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China

CHINA AIN'T WORTH IT: THE NEXT PHASE OF BUSINESSES FORAYS ~~INTO~~ OUT OF CHINA?

"We come to you with unbelievable savings."

Revlon is leaving China. The company announced in December 2013 that it would let go of 1,100 staff, including 940 beauty advisers in the Middle Kingdom. Two months earlier, Avon Products announced that possible fines related to foreign bribery probes in China might materially hurt profits. Meanwhile, this January, Utah-based Nu Skin Enterprises learned that the Chinese government would investigate its operations, after a report in the state-run *People's Daily* claimed that the skin-care and nutrition company operated as a "suspected illegal pyramid scheme." Are Revlon's departure and the investigations of Avon Products and Nu Skin two sides of the same coin? Evidence is mounting that China is intentionally creating challenges for foreign brands. As Beijing works to build up China's consumer economy and employ more citizens in service-sector jobs, the Chinese leadership wants the benefits to accrue to indigenous companies. Will more foreign companies decide "China Ain't Worth It?" (*Bloomberg*, 12/31/13 and 1/16/14)

TAKEAWAYS

- Beijing is increasingly creating difficulties for foreign brands operating in China, examples of which include undermining public perception of the brand, launching investigations of alleged illegal practices, creating regulatory hurdles or levying fines.

- The above challenges come at a time of rising success for a variety of indigenous Chinese brands, some of which are attempting to spread outside China's borders to compete globally.

- China's overall aim is to develop more of a consumer-based economy, while creating higher margins, higher wages and more jobs for its population; as part of that aim, Beijing will seek to create more service-oriented jobs in innovation, design and branding.

IMPLICATIONS

- Investigations, accusations and regulatory hurdles continue to be directed at major foreign brands operating in China, creating sales-growth challenges for their Chinese operations. Foreign brands in consumer-related sectors need to reassess their sales-growth plans that rely on the Chinese market.

- Challenges created by Beijing are eventually aimed at industries beyond consumer brands, such as industrial-product makers and financial services – sectors in which Beijing plans to create globally competitive brands.

- Beijing hopes to create favorable conditions for indigenous domestic brands, allowing them to grow, and through its geo-economic actions, the country seeks to make indigenous brands competitive globally.

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China Creates Challenges

Last week, state-owned network China Central Television (CCTV) accused Walmart of circumventing its own quality-control process and allowing the use of suppliers that lack production permits. The report is one of a several reports by CCTV and other state-run media in recent months that have aimed criticism at foreign-run companies, particularly those with iconic overseas brands. (*Reuters*, 1/24/14)

Consider recent difficulties faced by foreign companies operating in China:

- In November 2012, a report surfaced alleging that Yum! Brand's KFC used chicken raised with growth hormones and antibiotics. KFC's sales in China began to drop shortly thereafter. Also, last year, CCTV reported that KFC's ice cubes were dirtier than toilet water and that those at McDonald's were not up to drinking-water standards.
- Coca-Cola's distribution company in China was accused of "spying" because it had created GPS-based delivery-route maps within the country – a common distribution practice.
- Last year, Chinese government media accused Starbucks of overcharging its customers.
- Also in 2013, Chinese government media announced that Samsung's smartphones don't work properly.
- Again last year, Apple's CEO Tim Cook apologized for Apple's "arrogance" in the application of its warranty program for the iPhone 4S after criticism from state media.
- Milk-formula companies, including France's Danone, were fined for allegedly engaging in anticompetitive practices.
- China's environment ministry criticized an application by BMW to double capacity at a factory in China, citing weak environmental protection measures at the facility. "Drinking polluted water while driving BMW sedans is certainly not the type of industrialization we are looking forward to," said an environmental minister.
- Beijing accused GlaxoSmithKline (GSK) of a scheme to raise drug prices in the country by bribing government officials, pharmaceutical industry associations, foundations, hospitals and doctors.

(*Washington Post*, 8/10/13; *Bloomberg,* 1/16/14; *Motley Fool,* 1/16/14; *Financial Times*, 7/12/13, 8/1/13, 8/12/13, 10/9/13 and 12/12/13)

That last observation about regulatory troubles for GSK is striking in light of two other recent observations. Chinese regulators currently are working to reform China's drug-review process to be in line with international standards and to streamline the process so Chinese researchers and drug companies can get clinical trails for new drugs under way faster. Meanwhile, Chengdu Institute of Biological Products has received "prequalification" from the World Health Organization (WHO) for a vaccine for Japanese encephalitis. Previously, China had never received prequalification to meet the WHO's standard on any drug. Beijing is on a mission to make China become a global innovator and producer of drugs, which makes its moves against GSK less than surprising. (*China Daily,* 1/31/13; *Financial Times,* 10/10/13)

Considering pressures from the Chinese media on both Samsung and Apple, we were also not surprised to learn that the Chinese government plans to launch its own operating system for mobile devices, COS (China Operating System), which will compete with the likes of iOS and Android. The venture is a joint enterprise of the government, the Institute of Software at the Chinese Academy of Sciences (ISCAS) and a firm called Shanghai Liantong. (*InterMobile,* 1/17/14)

Beijing's actions, through regulators, state media and prosecutors, are reinforcing the signal that foreign firms are not going to have unfettered access to China's 1.2 billion-person market, particularly as Beijing prods indigenous companies to become national, and then global, leaders in their sectors. We first noted rising troubles for foreign firms in China in 2011 and outlined a four-stage process foreign companies seemed to experience. Stage 1: Go for It (where the allure of Chinese markets and money is too great to ignore); Stage 2: Collect but Watch (in which the rewards start coming in but some signs of trouble start to surface too); Stage 3: Pause and Reassess (in which mounting concerns trigger a look at whether the troubles encountered are transient or permanent – hint: they are permanent); and Stage 4: Abandon, Protect or Adjust (where the company or country takes appropriate action, depending on its situation) (see **IF 3206** and **3207**, "Business with Chinese Characteristics, Parts I and II" 3/25/11 and 3/28/11).

Several foreign companies now appear to be in Stage 3, during which they must ponder whether recent experiences in China are part of a permanent wave of pressure, and some, such as Revlon, are choosing the "Abandon" option of Stage 4. On January 2, 21st Century Fox also chose to abandon China, announcing it would sell its 47 percent stake in Star China TV. Fox had already sold

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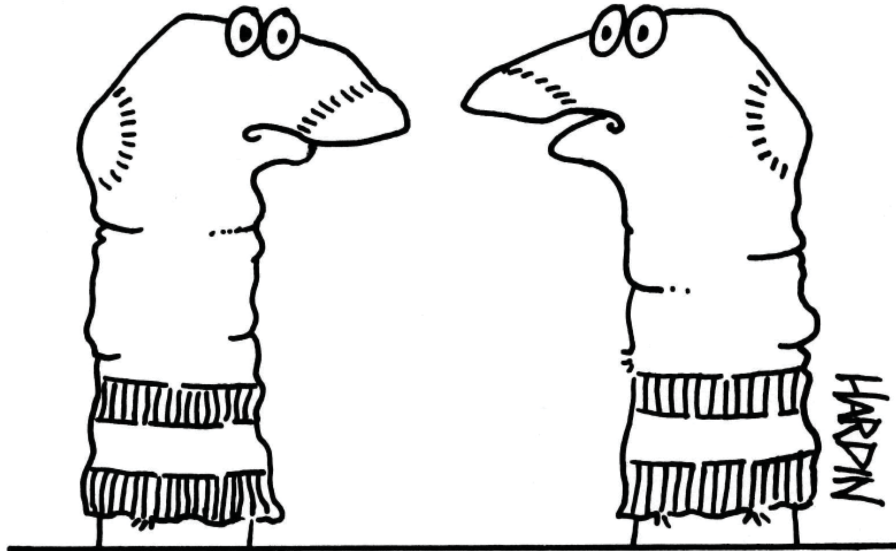
its controlling stake in the network back in 2010, which at the time reflected growing frustration with Chinese media regulations. (*Reuters*, 1/2/14 and 8/9/10)

Beijing is keen on China's developing a robust indigenous media sector, which may feed into its desire to project soft power around the world. Last year, the government and Chinese firms announced plans to develop their version of Hollywood – an $8.2 billion city of film studios to produce domestic films. China Film Group regulates how many Western movies can be shown in China, limiting that number to 34 per year, unless they are produced in China as a joint venture with a Chinese studio. In the first half of 2013, for the first time, revenues from domestic movies in China overtook revenues from foreign films, with 117 out of 146 films produced domestically. Domestic film sales rose 94 percent in the first nine months of 2013, while receipts from imported films actually declined 5.2 percent. (*Hollywood Reporter,* 10/4/13; *Wall Street Journal,* 10/24/13)



"I believe there's an unseen hand behind everything we do."

As with its attempts to nurture a media sector, Beijing is looking for China's next phase of growth to include the development of a variety of brands that dominate at home and are respected internationally. E-commerce is an arena in which China's own brands have already achieved rapid dominance within the country. In addition to Alibaba's dominance in e-commerce in China, website Autohome has become the leading online destination for auto shoppers in China. Qunar has become a major online travel site, while 58.com, an online marketplace known as the "Craigslist of China," is the country's top online classified-ad market. YY is the Chinese social network of choice, having hit 400 million users by the end of 2012, while Weixin, an app that is part social network, part messaging tool, part photo app, has leapt to 300 million users in China. Meanwhile, services such as Facebook, Twitter and YouTube remain banned in China. As for Alibaba, it accounts for more than 50 percent of China's online retail sales, compared to Amazon's 20 percent share in the United States. (*Investor's Business Daily,* 12/12/13 and 12/23/13; *New York Times,* 1/20/14)

Increasingly, Chinese-branded clothing retailers have achieved success, with some looking to spread overseas to compete with major global retail brands. Li-Ning's athletic shoes now compete against the likes of Adidas and Nike, with 7,000 retail locations in China, while Ochirly is one of China's top casual-wear brands, with fashions reminiscent of Topshop and Forever 21. As domestic brands grow, some are looking to push overseas. In 2012, the most expensive fashion store to open in London was that of Bosideng, a massive Chinese outerwear brand opening its first international store. Chinese fast-fashion retailer Metersbonwe, with 4,500 stores in China, is considering entering into the North American and European markets, where it would compete with Zara and H&M. Branded products are emerging, in some cases from large conglomerates, akin to Japanese *zaibatsu* or Korean *chaebol*, that are moving into retail brands. Garment manufacturer Youngor now directly operates its own line of 400 stores, with another 2,000 retailers in its sales network, and the firm has opened a design center in Italy; meanwhile, Erdos has grown to be China's leading cashmere brand. Yet both brands each have parent companies engaged in mining, energy, real estate and chemicals. In other words, even China's industrial conglomerates are operating consumer brands, directing industrial power into the consumer

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sector. (*Financial Times*, 12/13/13; *Women's Wear Daily,* 12/28/12)

Some indigenous firms like appliance maker Haier have already succeeded in projecting brand cachet throughout the developing world and increasingly sell products specifically designed for markets like the United States. In other cases, Chinese firms have simply purchased established Western brands outright: ThinkPad laptops and now both IBM's server business and Google's Motorola Mobility division, Volvo cars, AMC movie theaters, Weetabix cereal and Smithfield ham, to name a few. China is moving to a higher plateau, on which it not just manufactures products but creates an identity around them. (*Economist*, 10/12/13; *Wall Street Journal,* 5/31/13)

China's next phase of development goes beyond being the world's manufacturing center. It involves becoming a center of innovation, product development and branding. **In fact, from 1998 to 2012, China's economy tripled its allocation of GDP toward R&D, hitting 1.98 percent** and besting the 1.96 percent proportion of the collective 28 EU member states' economies devoted to R&D. In a world in which China plays roles previously controlled by nations in Europe, North America and Japan, one implication of this transition is that less-developed countries may become China's own "China" – that is, locations to which Chinese brands outsource manufacturing. Consider that Chinese firm Huajian Shoes, one of the country's leading shoe exporters, has set up a factory in Addis Ababa, Ethiopia, with 1,750 workers. That African country offers lower operating costs and preferential tariff arrangements with the U.S. and Europe, thereby enabling the company to export shoes to those markets at a 27.5 percent price advantage over a Chinese-based factory. Is this another step in China's own outsourcing of manufacturing and transition to a more service-based economy? (*Nature,* 1/9/14; *Financial Times,* 6/4/13)

"The corporation was very lonely, because people thought it was different from them."

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