PwC's 2016 APEC CEO Survey

Three ways executives in China will adapt to new market realities

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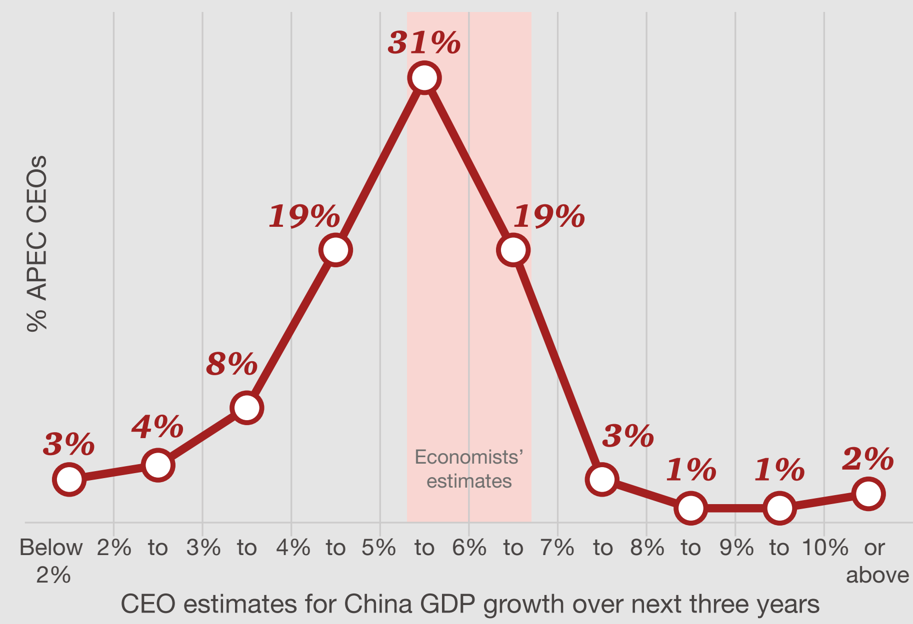
Ask executives how much they expect China's GDP will grow over the next three years...

And the projections fan across the chart. Ask what they think it will take to compete and a clearer pattern emerges despite the wide uncertainty in the macroeconomic environment.

Business leaders, both domestic and foreign, whether bulls or bears on China's economic growth, are gravitating toward three strategies, a new survey of over 1,100 CEOs from May-July shows. Over the next three years, executives want to work more in partnerships, build up their brand and find ways to reach customers beyond the coastal megacities. The only difference is that the more a CEO sees China's growth rate stabilizing, the more aggressive the adjustment the CEO is planning. The most optimistic stand apart in one area: They are more likely to rely on their capacity to innovate.

A third of all CEOs (34%) with operations in Asia-Pacific Economic Cooperation (APEC) economies expect China's GDP to grow less than 5% a year over the next three years, including 27% of China CEOs. These executives are below consensus economists' estimates of growth of around 5%–7% a year, averaged over the next three years. Half of APEC CEOs fall into this consensus range.

APEC CEO outlooks for China's GDP growth over next three years vary widely



Q: ... What is your estimation of the average annual growth rate for China over the next 3 years?
Base: 1,101. Don't know 8%. Estimates from EIU and IMF, 5.6-6.26%, 2016-2018 CAGR
Source: PwC's APEC CEO Survey, 2016-17

The official growth target is for at least 6.5% growth this year. Most economists expect the pace to start to slow next year.

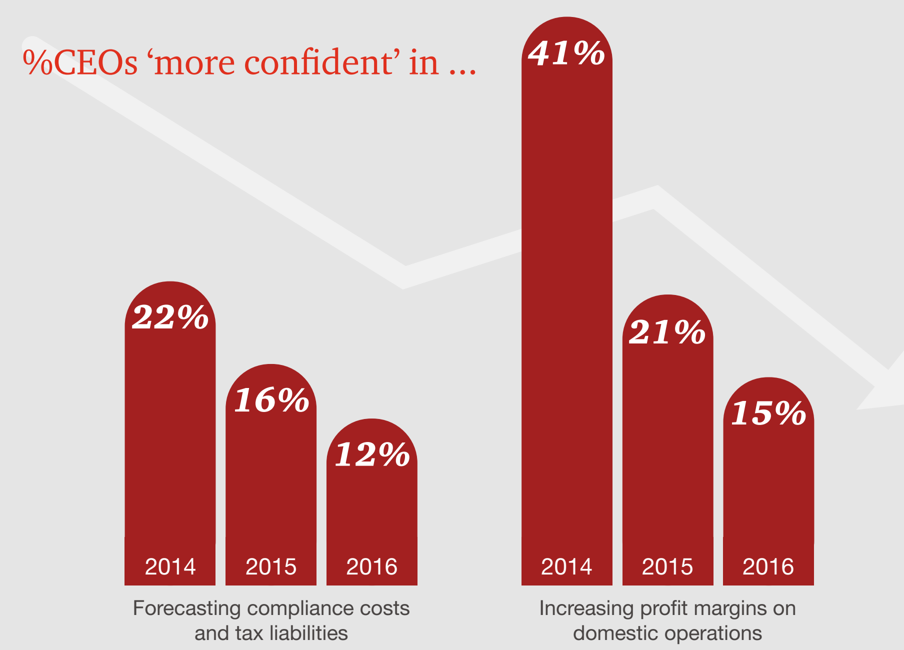
These findings reflect some difficult operational conditions for business in China. Executives don't naturally seek to share profits with partners or worry as much about the brand when visibility, as some executives like to say, is good. At the moment, CEOs are clearly working with a range of scenarios.

Bottom line pressure grows

China's underlying challenge is upgrading the industrial base and improving the competitiveness of the thousands of state-owned enterprises that still make up roughly 40% of GDP. The government has launched initiatives to spur supply-side structural reforms as China transitions from the low-cost, export-fueled model that drove over a generation of exceptional growth. Yet, as noted by the IMF in its October update, stimulus measures to stabilize growth slow the needed adjustments. The wide range of CEO views on China's near-term growth pace reflect the uncertainty that China's growth-reform dilemma presents for business.

At the same time, domestic competition is rising. Baidu, Alibaba, and Tencent (collectively known as BAT) have developed into juggernauts, but their own ascendant positions are under attack by a number of aggressive start-ups and small-to-medium-sized enterprises. While 73% of China and Hong Kong CEOs (222 respondents) are either 'very' or 'somewhat" confident' in prospects for revenue growth for their business over the next year compared with 71% at this time in 2015, there are indications of bottom line pressure building. Only 15% of China/HK CEOs say they're 'more confident' today than they were a year ago in increasing profit from domestic operations. That compares with 41% whose confidence was improving in 2014.

Operating challenges surfacing for more China CEOs



Q: Compared to a year ago, how has your confidence changed about…?
Base: 222 (2016), 157 (2015), 153 (2014). Note: 2014 survey results reflect the % of respondents choosing 'improving' confidence.
Source: PwC's APEC CEO Survey, 2016-17

Even industries positioned to grow rapidly will find new challenges in China's new form. In particular, businesses are more concerned about their ability to interpret regulations and anticipate costs: only 12% of China/HK CEOs are 'more confident' today in forecasting compliance or tax liabilities compared with how they felt a year ago. In this regard, China's CEOs are just like their peers with business growth responsibilities in the rest of APEC's economies, where just 14% are also more confident on forecasting these costs.

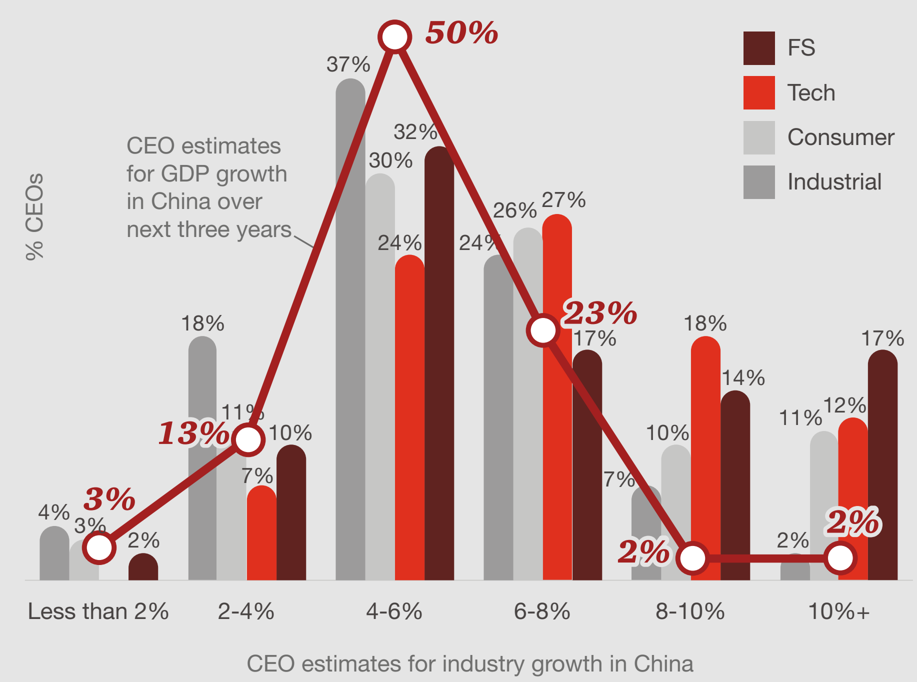
China is still a must-win market, CEOs see varying sector growth rates

China continues to be the biggest and best growth market for major industries like automobiles and continues to vie with the US as a top destination for cross-border investment within APEC. Over half of China respondents (59%) say they are planning to increase investment in China over the next year, compared with 54% last year. Among other APEC executives with a footprint in China, 43% say they are increasing investment. This compares with 53% last year.

Among all respondents in China, the sector-growth optimists are more likely in Financial Services and Technology businesses. Views on sector growth from CEOs in Consumer and Industrial businesses – representing the bulk of China's economy – are mixed: 44% of Consumer CEOs expect sector growth of 6% or less p.a. over the next three years.

Technology and Financial Services sectors benefit from China's rebalancing towards services. A big opportunity is in FinTech and alternative financing, like crowdfunding, offering a counterbalance to challenges in the sector. The IMF in October signaled the need to address excessive corporate debt as an urgent risk to the health of the overall economy.

Tech, FS CEOs more likely to think their industries will outperform China's economy over the next three years.



Q: … what is your estimation of the average annual growth rate for China over the next 3 years?
Q: … what is your estimation of the average annual growth rate for your principal industry in China over the next 3 years?
Base: APEC: 1,101, Industrial: 426, Consumer: 234, Technology: 115, FS: 167. Not showing 'Don't know' responses
Source: PwC's APEC CEO Survey, 2016-17

Just under a third of Technology and Financial Services executives estimate annual average industry growth of at least 8% a year over the next three years. Deregulation is a driver, but so is the rise of a new generation of consumers more likely to take advantage of financing options like car loans. Consumers in China are increasingly managing their personal finance online, and doing so on their smartphones. There are more mobile phone subscriptions than bank accounts in China, and the usage rate of mobile payments is rising.

China is fast becoming a proving ground for a digital-first organization. Almost one in five Chinese consumers shop online daily, making China the world's largest e-commerce market. It's a 4 trillion renminbi (US$590 billion) market, according to PwC's Total Retail report. And it's accelerating. E-commerce represented 13% of total retail sales in 2015, up 33%, according to government statistics. Executives want to get closer to that sort of dynamism, which they believe is shaping the future for their business.

In contrast, Industrial executives hold a more pessimistic view: 58% of industrial executives expect average annual industry growth of 6% or less p.a. over the next three years. Their sentiment mirrors forecasts by Oxford Economics of slower growth in manufacturing output compared to the overall China GDP growth in 2016–2017. A significant cause of uncertainty is the Chinese government's commitment to remove overcapacity from the manufacturing sector.

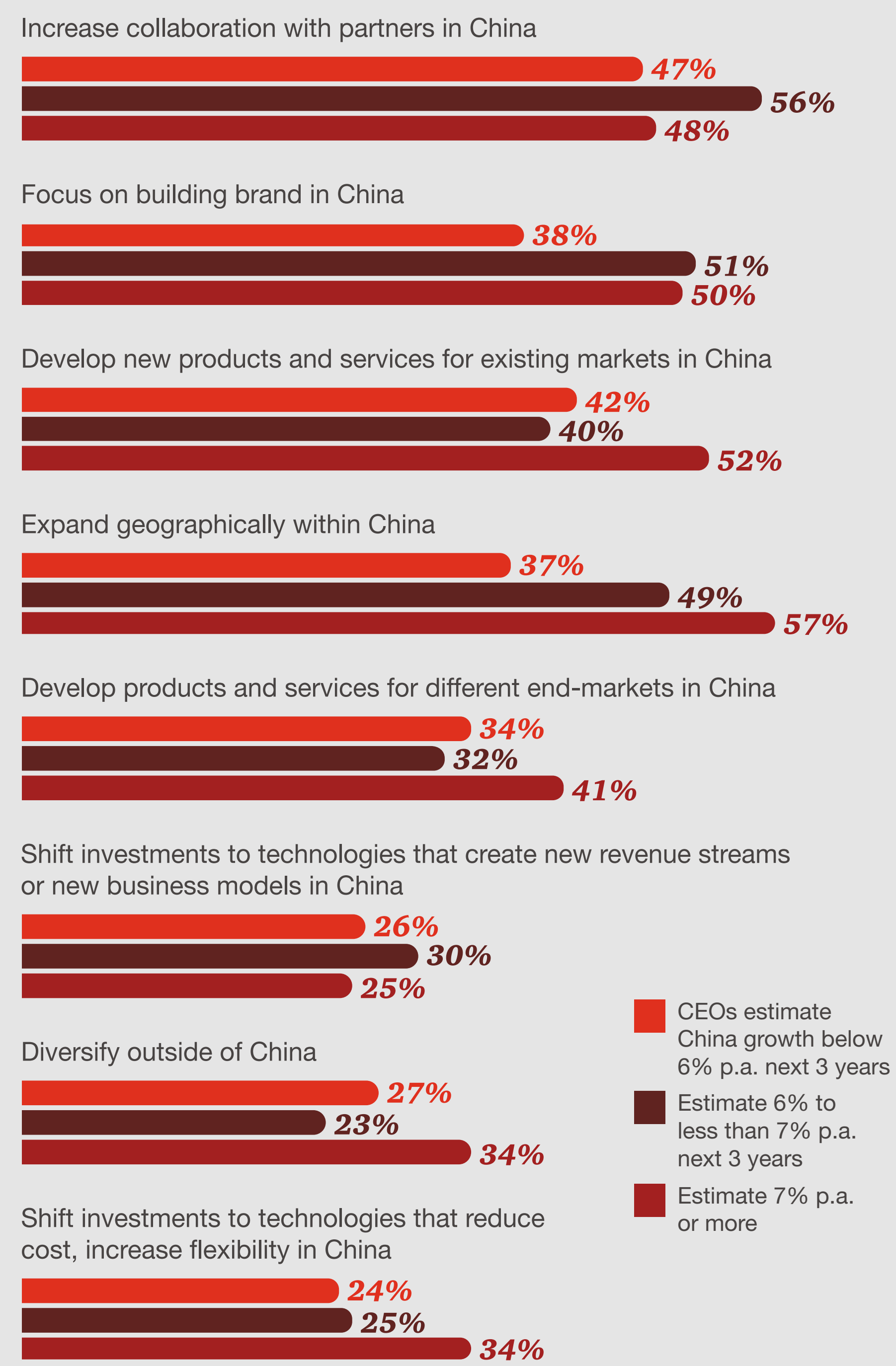
How do CEOs across these sectors plan to adapt? Here's a closer look at the three top ways.

#1 Expand inland to capture still untapped growth conditions

Rising incomes and the emergence of a middle class beyond China's coastal megacities are creating opportunities for more businesses: 41% of respondents are planning to expand geographically within China over the next three years, including 41% of China/HK CEOs. It helps that some provinces and inland cities are growing faster than China as a whole. For example, the economies of inland cities such as Guiyang, Xiangyang and Hengyang are estimated to grow by up to 12% in 2016, according to The Economist Intelligence Unit.

Retail sales are growing faster in rural China, rising 11.8% in 2015 on the year vs. a 10.5% increase in urban China. China's smartphone penetration rates likely offer a better proxy for business potential beyond the coast. Market research company Nielsen estimates penetration of smartphones in first-tier cities neared saturation in 2014, but finds that there is plenty of room to grow in rural China, where the penetration rate was estimated at 32% in the same period.

Executives in China plan on stronger partnerships and brands, and inland expansion regardless of views on GDP growth



Q: Considering your outlook for your organisation in the People's Republic of China, which of the following strategies, if any, do you plan to undertake over the next 3 years?
Base: 629 (overall), 418 (<6%) 151 (6-<7%), 44 (7%+). Not showing 'Don't know' responses.
Source: PwC's APEC CEO Survey, 2016-17

As Chinese consumers continue to shift their transactions online, businesses will come to expect e-commerce to follow a similar development across China.

Some of the inland growth is anticipated from the government's plans to develop infrastructure as part of the "Belt and Road" investment program to foster links between inland China to Eurasian and ASEAN markets. Russia's Summa Group, for one, expects to see benefits as Chinese cargo transits through Russia to Europe, Leyla Mammad Zada, Chief Operating Officer, told PwC.

M&A is part of the toolkit for expansion: 18% of all respondents who plan to expand geographically in China, develop new product or services or build up their brand say they'll rely on M&A to a 'great extent' to expand their footprint in China.

Expansion into the interior will come with fresh challenges, particularly in the lower-tier cities. Distribution channels and supply chains are far less developed there, and consumer awareness of Western brands is low.

#2 Lean on strong partners to accelerate market access

There's a resurgence in partnerships globally as companies counter the lack of organic growth in established markets and position themselves for technology-driven market transformations. The added challenges of expanding geographically in China into lower-tier cities are likely accelerating the trend in China. A strong local partner is becoming important again: 48% of respondents plan to increase collaboration with partners in China, including 56% of domestic CEOs. Recent deals involving some of the largest foreign brands in China's retail market show how evolving digital + geographic partnerships are playing out.

In June, Wal-Mart sold its online platform Yihaodian to JD.com and retained a stake, specifically calling out the Chinese e-commerce company's base of online customers and same-day delivery network in Eastern and Southern China. Yum Brands, the company behind KFC and Pizza Hut restaurants, in September sold a stake in the spinoff of its Chinese business to a Chinese investment firm and Ant Financial Services, an affiliate of Alibaba Group Holding Ltd. And

McDonald's has made clear that it's seeking partners to franchise its Chinese restaurants. Phyllis Cheung, Chief Executive of McDonald's China said in an interview with the Wall Street Journal in October that, "in the lower-tier cities, we want to accelerate, and a local partner would have more local wisdom and more local resources."

Bright Dairy & Food's 2010 investment in New Zealand's Synlait Milk provides another example. "It's probably helpful for us as we grow and develop as a company that we do have shareholding from China, which is a major and important market for us," John Penno, Managing Director and CEO of Synlait Milk, told PwC. "It helps us build friendships and deepen relationships with people who know the market well and who are deep in the market."

It's not just the long-established in China that are seeking new ways to grow via relationships. After battling head-to-head with Didi Chuxing, US ride-share company Uber announced this year that it would quit the market bypurchasing a stake in its Chinese competitor.

#3 Build a brand that belongs in digitally driven value chains

E-commerce is changing how companies approach the market. The strong interest in building brand reflects this trend: 42% of respondents, foreign and domestic, plan to focus on this over the next three years.

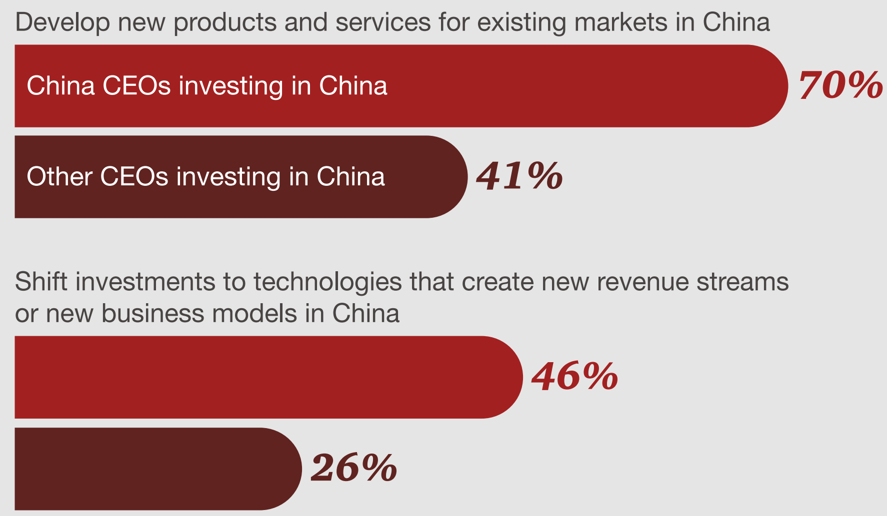
When big global brands first came to China, they were able to create awareness quickly by opening up brick-and-mortar stores to appeal to an emerging Chinese middle class. Now, foreign brands face home-grown competition in the digital arena.

British fashion house Burberry started an e-commerce campaign in China in 2011 by participating in popular social media platforms such as WeChat and Weibo. The brand has since accumulated over one million fans on Weibo, enabling it to consistently interact with its customers and position itself as a brand that fits Chinese taste. In 2014, the brand connected the social experience with e-commerce by offering exclusive access to WeChat users on its runway show in London and allowing them to purchase runway items online during or right after the show, with a simple linking of WeChat accounts to the e-commerce site.

What's next? Chinese companies are now focused on building internationally-recognized brands that live where new value is being created. As Lisa Tan, Executive Vice President and CFO of Haier Group, told PwC in an interview, companies are re-evaluating their relationships with their consumers. The consumer electronics and home appliances company acquired GE Appliances business this year, a "critical step" in its global strategy. Haier will seek to build direct relationships with local economies and consumers as a part of the strategy, bypassing traditional methods of selling strictly to distributors. "Ultimately, we hope Haier becomes localized in every region," she said.

Branding is likely to emphasize innovation efforts, spurred by market share gains by Chinese digital leaders. Seven Chinese companies in 2016 made Forbes' ranking of the world's most innovative. The emphasis on innovation is an area where China CEOs stand out compared with other executives in China: 70% of China CEOs investing in China plan to develop new products and services for existing domestic markets in China compared with 41% of other executives investing in China.

China CEOs are more likely to prioritize innovation over the next three years



Q: Considering your outlook for your organisation in the People's Republic of China, which of the following strategies, if any, do you plan to undertake over the next 3 years?
Base: 106 business leaders in China, excluding Hong Kong; 415 other APEC CEOs investing in China
Source: PwC's APEC CEO Survey, 2016-17

Implications for business growth in a changing China

CEOs see the need for these three strategies to support one another. They realize expanding into interior markets will require more than modifying products and having loose partnerships to help with distribution. They need to overcome low brand recognition, localize what they produce and how they produce it, and work closely with a partner that can help them reach the heart of the interior markets. In many cases, they will need to sell diverging product lines with coastal regions demanding increasingly high-end products and no-frills products in the interior.

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