ASIA PERSPECTIVE

China Economic Update Report

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This Issue

China's Q4 GDP growth beat expectations

China's GDP grew 7.9 percent year-on-year in the fourth quarter, the number beat expectations, lifted the overall yearly growth and reversed quarter-on-quarter declines recorded in previous quarters.

A fourth-quarter recovery had been expected after acceleration in industrial output in October and November and a jump in exports in December. Despite expectations, the upside surprise in China's fourth-quarter GDP data confirmed that the economy has officially exited its slowdown. The economy is expected to perform solidly in 2013 with analysts expecting a steady but modest recovery.

A gradual recovery would create a favorable backdrop for new President Xi Jinping and Premier Li Keqiang to pursue further reforms of China's economy and continue measures aimed at rebalancing the economy towards consumption of services thus reducing the country's reliance on investment in infrastructure, manufacturing and real estate.

China's foreign direct investment declines

China's foreign direct investment fell 1.35 percent in the first two months of 2013 from a year earlier. The decline extends a sequence of falls triggered by a drop in investor confidence in emerging markets as global economic growth slipped. Despite the decline, China remains one of the world's top FDI destinations. In 2012, China attracted $111.7 billion in FDI, just short of 2011's record $116 billion.

So far in 2013, investment flows from the European Union rose 43.0 percent in the first two months from a year ago to $1.2 billion, while investment by U.S. companies fell 5.4 percent during the same period to $497 million. FDI from the top 10 Asian economies including Hong Kong, Japan and Singapore fell 1.3 percent year on year in the first two months, to $15.2 billion.

Beijing has signaled that it wants to bring in $120 billion worth of FDI each year between 2012 and 2015.

China's auto sales set to rise in 2013 led by SUV segment

Already No.1 in the world, China's auto sales will increase by 7 percent in 2013. According to the China Association of Automobile Manufacturers (CAAM), new car sales are expected to rise to 20.6 million units in 2013 from a record 19.3 million last year. New car shipments for 2012 rose 4.43 percent from 2011. Growth in car sales represents good news for foreign automakers such as Ford and GM which have invested heavily in the country in recent times. The Chinese city of Chongqing is already Ford's largest manufacturing site outside of southeast Michigan and the company is doubling the number of assembly plants and its production capacity as it aims to bring 15 new vehicles to Chinese customers by 2015, while GM sold a record 2.84 million vehicles in China through its joint ventures representing an 11 percent increase from 2011.

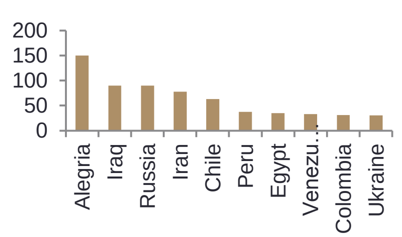
The continued growth in auto sales is being led by the fast growing SUV segment with SUV sales surging 91 percent to 240,700 units in January.

According to CAAM estimates, despite the robust increase in Chinese auto sales, the dominant share for Chinese brands shrunk to 42 percent of the overall market in 2012, a 0.4 percent decline from the year before – and a steep drop from just over 50 percent in 2010.

The fortunes of Chinese manufacturers compare starkly with those of Western manufacturers such as General Motors Co. the bestselling brand in China with a 14.7 percent share, and Volkswagen AG with 14.6 percent, which have prospered primarily through joint-venture agreements with large domestic auto companies. Chinese brands have suffered domestically because foreign brands are perceived to be of much higher quality by Chinese consumers.

In addition, while Chinese auto exports have risen from zero to over a million autos in less than two decades, not one fully developed market featured in the top 10 list. Algeria was the no.1 importer of Chinese cars last year followed by Iraq, Russia and Iran. Brazil was a top importer in 2011, until punitive import tariffs were imposed by the government. Now, Chinese auto manufacturers such as Chery Automobile and Anhui Jianghuai Automobile Co. Ltd. are seeking to build production facilities in the country.

Top Export Markets, 2012 (thousands of units)



Volvo wins approval to start making cars in China

The Swedish car maker, Volvo, owned by Zhejiang Geely Holding Group Co. won approval from China's main industry planner to begin producing vehicles in the country.

Since the 2010 acquisition of Volvo by Geely, Volvo has not been able to make cars in China under its own brand name as the Chinese government subjected the Swedish brand to the same regulatory procedures as all foreign car makers despite Greely's ownership. The authorization paves the way for Geely to offer cheaper prices on Volvo cars since vehicles produced in China are not subject to China's 25 percent import duty.

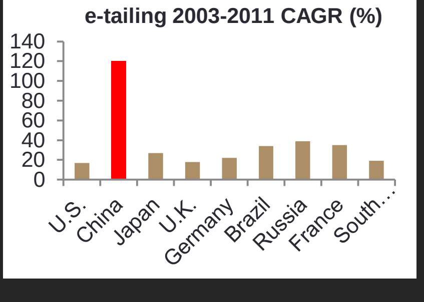
Volvo currently sells seven models in China and sales of its cars in the country rose 31 percent to 8,719 units in the first two months of the year, surpassing Sweden to become the carmaker's second-largest market, behind only the U.S.

With approval won to start producing vehicles in the country, Volvo has said that it is targeting Chengdu, the capital city of southwestern Sichuan province, as the site for its first Chinese manufacturing plant, paving the way for the company to produce Volvo cars locally and increase sale through cheaper prices.

China's E-tail revolution spurs incremental consumption

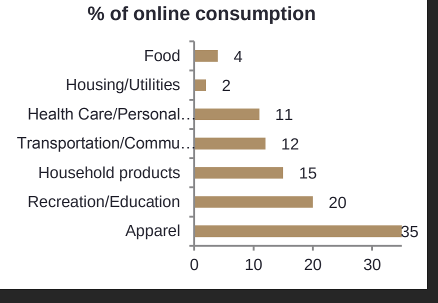
China has become one of the world's most wired retail markets with millions of newly minted consumers logging on to purchase a range of products they could only dream of acquiring only a few years ago.

China's e-tailing sales totaled $120 billion (RMB 774 billion) in 2011, surpassing online sales in Japan ($107 billion), the United Kingdom ($56 billion), and Germany ($32 billion). In 2012, the Chinese market had soared to an estimated $190 billion-$210 billion (RMB 1.2 trillion-1.3 trillion) in revenue - a year-on-year sales increase of circa 60 percent which is an extremely rare occurrence for a market measured in the hundreds of billions of dollars. This growth is outpacing the rest of the world by some considerable margin and as China's consuming class continues to expand, the market may reach $420 billion-$650 billion (RMB 2.7 trillion-4.2 trillion) in sales by 2020. Underpinning this growth is the world's largest online population - China had 129 million broadband accounts in 2011 compared to the 81 million accounts in the United States.



Apparel, recreation and education, and household products are the three largest product categories in Chinese e-tailing. They collectively account for 70 percent of online consumption.

Transportation/communication and health-care/personal products are the next two largest categories, accounting for a bit more than 10 percent each.



The growth of e-tailing is having a noticeable effect in the fulfillment of China's stated policy of moving towards a more consumption-based economy. E-tailing actually spurs incremental consumption and is not just a replacement channel for purchases that would have otherwise taken place offline. This boost in consumption is even more pronounced in smaller tier 3 and tier 4 cities where brick and mortar retail remains underdeveloped. Shoppers residing in these cities can now buy previously inaccessible offerings for the first time and even though their average income levels are lower, online shoppers in tier 4 cities spend almost as much on e-tailing as their counterparts in tier2 and tier 3 cities.

Chinese retail sales slow sharply in Jan-Feb

The national Bureau of Statistics (NBS) reported that retail sales grew 12.3 percent year-on-year to 3.78 trillion yuan ($602.1 billion) in the first two months of the year, a sharp decline from the 15.2 percent rise in December. The growth was also much lower than the government's target of 14.5 percent for 2013.

The race for retail and the *guanxi* factor

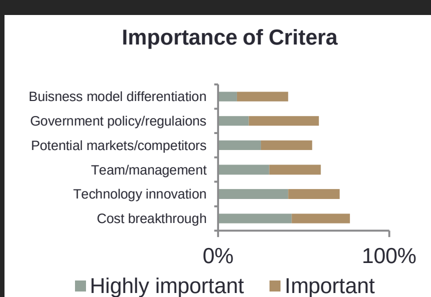
China's retail landscape has gone through rapid changes in the past two decades. In recent years, the retail market in first tier cities has become saturated and that in second tier cities increasingly competitive. Retail companies are now expanding their horizons towards lower tier cities which offer considerable opportunities since 70 percent of the Chinese population reside in these cities.

While third and fourth tier cities offer much promise for the future of retail in China, there are many challenges that need to be addressed if foreign retailers are to expand effectively, including the *guanxi* factor which encompasses the level and quality of connections essential to retailers who want access to the best retail locations, favorable policies, financing, land and building permits etc. The *guanxi* factor remains critical to success.

Localize…the Chinese way

According to a recent survey, Chinese decision makers identified cost benefits, technology innovation potential, and team management capabilities as the three most important criteria when assessing the potential of Western cleantech companies.

Cost breakthrough and technology innovation are central to China business models and an important piece of the puzzle when Chinese companies seek to get ahead of intense competition. Also, for Chinese based companies, team capabilities of potential Western partners can also be about access to Western markets as well as about effective management execution.



With an increasing number of Western cleantech companies looking to China for capital and incentives, well capitalized and well-connected Chinese companies can afford to be picky.

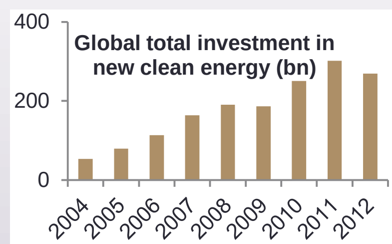
Increasingly, Chinese companies are investigating cutting-edge technology and know-how that is close to market readiness. Chinese companies and investors are generally more risk averse than their Western counterparts and near-term cost breakthrough via technology innovation plus management knowledge plays a more important role than longer-term 'technology in development' opportunities.

The survey also threw up an interesting observation in that 'business model differentiation' scored the lowest. One reason could be that the intensity and changing landscape of competition in the local Chinese market does not readily afford the luxury of time to formulate and execute a disruptive business model.

The survey's results also highlighted the reasons why Western companies seek to enter China – growing local markets, manufacturing speed and cost advantages and local government incentives. Respondents pointed to the failure of Westerners to assess local market pricing pressures, understand local market dynamics and appreciate the intensity of local competitors as areas for improvement in order to compete more successfully.

Chinese cleantech market expected to continue growing in 2013 despite headwinds

Nearly 50 percent of China's cleantech companies expect the market to continue growing rapidly in 2013 according to a newly released report while 9 percent, mainly in the renewable energy sector, are predicting bottlenecks due to tight financing conditions amidst the global slowdown.



U.S. companies surplus in clean energy trade with China

According to a recent report, U.S. companies enjoyed a $1.63 billion sales advantage over their Chinese counterparts in 2011, the latest year for which data is available. The report, based on data compiled by Bloomberg New Energy Finance, concludes that America's clean energy trade advantage is derived from the global presence of U.S. companies as well as leadership in innovation and entrepreneurship while China's clean energy industry enjoys an advantage in large-scale manufacturing and high-volume assembly of certain products. However, in recent years, tensions have increased due to fiercely competitive market conditions affecting

Chinese medical device market driven by both growth and value

In recent years, U.S. and European medical device companies have targeted China as a major growth opportunity as evidenced by the fact that well-known U.S. and European companies have directly entered the Chinese market by acquiring domestic Chinese medical device companies. While it is true that China is potentially a huge market for medical devices, those companies that can focus on value may be the ones best positioned for future growth.

Approximately 90 percent of the Chinese population is theoretically covered by a system of urban and rural government sponsored insurance programs. Patient co-pays vary with the wealth of the particular city/province and patients may need to pay anywhere between 20 to 60 percent of the price of a procedure. Furthermore, the standard model followed in China is for the patient to pay first and then seek reimbursement from the insurance system later.

Device reimbursement is complicated with high-value devices such as stents or orthopedic implants often reimbursed separately and reimbursement rates varying with the source of the device. For example, imported devices often get 50 percent reimbursement of list price whereas domestic get about 70 percent. More and more, the system is moving towards one where devices are reimbursed as part of an overall procedure reimbursement. – giving hospitals incentive to push back on pricing. The Chinese government is also making efforts to control high-value device/consumable pricing through national/regional tenders.

Large Chinese device makers often price their equipment and devices some 20 to 35 percent (and for some devices even more) below the prices charged by foreign companies. The combination of cheaper domestic devices, improved quality in Chinese medical technology, and increased government spending has greatly accelerated the growth of the Chinese medical device market and provides an opportunity for U.S. and European multinationals to target growth by acquiring the means to manufacture and distribute products at price points that are competitive with what domestic producers charge.

Much of the healthcare market in emerging markets is self-pay with only basic care subsidized by the government. It is thus increasingly important for foreign device companies to have manufacturing and R&D assets on the ground in China to compete in a market with significantly lower prices without eating into their margins. In summary, realizing the growth opportunity in China will depend on a company's ability to compete on value.

Medtronic buys stake in Chinese Medtech Company

Medtronic Inc., the world's largest medical technology company, acquired a stake in a Chinese maker of surgical instruments for $46.5 million in its latest bid to expand in a fast-growing market.

China is one of the world's fastest growing markets for medical devices and last year, Medtronic added 1500 employees, predominantly in China and India, and paid over $800 million to acquire Kanghui, a Chinese spine and joint implant maker.

SK Telecom to acquire 49% stake in Chinese Healthcare Company

U.S. companies aren't the only ones with an interest in the Chinese medical device and healthcare market.

SK Telecom, South Korea's largest mobile telecom carrier, acquired a 49% stake in Xi'an Tianlong Science and Technology Co. in a bid to diversify its business portfolio.

The acquisition was aimed at entering China's rapidly growing healthcare market and enables SK Telecom to participate in the Chinese firms' management although the size of the financial investment was not disclosed.

ASIA PERSPECTIVE

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With a highly collaborative team of problem solvers and a passion for excellence we will add value to your business. We work closely with our clients to create and deliver insight, advantage and real impact.

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