreign companies need to accelerate local innovation, leveraging their existing global competencies to keep this advantage for further development in China.

- **Local-for-local strategy:**

The "Local-for-local" strategy is a key success factor for foreign companies looking to strengthen their positioning and competitiveness in China. It calls for a new or partially new system separated from Europe or the US, from centralized and global R&D, production, supply chain, and logistics to sales and services.

For the manufacturing industry, such as the automotive sector, the rise of Chinese players in electrification made traditional foreign suppliers transform into close partners of the OEMs growing together in the Chinese market. New products are developed through a joint effort with new technical specs and standards. Innovation in China will not only benefit foreign companies' China operations, but also strengthen their global competencies and competitiveness.

For consumer goods sectors, the shifts in China's consumer groups - such as the increasing purchasing power of the new generation (e.g., Generation Z) - call for the evolution of engagement models of foreign companies. From brand recognition to brand interactions, China's new generation is seeking a different experience, providing an opportunity for foreign consumer brands to reassess their positioning, rethink their engagement approaches, and redesign their products and go-to-market strategies. To support foreign companies in China, it is important that China continues its reform and opening policies; lifts restrictions on certain sectors; creates a more level playing field (e.g.,public procurement); continues to improve IP protection; enables growth through decarbonization by setting clear policies and goals in green energy; promotes revisions to the household registration system for talent development, and improve vocational training, among others.

For many foreign companies, their China operations contribute significantly to their global profit contribution. For those organizations, it is crucial to strengthen the resilience of their China operations just as they mitigate risks for their global operations. As local companies become increasingly competitive, adapting more to the Chinese market is the logical response. The local-for-local strategy can empower foreign companies' China operations to act faster, be more customer-oriented, and cost-efficient, while increasing the resilience of the supply chains for the Chinese operations. China offers a comprehensive ecosystem of innovative technology, service providers, and excellent talents to execute local R&D.

With all the advantages the local-for-local strategy brings, foreign companies must find a balance between becoming more competitive in China and keeping their foreign DNA - which is often what made them successful in the first place. The strive for quality, reliability, and good governance should not be sacrificed, nor should the company's core values.

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AHK Greater China is part of the German Chamber of Commerce and Industry (DIHK) and the network of over 140 German Chambers of Commerce Abroad (AHKs), which includes 140 offices in 94 countries. Our history stretches back to 1981, when the first office was opened in Taipei. With a team of 150 employees based in 12 locations, we focus on trade and investment between Greater China and Germany.

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The German Chamber of Commerce in China is the leading platform of German business in China. The Chamber represents the interests of its 2,100 members and helps them succeed by hosting informative events, providing up-to-date market information, and offering practical advice.

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