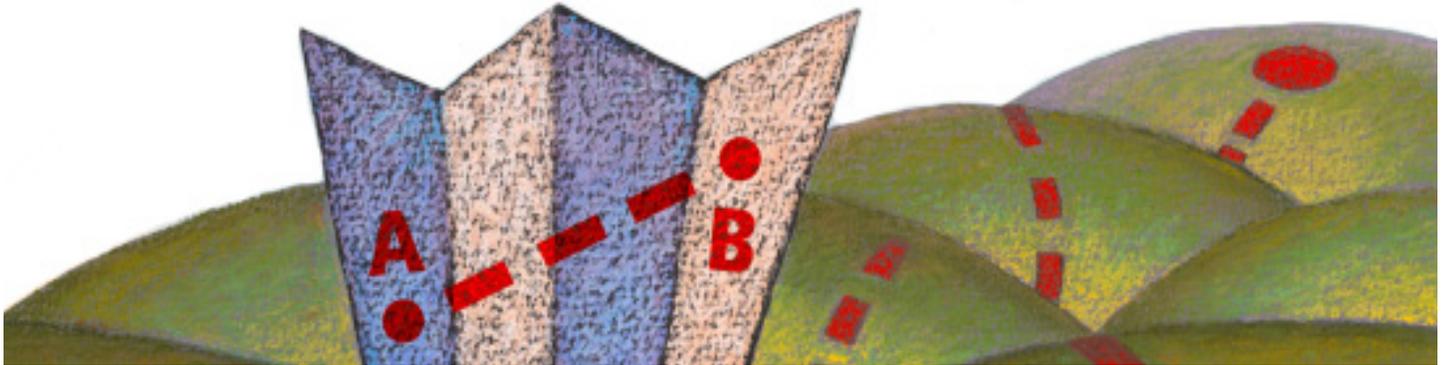


# Strategic Initiatives



## The Opportunities and the Challenges of Doing Business in China

By Bob Ludwig, Bill Hale, Yuan Haiying, and John Power



Bob Ludwig



Bill Hale

In recent years The Hale Group has expanded its international consulting practice recognizing that the food industry has become increasingly globalized and knows no national borders. This article looks at both the opportunities and the challenges of doing business in China and includes brief interviews with two of The Hale Group's Alliance Partners about their experience in and insight into the business world of China.

### Executive Summary

With change comes opportunity. A new generation of Chinese government leaders recently took over from the previous generation and is faced with the challenge of steering the economy in a direction that will continue economic growth and give full play to the power of the market in China. China watchers are hopeful that the current government stakeholders will look to foreign firms to contribute.

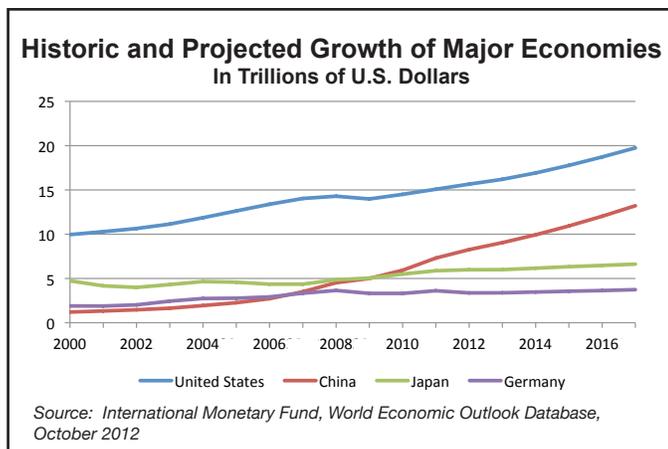
This changing environment provides tremendous opportunities for U.S. based food companies, but the opportunities do not come without challenges. An overview of the market's potential for growth along with factors to consider when evaluating opportunities in the food and agriculture sector in China are discussed in this article.



## China Overview

### 1. A time of Transition for China

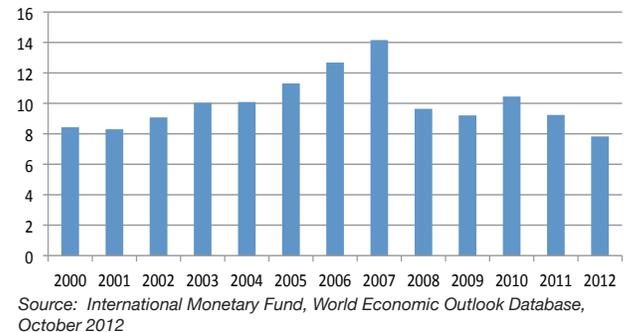
The year 2012 marked several major transitions for China's economy and for important stakeholders in the Chinese government. In early November, the 18th Communist Party Congress met with over 2,200 delegates representing the eighty million members of the Party. Senior Party officials presided over a change in senior government leaders, with Mr. Xi Jinping named as the Party Secretary. This is a once in a decade change of leadership.



Thus, China has executed a major, peaceful transition of power in the government; however, incoming officials are faced with a set of very complex challenges:

- Slowing growth to the 7.5% per annum level in an imbalanced economy
- Environmental devastation in many areas and in particular water pollution
- Rising public expectations
- An increasingly complicated foreign policy environment

### Real Annual Growth in China's GDP (Pct.)



The Chinese economy is now the second largest in the world with a reported 2011 GDP of \$11.44 trillion on a purchasing power parity (PPP) basis - thirteen times larger than twenty years ago. China is now entering the "middle level economy zone." This transition implies a shift from growth based on low labor costs to growth based on higher value-added activities. The economy will need to shift from growth achieved through exports and infrastructure investments toward a more robust services sector. A significant increase in the share of GDP from consumption, currently at 35 percent, is expected. By comparison, U.S. consumer share of GDP is 70 percent. This has been a very difficult transition for many countries and few have emerged as fully developed. Some experts believe the overall size of the Chinese economy on a PPP basis could match that of the U.S. by 2020.

At the upper end in the Tier One cities, the economy is almost fully developed but there are still large regions in the Center and West of China that are in earlier stages of development. In 2011, the Chinese middle class (over \$17,000 income per capita) was estimated to include more than 100 million citizens.

To reach an adequate level of wealth to support its population China will need to grow its economy to \$42.75 trillion in the next 20-25 years!



Thus, there is still a great deal of potential for economic growth, which means opportunities for companies serving the rapidly growing middle class. Furthermore, it is in the best interests of the new government leadership team to improve the business environment for foreign firms which will contribute to the improved satisfaction among Chinese consumers.

Clearly, now is a key moment for China's growing economy, as well as for the stakeholder government officials responsible for ensuring businesses run smoothly.

## 2. The Food and Agriculture Sectors: Factoids

The following table of facts highlights the importance of the food and agriculture sectors in China.

- Agriculture accounts for 10.1% of GDP but 36.7% of employment in 2011.
- 20 million rural people move to the urban areas each year. The goal is to move and re-house 300 million people in 15 years. This is like building a New York metro area or two times the Chicago metro area each year.
- Currently 50% of the population is urban and in 15 years the urban population will be over 70%. The increase in the Chinese urban population will be equivalent to the current U.S. population based on current trends.
- China is spending 9% of GDP or \$500 billion on infrastructure investment per annum.
- China has 160 cities with a population over 1 million today. In 2025 China will have 219 cities over 1 million and 24 over 5 million.



▲ A Chinese Supermarket Shelf

- It is expected that the international grocery retail chains will open 2,700 new stores over the next 4 years.
- The Chinese grocery market is now the largest in the world at \$970 Billion (2011) and growing at 10.9% per annum. By 2015 it is projected to be at the level of \$1.5 trillion and one third larger than the U.S. grocery market.
- Yum Brands has 4,600 restaurants in China and employs 460,000 people. A new KFC is opened every 13 hours. The long term Yum goal is to have 20,000 restaurants in China.
- The average Chinese person is eating four times as much meat and seven times as much dairy product as 30 years ago.
- China Foreign Direct Investment in Brazil in 2011 amounted to \$12 billion with infrastructure to move food commodities being targeted.
- Mr. Zong Qinghou, Founder & Chairman of the Wahaha Group, a beverage and food conglomerate, was ranked the richest person in China with a net worth of \$12.6 billion (Hurun 2012).



### 3. Conclusions

- While China faces many challenges, the growth rate is expected to remain at the 7.5%-8.0% level for several years. This will drive rapid middle class growth and a significant increase in demand for protein in the diet.
- This incremental demand will shift the axis of the global Agri-Food Sector to China-Brazil and away from North America-Europe.



▲ *Shanghai at Night*

- During the last thirty years, the Chinese Government has shown that it can manage difficult challenges so it is reasonable to expect that it can maintain an elevated level of growth for at least another decade.
- The rapid aging of the Chinese population will be a major challenge in the future but given the experience of other countries along with the rapid development of robotic technology one can expect that China will be able to manage this challenge.
- The development of human resources and the “war for talent” will continue to be a key challenge for business in China and elsewhere during the next decade.

## Interview with Mr. Yuan, President, Yuan Associates



Yuan Haiying

Mr. Yuan Haiying is the Founder and President of Yuan Associates, a consulting firm based in Beijing. Before starting Yuan Associates, Mr. Yuan held high level positions in the Chinese Ministry of Agriculture. With extensive experience in both the private and public sector, Mr. Yuan has keen insights into the interaction between government and business in China particularly with regards to the food industry. [www.yuanassociates.com.cn](http://www.yuanassociates.com.cn)

### 1. What has been your experience in the food and agriculture sector globally and in China?

In the early part of my career, I served with the Ministry of Forestry and Agriculture and then the Ministry of Agriculture. I was there through 1991, when I moved to Washington, DC, to serve as a Chinese diplomat responsible for agricultural exchanges between the United States and China. Beginning in 1995, I served as China’s representative to the United Nations Food and Agriculture Organization. Upon my return to China in 1998, I entered the private sector to serve as a consultant to multi-national corporations in the food and agriculture industries. Our clients include Cargill, ADM, Bunge, Mars, Kraft, Pepsi, Allenberg, Donovan Cotton, Monsanto, Pioneer, and others, including several trade associations.

### 2. What are the major challenges facing the agricultural sector in China?

The specific challenges are changing all the time. However, they generally fall into one of three constant issue areas: security, safety and sustainability. I refer to them as the “three S’s.”



The issue of food security at its heart is about the need to produce enough food for China's people.

The issue of food safety has arisen more recently with China's transition away from rural life toward urban life. It is a very large challenge. The poorer people in rural China struggle with food security – being able to acquire enough food for their families. The urban people generally have adequate income to buy enough food but worry about the safety of the food they eat due to several highly publicized incidents of food contamination.

The question of whether or not China's agricultural practices are sustainable is a major question, and a huge challenge. Available land is shrinking, land is polluted, and water sources are polluted as well. A big question is whether agriculture production can be sustained.

At this moment, I would add an additional factor, another "S": salaries. Can agricultural producers keep up with growing labor costs? It is a huge issue, and this is true across many industries in China. The agricultural sector is no exception.

### **3. What major agriculture and food policy changes are likely to result from the 18th Communist Party Congress and the new senior government leadership?**

Agriculture will remain the number one priority for the Party and government of China, because no matter who is in power, without an abundant food supply there is no point in talking about stability of political power and society.

As long as the three S's are still the major issues in the agricultural sector, the policies will stay more or less the same.

### **4. What are the subsectors that offer the greatest opportunities in terms of food and agriculture, and why should companies from overseas enter these sectors in China?**

If you look at staple foods, they are not open to foreign investors. Rice, wheat and corn are "forbidden" – owing to concerns over food security. This is why some foreign firms have had very difficult times here. China is very cautious about opening particular sectors to foreign companies.



▲ *Crowded Urban Areas of China*

If you look at vegetables, animal husbandry and fruits, you'll find opportunities.

However, some sectors remain open, and while the risks are high the returns are also very high.

Animal husbandry is one area that has ample opportunity. Breeding practices are an integral part of the food supply chain, but very few companies that operate in this space come to China, because they concerned about the risks.

The risk is especially large when climactic factors are accounted for. Much depends on the weather, on nature.



Almost all of the large food processing companies have come to China. U.S. and Western companies enjoy nearly automatic advantages in this area because their standards are recognized to be superior. Thus, foreign food companies enjoy popularity among urban consumers because of their positive image regarding food safety.

**5. Based on your experience with overseas companies what have been the key success factors for companies that have performed well in China?**

The three success factors that I would place near the top of the list include:

- a. Companies need to do good due diligence. This includes two components. The first is traditional market research, focusing on the industry, competition and so forth. The second is regulatory research, which should focus on critical policies and regulators.
- b. Next, companies should have a clear understanding of government stakeholders regarding their operations in China. To a considerable extent, government stakeholders can and will decide if you ultimately succeed in this market. Many foreign companies fail to fully understand the importance and complexity of this issue.
- c. Finally, a good Chinese partner is a must. Without an in-depth local understanding, it will be very difficult to establish profitable operations and be successful long-term.

**6. Based on your experience what have been the major mistakes that overseas food and agriculture companies have made in the China market?**

The mistakes that come to mind most immediately include:

- a. Companies sometimes understand China is not a fully developed market economy, and therefore assume there is little government intervention. That's where they can hit the wall and fail.
- b. Will China have a sufficient number of skilled workers, managers, engineers, scientists and government officials to support growth and development of the agricultural sector in the next ten years?
- c. China has a lack of talented people, especially at the mid-level and above. It is a big issue across the board in all industries.
- d. Cross cultural management is very difficult; companies should prepare to adapt and not assume they will be able to find the right people right away.

**7. How do you help multi-national corporations enter the China market?**

The services that Yuan Associates provide are the following:

- a. Due diligence
- b. Government stakeholder engagement, in particular at the local level
- c. Identifying Chinese partners
- d. Speeding up approval processes
- e. Negotiating with Chinese counterparts
- f. Building corporate image



## Interview with John W. Power: President, LSC International Inc. and Managing Director ADGENTECH LLC



John Power

The Hale Group and LSC have collaborated on many consulting assignments over the last several years – especially on assignments outside the United States. Mr. Power is part-owner of a business in China and travels to China frequently because of his business interests. The interview with Mr. Power provides his unique perspective on the situation in China today. [www.lscintl.com](http://www.lscintl.com).

### 1. What has been your experience in China?

I was very fortunate to be a host for the first official delegation that came from China to the U.S. in 1978 to visit leading manufacturers of agricultural machinery and to have had a successful sales trip to China in the spring of 1979. During the last 33 years, I have made many visits to China and been able to learn about several regions that are important for agriculture. I continue to be a student of China.

### 2. What are your current activities?

During the last 5 years, I have had a direct involvement in the seed corn business as an investor in a Chinese seed company and a licensor of U.S. corn breeding technology to the same company.

### 3. What is the focus of your activity?

The main focus is on the development of a modern corn research program by the Chinese

company which has involved significant investment in corn research stations in key corn producing regions, recruitment of Ph.D. level corn breeders, and the establishment of a national testing system for new corn hybrids that have been developed using U.S. and Chinese inbred lines. We now have some joint hybrids in the official government trials for approval so they can be put on the market.

### 4. What have been the major challenges?

We are building a national program from scratch and transferring modern U.S. corn breeding practices which are very different from the traditional Chinese practices and the approach taught in the universities. We are managing the transition from a traditional manual approach to a mechanized and data driven approach similar to the transition that occurred in the U.S. during the 1970s. We are facing challenges of language, resistance to change, high investment, and the time it takes for the research staff to have confidence in a new approach that requires four to five years to show results. Our Chinese partner has been willing to make the investments required and we are seeing real progress even if we would like to go faster. Of course, we need to adapt as much as possible to the conditions in China while retaining the key elements. **In short, we are transferring the best, cutting edge technology in corn breeding and applying it to the Chinese context to produce a major improvement in corn hybrids for Chinese farmers.**

From discussions with companies in other sectors, it is clear we are all facing a common set of challenges in the area of technology transfer and capturing the productivity of the U.S. approach and applying it to China.



## 5. What is your outlook for China?

While several commentators have become pessimistic, I have kept an optimistic/realistic outlook. This is mainly based on the capacity of the Chinese people, who are in many ways natural business people, and the deep commitment of the society to economic progress and improving the lives of hundreds of millions of people. From a global perspective and agri-food sector perspective, China will play a growing role in the world so it is the interest of everyone that the country does well. It is also clear that maintaining stability at home and abroad is the top priority for the Chinese Government who recognizes that it will not be possible for the economy to reach its full potential and the level of a developed country for the major part of its very large population without stability.

## Summary

It is widely known that China is the most populous nation in the world and that its economy is growing at extraordinarily high rates. These two factors account for the tremendous opportunity that the Chinese market represents for multi-national food companies.

However, entering the Chinese market and investing in the Chinese economy are not for the faint of heart. The unique Chinese culture and the very complex government – business relationship in China pose major challenges. The challenges are not insurmountable, but the prudent business person will seek expert counsel: (1) when deciding if and how to enter China; (2) executing the entry; and (3) strengthening the Chinese business venture.

The Hale Group and its affiliated consulting team are ready to assist you in any of these activities.

## About The Hale Group

The Hale Group provides strategic counsel to participants in the food system enabling them to pursue profitable growth opportunities. For assignments in China, The Hale Group collaborates with Yuan Associates in Beijing and LSC International in Chicago.

THG, Yuan Associates, and LSC work with clients to: (1) assess opportunities, (2) develop plans for capitalizing on new markets, and (3) advise clients on strategy execution. Given the challenges of operating successfully in China, this could involve one of the following options:

1. A complete review of the company's China strategy taking into account its current position, the dynamics of the market sector in China, a SWOT analysis, and a recommended strategy for the next five years taking the government's National Five Year Plan into account.
2. A high level review of the current company situation to identify strengths and weaknesses and make an evaluation of the resources that would be required to build a significant presence in the China market.
3. An analysis of the China opportunity for the company so that a well-informed Go / No-Go decision can be made regarding a commitment to entry.
4. Providing local business development advisory services to support the current strategy and make strategy execution more effective.
5. Providing on-going counsel regarding regulatory issues and governmental relations.

We would be pleased to discuss your situation with you in an effort to design an approach that will assist your company in a targeted fashion.

For more information about The Hale Group, visit our website at [www.halegroup.com](http://www.halegroup.com), call us at 978-777-9077, or email us at [rludwig@halegroup.com](mailto:rludwig@halegroup.com).