The Long Soft Fall in Chinese Growth

The game in China has changed from "expand strategically for the future" to "defend market share and realize profits now"

STRATEGIC OVERVIEW

BUSINESS IMPLICATIONS

CHIEF FINANCIAL OFFICER

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Prepare for a Down Market with Chinese Characteristics

China is amidst a deep structural slowdown—what we term a "long soft fall"—that will likely take more than a decade to run its course and ultimately leave China with a new trend growth rate of about 4 percent by 2020. A productivity crisis caused by a confluence of many factors—some common to maturing economies and some idiosyncratic to China—is at the core of the slowdown. At present, our projection for China's 2015 GDP growth is 6.5 percent, down from 7.3 percent in 2014. And we believe China's growth rate for the remainder of the decade will be closer to 5.5 percent. The days of double-digit growth and above-average margins are clearly over.

Our base-case long soft fall scenario is premised on the assumption that China's regulators have the financial resources and administrative tools to prop up growth and forestall a hard landing or crisis for the foreseeable future. While doing so provides stability—something seen as paramount by China's leaders today—it necessarily precludes the substantive, liberalizing reforms needed to restore productivity growth and put China's economy back on a sustainable path. The necessary reforms—installing more market-based incentives for business and regulation and rectifying the distorting incentive structures of the past—would almost certainly detract from near-term growth and very potentially cause heightened volatility or worse—a specter, we assert, that China's policymakers are opting not to contend with for the time being.

EXPLORE THE PORTFOLIO

This **Strategic Overview** is one offering from a suite of research products on the deceleration of China's economic growth. Additional research products on this topic include:

Principal Member Report, providing key insights and deeper analysis, research, and data;
Functional Reports, providing business implications targeted to specific executives and operations; and
White Paper that provides data and detailed economic analysis behind our conclusions

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THE LONG SOFT FALL IN CHINESE GROWTH
THE GAME IN CHINA HAS CHANGED FROM "EXPAND STRATEGICALLY FOR THE FUTURE" TO "DEFEND MARKET SHARE AND REALIZE PROFITS NOW"

STRATEGIC OVERVIEW
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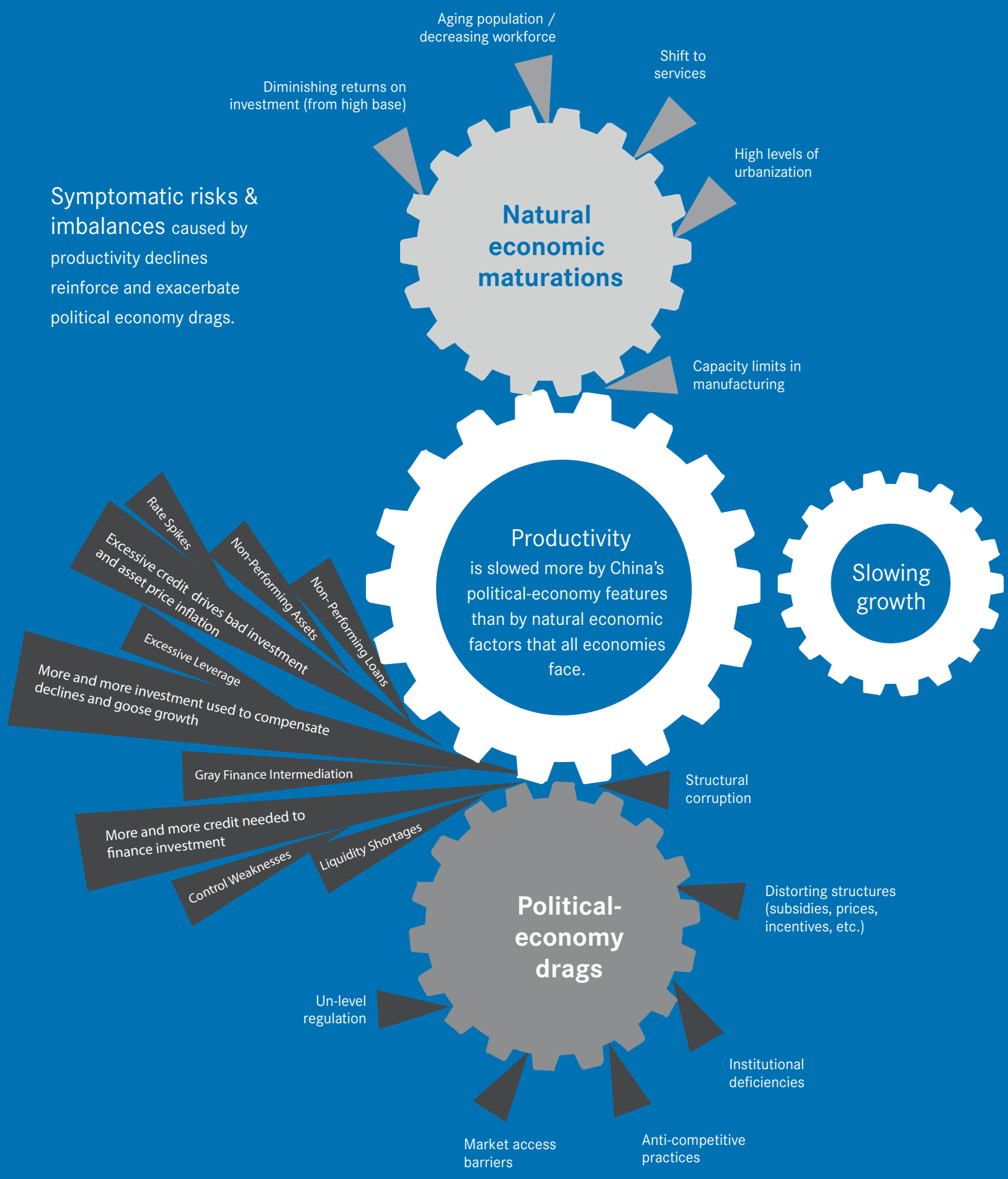
Symptomatic risks & imbalances caused by productivity declines reinforce and exacerbate political economy drags.

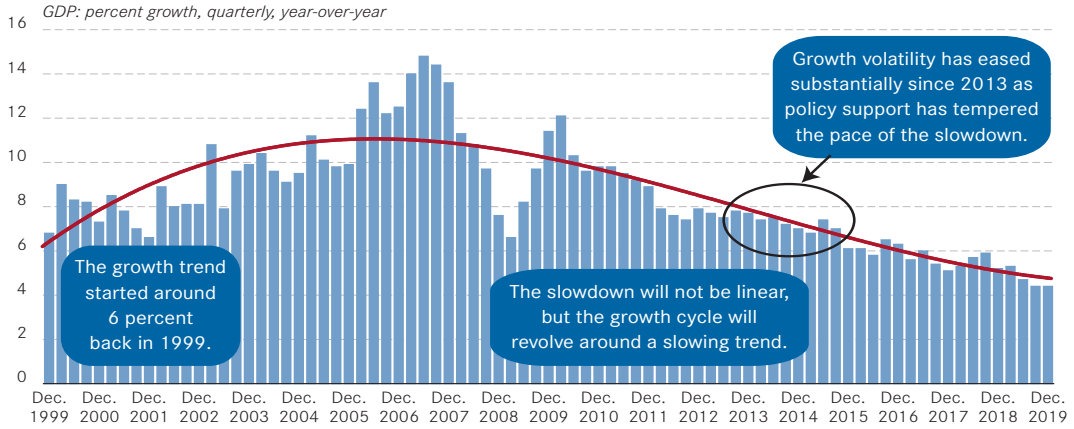


What the slowdown means for multinational corporations

For business leaders and planners, the transition requires a significant change in mindset and a holistic reappraisal of key strategic assumptions regarding China's opportunity set and growth potential to ensure that investment and resource allocations are appropriately calibrated. As China's long soft fall deepens, some important silver linings for multinational corporations (MNCs) should foreseeably emerge and yield improvements in operating conditions, even if the needed economic adjustment to a more marketized and consumption-driven growth model is a long time coming. For example:

- China's talent environment should improve dramatically as the intensity of demand for talent diminishes, wage escalation abates, and Chinese employees begin to moderate their expectations.
- In addition to better talent conditions, the mergers and acquisitions environment should improve as valuations come to ground and sellers become more receptive and reasonable. New partnering options with local firms, now driven by urgent commercial motivations rather than policy directives, should emerge.
- Competitive intensity may drop as weak local firms fail, and access to capital, even for the stronger local firms, becomes more constrained and expensive. Local firms will consequently be forced to compete more rationally to preserve precious capital and improve their balance sheets.
- Government and Communist Party officials at the local level stand to become more hospitable toward foreign investors, as it becomes clear that MNCs are—and arguably always have been—key providers of quality investment, employment, tax revenues, and corporate social investing in their jurisdictions.

Assuming little or no reform, the trend will not be your friend



Note: Stylized growth outlook, not actual projections.
Sources: NBS, CEIC, The Conference Board

At this juncture, MNCs should base their business planning for China on actual experience and observable realities, not on the policy proclamations of China's leaders. This requires the C-suite to get as close as possible to the business. In the absence of robust market data, your front lines are your best informants of changing market conditions. At this difficult juncture, it will be crucial to inculcate and convey the correct perspective that a China growing at 3 to 4 percent still presents tremendous opportunity and upside for MNCs that are appropriately lean, mean, and focused.

- Realistic targets for China growth and profitability should be set, factoring in difficult operating conditions and an exceptionally difficult compliance environment for MNCs, driven by desperate local regulators and competitors.
- Headquarter C-suites and boards need to be on the same page with country management regarding risks and contingencies.
- Cost management and productivity improvement should become paramount, as should teaching local organizations the tactics and mechanics for successfully managing down-market conditions.

Despite the Slowdown, There Is Still Plenty of Room for Growth

Despite the uncertain outlook, China remains a "must-do" priority market and production base for MNCs, even in the negative scenarios. China boasts scale and headroom for market development far and beyond other emerging markets; and, even while slowing, China's growth rate is a standout globally. That said, business conditions for MNCs in China are foreseeably biased toward the negative in the near term, as the regulatory intensity directed at foreigners is likely to increase in response to growing commercial and fiscal pressures. For example, the very recent, highly questionable, and disproportionate application of China's Anti-Monopoly Law (AML) to the MNC business community is, we believe, a byproduct of the pressures being exerted by the long soft fall.

China's growth model transition inevitably requires significant structural adjustment to decrease the economy's reliance on credit-fueled investment, de-lever nonperforming debt, consolidate massive industrial overcapacity, and bolster both returns on capital and productivity growth. Enacting reform policies to achieve these aims would not only elevate household consumption and private sector investment—including MNC investment—to be the key next-stage growth drivers, but also ensure that the transformation ultimately leads to more balanced and sustainable economic development. In the near term, this adjustment process will necessarily be painful insofar as it requires a marked decrease in fixed asset investment in real estate, infrastructure, and industrial plants. Such investment has accounted for over 50 percent of Chinese growth in recent years.

For foreign investors in China, this period of transition encompasses both risks and opportunities, as do transitions anywhere. While the short-term portends to be turbulent and increasingly difficult—as a function of both slowing growth and heightened regulatory intensity—the prospects are strong that the transition will ultimately trigger marketizing reforms that improve the operating conditions for MNC business in the long-term. By "marketizing," we mean reforms that reduce the State's involvement in the Chinese economy—i.e., central planning, policy-directed investment, and State-owned enterprises (SOEs) as economic pillars, etc.—and elevate the role of innovation-based market competition, and the creative destruction it involves, as the key driver of investment and growth.

This transition is likely to be a long slog—potentially, very long—as it involves many momentous challenges: political, economic, and social. Indeed, reform requirements go to the very core of the Chinese Communist Party's economic management ideology and age-old governance structure—features that will not be easily or quickly changed, if they are changeable at all. Clearly understanding these challenges—and planning and preparing accordingly for the plausible features of the transition, and the realities of an unreformed operating environment—is critical to weathering the difficult near-term conditions and building the enabling foundations for breakout performance coming out of transition longer-term.

The near- to medium-term outlook for the MNC business environment is a down market with Chinese characteristics

"Old School" Regulatory Environment	City-Level Fragmentation and Centrifugation	Disparate Growth Dynamics
Weakening bureaucratic protection for foreigners–results in heightened levels of regulatory predation and anticompetitive measures	Onset of spread of city-level debt paralysis	Promising (but unrealized) potential growth
Changing levers of market access and regulatory space creation	More pronounced regional/city-level differences in market opportunity and regulatory hospitality	Some real growth in aggregate
The part of the market that was somewhat familiar will diminish	De-standardization of regulatory stance and practice–some friendly places, some unfriendly	Some pockets of high growth
	New right-sizing challenges	Increasing pockets of negative growth
		Diminishing volume opportunities–strengthening niche opportunities
		Onset of trapped wealth effects in real estate

What to Plan For

The key success factors for weathering the transition will be an accurate view of the opportunity set and risks, highly focused market planning, realistic growth and profitability targets, and organizational adjustments that ensure utmost agility. There must be consistent understanding of the situation and "the revised plan" by the board, headquarters, and country management to ensure success in execution. Managing expectations, both internal and external, regarding China growth and profitability will be more important, and more difficult, than ever.

For CEOs, strategists, and business planners, the most important features of the long soft fall to be aware of and prepared to respond to are fivefold:

Slowing demand and increasing disparity of demand across cities For the last 20 years, all cities in China grew fast—with some growing faster than others. This will change. Demand growth at the city level appears to be more dependent on investment than previously recognized. As investment drops, so, too, will demand growth. Moreover, deeply indebted and overbuilt lower-tier cities—those heretofore most dependent on investment-driven growth—will likely see severe drops in demand, as well as increasing nonpayment problems associated with triangular debt.

Margin compression As the soft fall deepens and demand growth decreases, overcapacity manifestations will become more prevalent and acute. Pricing and margin pressure will ensue, particularly intensely in product segments featuring subsidized domestic players with the abilities to price irrationally.

Increased volatility Liquidity problems in the trade caused by triangular debt are likely to impact channel flows and order pipelines and create pressure on accounts receivables. Many suppliers, distributors, and corporate customers who have invested in off-balance-sheet real estate and financing schemes in these recent years will face liquidity problems, if and when these investments sour.

Increased regulatory and competitive predation As survival pressure sets in for weak domestic firms, they will no doubt engage in efforts to tear down the competition via the regulatory and media levers available to them. Predation can most easily be mitigated by avoiding the real problems that invite it, so early warning of potentially inflammatory product and service issues, compliance conflicts, labor issues, and supply chain issues will be paramount. At this juncture, no cost should be spared to monitor control and risk points, both internally and externally, and ensure compliance—even at the expense of near-term margins.

Eventual lowering of competitive intensity and consolidation opportunities On the positive side, the long soft fall is likely to eventually push weak Chinese competitors out of the market, resulting in lower and more rational competitive intensity. In addition, the partnership universe stands to expand as Chinese firms seek genuine, mutually beneficial partnerships with foreign firms to strengthen their commercial foundations and ensure survival.

Recommendations
Adjusting Strategy for the Long Soft Fall

Revisit and reset targets, as necessary Demand growth has, until now, never been a question for most MNCs in China. But demand is proving to be much more sensitive to investment than previously thought due to stocking and inventory effects, and data weakness makes quantifying real demand levels very difficult. Demand assumptions should be carefully reappraised through end-market due diligence and capacity, budgets, and financial projections recalibrated accordingly. Right-sizing requirements and action plans will need to be determined, bearing in mind that retrenchment actions are highly sensitive and subject to high opportunity costs as a function of both labor activism and unfriendly regulatory and media scrutiny.

Revisit and recalibrate investment plans, as necessary Long-term strategic investment assumptions need to be revisited, somewhat critically, in favor of realistic, short-term, profitable engagement. Strict minimalizing of capital investment is key, with appropriate tweaking of optics. Over-reactively cutting investment will be counterproductive to competitive positioning and should be carefully considered.

Enhance positioning around the innovation agenda MNCs are in charge of innovation in China, and it is important to ramp up innovation aimed at creating more regulatory space. Consumers want it. Local governments can be persuaded to support it. Central-level reforms portent to create some wedge points to exploit. Government relations investments focused on conveying the value proposition of innovation projects at the local level should bear fruit.

Explore new partnership opportunities As the long soft fall deepens, wider ranges of alliances and partnering opportunities with domestic players are becoming more available and more rationally driven. Going forward, partnerships may very well prove to be critical to market access, market coverage, value chain efficiency, cost structure competitiveness, and finance. The M&A environment should also improve, as valuations come to ground and sellers become more receptive and reasonable. In the longer term, distressed asset roll-up opportunities—and even privatizations—should arise, and maybe in high volume. Previously held partnering assumptions should be revisited to identify new and potentially promising opportunities.

Plan for contingencies and closely monitor business conditions China's transition will necessarily be volatile, both economically and policy-wise. Visibility into the demand outlook will be very limited. Robust contingency planning and preparedness will be critical to success. Closely monitoring business conditions via frontline field staff experience will be critical to well-informed decision making.

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