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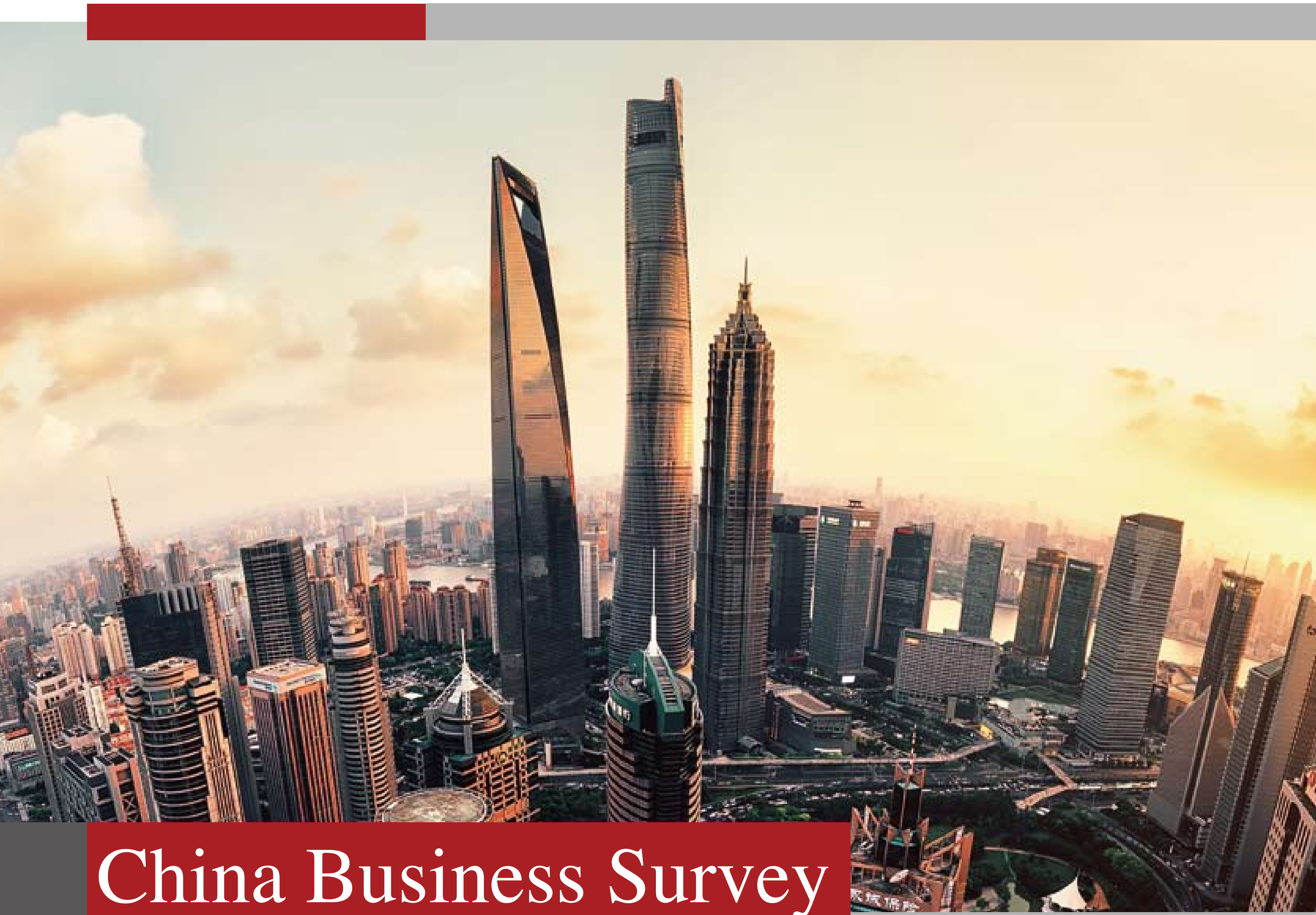

# China Business Survey

## 2017

Juan Antonio Fernandez
Bin Xu
Dongsheng Zhou
Maria J. Puyuelo
Yuwen Dai

# 2017 China Business Survey

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China Europe International Business School


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# LETTER FROM THE RESEARCH TEAM

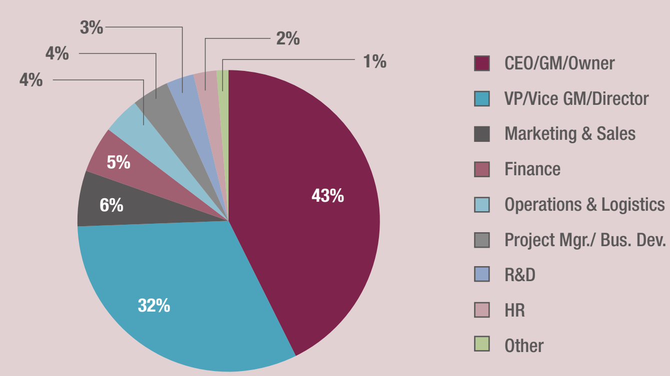
We are pleased to present the 7th annual CEIBS China Business Survey.

We want to sincerely thank all of the executives working in China who have participated in this survey for their time and valuable contribution. In particular we thank the CEIBS alumni community and current MBA, FMBA, EMBA and Executive Education students who have given their support to this research. Our gratitude is also extended to the China-Italy chamber of commerce and to various Swiss organizations in China: Swiss Center China, Swiss Embassy in China, Swiss Business Hubs, Swissnex China, SwissCham, China Integrated. Ltd.

Finally, we acknowledge the financial support from CEIBS Research Fund. Top management executives and also functional experts have given us a very valuable and rich perspective of the situation of their businesses in China in 2016 and their expectations for 2017 and the future.

The 2017 CEIBS Business in China Survey was completed by 1,300 executives between October and December 2016, with 843 from Chinese companies (65%) and 457 from foreign companies (35%). Among them were 558 CEOs, GMs, and company owners; 414 Vice Presidents, Deputy General Managers or Directors. The rest represented all the remaining business functions: HR, Finance, Marketing, Sales, Operations and Research & Development. Of the respondents, 88% are from the Chinese mainland, 2% from Taiwan, Hong Kong or Macao, and 10% from other countries, 55% of the total sample has more than 20 years of work experience. The firms they work for are both Chinese owned (65% of them) and foreign owned (45%). This broad and experienced sample added rich and valuable perspectives to the survey.

FIGURE 1 - WHAT IS YOUR POSITION IN THE COMPANY? N= 1300



# THE RESEARCH TEAM


Prof. Juan Antonio Fernandez

**Dr. Juan Antonio Fernandez** is a Professor of Management at China Europe International Business School (CEIBS) in Shanghai, China.

Prof. Fernandez has co- authored six books: America Latina en China, CHINA CEO, Chinese SOEs Reform, China CEO: A Field Guide, China (Foreign) Entrepreneur and Chinese Entrepreneurs. He has given presentations about his Chinese research in USA, India, Japan, Korea, UK, France, Italy, Spain, Vietnam, Mongolia and Ghana


Prof. Bin Xu

**Dr. Bin Xu** is Professor of Economics and Finance, Associate Dean (Research) at CEIBS. He received his B.A. and M.A. from Fudan University, and Ph. D. from Columbia University.
Dr. Xu's current research focuses on the global and Chinese economy, multinational enterprises in China, and trade and finance issues of emerging markets. He has published extensively in both international and Chinese journals, and is author of International Trade (Peking University Press, 2009). Dr. Xu has worked as a consultant for International Monetary Fund (IMF) and the World Bank.


Prof. Dongsheng Zhou

**Dr. Dongsheng Zhou** is Professor of Marketing at CEIBS. He is also the academic director of SEPC, a joint executive training program with Harvard Business School and Tsinghua University. He received his Ph.D. from the University of British Columbia (UBC), Canada.
Dr. Zhou's research focuses on marketing strategies, game theory, MNE strategies in China and China's private enterprises. His research has been published in the Academy of Management Review, International Business Review, International Marketing Review, and others. Dr. Zhou has conducted consulting services for a number of firms (e.g. IBM, DuPont).


Maria J. Puyuelo

**Maria J. Puyuelo** is Research Associate at CEIBS. She obtained her MBA from Stanford Graduate School of Business (USA) and her MSc in Engineering from the University of Zaragoza (Spain).
Maria started her career at Procter & Gamble and has held various senior marketing positions at L'Oreal Luxury Goods Division. Most recently, she has worked as a free lance consultant, helping businesses develop and grow their markets in China. She has co-authored the book America Latina en China


Dr. Yuwen Dai

**Dr. Yuwen Dai** is Research Fellow at CEIBS. She received her PhD from the University of York in the UK. Prior to joining CEIBS, Dr. Dai had more than 5 years of teaching experience in Australia, US and UK. She has also worked as a consultant for the International Monetary Fund (IMF) and the Asian Development Bank (ADB). As a global citizen, Yuwen has living experience in 9 cities, 6 countries across 4 continents, and she has also travelled extensively to over 50 countries across 5 continents.

# SPECIAL TOPICS

This section tackles subjects that are particularly relevant to current business life in China.

- Reform Effects Seen as Weak by Companies in China
- Building a Climate of Innovation in Organizations

The purpose of this section is to give an in-depth overview of what we learn about the above topics from the diverse range of surveyed companies.

# REFORM EFFECTS SEEN AS WEAK BY COMPANIES IN CHINA

*China's policy makers have been faced with a difficult dilemma in recent years. On one hand, long-standing problems such as overcapacity have become so severe that they threaten the long-term health of the economy and highlight the need for deep-level structural reform. On the other hand, mounting pressure to maintain middle-high economic growth has resulted in the use of short-term stimulus and the delay of supply-side reform. Over the past few years, we have seen policy priority swinging between reform-promotion and growth-maintenance. The impact, according to our poll of 1,300 executives from companies doing business in China, has been mixed feelings of high anticipation for deep-level reform and low satisfaction with what has actually been done.*

Chinese and foreign executives who participated in the CEIBS Business in China Survey over the past few years had high expectations for structural reform. In the 2014 Survey, a poll of 1,017 executives from companies doing business in China responded very positively to the reform initiatives laid out by China's new leadership, including the establishment of a free trade zone in Shanghai. In the 2015 Survey, participating executives anticipated that the new round of economic reform which got underway in 2014 would help establish "the decisive role of the market in resource allocation". In the 2016 Survey, we found that the business confidence levels of both Chinese and foreign executives reached their lowest levels in late 2015, which partially explains the shift of policy focus from reform to stimulus in that year. In spring 2016, the Chinese government, through the voice of an anonymous "authoritative person" in People's Daily, expressed its strong will to pursue structural reform, and started to implement a policy labelled "cutting excess capacity, reducing inventory, and deleveraging". It is against this background that 1,300 executives (65% from Chinese companies and 35% from foreign companies operating in China) answered our online questionnaire in late 2016. In this article, we summarise the findings on their views on how their companies had been affected by the reform policies. By comparing the results with those from previous surveys, we find that the results from this year are particularly revealing.

**Overcapacity: Severe Problem, Policy Seen as Weak**

When asked about how serious a problem overcapacity is in the industry of their main business, about half of the surveyed executives considered it serious. Out of the 1,290 company executives who answered this question in late 2016, 18% of them claimed that the degree of overcapacity was "extremely high (over 30%)", and 31% said that it was "significantly high (between 15% and 30%)" (see **Figure 2**). Similar statistics are found from the subsamples of 840 Chinese companies and 450 foreign companies. Only 19% of the surveyed executives did not see overcapacity as a problem in the industry of their main business (see **Figure 3**).

**FIGURE 2 - WHAT IS THE DEGREE OF OVERCAPACITY IN THE INDUSTRY OF YOUR COMPANY'S MAIN BUSINESS? (2017 SURVEY)**

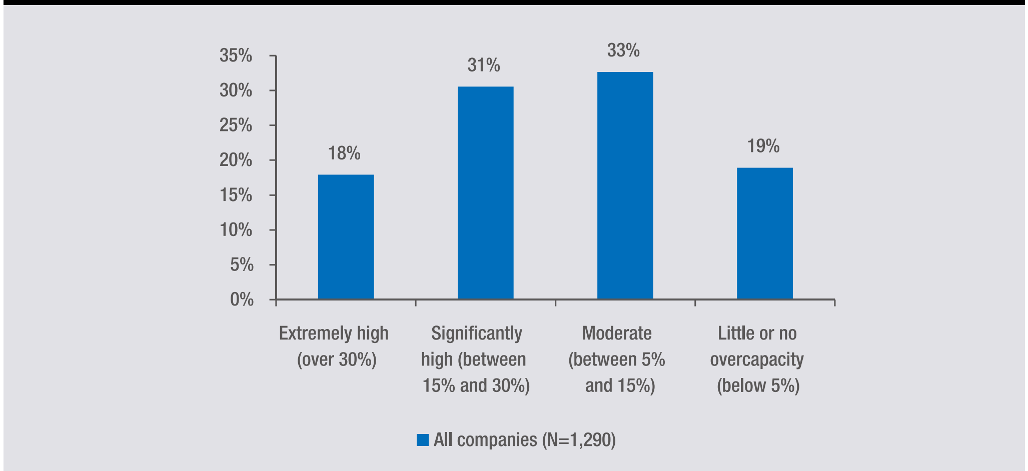
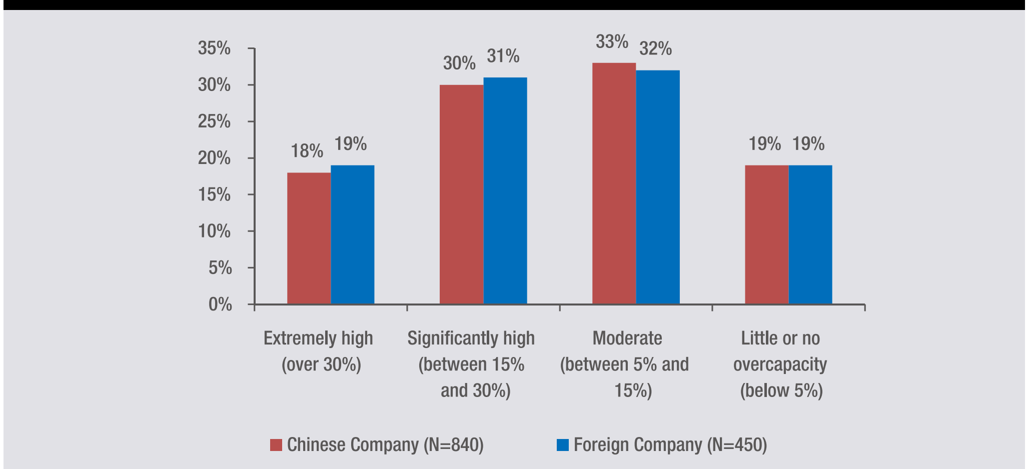



**FIGURE 3 - WHAT IS THE DEGREE OF OVERCAPACITY IN THE INDUSTRY OF YOUR COMPANY'S MAIN BUSINESS? (2017 SURVEY)**




The Chinese government implemented a policy dubbed "cutting excess capacity, reducing inventory, and deleveraging" in 2016. The 2017 Survey asked the executives how their companies were affected by this policy. Out of the 1,290 executives who answered this question, 45% and 36% said – respectively – that this government policy did not affect or mildly affected their companies, and only 16% said that this policy had a large effect on their companies (see **Figure 4**). Not surprisingly, this government policy had more effect on Chinese companies than foreign companies. Meanwhile, 56% of executives from Chinese companies reported that their companies were at least mildly affected by the policy, compared to 46% of executives from foreign companies. Overall, the effect of the policy on overcapacity was only weakly felt in 2016 by both Chinese and foreign companies in our sample, as 44% of Chinese company executives and 54% of foreign company executives said that their companies were not affected by this policy (see **Figure 5**).

FIGURE 4 - HOW IS YOUR COMPANY AFFECTED BY THE CHINESE GOVERNMENT'S POLICY OF CUTTING EXCESS CAPACITY, REDUCING INVENTORY, AND DELEVERAGING? (2017 SURVEY)

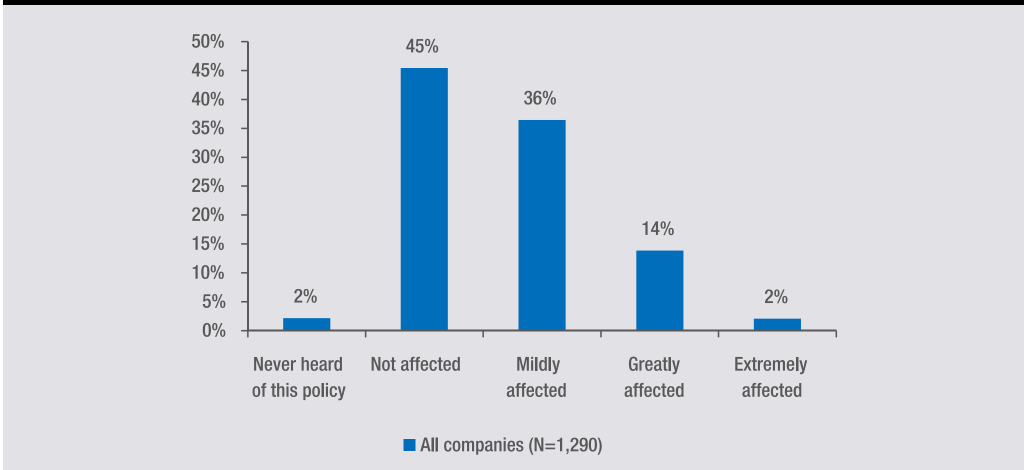
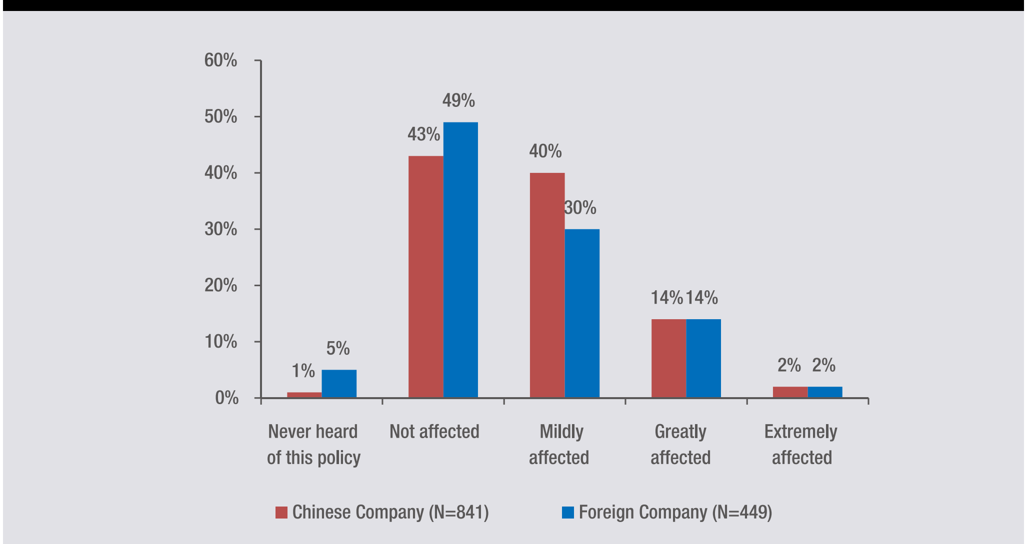



FIGURE 5 - HOW IS YOUR COMPANY AFFECTED BY THE CHINESE GOVERNMENT'S POLICY OF CUTTING EXCESS CAPACITY, REDUCING INVENTORY, AND DELEVERAGING? (2017 SURVEY)




**Shanghai FTZ: High Expectation, Limited Impact**

In the 2014 Survey, participating executives expressed high expectation and strong interest in the Shanghai Pilot Free Trade Zone (FTZ), which was officially launched on September 29, 2013. In November/December of 2013, when answering the survey question "What is your expectation of the Shanghai Free Trade Zone?", 31% of Chinese company executives and 21% of foreign company executives had high expectations and considered it a model for China's economic reform. In addition, 55% of Chinese company executives and 56% of foreign company executives had moderate expectations and were waiting to see how far the policies in the Zone would go (see **Figure 6**). In answering the question "Does your company have an interest in the Shanghai Pilot Free Trade Zone", 59% of the state-owned companies and 50% of the privately-owned

Chinese companies expressed an interest. Understandably, many executives, especially those from foreign companies, felt that there was not enough information available in order to judge if the Zone would be of interest to their companies (see **Figure 7**).

FIGURE 6 - WHAT IS YOUR EXPECTATION OF THE SHANGHAI FREE TRADE ZONE? (2014 SURVEY)

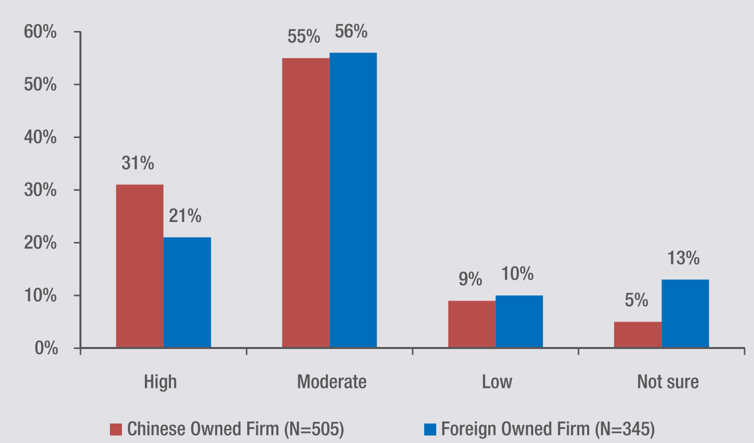
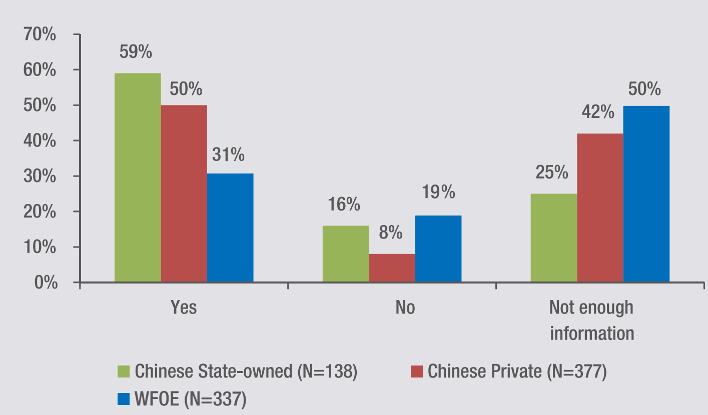



FIGURE 7 - DOES YOUR COMPANY HAVE AN INTEREST IN THE SHANGHAI FTZ? (2014 SURVEY)




September 29, 2016 marked the third anniversary of the Shanghai Free Trade Zone. In the 2017 Survey, we ask the question "How is your company affected by the establishment of the Shanghai Free Trade Zone?" Out of the 1,289 executives who answered this question in late 2016, 79% said that their companies had not been affected by the establishment of the Shanghai FTZ, and only 19% reported a positive effect from the Zone (see **Figure 8**). It is worth noting that there are 24% of executives from foreign companies who reported a positive effect on their companies from the Zone, which is much higher than the 16% of executives from Chinese companies (see **Figure 9**).

**FIGURE 8 - HOW IS YOUR COMPANY AFFECTED BY THE ESTABLISHMENT OF THE SHANGHAI FREE TRADE ZONE? (2017 SURVEY)**

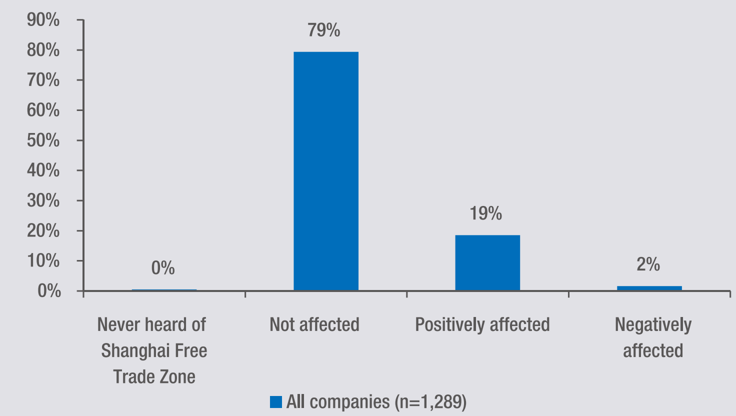
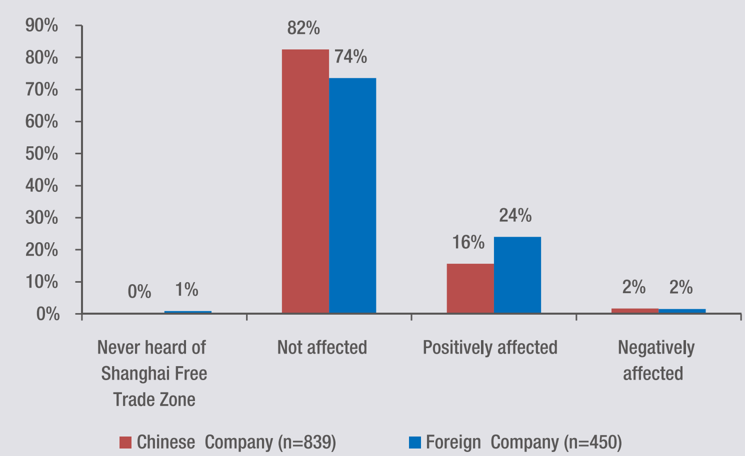



**FIGURE 9 - HOW IS YOUR COMPANY AFFECTED BY THE ESTABLISHMENT OF THE SHANGHAI FREE TRADE ZONE? (2017 SURVEY)**




**Structural Reform: High Expectation, Perception of Slow Pace**

Shanghai Free Trade Zone is not the only reform policy that was perceived to be not as effective as hoped for by executives. When asked "How do you feel about the pace of economic reform in China in 2016", only 11% of the 1,291 executives chose "Good progress", compared to 55% who chose "Slow progress" and 17% who chose "No progress". There were even 16% who chose "Going backwards" (see **Figure 10**). When we break the sample into 841 Chinese company executives and 450 foreign company executives, we find that only 9% of executives from Chinese companies felt that there was "Good progress" made in economic reform in China in 2016, compared to 13% from executives of foreign companies. In contrast, more than half of the surveyed executives, with 57% from the subsample of Chinese company executives and 50% from the subsample of foreign company executives, felt that there was only "Slow progress" on economic reform in China in 2016;  and around one-third of the surveyed executives, with 31% from the subsample of Chinese company executives and 35% from the subsample of foreign company executives, felt that economic reform in China could best be described as "No progress or going backwards" in 2016 (see **Figure 11**).

FIGURE 10 - HOW DO YOU FEEL ABOUT THE PACE OF ECONOMIC REFORM IN CHINA IN 2016? (2017 SURVEY)

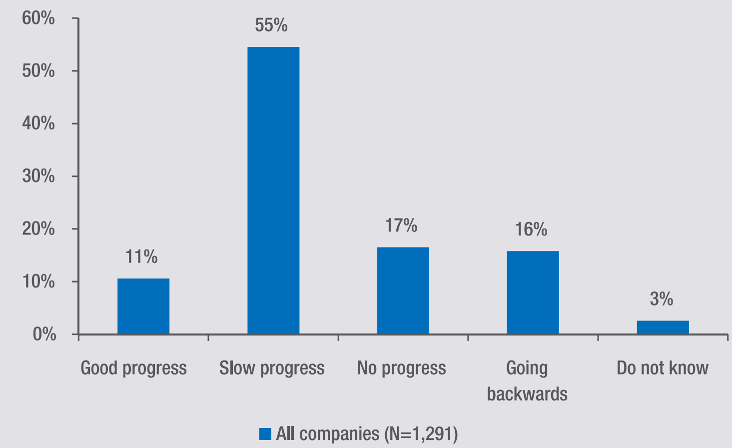
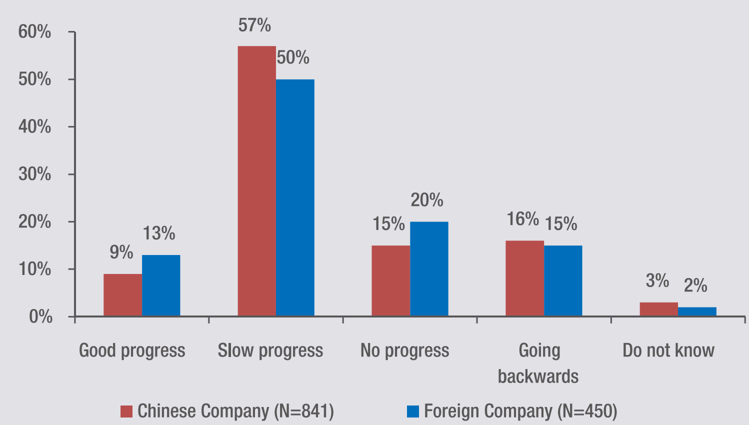
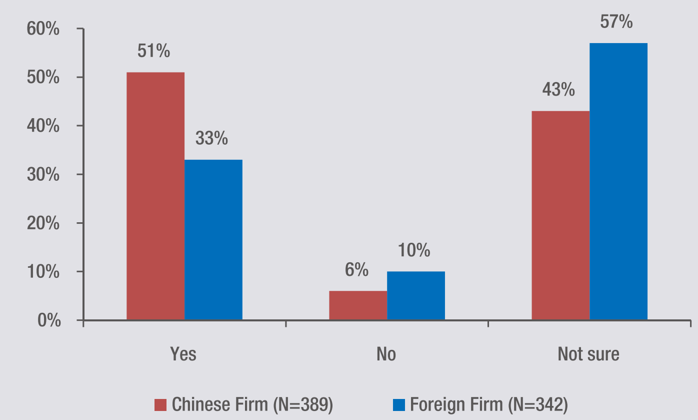



FIGURE 11 - HOW DO YOU FEEL ABOUT THE PACE OF ECONOMIC REFORM IN CHINA IN 2016? (2017 SURVEY)




It is not entirely surprising that the effects of economic reform policies were not strongly felt in 2016. In recent years, there has been high uncertainty surrounding the effects of economic reform policies as perceived by the executives. In the 2015 Survey, we asked the question "Do you think your company will benefit in the future from current reform policies?" Among the 731 executives who answered this question, 43% of Chinese company executives and 57% of foreign company executives said that they were not sure (see **Figure 12**).

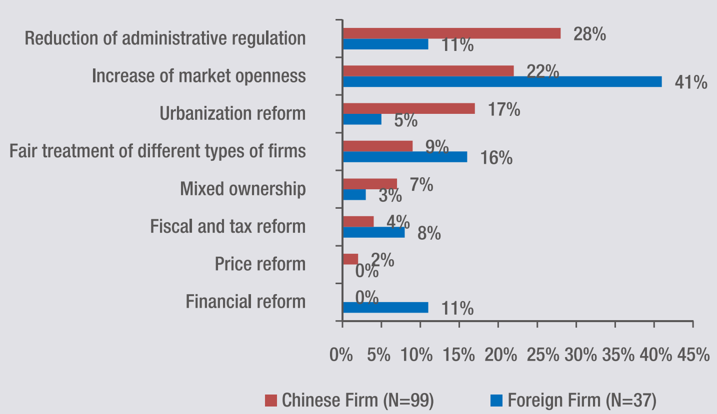
FIGURE 12 - DO YOU THINK YOUR COMPANY WILL BENEFIT IN THE FUTURE FROM CURRENT REFORM POLICIES? (2015 SURVEY)




**Getting the Policy Priority Right**

The type of economic reform longed for by the executives is supply-side reform. In the 2015 Survey, we asked a follow-up question to the 136 company executives who said that they had already benefited from new reform policies implemented in 2014. Their answers reveal the areas of reforms that companies prefer. For the 99 Chinese company executives who answered the question, 28% listed "reduction of administrative regulation" as the number one benefit from new reform policies implemented in 2014. For the 37 foreign company executives who answered the question, 41% listed "increase of market openness" as the number one benefit (see **Figure 13**). These answers indicate that companies prefer supply-side reform policies that increase the role of the market and decrease the role of the government.

FIGURE 13 - WHICH REFORM POLICY BENEFITED YOUR COMPANY IN 2014? (2015 SURVEY)



As discussed earlier, China's policymakers face a difficult choice between promoting structural reform whose effects are usually not immediately felt, and maintaining middle-high economic growth which is a mandate for the Chinese government in order to fulfil its promise to the Chinese people of doubling their real income in ten years (from 2010 to 2020). In the second half of 2015, pressed by the rising pace of economic slowdown, the Chinese government's policy priority shifted towards short-term stimulus, notably in the real-estate market, which led to a significant increase of the already-high housing prices in late 2015 and in early 2016. As the skyrocketing housing prices looked to threaten economic and social stability, the Chinese government reversed the policy direction and introduced strong administrative methods to cool down the real estate market in mid 2016. Thus people in China had a rollercoaster experience in 2015-2016 in the real estate market.

In the 2017 Survey, we asked the question "How is your company affected by the roller-coaster changes of China's real estate market?" Out of the 1,290 executives who answered this question, 35% claimed that their companies were negatively affected, compared to only 8% of executives who claimed that their companies were positively affected (see **Figure 14**). In addition, we find that the real-estate policy's effects, whether negative or positive, were more pronounced on Chinese companies than on foreign companies. Among Chinese company executives, 38% reported negative effects and 10% reported positive effects. By contrast, among foreign company executives, 31% reported negative effects and 5% reported positive effects (see **Figure 15**). Despite the percentage differences, it is clear that the roller-coaster changes of China's real estate prices negatively affected most companies doing business in China.

**FIGURE 14 - HOW IS YOUR COMPANY AFFECTED BY THE ROLLER-COASTER CHANGES OF CHINA'S REAL ESTATE MARKET? (2017 SURVEY)**

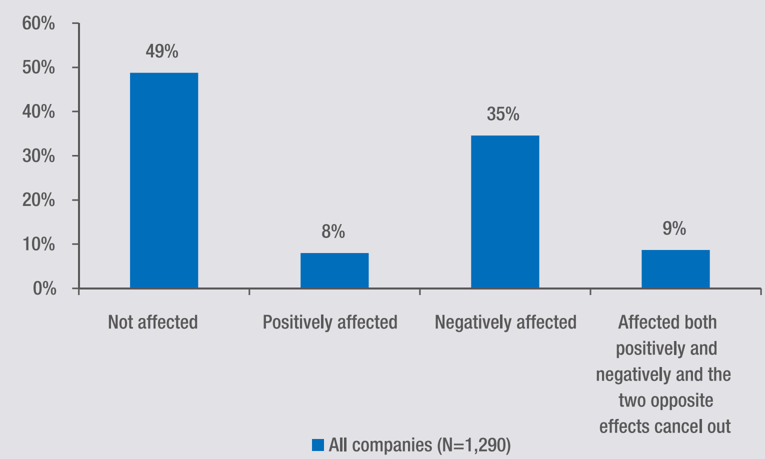
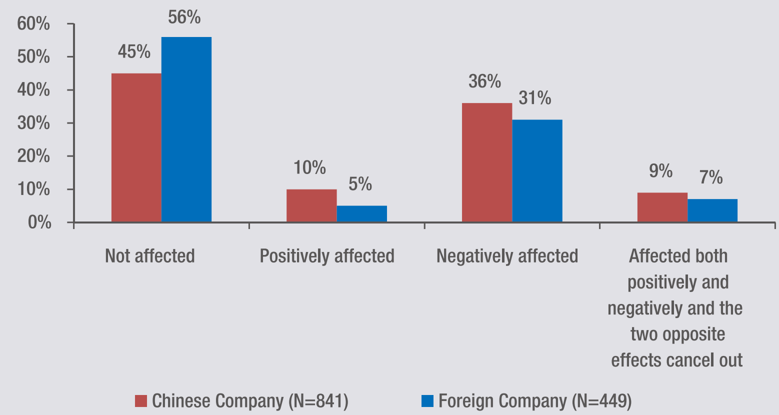


FIGURE 15 - HOW IS YOUR COMPANY AFFECTED BY THE ROLLER-COASTER CHANGES OF CHINA'S REAL ESTATE MARKET? (2017 SURVEY)




**Conclusion: Note and Caveat**

We would like to end with a note and a caveat. First, the note: It is important to understand that it takes time for supply-side reform to be fully implemented, and hence our finding that reform effects were weakly felt by the executives surveyed in 2016 does not necessarily mean that reform policies are not effective. The perception of weak reform impact found in our survey may come partly from the slower-than-expected implementation of reform policies, and partly from the fact that some of the reform policy effects will take a longer time to be felt. Take the Shanghai FTZ as an example. There is no denying that some of the policies created in the Zone, such as Free Trade Bank Accounts, have been put on hold due to the changing macroeconomic environment both in and outside China. However, it is also true that some other reform policies created in the Zone, such as the "negative list" policy, are in the process of being tested and improved; and the fact that their effects are yet to be felt does not imply the ineffectiveness of these policies.

Second, the caveat: The sample of executives who participated in our survey has some unique features that may affect the interpretation of the results. The majority of our survey participants are alumni or students of China Europe International Business School, and most of them come from companies ranked high in their respective industries. Taking the 2017 Survey as an example, the companies of the surveyed executives are mostly in the mid- and high-end of their respesctive markets. In the sample of our 2017 Survey, 48% of the companies operate mainly in the premium segment of their business areas, another 48% in the middle segment, and only 4% in the low-end of their respesctive market. Moreover, 34% of the companies identify themselves as market leaders for their main business line and 43% consider themselves to be in the Top 5 of their main business line. Given this "upward bias" of the sample, one needs to interpret the results from the research more carefully. For example, the policy of "cutting excess capacity, reducing inventory, and deleveraging" may be implemented unevenly across different types of companies. It is possible that this policy has been applied more frequently in companies which are more poorly managed and thereby are targeted by the policy. If this is the case, then our result that companies did not feel much effect from this policy warrants a re-examination.

## BUILDING A CLIMATE OF INNOVATION IN ORGANIZATIONS

*Innovation has become a key factor for the success of Chinese businesses, and therefore for the prosperity of the country's economy. Individual and team creativity can be fostered in organizations by creating an environment that is conducive to creativity and by implementing processes that enhance creativity skills and by exercising the right leadership style.*

One of the questions that we have been asking since the beginning of our annual survey, seven years ago, deals with the most pressing challenges of doing business in China as well as the key success factors. The issue that has become the most critical in the past five years is fierce competition, increasing in importance year after year and taking the top position in the 2017 Survey. The competitive landscape has changed too. A few years ago, main competitors were international companies but now Chinese firms, specifically private firms, are the strongest competitors. At the same time, labor costs have been raising. In such scenario, one way to compete is by being more efficient and reducing costs. Many of the sampled Chinese companies reflect this new reality. In this year's survey, cost control and operations efficiency have become the second most important success factor - five years ago it was absent from the Top 4 chart.

**Chinese firms – Top 4 External Challenges**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Fierce competition (63%) | Rising labor cost (63%) |
| 2 | Rising labor cost (62%) | Fierce competition (55%) |
| 3 | Economy slowdown in China (55%) | Economy slowdown in China (54%) |
| 4 | Government & Legal environment (39%) | Government & Legal environment (34%) |

**Chinese firms – Top 4 Success Factors**

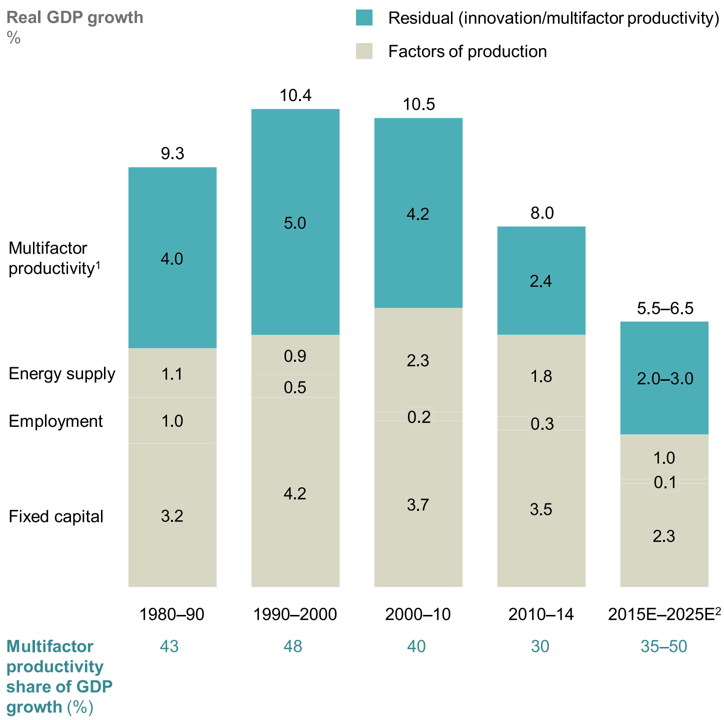
| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Quality of the products/services (51%) | Quality of the products/services (56%) |
| 2 | Cost control, operations efficiency (40%) | Quality of the management team (43%) |
| 3 | Quality of the management team (33%) | Strong company culture & values (42%) |
| 4 | Strong company culture & values (33%) | R&D and product innovation (41%) |

However, a strategy focused mainly on reducing costs has its limits, as eventually margins erode and quality of products and services suffer. Another possible strategy is to innovate. Innovation allows companies to improve quality while also increasing efficiency. Innovation is not just launching new products and services, but also creating improved processes, or a combination of both approaches. The McKinsey Global Institute report "The China Effect on Global Innovation" published October 2015[1], suggests that China can change its role from an absorber of innovation from other countries to an innovation leader. The report indicates that China faces an urgent need to innovate. As the two previous sources of economic growth (labor force expansion and heavy capital investment) are losing importance, innovation becomes critical for future GDP growth. According to McKinsey projections, up to 50% of the GDP growth in 2020-25 will need to come from innovation.

[1] *http://mckinseychina.com/the-china-effect-on-global-innovation/*

## FIGURE 16 - PROJECTION: INNOVATION CONTRIBUTION TO GDP GROWTH IN CHINA

**Innovation (broadly defined) can contribute 2 to 3 percentage points of GDP growth in China by 2025, accounting for 35 to 50 percent of total GDP growth**




1 Calculated as total GDP growth minus three factors of production (energy, labor, and capital), multifactor productivity broadly measures the impact of innovation on the economy.
2 Baseline GDP estimate developed by regressing more than 100 variables from historical trends, assuming no major economic shocks. Key variables include demographic change, unemployment rate, interest rate, factor cost changes, depreciation, inflation, and urbanization rate.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute analysis

According to the McKinsey report, China is already performing well in certain industries, mainly in those that are consumer-focused and efficiency driven. Some examples of consumer-focused industries are household appliances, smartphone manufacturing or Internet services. Solar-panel manufacturing or semiconductors are instances of efficiency driven industries. However, there are others industries where the potential for improvement is still great, mainly those in engineering and science-based activities. Some instances are medical devices, branded pharmaceuticals or biotechnology. Given the importance of innovation for the future of China and therefore the very survival of Chinese companies, the question now is how to foster innovation in organizations.

**Fostering innovation**

A common misconception is that creativity results from innate talent, that there a “lucky few” who are born creative. But in fact, research has shown that creativity is a teachable and learnable skill. It can be enhanced through hard work, adequate practice and processes, and an environment that nurtures creativity. In order to foster innovation, companies need three things: a climate for innovation processes and tools to guide innovation, and the right leadership.


**1. A climate for innovation**

Harvard professor Teresa Amabile has summarized the research in the field of creativity in a model that encapsulates what makes a person creative[2]. The necessary components for an individual to produce creative ideas or products in a given domain are three: 1) **Expertise**, or knowledge, in the domain where the person is trying to innovate; 2) **Creativity Skills**, or thinking skills and attitudes that help us see new perspectives and take risks in solving problems; and 3) **Motivation**, or the desire to engage in a task because it is interesting or personally motivating, not only because it is required or because there is the potential for external rewards. The work environment affects all there components, especially task motivation. Therefore, certain work environments enhance creativity and innovation while others suppress it.

Considering the importance of innovation for Chinese companies, this year we introduced some questions to measure the climate for innovation in the organizations where they work. There are three organizational components that affect individual or team creativity: Management practices, Organizational motivation, and Resources. **Management practices** need to encourage employee freedom and a sense of control over their work, provide challenging work, encourage individual contributions and support open communication. **Organizational motivation** is an orientation towards innovation, a culture than encourages creativity and does not impede it through obstacles such as harsh criticism or internal politics. **Resources** need to be accessible to employees, including sufficient time, information and tools. It includes realistic workload that does not drown people in deadlines and pressure.

We selected the following questions from a questionnaire developed by Amabile that measures the three components mentioned above[3]. Higher implementation of the practices covered in the questionnaire is associated with more innovation for a large database of organizations worldwide .

[2] *Amabile, Teresa M., Regina Conti, Heather Coon, Jeffrey Lazenby, and Michael Herron. "Assessing the Work Environment for Creativity." Harvard Business School Working Paper, No. 96-004, July 1995.*

[3] *KEYS® to Creativity and Innovation*

## FIGURE 17 - EXTRACT FROM 2017 SURVEY QUESTIONNAIRE

**How does the work environment in your organization encourage employee initiative?**

| | Never | Sometimes | Often | Always |
|---|---|---|---|---|
| I have the freedom to decide how I carry out my projects | ○ | ○ | ○ | ○ |
| I work on projects that challenge me | ○ | ○ | ○ | ○ |
| Management encourages and supports work on new ideas | ○ | ○ | ○ | ○ |
| There is free and open communication within my workgroup | ○ | ○ | ○ | ○ |
| People are encouraged to solve problems creatively | ○ | ○ | ○ | ○ |
| The organization culture fosters creativity | ○ | ○ | ○ | ○ |
| Generally, I can get the resources I need for my work | ○ | ○ | ○ | ○ |
| There are no unrealistic expectations or excessive pressure | ○ | ○ | ○ | ○ |
| My organization is very crearive | ○ | ○ | ○ | ○ |

In a comparison of State-Owned companies, Chinese private companies and foreign firms (WFOEs), Chinese private firms have the highest scores when it comes to the three components of a climate that nurtures innovation (Management practices, Organizational motivation and Resources). SOEs show the lowest values. Access to appropriate resources, including the necessary time to work on innovative work is the lowest rated component for all companies. In terms of perceived creativity outcome (whether people believe they actually produce creative work), Chinese private firms and WFOEs are both somewehere, between “sometimes” and “often”. SOEs have a lower score.

## FIGURE 18 - BY TYPE OF COMPANY: CLIMATE FOR INNOVATION

The next set of graphs examine the components of a climate for innovation by industry. We observe that Technology & Telecommunication shows the highest scores for management practices that foster innovation, and organizational motivation to innovate. However, they are not the leading industry in terms of access to resources, maybe because the fast pace of the industry results in high pressure or unrealistic expectations, which is counterproductive to innovation. Industrials and Basic materials are the leading industries in terms of access to resources (which includes tangible resources like funds, facilities, but also time to work on the innovations).

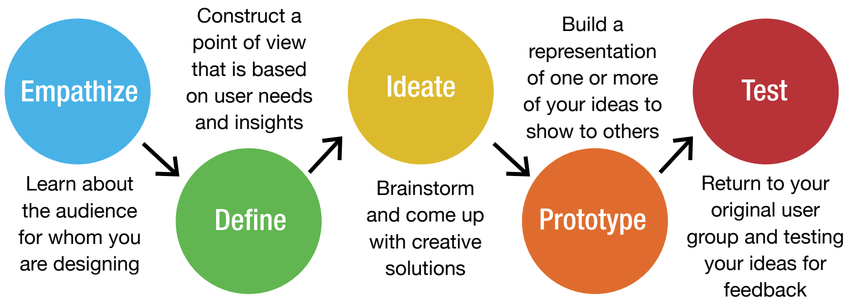
**FIGURE 19 - BY INDUSTRY: CLIMATE FOR INNOVATION**


Let us see now the second factor of the innovation equation.

**2. Processes & tools that foster innovation**

One successful method used for creative problem solving and innovation is Design Thinking. It is used by companies and organizations around the world as it is based in well proven tools and techniques to enhance personal and team creativity. The method combines a number of steps: looking at the problem at hand with open mind; researching and gaining fresh perspectives by reaching out to users and empathizing with them; using divergent thinking to ideate as many solutions to the problem as possible; using convergent thinking to narrow down on the most promising idea; rapid prototyping and testing; learning from successes and failures and iterating until goal is reached.

The d.school is an institute of design based at Stanford University that has as objective to spread the use of design thinking. It is one of the various institutions working to disseminate this creativity enhancing method throughout the world. The d.school partners with industries, researchers, non-profit and government organizations to tackle complex problems that require innovative thinking.  Their model includes five steps in the innovation process:




Source: Stanford Design Institute

CEIBS has created the eLab to bring the innovation to our students and disseminate innovation practices in China.


Pictures: The eLab, the creative space at CEIBS

However, the model is not complete without the leader support.

**3. The right leadership**

Having the right person in the driving seat is fundamental in order to create a climate for innovation in which individuals and teams can tap into their full potential, Creative leaders allows followers to experiment, take risks and even fail as long as they learn from mistakes.  Creative leaders set the context for their subordinates to express themselves. Creative leadership can be defined as[4], "the ability to deliberate engage one's imagination to define and guide a group toward a novel goal – a direction that is new for the group." This requires a new leader's mindset from telling to collaboration in which the leader breaks the barriers of hierarchy.

The combination of the right leader in an organization that has the right climate and offers the right tools for innovation can go a long way towards fostering innovation, which is so vital to the future of Chinese companies. However it will still not be an easy task to transform a traditional organization into an innovative one. But as Lao Zi said: a long journey starts with a small step.

[4] *Gerard Puccio, Marie Mance, & Mary Murdock. (2011). Creative Leadership: Skills That Drive Change. Los Angeles: Sage Publications.*

SECTION 1

# DESCRIPTION OF THE COMPANIES PARTICIPATING

This section details the following information about the companies that have participated in the 7th edition of the CEIBS China Business Survey

- Type of ownership (Chinese or foreign), business sector, industry and type of activity
- Location of Global Headquarters
- Degree of internationalization
- Number of employees in China and globally
- Revenue level in China
- Legal form in China
- Years of operation

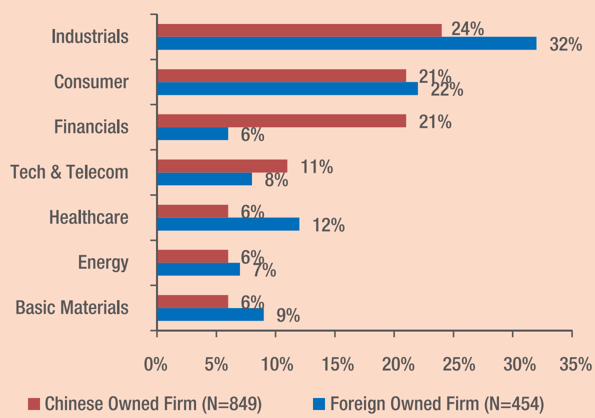
The purpose of the section is to give a general overview of the type of companies that took part in the survey. This information helps clarify the scope of the survey and provides background to interpret survey results.

A total of 1,300 companies operating in China have participated in the 2017 edition of the CEIBS China Business Survey. This sample of businesses includes 843 (65%) Chinese owned companies (i.e. with 50% or more Chinese ownership)[5] and 457 (35%) foreign-owned companies (i.e. with more than 50% foreign ownership).

In terms of business activity, the sample is well balanced with 48% of firms having their main activity in manufacturing and 52% in services. 75% of the total sample of firms are B2B companies, having other businesses as main clients, while 25% are B2C companies, offering products and services directly to consumers.

The industries represented are varied, topped by industrial products and services (346 firms, 27% of total sample), consumer goods and services (278 firms, 21%), Financials (206 firms, 16%), Technology and Telecommunications (132 firms, 10%), Healthcare (107 firms, 8%), Basic Materials like chemicals, forestry and mining (92 firms, 7%), and Energy (79 firms, 6%). However, we observe a considerably larger presence of financial companies within the Chinese-owned firms of our sample (21% versus 6% of foreign firms), a consequence of existing regulations limiting or constraining foreign investment in the sector. Foreign-owned firms are markedly more represented in "Industrials" with 32% of them vs. 24% of Chinese-owned firms in the industry.

## FIGURE 20 - WHAT IS THE MAIN INDUSTRY WHERE YOUR COMPANY OPERATES?




In terms of market position, the firms surveyed operate mostly in the mid and high ends of the market. According to survey answers[6], 525 firms (48%) in our sample operate mainly in the premium segment, another 524 (48%) in the middle segment and only 44 (4%) in the low-end of the market. Moreover, 377 companies (34%) identify themselves as market leaders for their main business line and 470 (43%) consider to be in the Top 5. When splitting by type of company ownership, we do observe a considerable difference in market positioning between the two groups with 70% of foreign companies in the sample in the premium segment vs. a lower 38% of Chinese-owned firms. Inversely, 57% of Chinese-owned firms operate in the middle segment of the market, while 28% of foreign-owned do so.

The location of their Global headquarters is shown in the following map:

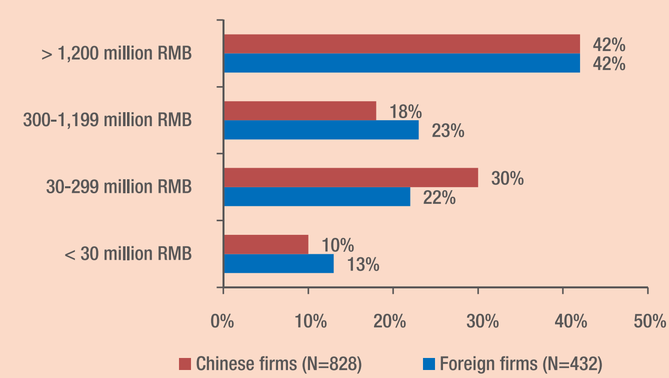
[5] *Including Chinese controlled Joint Ventures*
[6] *N= 1300*

FIGURE 21 - WHERE ARE YOUR GLOBAL HEADQUARTERS LOCATED? N=1300


In 2016, participating companies had generated collective revenue of more than 880 billion RMB and were employing more than 9.5 million people in China alone.

Of participating companies, 60% of the Chinese-owned firms and 65% of the foreign-owned firms surveyed are considered large[7].

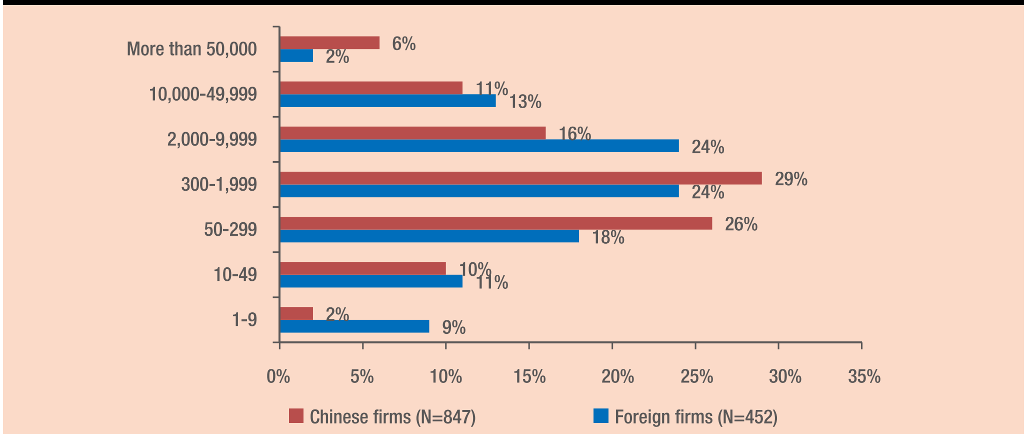
FIGURE 22 - WHAT ARE YOUR COMPANY'S TOTAL CHINA SALES IN 2016?




The sample of companies varies widely in size, ranging from companies with less than 10 employees in China to those with more than 50,000. Surveyed Chinese firms tend to be larger than foreign ones with, in average, 4,500 employees in China or more, compared to 2,800 employees or more for foreign-owned firms. Moreover, 20% of foreign-owned firms surveyed have less than 50 employees versus only 12% of Chinese firms.

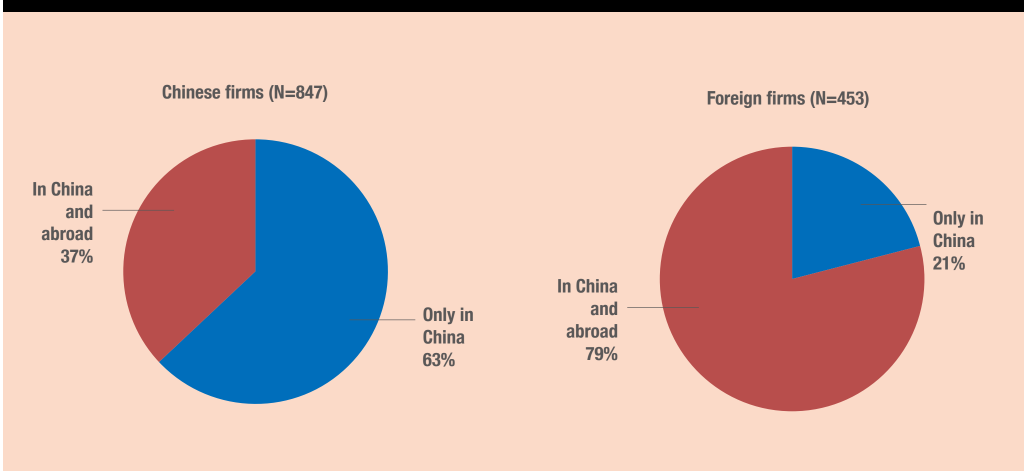
[7] *According to China official definition companies with more than 300 million RMB are considered large.*

## FIGURE 23 - HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE IN CHINA?




37% of the Chinese owned firms in our sample have operations abroad too. And although 79% of foreign firms in our sample are international, there is a non-negligible 21% of foreign owned firms that only operate in China. These are foreign entrepreneurs who have started their business ventures in China.

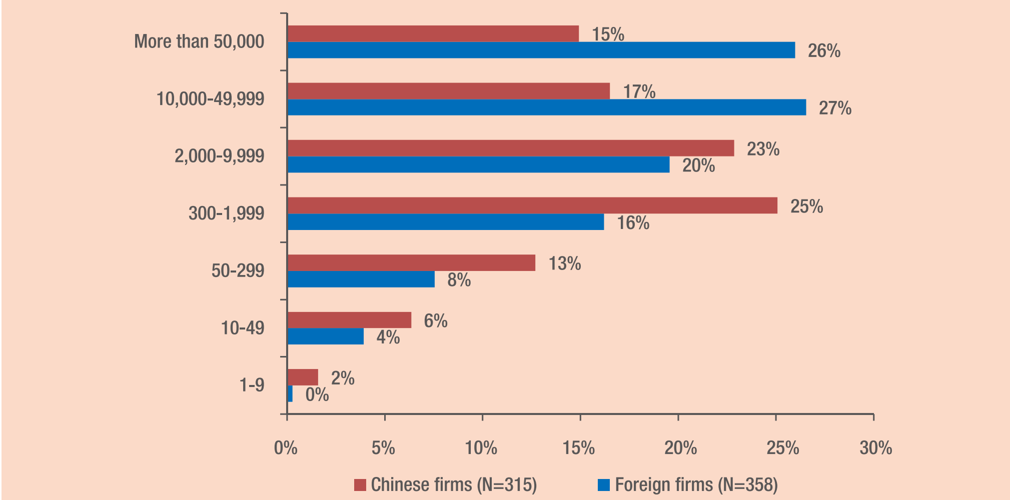
## FIGURE 24 - WHERE DOES YOUR COMPANY HAVE OPERATIONS?




Within the companies that operate both in China and abroad, foreign-owned ones are overall larger in their global operations than Chinese-owned firms. 53% of the surveyed foreign companies with international operations have more than 10,000 employees globally vs. 32% of their Chinese-owned counterparts. Chinese international firms in our survey fall mostly within the small and medium categories (21% with < 300 employees, 48% with 300-9,999)[8].

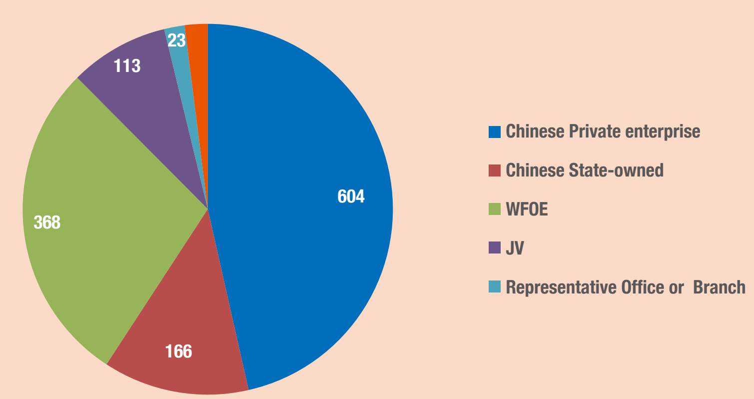
[8] *In our survey, companies are classified in terms of number of employees as Small (<300 employees), Medium (300-10,000) and Large (>10,000)*

FIGURE 25 - FIRMS WITH INTERNATIONAL OPERATIONS- HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE GLOBALLY?

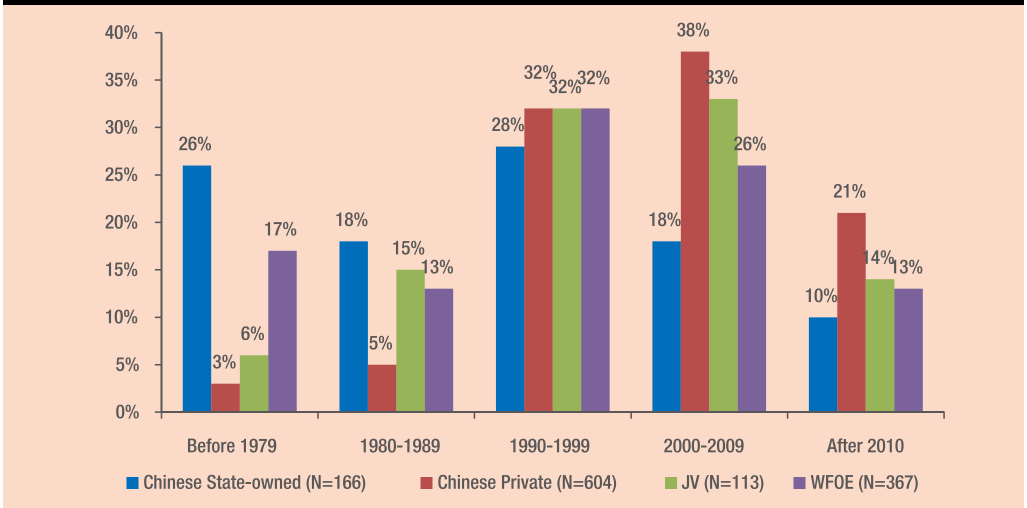



46% of surveyed companies are Chinese privately owned or private-holding companies and 13% are state-owned or state-holding enterprises. Joint Ventures (JV) constitute 9% of the sample, with different levels of Chinese and foreign ownership. Most of the foreign-owned companies are Wholly Foreign Owned Enterprises (WFOE, 28% of total sample), with Representative Offices (RO) and Branches of foreign companies making up the rest.

FIGURE 26 - WHAT IS THE LEGAL STATUS IN CHINA OF THE COMPANY YOUR WORK FOR? N=1,300



## FIGURE 27 - WHEN WAS YOUR COMPANY ESTABLISHED IN CHINA?




Most of Chinese private companies in our sample, 91%, have been established after 1990 following the economic reforms initiatiated by Deng Xiaoping in the late 1980s and early 1990s, which triggered a remarkable growth of the private sector. In contrast, 44% of the SOE in our sample were established before 1990.

SECTION 2

# BUSINESS INDICES

This section presents four Indices:

- Two Business Performance Indices that measure performance variation compared to the previous year, and expected performance for the next year. They are based on sales revenue and profit growth, realized and expected.
- Two Business Confidence Indices give reading on the optimism and confidence in business results declared by respondents.

**Business Performance Indices** are:

- Current Performance Index (CPI)
- Expected Performance Index (EPI)

These two directional indices were introduced in the 2013 report to measure variation both in current and expected performance of the surveyed companies. Each index (ranging from 0 to 100) is constructed similarly to the well-known Purchasing Managers' Index (PMI): an index reading of 50 means that performance is unchanged compared to previous year, a number over 50 indicates an improvement while anything below 50 suggests a decline. The further away from 50 the index is, the stronger the change over the period. The indices are based on multiple choice questions with 5 possible answers[9].

**Business Confidence Indices** are:

- Business Confidence Index, for next year
- Business Confidence Index, for the next 5 years

The Business Confidence Index is a measure of the optimism stated by executives in our sample with respect to the evolution of their businesses for the next year (2017) and the next 5 years (2017 to 2021). These 2 indices have been part of the CEIBS Business in China Survey since its inception 6 years ago, which allows us to start recognizing emerging trends as well as current values.

The reading ranges from 0 to 10 (0 = Absolutely Not Confident, 3 = Not Confident, 5 = Neutral, 7 = Confident, 10 = Extremely Confident). The executives in our survey are asked to state their confidence level in the short term (next year) and in the medium term (next 5 years).

*[9] INDEX = (P1*1) + (P2*0.75) + (P3*0.5) + (P4*0.25) + (P5*0)*
*P1 = Percentage number of answers that reported a substantial improvement.*
*P2 = Percentage number of answers that reported an improvement.*
*P3 = Percentage number of answers that reported no change.*
*P4 = Percentage number of answers that reported a deterioration.*
*P5 = Percentage number of answers that reported a substantial deterioration.*

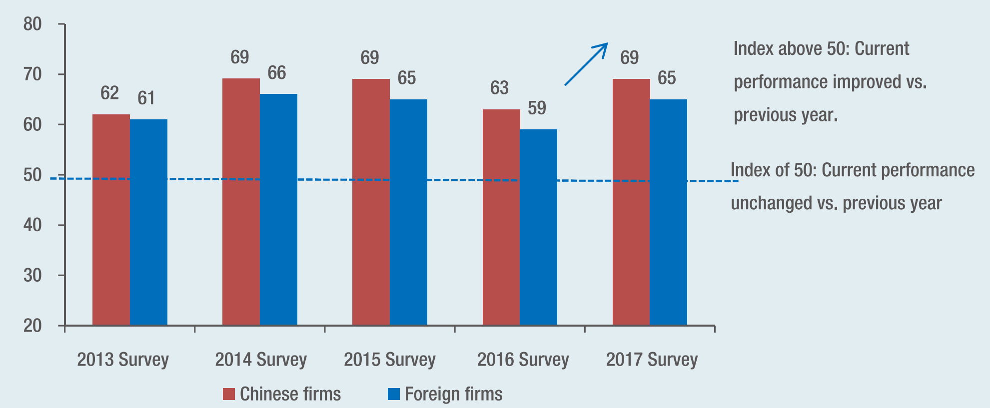
## 2.1. CURRENT PERFORMANCE INDEX – CPI

*Recovery in performance of firms in 2016 after the deceleration suffered in 2015. Surveyed executives declare growth levels in revenue and profit in 2016 similar to those in 2014.*

The CPI Index is calculated as a composite of 2 survey questions: Revenue and Profit Level. Each variable is attributed the same weighting. An index above 50 indicates performance improvement vs. the previous year, the further away from 50 the index is, the stronger the change over the period. Performance is based on both revenue and profit evolution in 2016.

2016 Current Performance Indices (CPIs) are higher than 50 for both sampled Chinese and foreign firms, reflecting better business results in 2016 than in 2015. Moreover, their indices are higher than the previous year, 2015. While 2015 had shown a slight slump in growth of profits and revenues when compared to previous years, 2016 seems to have brought a recovery and are back to where they were in 2014. Current Performance Index for 2016 is 69 for Chinese companies and 65 for foreign companies, versus last year's indices of 63 and 59 respectively. Chinese owned companies in our sample reflect slightly better results than foreign ones.

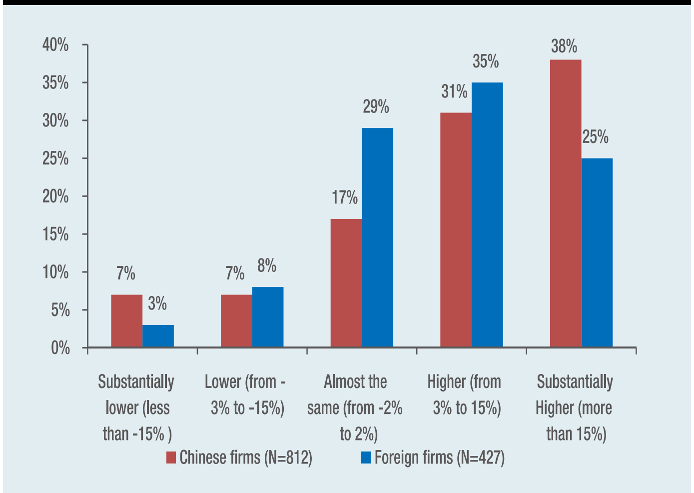
FIGURE 28 - CURRENT PERFORMANCE INDEX



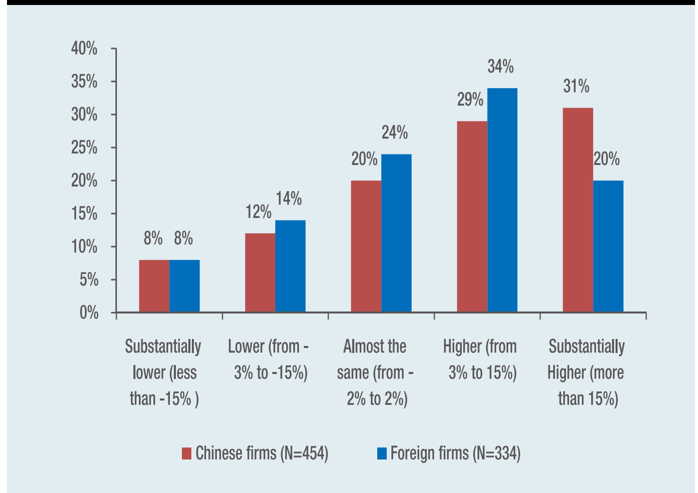

Given that the CPI integrates sales and profits results into one index, we can explore both business indicators separately to better understand the growth in 2016.

<u>Sales:</u>
Figures 21 and 22 reflect the answers of our sample to the question "How do you expect your company's China sales compared to last year?" as asked in 2016 and 2015. We observe that 69% of Chinese firms reported higher or substantially higher sales for 2016, vs. a lower 60% in 2015. Within foreign firms, 56% of our sample reports sales growth in 2016 and only 11% experience decrease in sales vs. 22% in2015.

## FIGURE 29 - HOW DO YOU EXPECT YOUR COMPANY'S CHINA SALES IN 2016 COMPARED TO 2015?



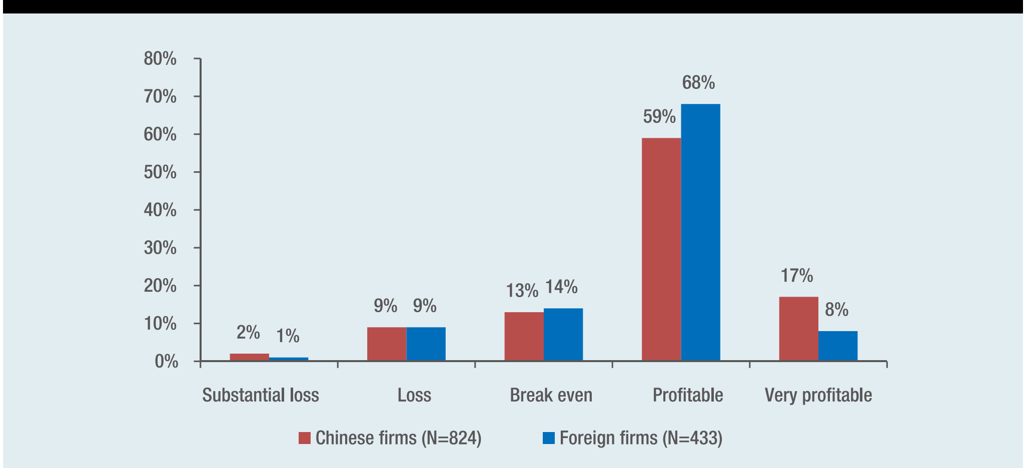

## FIGURE 30 - HOW DO YOU EXPECT YOUR COMPANY'S CHINA SALES IN 2015 COMPARED TO 2014?




Profits:

In our overall sample, 76% of the companies declared being profitable or very profitable in 2016, while 9% incurred losses, a situation improved versus last year's survey in which 13% of them declared losses. Figure 23 reflects the profit situation of our sample in 2016, separating the results of Chinese and foreign firms.

## FIGURE 31 - HOW PROFITABLE DO YOU CONSIDER YOUR CHINA OPERATION IN 2016?




In terms of industry, Healthcare and Basic Materials sectors report the largest percentage of firms profitable or very profitable in 2016, 87% and 85% respectively. Financials (79%), Consumer (76%) and Industrials (76%) follow closely. However, in what refers to improvement versus 2015, Healthcare, Industrials and Technology firms in our sample report the biggest jump in percentage of profitable firms with 87%, 76% and 67% of them experiencing profits in 2016 vs. lower 76%, 47% and 59% respectively in 2015.

**FIGURE 32 - 2017 SURVEY: HOW PROFITABLE DO YOU CONSIDER YOUR CHINA OPERATION IN 2016? PROFITABLE OR VERY PROFITABLE - BY INDUSTRY**

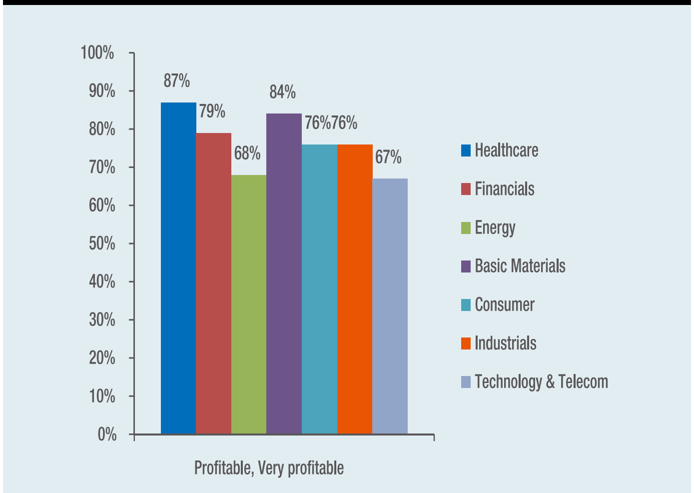
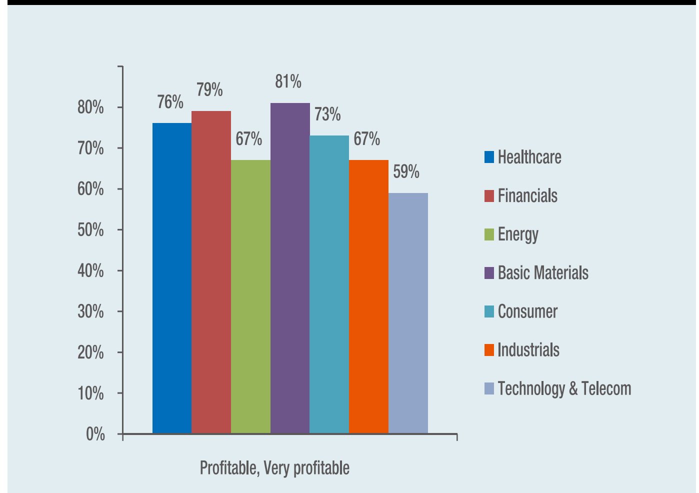



**FIGURE 33 - 2016 SURVEY: HOW PROFITABLE DO YOU CONSIDER YOUR CHINA OPERATION IN 2015? PROFITABLE OR VERY PROFITABLE - BY INDUSTRY**



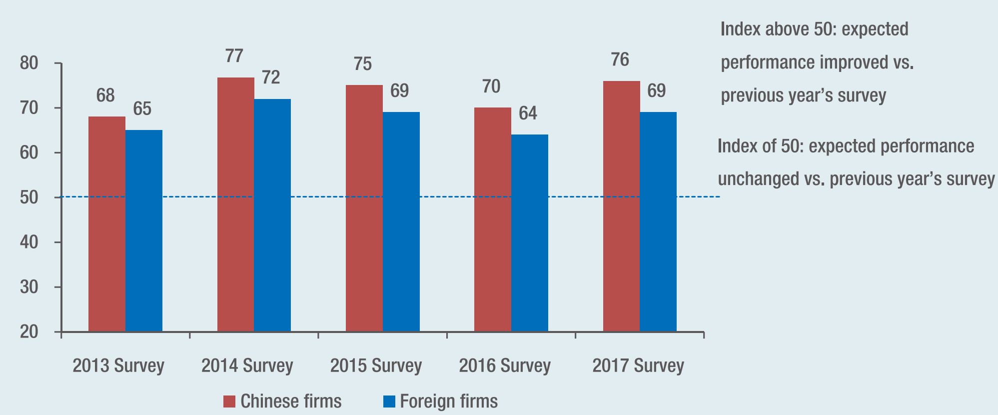
## 2.2. EXPECTED PERFORMANCE INDEX – EPI

*Growth expectation for 2017 stronger than what was expected for 2016 in last year's edition of the survey.*

A majority of the companies surveyed are optimistic for 2017, and more than what they were for 2016 in last year's survey. The Expected Performance Index (EPI) amounts to 76 (Chinese companies) and 69 (foreign companies), reflecting an expected growth for 2017 for both types of companies[10]. These EPI values are higher than those declared in last year's survey (70 for Chinese companies and 64 for foreign companies) and are back at the levels the 2015 edition of the survey.

The EPI is calculated as a composite of 2 survey questions: Revenue and Profit Level expectations for 2017. Each variable is attributed the same weighting.

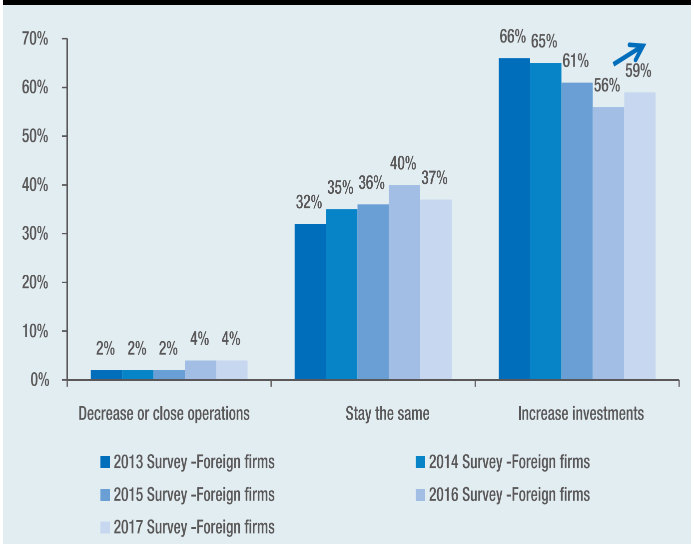
FIGURE 34 - EXPECTED PERFORMANCE INDEX



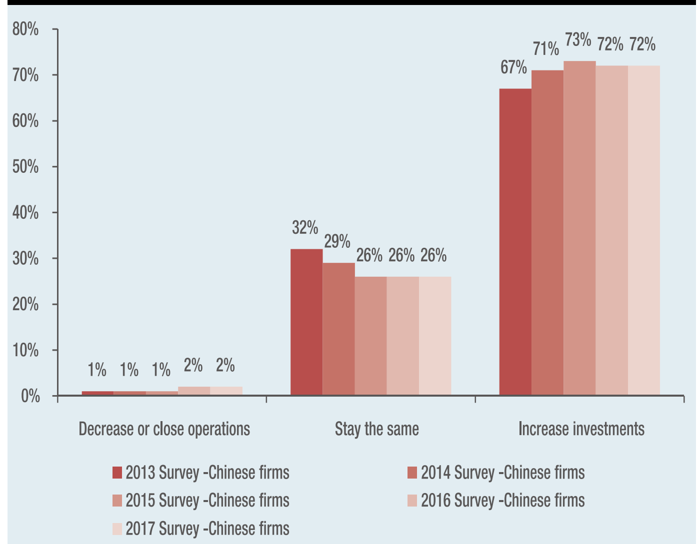

When we look at planned investments in China for 2017, which are closely related to growth expectations, optimism is observed especially in foreign firms. This redresses the trend in foreign firms to keep stable level of investments seen in the past four editions of the survey. Chinese firms show relative stability in their intention to increase investments in China compared to previous years (67% in 2013, 71% in 2014, 73% in 2015, 72% in 2016, 72% in 2017).

[10] *An index above 50 indicates expected growth in sales and profit, the further away from 50 the index is, the stronger the change over the period.*

## FIGURE 35 - FOREIGN FIRMS: WHAT INVESTMENTS DO YOU PLAN FOR THE NEXT YEAR IN CHINA?




## FIGURE 36 - CHINESE FIRMS: WHAT INVESTMENTS DO YOU PLAN FOR THE NEXT YEAR IN CHINA?



## 2.3. BUSINESS CONFIDENCE INDICES – BCI

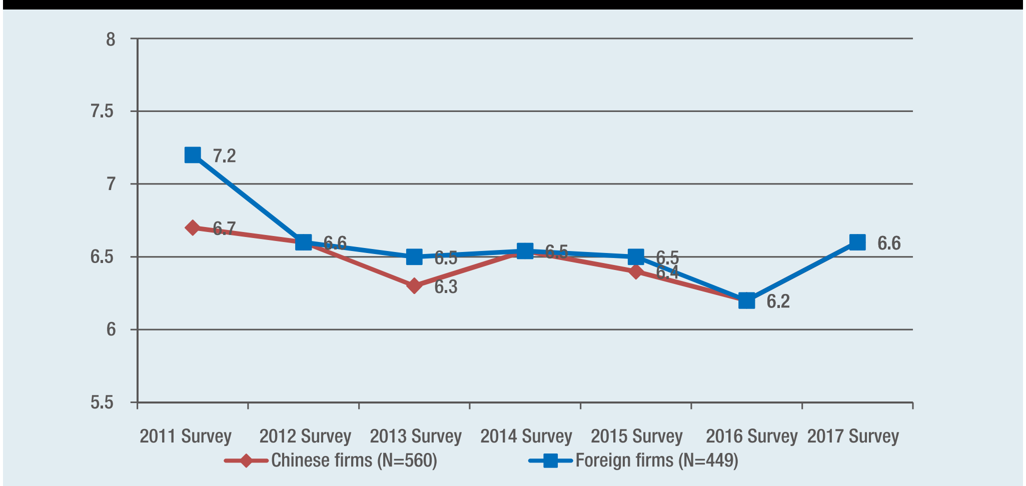
*Confidence in the next year goes up to levels not seen since 2012. Confidence in the next five years stays stable.*

The annual survey provides two confidence indices based on the question, “How confident are you that your operations in China will be successful in the next year and in the next 5 years?” The scale is from 0 (no confidence at all) to 10 (maximum confidence).

The current issue reveals very similar levels of business confidence for Chinese and foreign firms as both claim to be close to “confident” that their operations in China will be successful in 2017 (confidence index of 6.6). Nevertheless, Chinese firms show slightly more enthusiasm for the next 5 years with an index of 6.9 vs. 6.7 for non-Chinese firms.

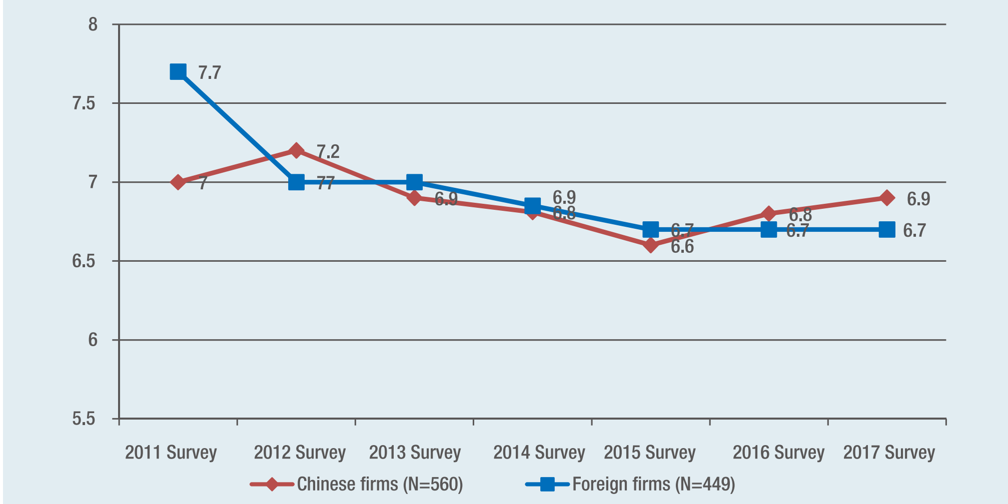
Confidence for the next year: When examining the seven year trend we remark that in the past five years, the value of the one-year confidence index had been moving down and reached its lowest level in 2016 at 6.2 for both Chinese and foreign companies. This year’s survey shows a reversal in this trend with confidence level picking up to 6.6, the level of the 2012 edition of the survey.

FIGURE 37 - HOW CONFIDENT ARE YOU THAT YOUR OPERATIONS IN CHINA WILL BE SUCCESSFUL IN THE NEXT YEAR?
0=ABSOLUTELY NOT CONFIDENT, 3=NOT CONFIDENT, 5=NEUTRAL, 7=CONFIDENT, 10=EXTREMELY CONFIDENT




Confidence for the next five years: We notice that the five-year confidence of executives continues the timid recovery started last year, after a four-year downward trend in confidence recorded from 2012 to 2015 editions (Figure XX). This may be a sign of perceived consolidation of the “new normal” stage in the Chinese economy together with optimism brought by the improved performance of sampled companies in 2016, as described in Section 2.1 of this report.

FIGURE 38 - HOW CONFIDENT ARE YOU THAT YOUR OPERATIONS IN CHINA WILL BE SUCCESSFUL IN THE NEXT 5 YEARS?
0=ABSOLUTELY NOT CONFIDENT, 3=NOT CONFIDENT, 5=NEUTRAL, 7=CONFIDENT, 10=EXTREMELY CONFIDENT




Analyzing by industry, we notice that companies in Healthcare exhibit the most confidence in the next year and the next five year (7.0 and 7.3 respectively). Comparing to last year's survey, Basic Materials and Industrials exhibit the biggest jump in confidence in their results for the next year, changing from 5.7 and 5.8 respective in last year's edition of the survey to greatly improved 6.5 and 6.6 confidence levels this year.

FIGURE 39 - 2017 SURVEY: BY INDUSTRY - HOW CONFIDENT ARE YOU THAT YOUR OPERATIONS IN CHINA WILL BE SUCCESSFUL IN THE NEXT YEAR AND IN THE NEXT 5 YEARS?

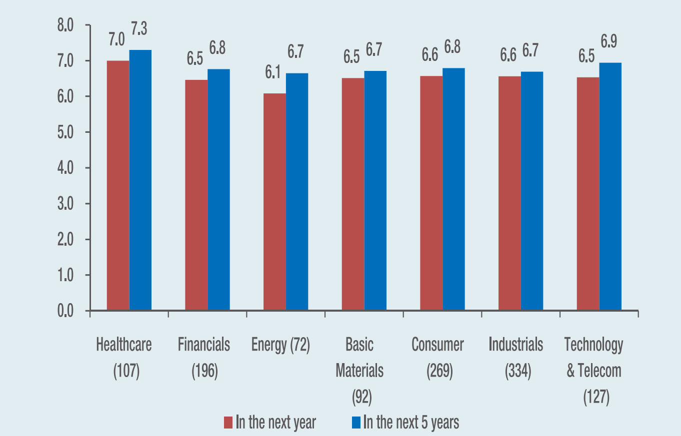
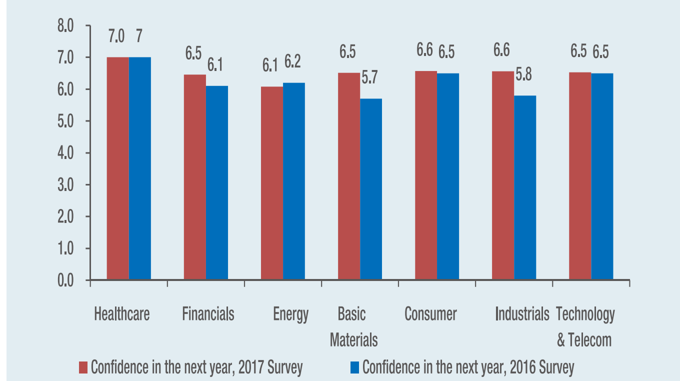



FIGURE 40 - 2017 SURVEY VS. 2016 SURVEY : BY INDUSTRY: HOW CONFIDENT ARE YOU THAT YOUR OPERATIONS IN CHINA WILL BE SUCCESSFUL IN THE NEXT YEAR?



SECTION 3

# CHALLENGES AND SUCCESS FACTORS

This section details the difficulties encountered in China by the firms in our sample and the keys to their success:

- External Challenges
- Internal Challenges
- Success Factors

The purpose of this section is to identify the main challenges faced in China by the companies surveyed, explore the relevant differences in the difficulties faced by Chinese companies compared to foreign companies, and learn how the companies in our survey deal with these challenges.

## 3.1. EXTERNAL CHALLENGES

*The fierce competition in China's business environment has become the most pressing external challenge for our sample of firms when compared to five years ago. Rising labor costs, economy slowdown in China and struggles with the government and legal environment remain in the Top 4 of external challenges.*

We compare the evolution of the Top 4 External Challenges for both Chinese and foreign companies in the last five years. For both Chinese and foreign companies in our sample, "Fierce Competition" has become the number one concern surpassing "Rising labor costs" and "Economy slowdown in China", which were the most pressing issue of Chinese and foreign firms five years ago. This phenomenon reflects the fundamental changes that the Chinese economy and business landscape have experimented over the past half-decade.

Despite this change in the most pressing issue, the Top 4 External Challenges remain unchanged for both Chinese and foreign firms in the last 5 years: "Fierce competition", "Rising labor costs" "Slowdown of Chinese economy" and "Government and legal environment".

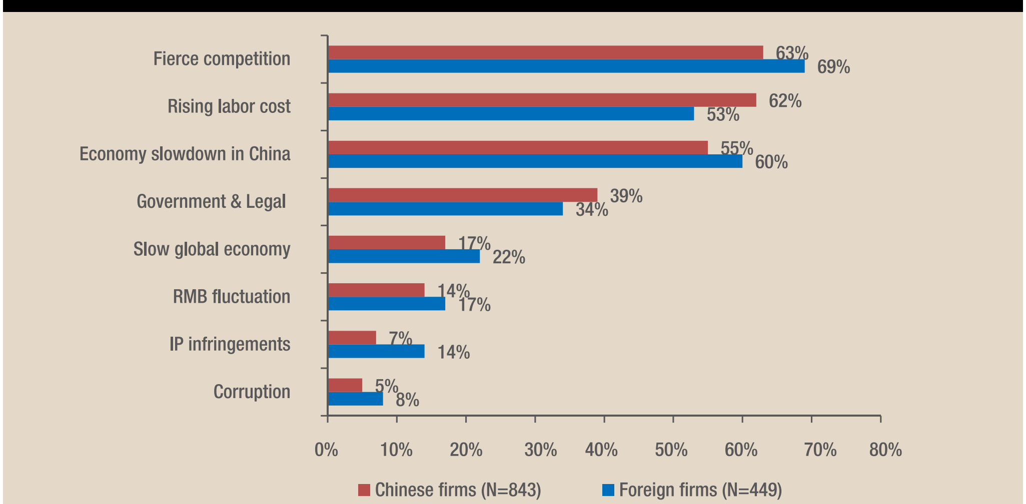
**Chinese firms – Top 4 External Challenges**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Fierce competition (63%) | Rising labor cost (63%) |
| 2 | Rising labor cost (62%) | Fierce competition (55%) |
| 3 | Economy slowdown in China (55%) | Economy slowdown in China (54%) |
| 4 | Government & Legal environment (39%) | Government & Legal environment (34%) |

**Foreign firms – Top 4 External Challenges**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Fierce competition (69%) | Economy slowdown in China (60%) |
| 2 | Economy slowdown in China (60%) | Fierce competition (59%) |
| 3 | Rising labor cost (53%) | Rising labor cost (57%) |
| 4 | Government & Legal environment (34%) | Slow global economy (36%) |

FIGURE 41- 2017 SURVEY: WHAT ARE THE GREATEST EXTERNAL CHALLENGES FACING YOUR COMPANY IN CHINA?



## 3.2. INTERNAL CHALLENGES

*Three top internal challenges are shared by both Chinese and foreign owned firms and remain unchanged from previous years' polls: Finding and retaining talent, innovation, and marketing capabilities.*

The Top 3 internal challenges of Chinese and foreign firms in our sample remain unchanged over the last five years: "Finding and retaining talent", "Innovation Capability", and "Marketing Capability". However, both innovating and marketing capability appear to be more critical skills in 2017 than they were in 2013. This is consistent with the changes experienced by the Chinese economy. When the economy matures and competition heats up, coming up with innovative products and services and effective marketing tactics increase in importance.

The 4th challenge on the top list differs for both groups. "Corporate governance" is a concern relatively more prevalent in Chinese firms with 40% of the executives working them selecting it vs. a lower 30% of those working for foreign companies. This effect was already observed five years ago, in 2013. On the other hand, for executives working for foreign-owned companies "Support from Head Office" is one of the top issues more frequently mentioned, cited by 34% of them and this is also consistent with previous polls (vs. a much lower 9% of Chinese firms) and with the physical and cultural distance with their global headquarters.

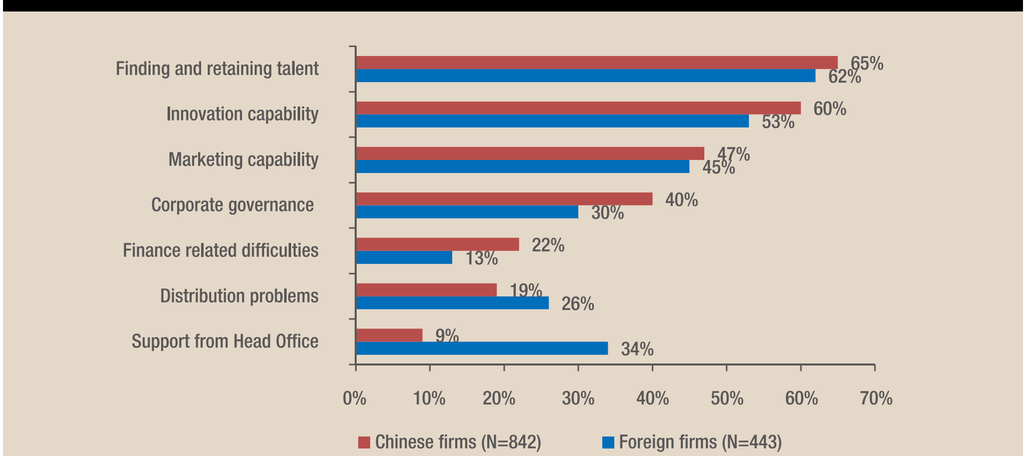
**Chinese firms – Top 4 Internal Challenges**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Finding and retaining talent (65%) | Finding and retaining talent (63%) |
| 2 | Innovation capability (60%) | Innovation capability (50%) |
| 3 | Marketing capability (47%) | Marketing capability (38%) |
| 4 | Corporate governance (40%) | Corporate governance (36%) |

**Foreign firms – Top 4 Internal Challenges**

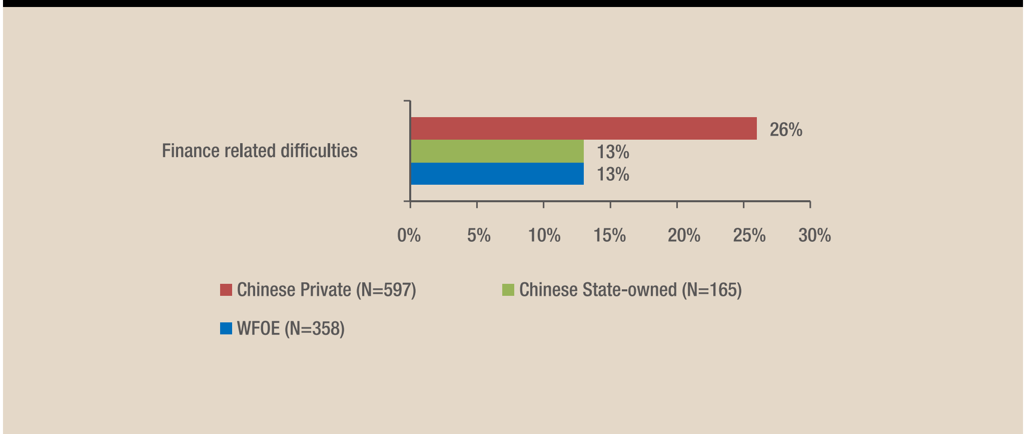
| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Finding and retaining talent (62%) | Finding and retaining talent (67%) |
| 2 | Innovation capability (53%) | Innovation capability (31%) |
| 3 | Marketing capability (45%) | Marketing capability (29%) |
| 4 | Support from Head Office (34%) | Support from Head Office (29%) |

FIGURE 42 - 2017 SURVEY: WHAT ARE THE GREATEST INTERNAL CHALLENGES FACING YOUR COMPANY IN CHINA?



A group-specific challenge is “Finance related difficulties” which worries 26% of the Chinese private firms vs. a much lower 13% of SOEs and 13% of foreign firms.

**FIGURE 43 - 2017 SURVEY: WHAT ARE THE GREATEST INTERNAL CHALLENGES FACING YOUR COMPANY IN CHINA? ZOOM “FINANCE RELATED DIFFICULTIES”**



## 3.3. SUCCESS FACTORS

*Product and service quality and the ability to control costs are key success factors in the current economy.*

Both executives from Chinese and foreign-owned companies in our sample believe that success in China is linked to product and service quality superiority coupled with cost control and operations efficiency. Interestingly, the ability to control costs was not in the Top 4 of challenges five years ago. The fierce competition in the current economy forces companies in China to be careful with their operating expenses if they want to survive and be profitable.

Brand awareness and creation is a top concern for foreign companies pooled (40% cite it as key factor), but less so for their Chinese counterparts (27%) . Soft factors such as company culture & values and quality of the management team also make the Top 4 Success Factors in the 2017 survey. "Employee selection and training", although not in the Top 4 list, stands out as a factor more frequently considered key to success by foreign companies than by Chinese companies, 24% of foreign firms vs. 16% of Chinese firms.

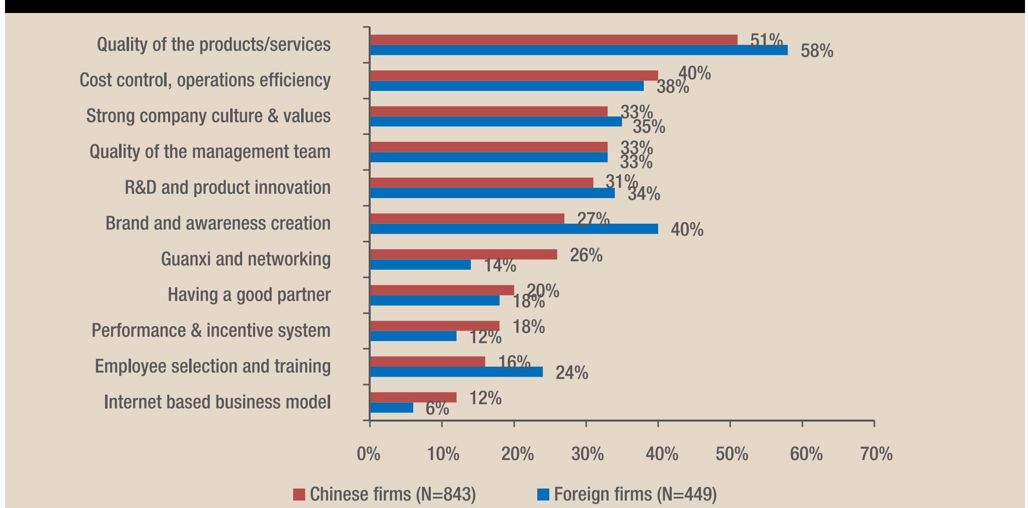
**Chinese firms – Top 4 Success Factors**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Quality of the products/services (51%) | Quality of the products/services (56%) |
| 2 | Cost control, operations efficiency (40%) | Quality of the management team (43%) |
| 3 | Quality of the management team (33%) | Strong company culture & values (42%) |
| 4 | Strong company culture & values (33%) | R&D and product innovation (41%) |

**Foreign firms – Top 4 Success Factors**

| | 2017 Survey | 2013 Survey |
|---|---|---|
| 1 | Quality of the products/services (58%) | Quality of the products/services (64%) |
| 2 | Brand and awareness creation (40%) | Quality of the management team (50%) |
| 3 | Cost control, operations efficiency (38%) | Strong company culture & values (48%) |
| 4 | Strong company culture & values (35%) | Brand and awareness creation (45%) |

**FIGURE 44 - 2017 SURVEY: WHAT ARE THE MOST IMPORTANT FACTORS FOR YOUR COMPANY'S SUCCESS IN CHINA?**

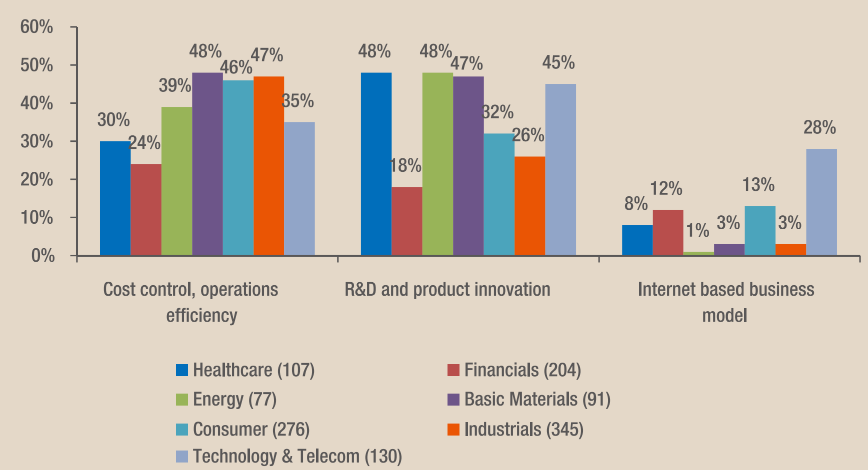


When analyzing success factors by type of industry, some differences are revealed: According to our sample of surveyed companies, cost control and operations efficiency is considered a success factor more often for companies operating in mature sectors like Basic Materials, Industrials and Consumers (48%, 47% and 46% of them, respectively). In contrast, more recently established sectors, like Financials and Healthcare, seem to rely less often in operation efficiency as key to their success (24% and 30%, respectively).

Healthcare, Energy, Basic Materials and Technology and Telecommunications firms in our sample rely in R&D and Product Innovation more often than firms in other sectors, with 48%, 48%, 47% and 45% of them choosing it as a success factor. This contrasts with a much lower 18% of companies in the financial sector emphasizing the role of innovation in their success.

The internet is revolutionizing the way business is conducted in China and around the world. However, our sample reveals that for the time being, its effect in China is stronger in some industries than for others. Firms in Technology and Telecommunications sectors seem to rely on internet based business models more often than firms in other sectors: 28% of sampled firms for Technology & Telecom vs. 1% for Energy and 3% for Basis Materials and Industrials.

FIGURE 45 - BY INDUSTRY: WHAT ARE THE MOST IMPORTANT FACTORS FOR YOUR COMPANY'S SUCCESS IN CHINA?



SECTION 4

# FOCUS BY AREA

This section gives an overview of the following topics:

- Human Resources
  The chapter covers the top HR issues that companies in our sample face in China. It also gives an in-depth commentary on what the executives in our sample think are the most effective measures to retain employees.
- Sales and Marketing
  This chapter describes the competitive landscape and includes an overview of the market segments where companies in our sample operate. It also details which are the most effective sales and marketing strategies for the companies in our sample.
- Research & Development
  This chapter presents a summary of main learning's on R&D trends from our sample of surveyed companies.
- Government and Legal Environment
  This chapter discusses the perceived important of establishing relationships with the Chinese government as well as polled executives' outlook on corruption in their industries and in general.

## 4.1. HUMAN RESOURCES

*Labor force increased in 2016 for 55% of the sample while it stayed stable or decreased for the other 45%. Chinese SOE's and firms in rapidly growing sectors (Healthcare, Financials and Technology & Telecom) lead the workforce growth. Finding talent and rising labor costs are cited as the top HR issues for managing businesses in China. Offering a good career path and developing a feeling of belonging to the company are cited most often as successful strategies to retain employees.*

### 4.1.1. Change in labor force, employee turnover and salary increase

In line with the overall positive business performance experienced by our sample of firms in 2016 (see Section 2.1 of this report), a large proportion of the surveyed companies increased their labor force in 2016: 62% of Chinese SOE, 59% of Chinese private and 46% of foreign firms. Chinese SOEs are the companies sampled showing overall lower levels of salary increase and employee turnover in 2016.

The transformation of the Chinese economy from heavy industry and manufacturing to a more modern one with a higher representation of services and technologies can be witnessed in our sample of surveyed companies. Analyzing the data by industry, we discover that it is Healthcare, Financials and Technology & Telecom firms that have proportionally increased their in labor force the most in 2016, with 70%, 66% and 59% of them expanding in number of employees. This compares to a significantly lower 46% for companies in the industrial sector. Also in line with the economy transformation of China, we note 61% of firms dealing with services increased labor force in 2015 compared to a lower 49% of firms in the manufacturing side of their industries

FIGURE 46 - BY LEGAL STATUS - THE CHANGE IN YOUR COMPANY LABOR FORCE IN 2016 VS. 2015 IS:

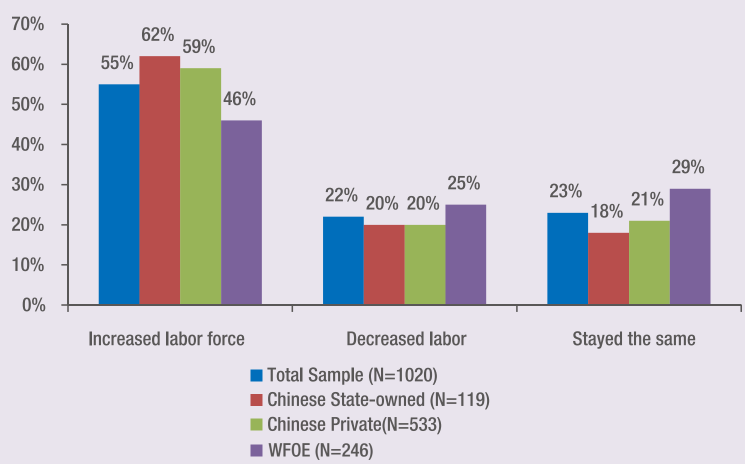


FIGURE 47 - BY INDUSTRY - THE CHANGE IN YOUR COMPANY LABOR FORCE IN 2016 VS. 2015 IS:

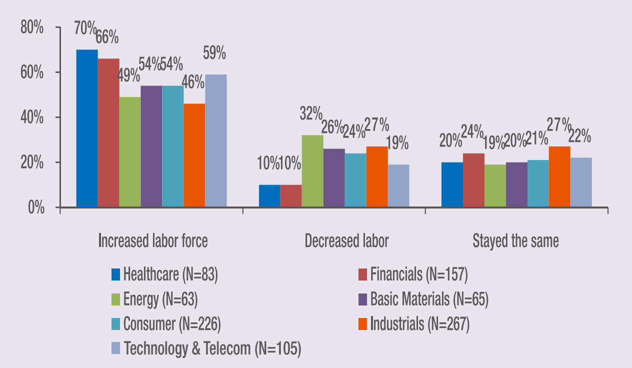



FIGURE 48 - BY SECTOR - THE CHANGE IN YOUR COMPANY LABOR FORCE IN 2016 VS. 2015 IS:

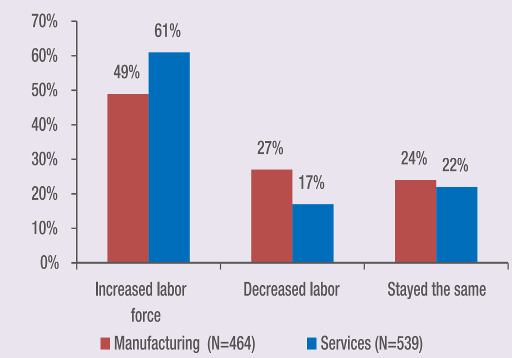



FIGURE 49 - THE TOTAL SALARY INCREASE IN 2016 COMPARED TO 2015 IS:

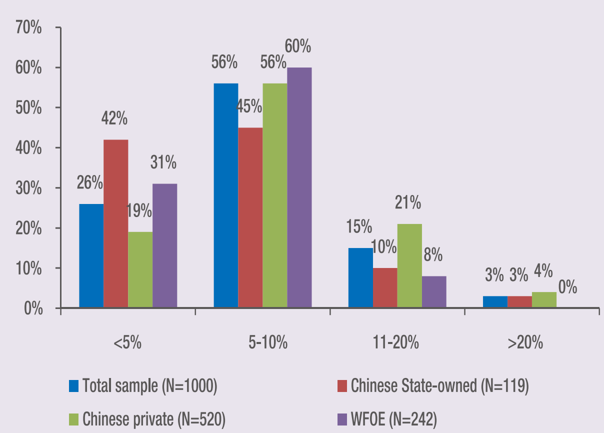
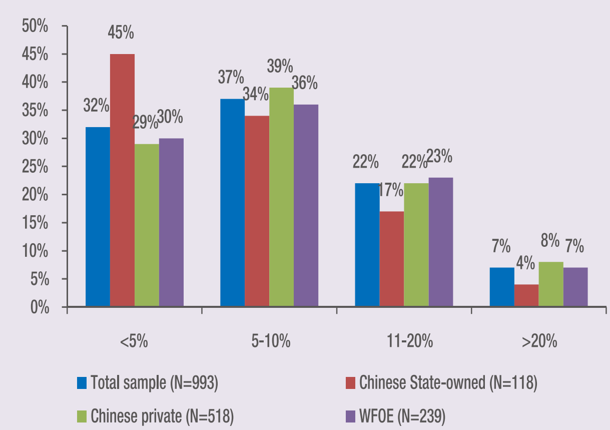



FIGURE 50 - THE TOTAL EMPLOYEE TURNOVER IN 2016 COMPARED TO 2015 IS:

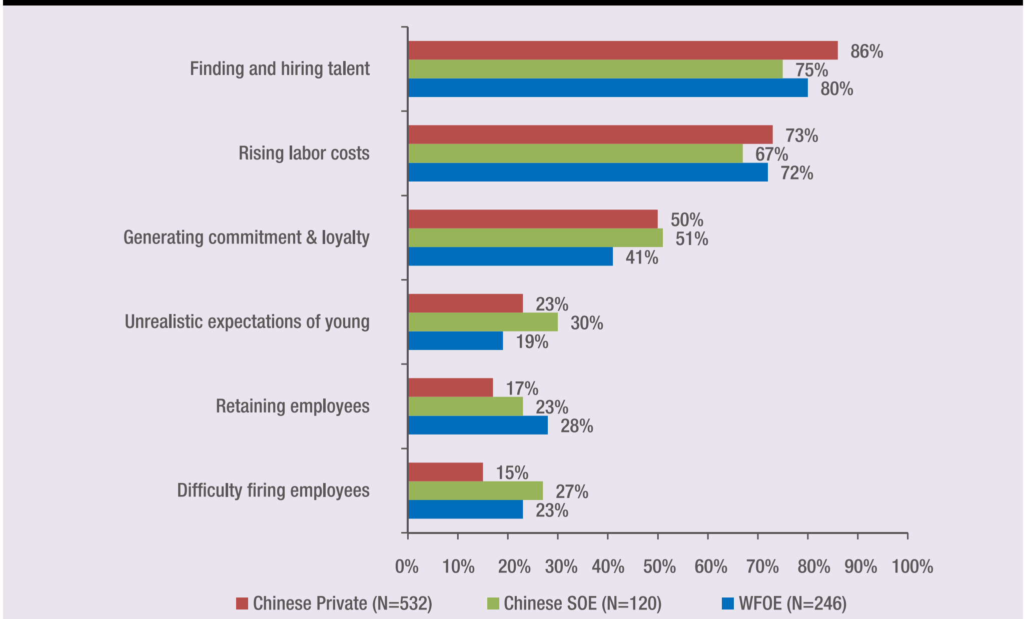



### 4.1.2. Top Human Resources issues in China

Consistent with previous years, "Finding and hiring suitable talent", "Rising labor costs" and "Generating commitment and loyalty" are the top HR concerns for surveyed Chinese and foreign companies. The rapid growth of Chinese private firm results in them struggling relatively more than SOEs and foreign firms with "Finding and hiring suitable talent" (86% of Chinese private firms, vs. 75% of SOEs and 80% of foreign firms declare issues in hiring suitable talent). Healthcare, Consumer and Technology & Telecommunications have encountered the most problems finding fitting talent with 86% and 85% and 85% of them reporting staffing to be a key HR issue in 2015. Industrials and Healthcare declare to struggle more often with the issue of rising labor costs (79% and 73% of them, respectively).

The most cited causes why sampled companies loose employees are them leaving to take care of their family, start their own businesses or work for other Chinese private companies. Foreign-owned firms (WFOEs) lose their employees also to other foreign firms although this happens less often to Chinese owned firms. On the other hand, Chinese SOEs lose employees to Chinese private companies more often than WFOEs and Chinese private companies.

## FIGURE 51 - BY COMPANY TYPE: WHICH ARE THE MAJOR HUMAN RESOURCES ISSUES FACING YOUR COMPANY IN CHINA?




## FIGURE 52 - BY INDUSTRY: WHICH ARE THE MAJOR HUMAN RESOURCES ISSUES FACING YOUR COMPANY IN CHINA?

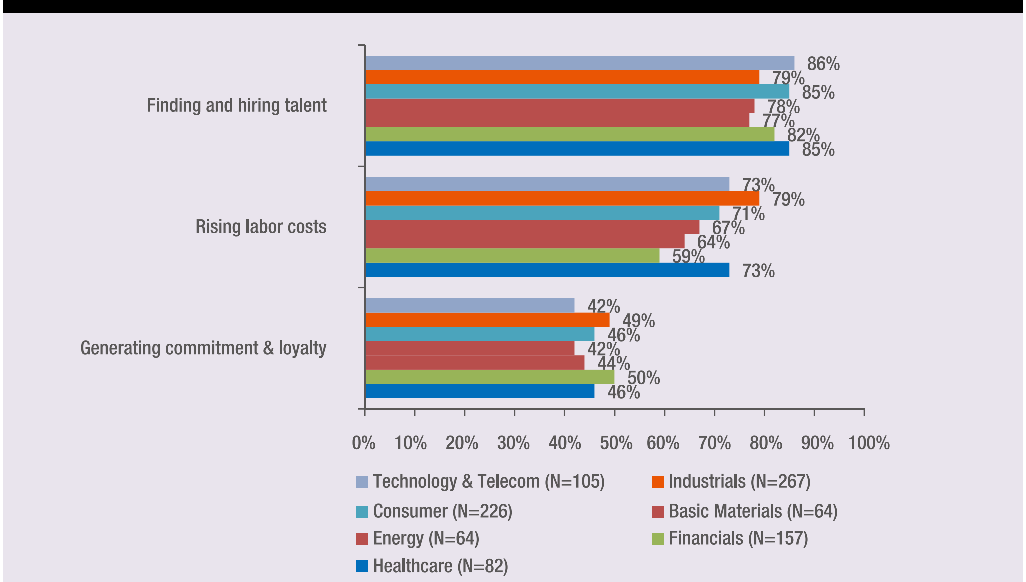
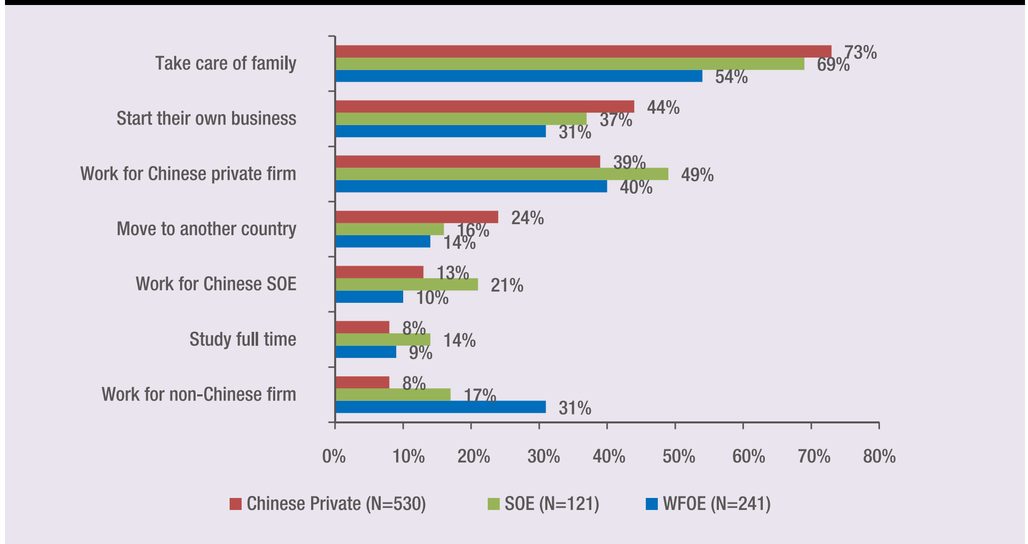


FIGURE 53 - BY COMPANY TYPE: PEOPLE WHO LEAVE YOUR ORGANIZATION USUALLY GO TO:

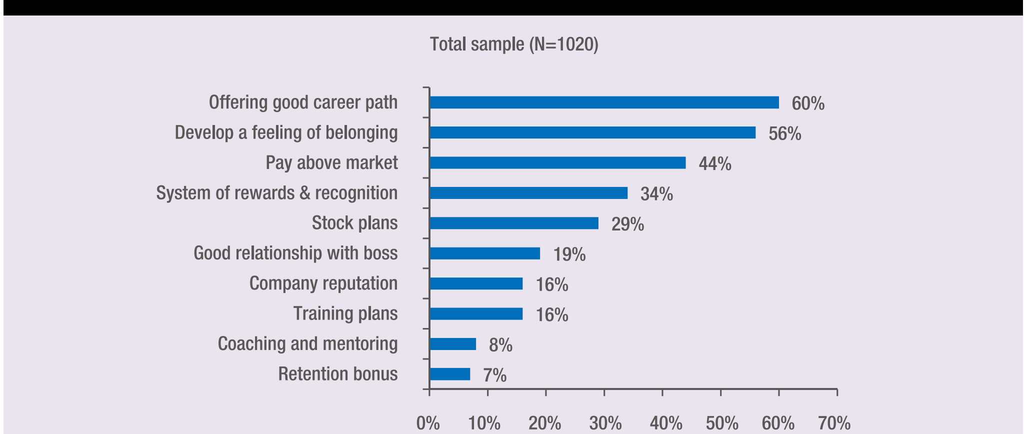



**4.1.3. Most effective measures to retain employees**

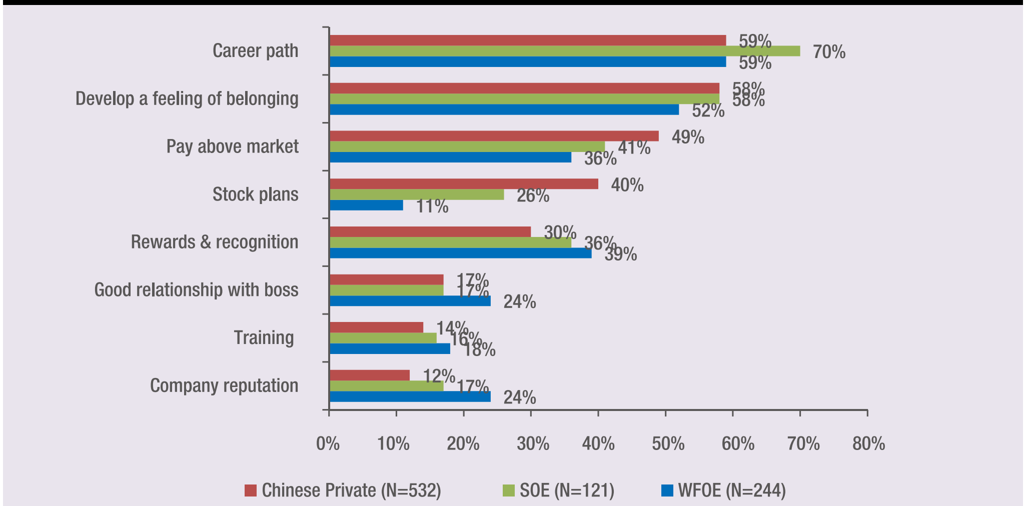
In terms of most efficient measures to retain employees, “Offering good career path” is cited as most efficient measure by 60% of the total sample. It is closely followed by “Develop a feeling of belonging to the company” (56% of the sample). Both sets of measures come before salary as “Pay above market” is the third most mentioned measured cited by 44% of sampled companies.

We observe differences in the relative weight of some of the strategies between types of firms. A larger proportion of Chinese private firms favor compensation related measures when compared to SOEs or foreign firms. Offering good career path is favored more often by SOEs than by Chinese private firms or WFOEs. The use of stock plans to retain employees, even if less frequent, is more successful amongst Chinese private firms (40% of Chinese private firms, 26% of SOEs and 11% of WFOEs). On the other hand, foreign firms put more emphasis on company reputation and keeping a good relationship with the boss.

FIGURE 54 - TOTAL SAMPLE - WHAT MEASURES DO YOU FIND MOST EFFICIENT IN RETAINING EMPLOYEES?



## FIGURE 55 - BY COMPANY TYPE: WHAT MEASURES DO YOU FIND MOST EFFICIENT IN RETAINING EMPLOYEES?



## 4.2. SALES AND MARKETING

**4.2.1 Competition**
*85% of Chinese firms and 89% of foreign firms polled consider the competition in China to be intense or very intense, which is consistent with competition being the most pressing external challenge faced by our sample of companies (Section 3.1).*

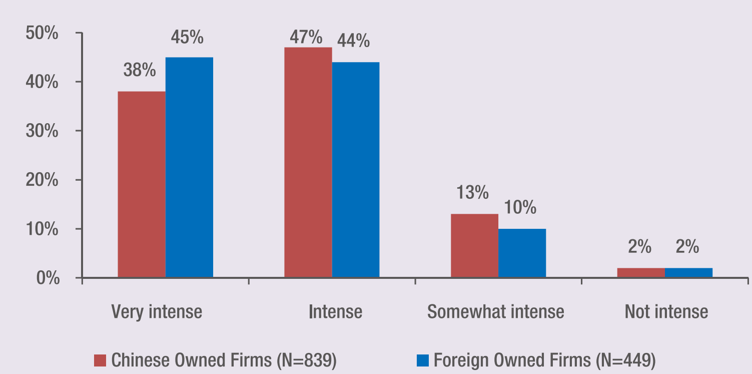
A majority of respondents cited their main competitors to be Chinese private enterprises (80% of Chinese firms and 72% of foreign firms). Chinese-owned respondents cite state-owned enterprises as a distant second (42%). In contrast, foreign companies measure themselves also amongst each other, citing WFOE (59%) as their second major type of competitor. These results are consistent with previous surveys.

The top strengths of foreign firms according to their Chinese competitors are related to their capability to create brands, the superiority of their products and their technology. In contrast, foreign-owned firms consider that their main weaknesses vis-à-vis their Chinese competitors lay in Chinese firms' superiority in "Cost advantages", "Price", and "Relationships with Government and other guanxi".

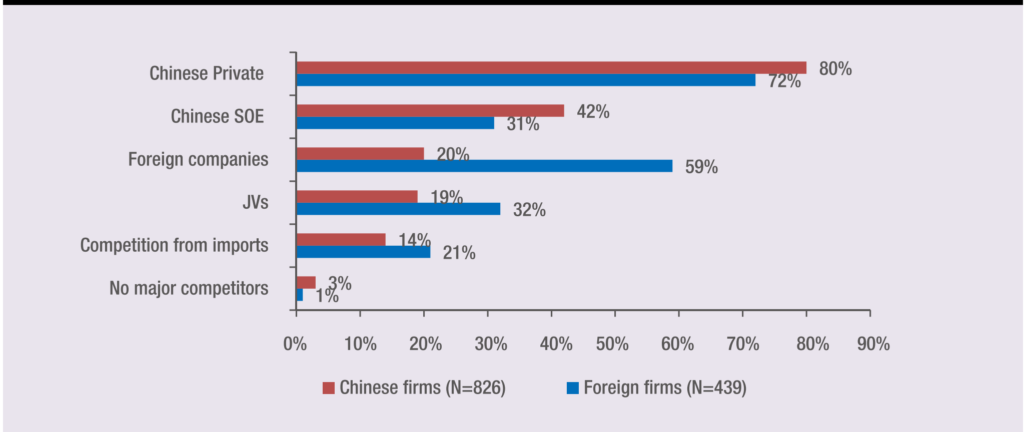
"Unethical behavior" is seen by 29% of polled executives working for foreign-firms as a competitive advantage of Chinese firms. On the contrary, a much lower 1% of executives in Chinese firms mention "Unethical behavior" as strength of their foreign competitors. This difference may be due to the sometimes stricter environmental control policies that foreign firms apply in their production sites, thus increasing their costs.

"Local knowledge and reach" is seen as a competitive advantage of Chinese firms by 28% of polled executives working for foreign-firms while only 8% of those in Chinese firms mention it as a capability of their foreign competitors.

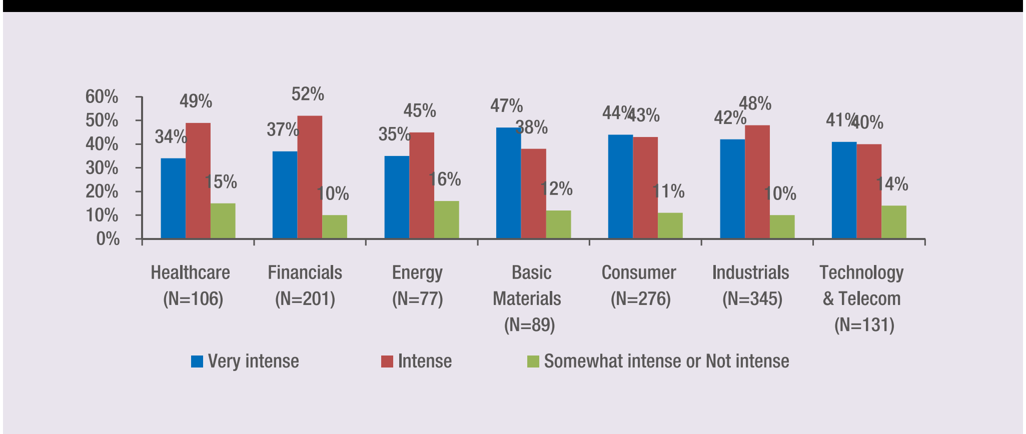
FIGURE 56 - HOW INTENSE IS THE COMPETITION YOU ARE FACING IN CHINA?



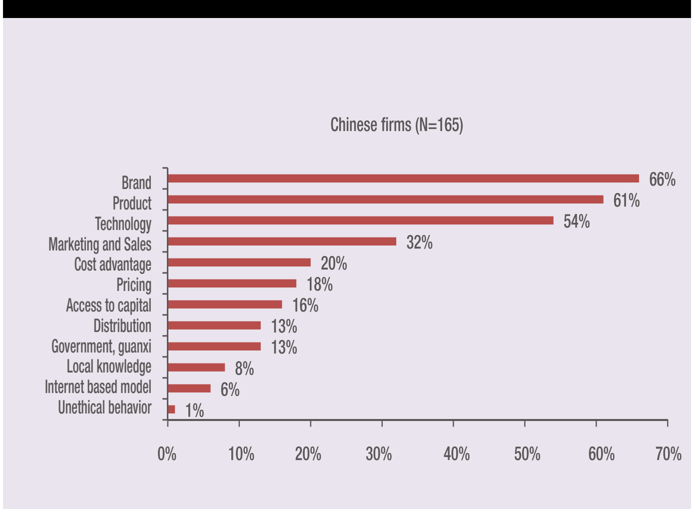
## FIGURE 57 - WHO ARE YOUR MAIN COMPETITORS IN CHINA? MULTIPLE ANSWERS



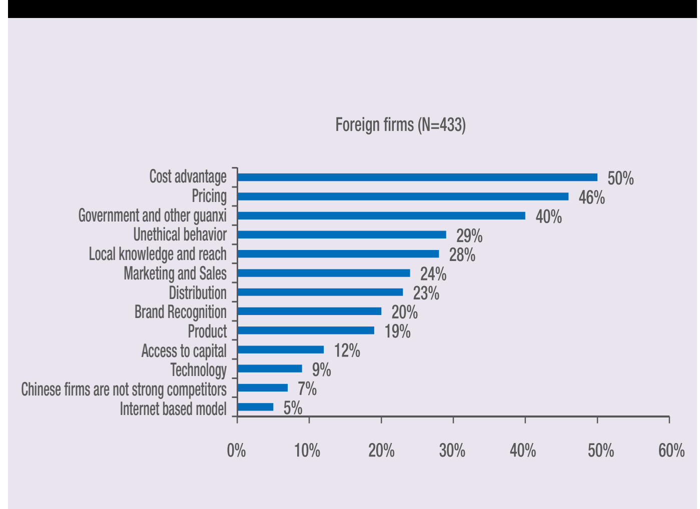

## FIGURE 58 - BY INDUSTRY - HOW INTENSE IS THE COMPETITION YOU ARE FACING IN CHINA?




## FIGURE 59 - WHAT ARE THE COMPETITIVE ADVANTAGES OF YOUR MAIN FOREIGN COMPETITORS IN CHINA? MULTIPLE ANSWERS




## FIGURE 60 - WHAT ARE THE COMPETITIVE ADVANTAGES OF YOUR MAIN CHINESE COMPETITORS IN CHINA? MULTIPLE ANSWERS



### 4.2.2. Market segments and mobility

Our sample of companies operates mainly in the premium and middle segments with 48% and 48% of companies respectively, and only a small 4% in the low-end. The foreign firms sample is more skewered towards high end markets than the Chinese sample: 70% of foreign firms declare to operate in the premium market vs. 38% Chinese firms.

In terms of segment mobility we see that even if a majority of companies plan to grow future sales within their existing segment, there is still a significant amount of companies that plan to grow outside of their current segment. This trend is stronger for companies in the low and middle segments where 48% and 32% of them, respectively, plan to move up into the next segment. For companies currently operating in the premium segment, a smaller proportion (22%) of them wants to expand down into the middle segment.

FIGURE 61 - WHICH IS YOUR MAIN MARKET SEGMENT IN CHINA?

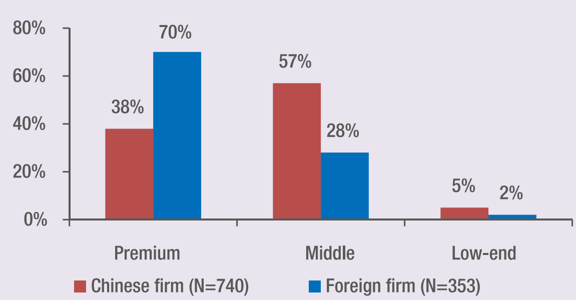
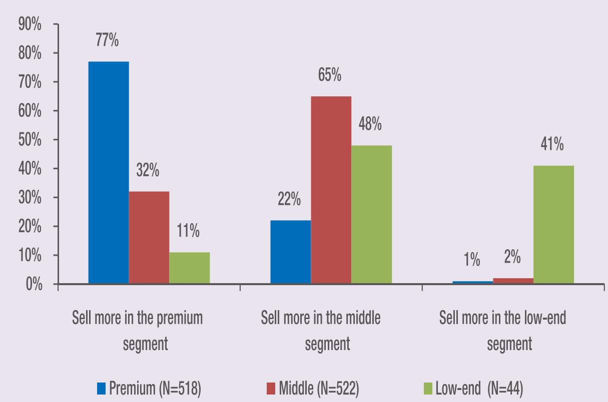



FIGURE 62 - WHAT ARE YOUR PLANS FOR THE FUTURE?




### 4.2.3. Marketing, Sales and Distribution strategies

Marketing & Sales spending: There is no significant difference in marketing and sales spending for Chinese owned and foreign-owned firms or in their spending intention for the coming year. However, we remark important differences between B2C and B2B companies with the former dedicating more important budgets to marketing and sales activities. These results are consistent with previous edition of this survey not surprising given the high cost in China of advertising and promotion activities directed to the consumer.

When analyzing marketing investments by sector, the industries with larger percentage of players declaring marketing investments of above 10% of revenues are Healthcare, Technology & Telecommunications and Consumer goods or services. In contrast, 60% of respondents working in Basic Materials and 45% of those in Industrials claim to spend in marketing & sales activities below 5% of their revenues. Companies operating in the medium and low-end segments of the market tend to have larger marketing & sales spending than those in the premium sectors.

Sales strategies: B2B companies in our sample emphasize providing service and high quality above other factors. However, executives in B2C companies consider their distribution network most often as a key success factor for their sales.

Marketing strategies: Most cited marketing expenditures for B2B companies in our sample are visits to clients or prospective clients, followed distantly by organizing seminars and attending conferences. In contrast, B2C firms favor mostly social media, internet marketing and traditional advertising. When trying to understand more about main users of social media as a marketing tool, we see that 56% of sampled low-end companies rely on it (amongst other marketing tools), versus a lower 33% of companies in the middle segment and 27% of those operating in the higher end of the market.

Distribution network: 21% of the total sample considers their distribution network in China to be bad or very bad, 49% consider it sufficient and 30% of them label it efficient or very efficient. More firms in B2C label are satisfied with their distribution system than firms in B2B. Companies operating in the low-end segment appear to be most satisfied with their distribution system (49% of them describe it as efficient or very efficient vs. lower 26% of companies in the middle segment and 32% of those in the premium segment).

Companies using the internet as sales channel report higher levels of satisfaction than those keeping traditional channels with 35% of them claiming to be satisfied or very satisfied with their distribution network vs. 26% of companies without internet sales.

**FIGURE 63 - BY B2B/B2C: WHAT % OF YEARLY REVENUES DO YOU SPEND IN MARKETING & SALES?**

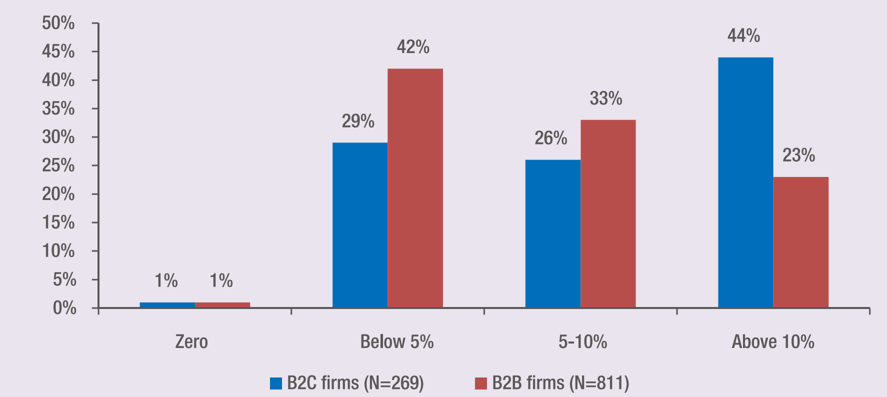
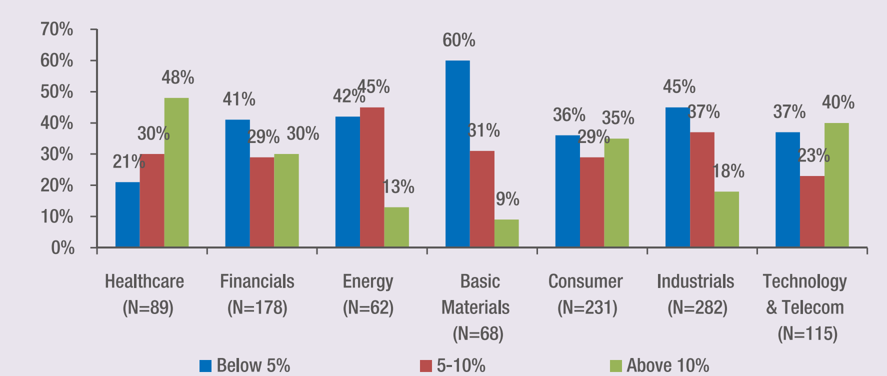
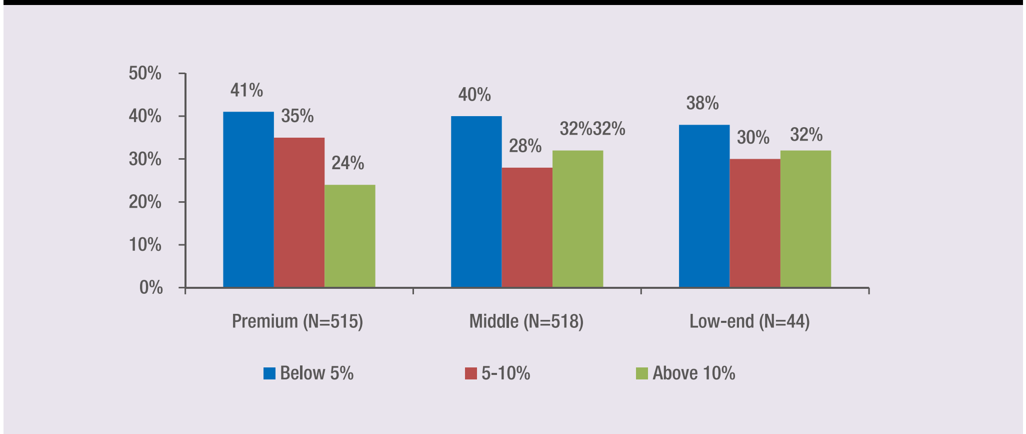


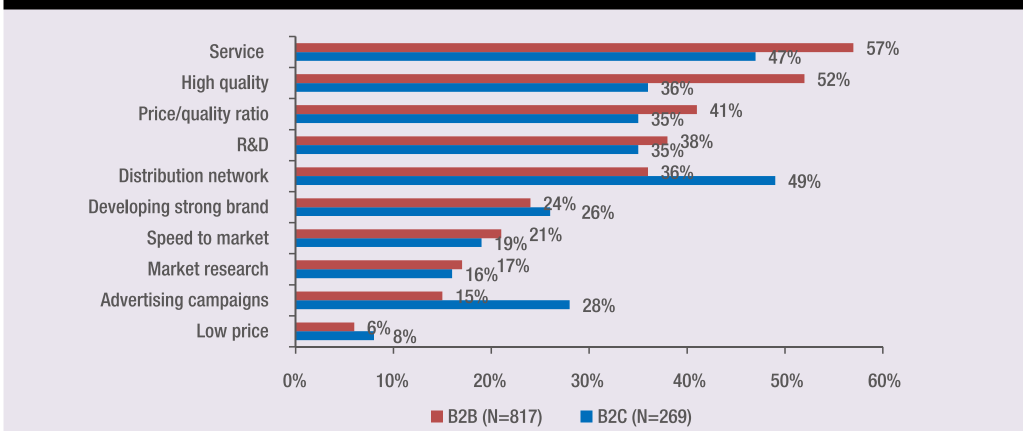

**FIGURE 64 - BY INDUSTRY - WHAT % OF YEARLY REVENUES DO YOU SPEND IN MARKETING & SALES?**



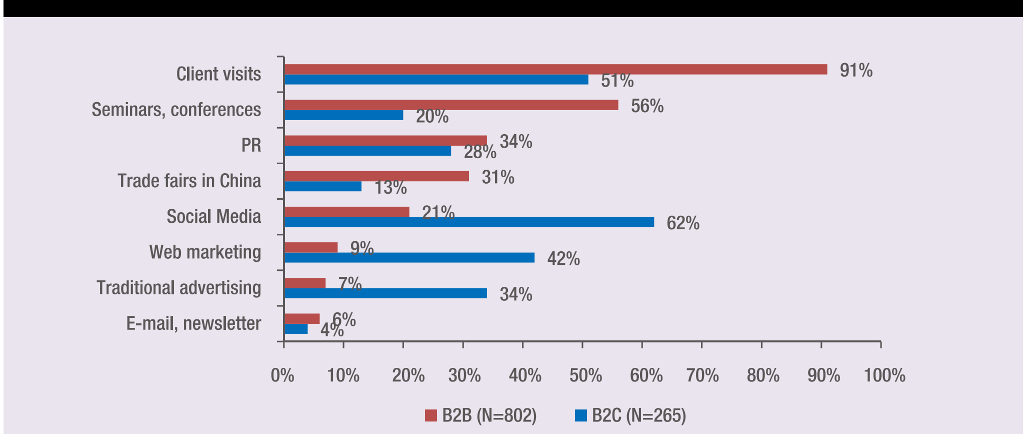
## FIGURE 65 - BY MARKET SEGMENT - WHAT % OF YEARLY REVENUES DO YOU SPEND IN MARKETING & SALES?



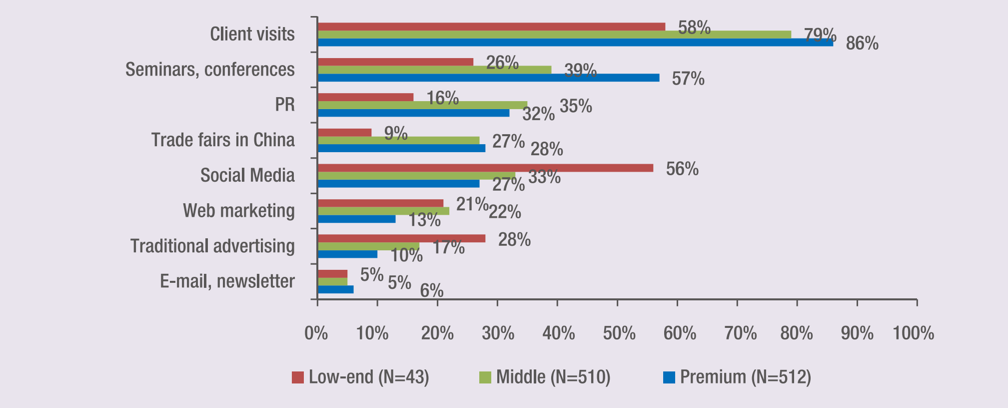

## FIGURE 66 - BY B2B / B2C: PLEASE CHOOSE THE MOST IMPORTANT FACTORS ON THE SUCCESS OF YOUR SALES IN CHINA. MULTIPLE ANSWERS POSSIBLE



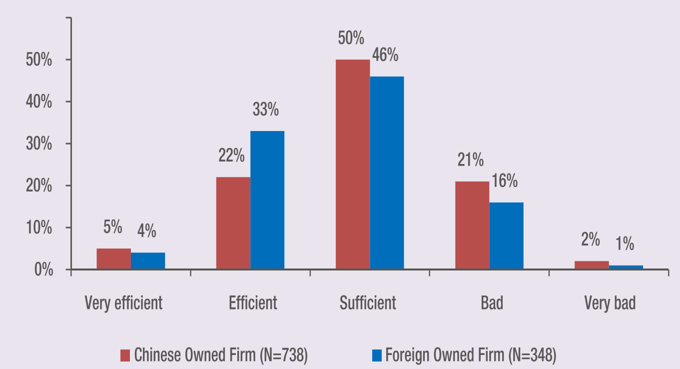

## FIGURE 67 - BY B2B/B2C: WHICH MARKETING ACTIVITIES ARE MOST EFFECTIVE FOR YOUR MAIN BUSINESS?



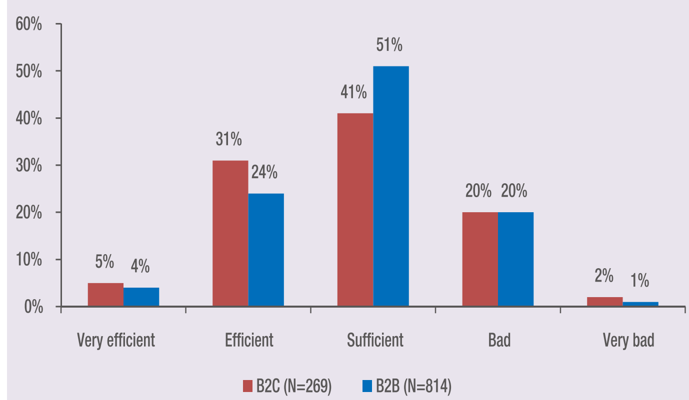
## FIGURE 68 - BY MARKET SEGMENT - WHICH MARKETING ACTIVITIES ARE MOST EFFECTIVE FOR YOUR MAIN BUSINESS?



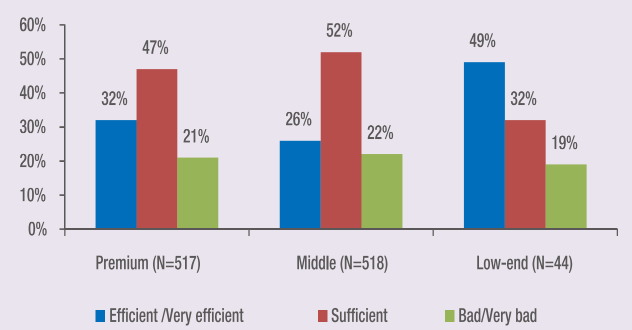

## FIGURE 69 - HOW DO YOU EVALUATE YOUR COMPANY DISTRIBUTION NETWORK IN CHINA?



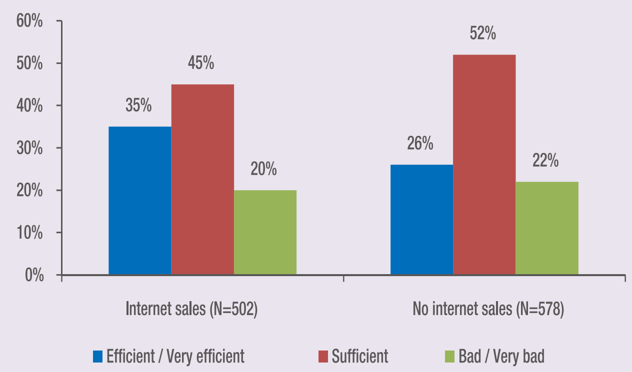

## FIGURE 70 - BY B2B/B2C - HOW DO YOU EVALUATE YOUR COMPANY DISTRIBUTION NETWORK IN CHINA?



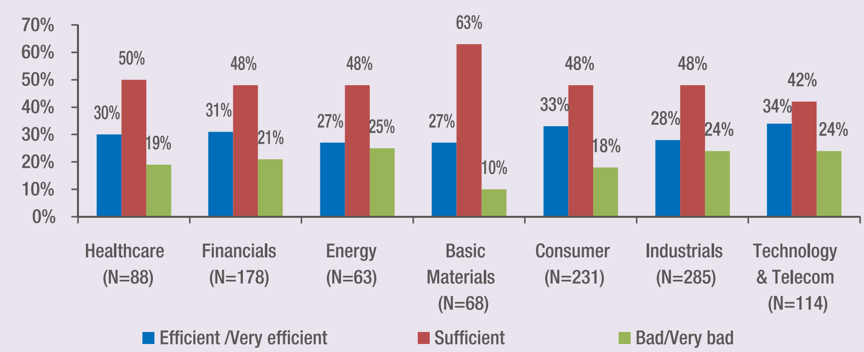
## FIGURE 71 - BY MARKET SEGMENT- HOW DO YOU EVALUATE YOUR COMPANY DISTRIBUTION NETWORK IN CHINA?




## FIGURE 72 - INTERNET SALES YES/NO - HOW DO YOU EVALUATE YOUR COMPANY DISTRIBUTION NETWORK IN CHINA?




## FIGURE 73 - BY INDUSTRY - HOW DO YOU EVALUATE YOUR COMPANY DISTRIBUTION NETWORK IN CHINA?



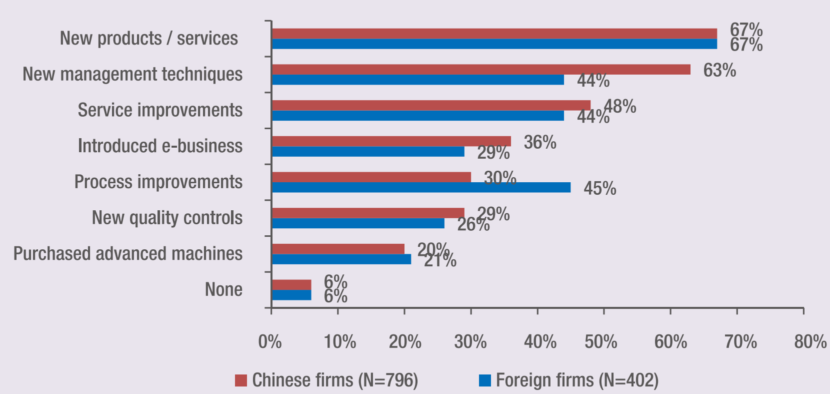
## 4.3. RESEARCH & DEVELOPMENT

*Chinese and foreign executives who participated in this year's survey report high levels of innovation for their companies as 67% of them have introduced new products or services in 2016. More Chinese firms declare introducing new management techniques than foreign ones (63% vs. a lower 44% of foreign firms). Service improvements, introduction of e-business and process improvements have been popular within our sample too.*

Levels of R&D investment vary for Chinese and foreign companies in our sample with Chinese firms leading in large investments (above 10% of revenues). This tendency appears to be consolidating further as 60% of executives working for Chinese firms declare intention of their company to increase R&D spending in the next three years vs. a significantly lower 48% of executives working for foreign firms. Within Chinese companies, it is private firms that take the lead in intention to expand R&D investment.

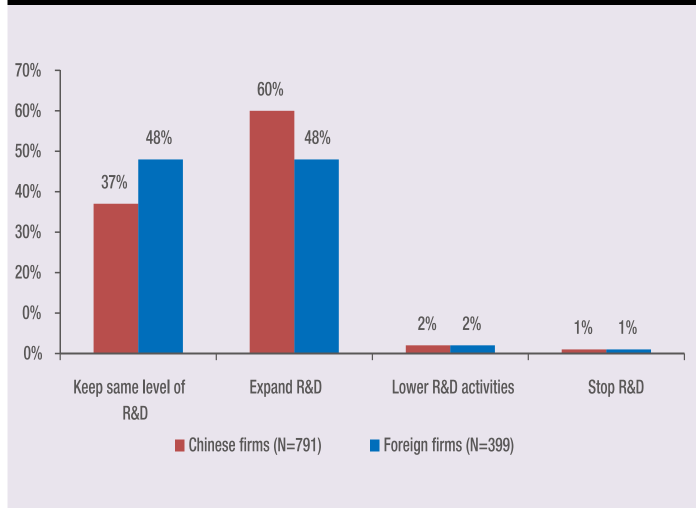
When we explore R&D investment by industry in our sample we observe that Technology & Telecommunication have the highest percentage of "big R&D spenders", or firms that devote more than 5% of their sales revenues to R&D (65% of them), closely followed by Healthcare (56% of them). In contrast, lower 15% of Basic materials companies declare such high R&D investments.

FIGURE 74 - WHAT TYPES OF INNOVATIONS HAVE YOU INTRODUCED IN 2016?

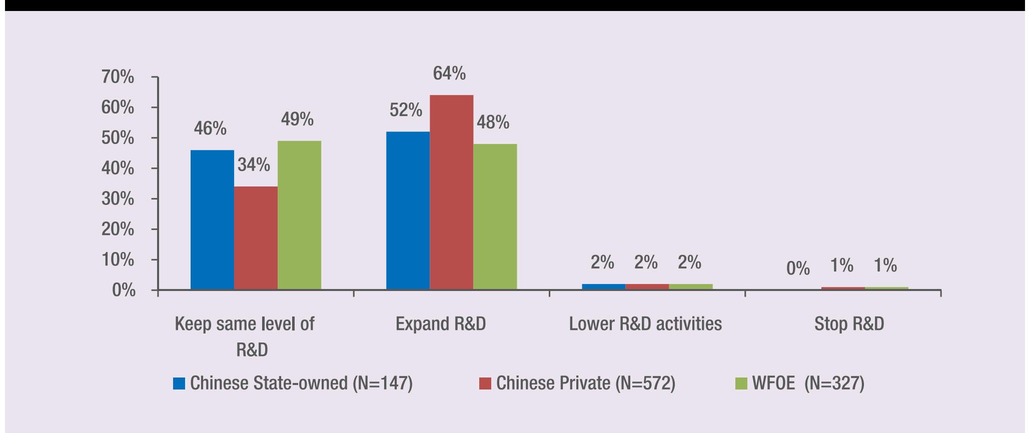


### FIGURE 75 - WHAT IS YOUR ANNUAL EXPENDITURE IN R&D AS A % OF REVENUES?


### FIGURE 76 - WHAT ARE YOUR PLANS FOR THE NEXT 3 YEARS?




### FIGURE 77 - BY TYPE - WHAT ARE YOUR PLANS FOR THE NEXT 3 YEARS?




### FIGURE 78 - BY INDUSTRY - HAVE YOU INTRODUCED NEW PRODUCTS OR SERVICES IN 2016?

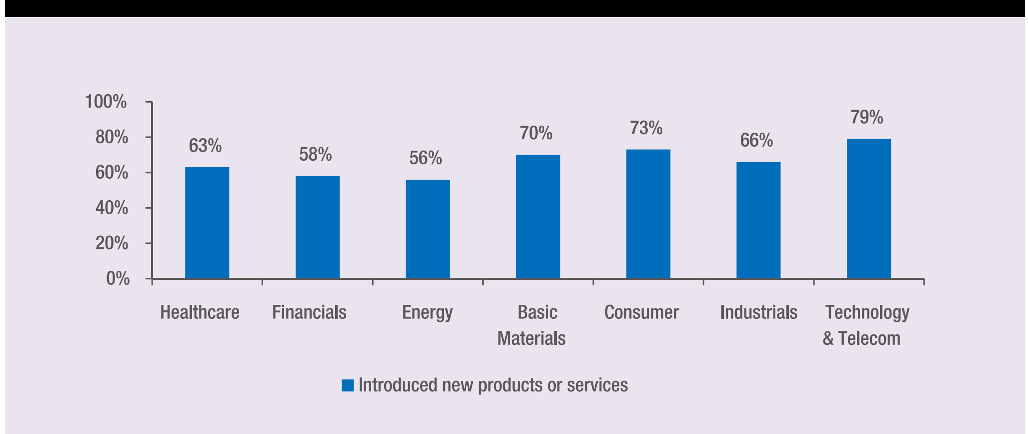
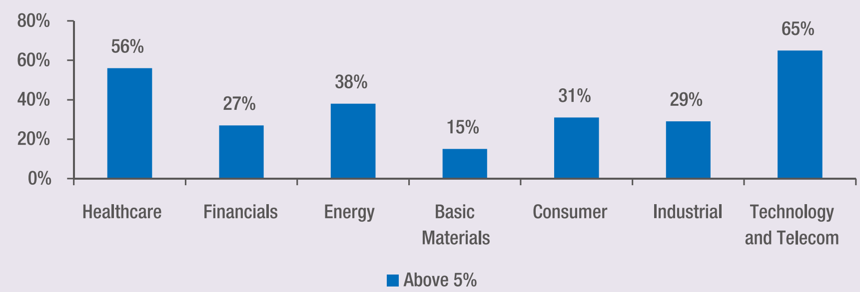


FIGURE 79 - ZOOM BY INDUSTRY: ANNUAL R&D EXPENDITURE ABOVE 5% OF SALES REVENUES



## 4.4. GOVERNMENT & LEGAL ENVIRONMENT

### 4.4.1. Government relationships

*70% of the sample executives view the relationship with the Chinese authorities as important or very important to their businesses, regardless of whether they work for a Chinese or foreign firm. However, it is Chinese state-owned firms that emphasize most the importance of this relationship, with 38% of them labeling it critical for business success.*

When analyzing by industry, we observe different levels of importance of government relationships. Our polled sample would suggest that such relations may be more significant for companies operating in Healthcare, Financials or Energy, where 86%, 86% and 73% of their executives in our sample have labeled them important or critical.

FIGURE 80 - HOW IMPORTANT ARE THE RELATIONSHIPS WITH THE AUTHORITIES?

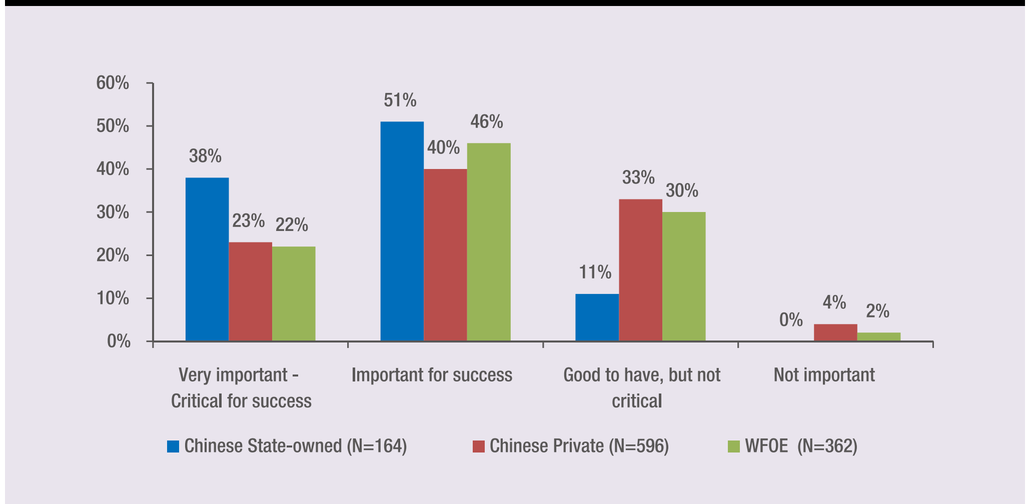
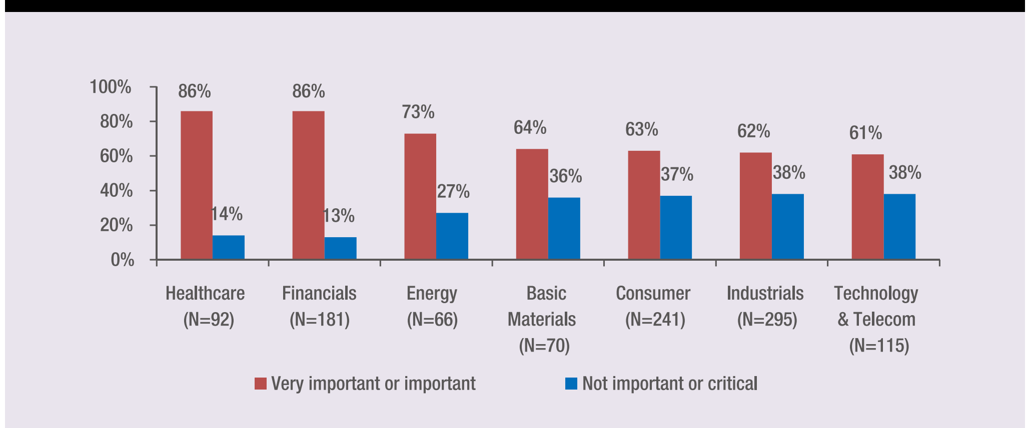



FIGURE 81 - BY INDUSTRY HOW IMPORTANT ARE THE RELATIONSHIPS WITH THE AUTHORITIES?



### 4.4.2. Corruption

The Corruption Improvement Index is based on the multiple choice question “In your view, how is corruption in your industry compared to last year?” and it is built in similar way to the well-known Purchasing Managers’ Index (PMI) . A reading of 50 means that corruption is unchanged; a number over 50 indicates an improvement while anything below 50 suggests a worsening of the situation in the past year. The further away from 50 the index is, the stronger the improvement over the year.

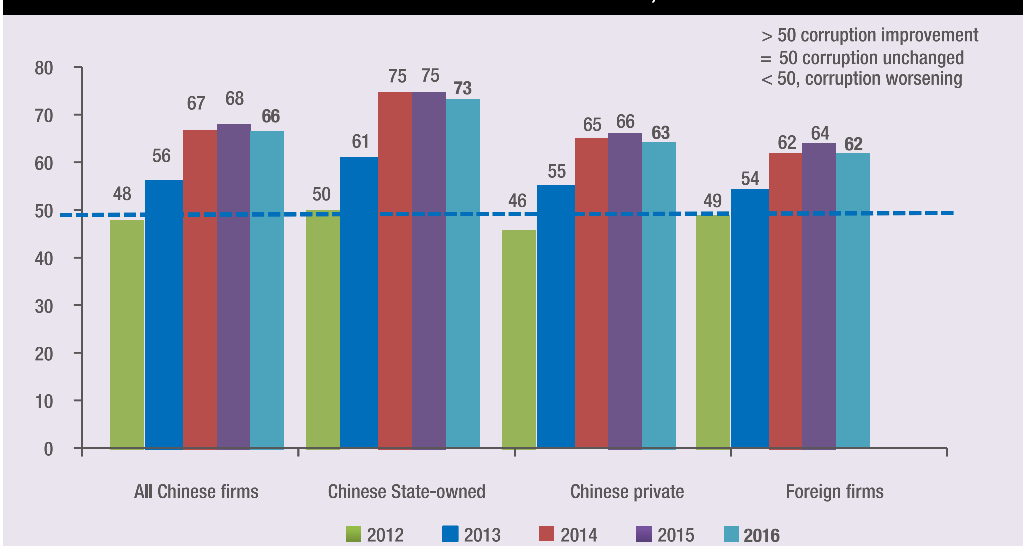
After four years observing the Corruption Improvement Index get better year after year, 2016 shows a slight deterioration. The index is still larger than 50, meaning that our sample perceives an improvement in the corruption situation in 2016 vs. 2015. However, its value is smaller than what it was in 2015.

An interesting phenomenon that we have been observing in all editions of this survey is that respondents perceive corruption in China as being less acute when asked about one’s own industry than when asked about the country in general. When we ask our sample about general corruption in China, a large majority (68% of respondents) view corruption in China to be a problem (moderate to serious). However, when asked about corruption in their industry, the number of respondents seeing it as a problem drops to 35%. This circumstance is observed with respondents from all types of companies (Chinese private-owned firms, WFOEs and Joint Ventures), and across industries.

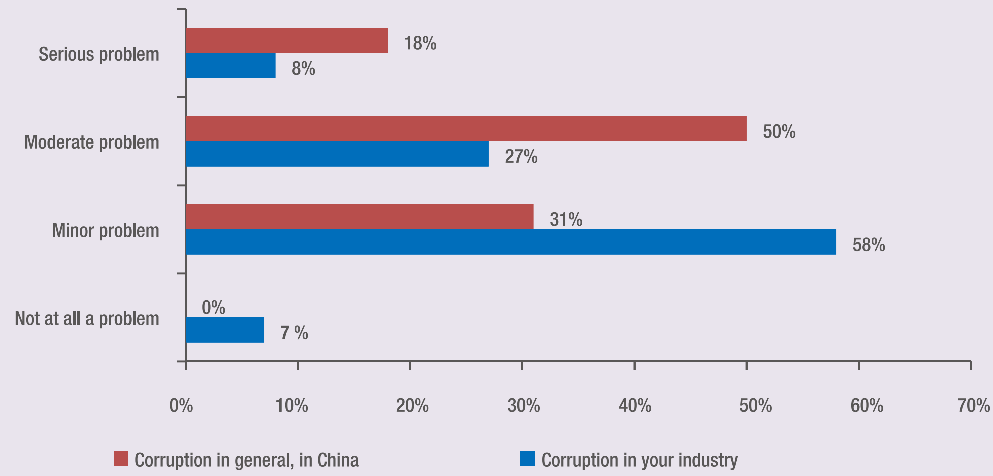
Different industries seem to perceive different levels of corruption. Of the executives surveyed, those working in Healthcare emphasize the existence of corruption in their industry much more often than others with 54% of them rating corruption in their industry as being a moderate or serious problem. Those working in Technology and Telecommunications seem to perceive corruption in their industries the least often with 76% of them considering corruption to be either nonexistent or a minor problem in their industry.

With respect to the legal status of the company, State-owned companies appear to perceive corruption as less problematic than those in the private sector. This same situation is observed whether asked about corruption in China in general or corruption in one’s own industry.

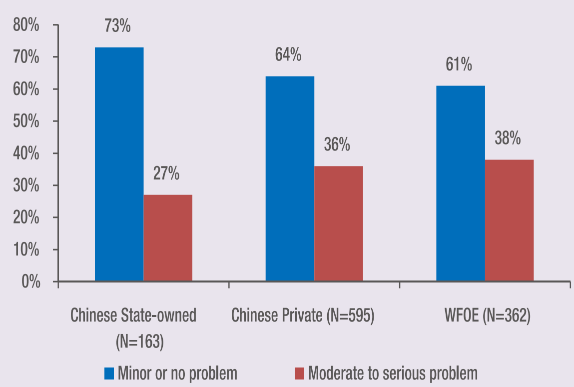
FIGURE 82 - CORRUPTION IMPROVEMENT INDEX BY COMPANY TYPE (IN YOUR VIEW, HOW IS CORRUPTION IN YOUR INDUSTRY COMPARED TO LAST YEAR?)



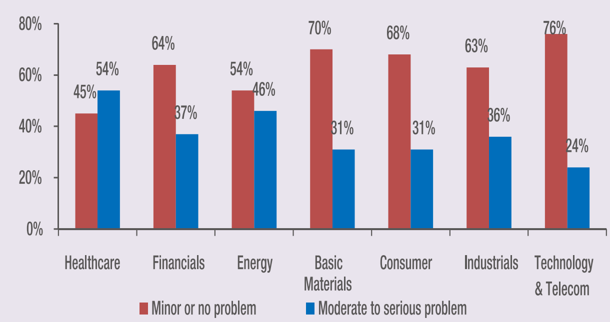
## FIGURE 83 - IN YOUR VIEW, HOW SERIOUS IS CORRUPTION IN CHINA, IN GENERAL, AND IN YOUR INDUSTRY? N=1285




## FIGURE 84 - BY COMPANY TYPE - IN YOUR VIEW, HOW SERIOUS IS CORRUPTION IN YOUR INDUSTRY?




## FIGURE 85 - BY INDUSTRY - IN YOUR VIEW, HOW SERIOUS IS CORRUPTION IN YOUR INDUSTRY?



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