

Dealing with disruption: Thriving in China's “new normal”





The slowdown in China's economic growth has drawn world-wide attention in recent months as business leaders and decision makers adjust to what the "new normal" means for the global economy.

Inside China, CEOs are facing not only the impact of the economic rebalancing, but also the impact of global disruptive trends such as increasing competition, changing consumer behaviour and digital innovation.

And yet, despite a fall in confidence since we spoke to them in the previous survey (2014), there is evidence China's CEOs are adapting to the new business environment.

China's CEOs are keenly aware of the threats and are working hard to position their businesses for growth. They intend to increase headcount and are planning to engage in more partnerships and alliances.

Following is a summary of the China findings from the PwC 18th Annual Global CEO survey. It provides a unique insight into the views of China's CEOs on growth, deals, partnerships, disruptions, technology and talent.

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Confidence tested as “new normal” sinks in



“We still believe China will be the growth leader ... you cannot help but be impressed by China's growth.”

Alexey Repik
Chairman of the Board,
R-Pharm, Russia

Confidence shifts as restructuring takes place

China's CEOs have experienced a fall in confidence since the PwC 17th Annual Global CEO Survey. Thirty-six percent are 'very confident' of their company's growth prospects in the next 12 months, down 11 percentage points from last year. Confidence in long-term growth has dropped as well, and now sits below the global average.

It appears that among global CEOs, confidence in China has shifted too. For the first time in five years the US has overtaken China as the top destination for growth.

Such an outlook is somewhat understandable given the ongoing structural rebalancing of China's economy, which continues to slow growth to a level referred to as the “new normal” by the country's leadership.

According to President Xi Jinping, under the “new normal”, China's economy “has entered a period of medium-to-high growth from high growth, a shift from quantity to quality as well as from speed to efficiency in terms of development”.

“The ‘new normal’ also requires a restructuring that focuses on improving productivity rather than on expansion in scale,” according to a statement issued after the leadership's economic work conference in December 2014.

Another feature of the “new normal” emphasises that the economy is to be driven by innovation instead of input and investment.

Yet the situation is more complicated than it appears. The challenges China faces include the continued weakness in global demand for its exports, falling business investment as a result of the rebalancing, sectors with excess capacity and a softening real estate market. On top of these, there's also changing consumer behaviour and disruption brought about by digital technology. It's no surprise that CEOs are less confident.

And yet, despite these challenges, it's not all doom and gloom among China's CEOs. Almost three quarters (71%) say there are more growth opportunities for their company now than there were three years ago. And more than half (57%) are planning to increase headcount in the next 12 months.

CEOs no doubt recognise the size and fundamental strength of China's economy, and the opportunities it presents. Even though the country in 2014 recorded its lowest annual growth in 24 years of 7.4%, this was still within the government's target range and is the envy of many countries.

In the Government Work Report delivered by Premier Li Keqiang at the annual National People’s Congress in early March 2015, China’s growth target is set at “approximately” 7%, lower than the goal of 7.5% for last year.

This new target takes into account the complicated and challenging international and domestic business environments. The government believes that with the economy expanding at such a rate, sustainable growth would be ensured.

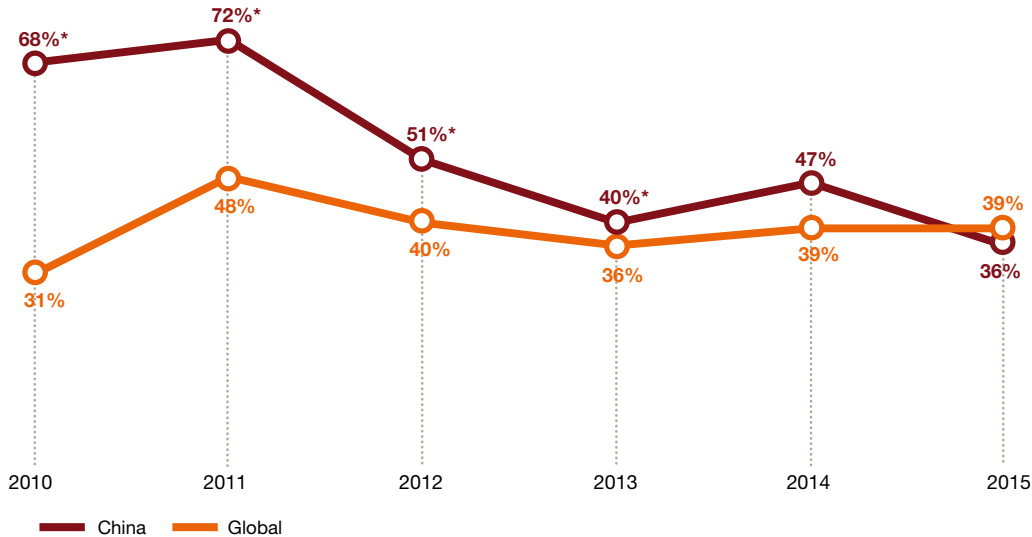
According to PwC’s latest projections, China’s economy is expected to grow at an average annual rate of 6.3% in the coming years towards 2020. Despite the lower projection, China will overtake the US to become the world’s largest economy in market exchange rate terms (MER) in 2028.¹

This complex picture of confidence in many ways reflects the intricate situation currently facing China’s CEOs. They have to work hard to find growth in a domestic economy undergoing major transformation and a global economy marked by dynamic and disruptive forces.

Figure 1

Over one third of China’s CEOs are very confident of business growth in the coming year

Q: How confident are you about your company’s prospects for revenue growth over the next 12 months?



Base: China, Global (2015 = 136, 1,322; 2014 = 66, 1,344; 2013 = 132, 1,330; 2012 = 160, 1,258; 2011 = 46, 1,201; 2010 = 60, 1,198), respondents who selected 'very confident'
 Note: *refers to China and Hong Kong figures combined

1. The World in 2050, Will the shift in global economic power continue? February 2015, by PwC

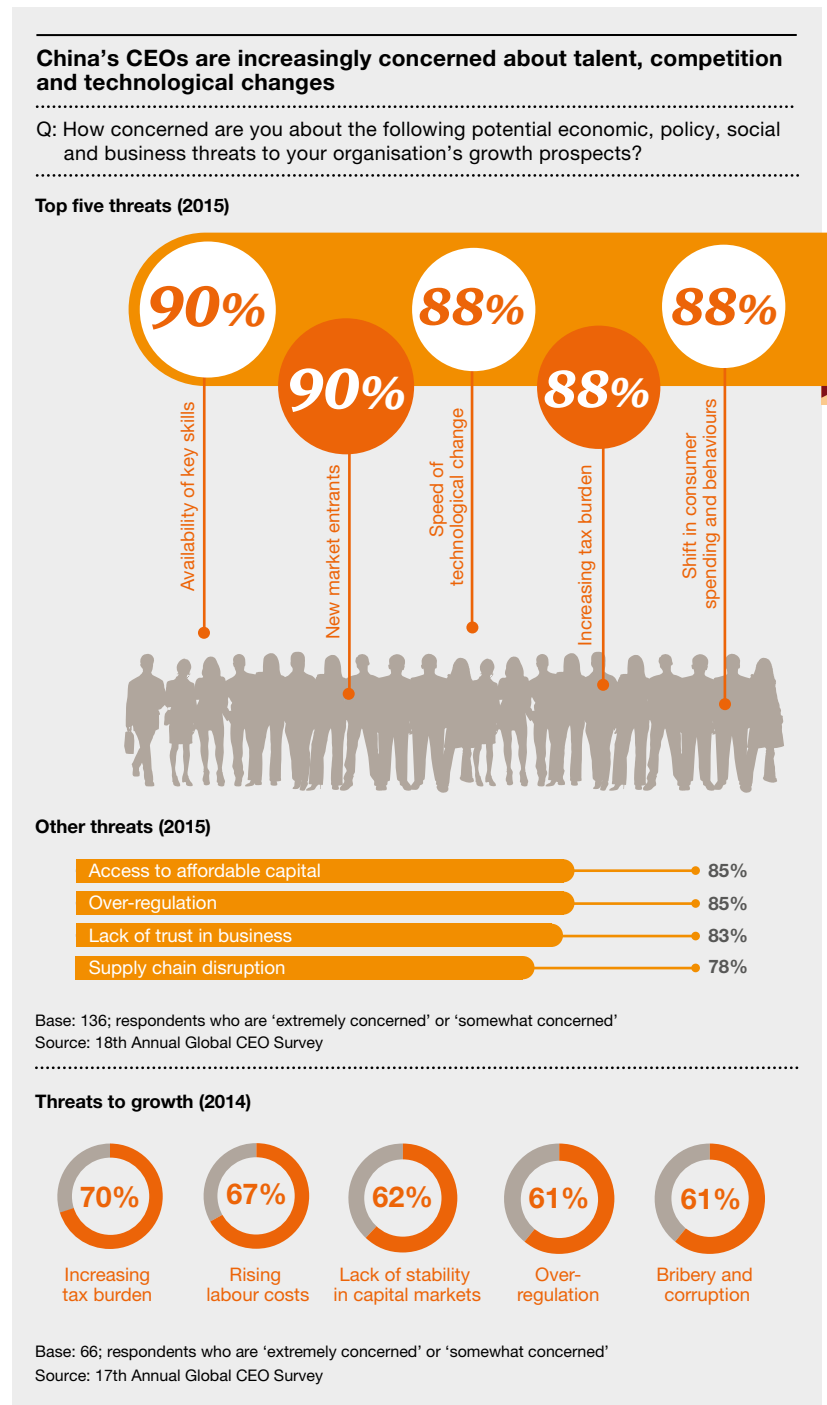
Threats to growth

China’s CEOs see threats to growth on a number of fronts. Their level of concern is higher than it was last year and generally higher than that of their global peers.

Access to affordable capital is an ongoing concern for CEOs in China. Historically, banks have tended to lend to state-owned enterprises (SOEs), which are deemed safer borrowers supported by the local or central government, than to privately-owned enterprises. As for small- and medium-sized enterprises (SMEs) in China, access to affordable capital is still a challenge despite the government’s repeated calls for change and steps taken to rectify the problem. Non-performing loans (NPL) and the NPL ratio are also likely to increase, posing a serious impact on profit growth in China’s banking industry.

But ensuring a growth-friendly environment is clearly on the government’s radar. In February 2015, the People’s Bank of China (PBOC), China’s central bank, cut benchmark interest rates for the second time in three months in an attempt to lower borrowing costs. Earlier in February, the PBOC also made it easier for lenders to increase the supply of liquidity by reducing the reserve requirement ratio (RRR), which is the amount of cash set aside for reserves, by up to 100 basis points.

Figure 2



In terms of business threats, China's CEOs are concerned about the availability of new skills, shifts in consumer behaviour, and the speed of technological change. This relates in part to the impact of the "new normal", whereby demand in China has been characterised as the "consumption of products and services (that) are more customised, personal and diverse".

China's CEOs are also worried about new market entrants. In fact, nine out of 10 CEOs say it's a key threat, by far the highest ratio of any country surveyed. This heightened awareness about the threat of competition is significant on a number of fronts. First, it is the recognition of the impact of market liberalisation, which will only increase with time as the government continues to pursue a reform agenda. Under China's economic restructuring, the government will "let the markets play the decisive role in allocating resources". Second, the cost of doing business in China is rising, making other countries with cheaper labour more competitive than they once were as a manufacturing base. Third, China's CEOs are mindful of the threat posed by emerging digital businesses that are disrupting traditional industries both in China and around the world.

Skill shortages, while not a new problem for China's businesses, have also become critical in the face of China's "new normal" and against a backdrop of an aging population. And as the government put it, "growth must come from innovation and technological breakthroughs" in China's aging society and decreasing rural workforce.

How can CEOs drive growth?

To ensure they continue to thrive in the "new normal", China's CEOs should pay particular attention to the following critical aspects of their business:

- **Competencies:** be clear about what your core competencies and strengths are, what it is you really are good at.
- **Skills:** develop smart ways to attract, incentivise and retain the right talent in your business, including digital talent.
- **Capital:** consider new and alternative ways of accessing or diversifying capital, including bank borrowing, venture capital and IPOs.
- **Innovation:** stay adaptable to available digital technologies, invest in innovation and "dare to disrupt".
- **Agility:** remain alert to disruptions, competitive threats and ongoing economic change, and be prepared to respond.

Unlocking value through disruptions

Disruptive trends: competition and the changing consumer

When China's CEOs were asked to name the most disruptive trends for their industry over the next five years, almost eight out of 10 cited increasing competition and changing consumer behaviours. They were more concerned about these trends than were their global peers.

This is because consumer behaviour has changed so substantially in China in the past few years, driven by unique demographic and technological shifts. Economic growth is leading to rising wages, urbanisation is lifting people's expectations and aspirations, and the rapid uptake of digital and mobile technology is radically altering the way people shop. Customers are increasingly demanding more personalised products and services, in everything from consumer durables to the way they bank.

"The change from gift cards to consumers' (using their) own money is driving the growth of the retail industry in a real sense."

Dong Mingzhu
President & Chairwoman,
Gree Electric Appliances Inc.
of Zhuhai, China

As China’s businesses realise the impact of these disruptive trends, and are working hard to adapt and overcome, they are also aware that such disruption brings greater opportunities for competition. Many are now finding themselves having to fend off threats not only from international technology giants, but from homegrown ones as well.

E-commerce companies such as Alibaba and online shopping malls Jingdong and Dangdang

have marginalised traditional retailers as they create a different shopping experience. Third-party payments platform Alipay, a subsidiary of Alibaba, has been challenging retail banking services by offering wealth management products online with relatively higher yields. The use of mobile internet has also extended to the car pick-up business by providing door-to-door services at competitive prices, rivalling the traditional taxi business.

Figure 3



Coming to grips with digital

Digital technology is another major disruption that continues to radically change the way businesses and consumers interact in China. In December 2014, the number of internet users topped 649 million in the country. The way people use the internet is changing too, with mobile phones (86%) now preferred over traditional desktop computers (81%)².

And while many of China's CEOs recognise the significance of these major trends on their businesses, others are less clear about how to drive value from them. Only two-thirds (67%) say they have a clear vision of how technologies can help achieve competitive advantage. This is a relatively lower percentage compared to that of the global average (86%) and the US (92%). China's CEOs have some way to go to catch up to a number of their global peers when it comes to using digital technology to drive growth.

In the face of intensifying competition and the "new normal" of slowing economic growth, China's CEOs need to make it a priority to get a better understanding of precisely how they can leverage digital technologies in their businesses. This requires thinking deeply about integrating digital innovation from the ground up, not simply "bolting on" digital parts to the organisation.

One of the genuine challenges China's CEOs face in taking full advantage of digital technologies is the restriction on the flow of data. For companies to compete effectively in digital space there needs to be a relatively free flow of information.

Businesses also need the ability to capture and analyse data effectively. For example, the ability of internet giants such as Alibaba to leverage data captured through its e-commerce sites (like TMall and Taobao) through to the digital payment mechanism of Alipay, has now facilitated a suite of targeted financial products and services.

67%

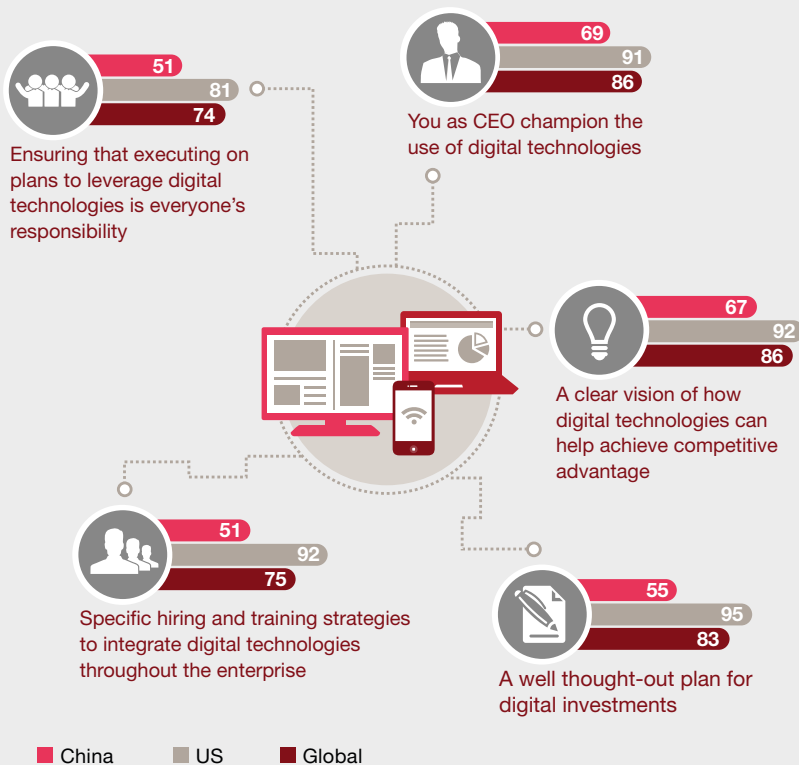
of China's CEOs have a clear vision of how technologies can help achieve competitive advantage

2. Statistic Report on Internet Development in China: the 35th Survey, January 2015, by China Internet Network Information Centre (CNNIC)

Figure 4

China's CEOs less sure than global peers about the keys to driving value from digital

Q: How important are the following factors in helping your organisation get the most out of its digital investments?



Base: China, US, Global (136, 103, 1,322), respondents who selected 'somewhat important' or 'very important'

How can CEOs turn disruption into value?

Responding effectively to the current disruptions facing China's CEOs means both making the right choices about investments and ensuring your organisation is properly aligned to best exploit them. Here are six key steps to help companies move from digital strategy to business execution:

- Adopt a "mobile first" approach to customer engagement.
- Turn social engagement into commercial impact by focusing on business outcomes.
- Understand the customer; focus on Smart Data, not only Big Data.
- Be agile in digital development and adopt a "test and learn" agenda.
- Organise around the customer; adopt a cross-functional and flexible approach to working.
- Drive additional value by using digital strategies to transform your own workforce.

Partnering for growth

JVs, alliances and restructures on the rise

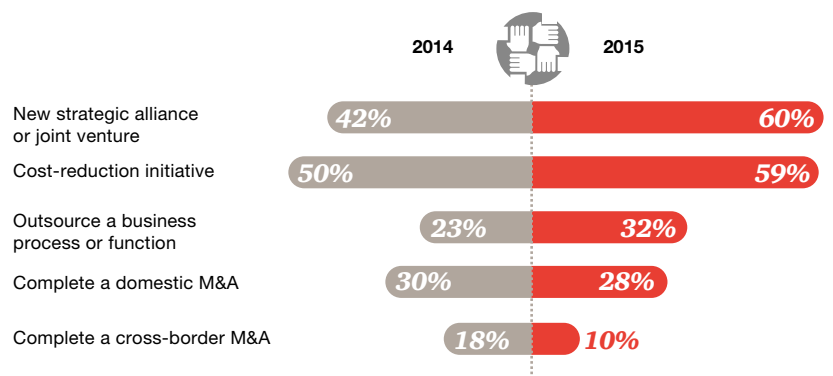
Despite challenging circumstances and tested confidences, China's CEOs are not sitting on their hands. Planned joint venture (JV), alliance and restructure activity has jumped as companies look for new ways to deliver growth.

Six out of 10 CEOs in China are looking to undertake a joint venture or alliance in the next 12 months, an 18 percentage point increase compared to the previous survey. CEOs value the greater flexibility that comes from these kinds of partnerships, particularly in the context of increasing disruption and technological change.

Figure 5

China's CEOs are planning more JVs and alliances

Q: Which, if any, of the following restructuring activities do you plan to initiate in the coming 12 months?



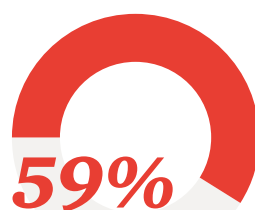
Base: China (2015 = 136; 2014 = 66)

China's CEOs are also looking to drive efficiencies internally, with 59% of respondents planning to undertake a cost-reduction initiative. And 32% are expecting to outsource a business process or function in the next 12 months, up from 23% in the previous survey.

On the mergers & acquisitions (M&A) front, China's CEOs are continuing to show a preference for local deals, with planned domestic M&A steady but cross-border M&A down from the previous survey. While SOEs were more cautious amidst the government's anti-corruption drive, ongoing SOE reforms in China were, and will be, a source of larger M&A transactions. And against the backdrop of a slowing economy, acquisitions will be a source of inorganic growth for businesses.

According to the *PwC M&A 2014 Review and 2015 Outlook*, domestic strategic M&A in China (including Hong Kong and Macau) grew by nearly two thirds in 2014 and cross-border outbound M&A increased by a third, each a new record. CEOs of privately-owned enterprises led the outbound charge, in many cases looking for advanced technologies, know-how and brands to bring back to the China market.

These healthy trends in China M&A are expected to continue in 2015.



59%
of China's CEOs plan to implement a cost-reduction initiative in the coming 12 months

"We are partnering with universities like Stanford, ECNU in China, TU Berlin in Germany ... all these academic partnerships will help us ensure that we continue to focus on education as a lifelong foundation for our employees."

Dr. Vishal Sikka
Chief Executive Officer and
Managing Director, Infosys,
India

The growth of partnerships

China's CEOs appreciate the value of both formal and informal partnerships. More than a third (34%) are currently engaged in collaborations with customers, and a quarter (26%) are partnering with suppliers. These relationships make economic sense, particularly considering the growing importance CEOs place on better understanding the changing behaviour of customers.

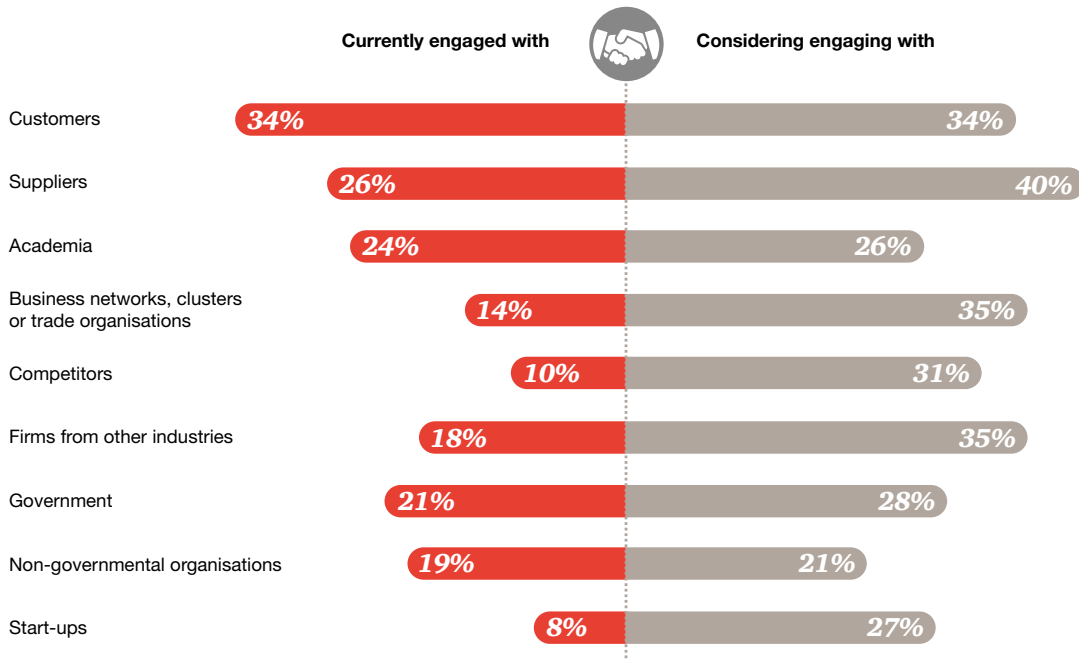
The number of China's CEOs that are considering entering a partnership is even greater, suggesting the popularity of this type of informal collaboration is on the rise. While most partnerships are with traditional stakeholders, there is growing interest in cooperative alliances across a wider range of groups including academia, governments and firms that operate in other industries. One in 10 CEOs in China say they are even partnering with competitors.

This is a positive development. Diverse partnerships can introduce new skills, bolster core competencies and drive innovation in a way that is potentially more flexible and adaptive than traditional deals. As the competitive pressures in China increase, so will the need for companies to find new and productive ways of partnering and collaborating.

Figure 6

Partnerships – particularly with customers and suppliers – are increasingly important for China's CEOs

Q: Are you currently engaged with or considering engaging with, any of the following types of partners through joint ventures, strategic alliances or informal collaborations?



Base: 136, respondents who stated 'yes'

Case study: The power of partnership

When it comes to partnering, The Volvo Group President & CEO Olof Persson says the company has basically two approaches.

“One is the more traditional equity-based joint venture (or) strategic alliance with manufacturers around the world and we have been very successful in doing that in India and China, for instance.

“But then we are also, of course, partnering very much on a non-equity basis on our development projects.”

Persson cites the recent launch of Volvo’s hybrid plug-in buses as an example.

“If you look at what happened there, we developed a very efficient and good hybrid driveline.

“But we didn’t have the knowledge about charging stations, we didn’t have the knowledge about advance traffic management systems and we didn’t have the knowledge about how to integrate this in the city structures that we have.

“We have a great product, but by partnering with those who have that additional knowledge we could actually get the product to market faster.”

Persson says that in the future partnering will also be a very important aspect of the business to make sure Volvo has “speed-to-market”.

Government priorities

More than half of China's CEOs (55%) believe the government's top priority in 2015 should be to create a more internationally competitive and efficient tax system. And just under half (46%) want the government to do more to create a skilled and adaptable workforce. On these issues China's CEOs are in step with their global peers, who also cite these as top priorities.

In terms of workforce skills, there is scope for the government to facilitate a system that makes it easier for people to move within the country and to where employment demand is high. And when it comes to tax, the challenge for the government is to reduce the burden on business while safeguarding the needs of citizens. The willingness to pursue tax reform and more efficient regulation would be a step in the right direction.

While they believe the government has made good progress in relation to infrastructure (both physical and digital), China's CEOs believe there is more that could be done to encourage innovation. Only 21% said the government has been effective at developing an 'innovation ecosystem', which is one that supports growth by fostering technology development and innovation activities. The development of such an ecosystem was one of the top priorities that China's CEOs cited in the previous survey. The recent government announcement of a RMB 40 billion fund to support start-ups in emerging industries will provide new impetus for their growth.

Tax incentives are another important driver of innovation. The current measures include corporate tax concessions for high-tech software and hardware companies, and corporate tax exemptions for the income from sales of qualified technologies.

But there is room for further support. For example, increasing the tax concessions for companies with proprietary technologies, as well as extending concessions from the technology sector to traditional industries would lead to more widespread adoption of innovation. Providing tax concessions for companies that reward their employees' creativity with stock options would encourage innovation as well.

The Government Work Report delivered in early March 2015 unveiled a "Made in China 2025" strategy that would see innovation and digital technologies drive manufacturing up the value chain. Policies such as government subsidies, the promotion of digital transformation for traditional industries and measures to spur more M&A are expected to be included in the plan to help increase competitive advantage among businesses in the "new normal" economy.

There's also more that China's CEOs could be doing themselves to progress this and other top government priorities. Only one quarter say they plan to collaborate with the government in relation to workforce issues – which they see as one of the biggest threats to growth – and only 10% in relation to tax. While the influence China's CEOs have on policy is limited, there is certainly greater scope for businesses and the government to work more collaboratively, particularly as China pushes ahead with its market-based reforms.

Figure 7

Tax should be top of the agenda for government, according to China's CEOs



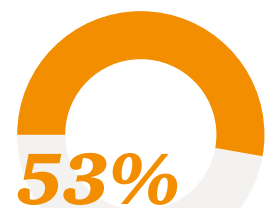
Base: 2015 = 136; 2014 = 66

Talent in the digital era

Finding, nurturing and keeping skilled talent, particularly in senior management, has long been a priority for China's CEOs. This year it was the equal top threat to growth, with nine out of 10 CEOs saying they were concerned about it. They also see it as a key priority for government. Add to this the impact of digital disruption and you can understand why China's CEOs are putting talent at the top of their to-do lists.

One of the challenges for China's CEOs at the moment is that digital talent is scarce. This puts traditional companies in something of a double bind. They are being disrupted by digital players, but are struggling to access the talent that would help them compete and succeed in an increasingly digitally-driven economy.

China's CEOs may also have some way to go to successfully implement the known nexus between technology, talent and value generation. For example, 82% of CEOs say data analytics delivers high value for their organisation yet only 53% use these tools to provide better insight into how skills are deployed.

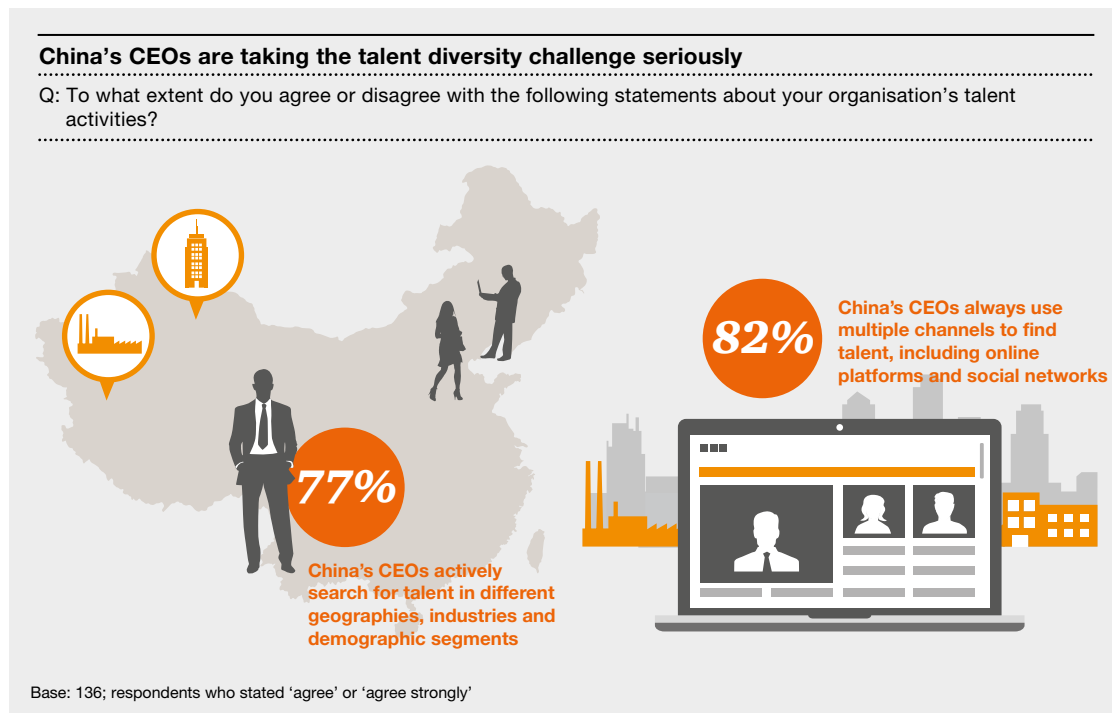


53% of China's CEOs use data analytics to provide better insight into how effectively skills are being deployed within the organisation

"In terms of cultural diversity, when we do something in China we have Chinese contributing at the top table so that the Chinese cultural perspective can be understood straight away. Diversity improves your chances of success and therefore has a positive effect on the bottom line."

Theo Spierings
Chief Executive Officer,
Fonterra, New Zealand

Figure 8



Talent diversity matters

Having the right mix of talent will be critical as companies look to apply their abilities in new and innovative ways. But it is important to realise that talent diversity means more than hiring people who look or sound different. It requires people who can think and work in highly different ways. For example, companies need people who can come up with new ideas and others who can turn those ideas into reality. They need people who can see the opportunities as well as those who are alert to the risks.

Encouragingly, China's CEOs are taking the talent diversity challenge seriously. More than three quarters are actively searching for talent in different geographies, industries and demographic segments, and over 80% are using multiple channels to find talent, including online platforms and social networks. But although China's CEOs understand the value that diversity brings to their organisation, only half have a strategy to promote it.

How can CEOs attract and retain the right talent?

- Develop and implement a strategy to increase and leverage the diversity of your talent pool.
- Find and put in place the right digital talent; look to international markets if necessary.
- Consider ways to incentivise and reward innovation; this may include share options or bonuses tied to innovation outcomes.
- Use digital technologies, such as data analytics and mobile, to improve the productivity of your workforce.
- Make sure your talent strategy is aligned with business goals.

A roadmap for CEOs

Despite the fall in confidence of China's CEOs as they adjust to the "new normal", there is much for them to be optimistic about. In particular, the economy continues to perform strongly, especially relative to the growth rates of other major economies. The economic rebalancing and ongoing market-based reforms are continuing to create new opportunities for businesses.

China's CEOs have done an outstanding job delivering record growth. But they are also right to recognise the risks of the "new normal" and to plan and act accordingly. This means focusing deeply on core competencies, building diverse yet aligned partnerships, investing in innovation and digital technologies, developing the right mix of talent, and considering new sources of capital. And above all, staying agile.

As China's government resolves to continue economic reforms to ensure sustainable growth, the determination of CEOs to bring their most original ideas to the table will be tested. Only the most innovative and agile businesses will thrive.

Survey methodology

This is the China-focused report of the PwC 18th Annual Global CEO Survey.

The PwC 18th Annual Global CEO Survey polled 1,322 CEOs based in 77 countries. Of these, 136 from mainland China were surveyed from October through December 2014. We supplemented their comments on plans for business growth and assessments of constraints with insights from the global PwC network and in-depth interviews with 33 CEOs. The combined views and responses form the basis of the PwC 18th Annual Global CEO Survey.

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