China’s Changing Investment Environment: 2010 and Beyond

U.S. Chinese Services Group
May 7, 2010
Agenda

• Navigating risk in a land of opportunity
• China’s 12th Five-Year Plan (FYP) and opportunities for engagement
• Q & A

February 14, 2010 marks the start of the Chinese New Year of the Tiger
Navigating risk in a land of opportunity
Given recent events, 2009-2010 will likely qualify as another turning point in Chinese economic development.


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China Today – Engine of Global Recovery
Comparing China’s GDP Growth to Other Markets

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>9.6</td>
<td>8.7</td>
<td>10.0</td>
</tr>
<tr>
<td>U.S.</td>
<td>0.4</td>
<td>-2.5</td>
<td>2.7</td>
</tr>
<tr>
<td>EU-27</td>
<td>1.0</td>
<td>-4.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Japan</td>
<td>-1.2</td>
<td>-5.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>5.1</td>
<td>-0.4</td>
<td>4.7</td>
</tr>
<tr>
<td>Russia</td>
<td>5.6</td>
<td>-9.0</td>
<td>3.6</td>
</tr>
<tr>
<td>India</td>
<td>7.3</td>
<td>5.6</td>
<td>7.7</td>
</tr>
<tr>
<td>ASEAN 5*</td>
<td>4.7</td>
<td>1.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Australia</td>
<td>2.4</td>
<td>0.7</td>
<td>2.0</td>
</tr>
<tr>
<td>World</td>
<td>3.0</td>
<td>-0.8</td>
<td>3.9</td>
</tr>
</tbody>
</table>

China accounted for 50% of global economic growth last year

Source: IMF * Indonesia, Malaysia, Philippines, Thailand and Vietnam
FDI into China
– Defying Expectations

Although FDI into China fell 2.6% during 2009, China still had its 2nd best-year at a time when global FDI flows fell 39%.

Source: PRC Ministry of Commerce (MOFCOM)

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U.S. FDI in China – Resilient Despite the Downturn

After investing approximately US$64 billion through 2008 – 7.5% of China’s cumulative total - U.S. investors continued to favor China in 2009 despite the global downturn.


U.S. FDI into China during 2009 was US$3.6 billion – a 24% increase from 2008 despite the economic crisis.

Source: PRC Ministry of Commerce
Achieving coverage and scale in China
The key challenge for U.S. investors in the years ahead

Positioning your company to have the right coverage and scale commensurate with your stage of development in China is key to sustainable success.
Pursuing Coverage and Scale
World’s 2nd largest retailer

- As of Dec. ‘09, 157 stores in 40+ cities since opening first in ‘95
- 22 stores added in ‘09 - 22 in ‘08 and 16 in ‘07
- 16% annual revenue growth in China in ‘09 – bright spot globally but sufficient to keep pace with 17% growth in retail sales in China during ‘09?
- China’s largest foreign retailer, but ranked 6th overall for 3 yrs. straight

Source: PRC National Bureau of Statistics, Carrefour
## Pursuing Coverage and Scale
### U.S. automakers

<table>
<thead>
<tr>
<th>Company</th>
<th>Relative Market Opportunity</th>
<th>New Investment</th>
<th>Timeframe</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009 U.S. Sales (Vehicles)</td>
<td>2009 China Sales (Vehicles)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2009 vs. 2008 U.S. sales growth (overall market growth)</td>
<td>2009 vs. 2008 China sales growth (overall market growth)</td>
<td>Estimated cumulative investment in China, as of 2008</td>
</tr>
<tr>
<td>&quot;Big Three&quot; automaker 1</td>
<td>2,070,000</td>
<td>1,826,424</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>-33% (-21%)</td>
<td>67% (40%)</td>
<td></td>
</tr>
<tr>
<td>&quot;Big Three&quot; automaker 2</td>
<td>1,620,000</td>
<td>440,619</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>-15% (-21%)</td>
<td>44% (40%)</td>
<td></td>
</tr>
</tbody>
</table>

### Is your company matching investments decisions to market opportunities?

Sources: Corporate websites, media, * Total investment based on publically-available information, ** Confirmed US$5 billion investment plan through 2012 announced in December 2007
But what about risk?

<table>
<thead>
<tr>
<th>Risk Rater</th>
<th>U.S.</th>
<th>China</th>
<th>India</th>
<th>Brazil</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economist Intelligence Unit Country Risk Rating¹</td>
<td>B</td>
<td>C</td>
<td>C</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>S&amp;P Sovereign Rating² (Local Currency)</td>
<td>AAA</td>
<td>A+</td>
<td>BBB+</td>
<td>BBB+</td>
<td>BBB</td>
</tr>
<tr>
<td>Transparency International Corruption Perceptions Index³</td>
<td>7.3</td>
<td>3.6</td>
<td>3.4</td>
<td>3.5</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Key
1. October 2009 - Rating scale from A (least risky) to E (most risky)
2. October 2009 - Rating scale is divided into ten overlapping bands: AAA (least risky), AA, A, BBB, BB, B, CCC, CC, C, D (most risky); + and – denote gradations within the bands
3. 2008 Corruption Perceptions Index - Rating scale from 10 (least corrupt) to 1 (most corrupt)

Based on these risk ratings, it would appear that doing business in China is no riskier than doing business in other large emerging markets – but considerably riskier than doing business in the U.S.
Managing risk in China
Risks, as perceived by U.S. investors in China, change fast

<table>
<thead>
<tr>
<th>Rank</th>
<th>2003 Member Survey</th>
<th>2005 Member Survey</th>
<th>2007 Member Survey</th>
<th>2009 Member Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Trading Rights</td>
<td></td>
<td>Human Resources</td>
<td>Administrative &amp; Business Licensing</td>
</tr>
<tr>
<td>2</td>
<td>Transparency</td>
<td>Distribution Rights</td>
<td>Administrative &amp; Business Licensing</td>
<td>Impact of Economic Downturn on China Operations</td>
</tr>
<tr>
<td>3</td>
<td>Distribution Rights</td>
<td></td>
<td></td>
<td>Human Resources</td>
</tr>
<tr>
<td>4</td>
<td>Standards, Technical Regulations</td>
<td>Human Resources</td>
<td>Competition and Overcapacity</td>
<td>Competition and Overcapacity</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>Market Access in Services</td>
<td>IPR Enforcement /Transparency</td>
<td>Market Access in Services</td>
</tr>
</tbody>
</table>

Effective risk management in China requires constant updating of priorities and not overly relying on past experience

Source: US-China Business Council
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So Why is Risk Management in China So Difficult?
Three reasons the “Learning Curve” often does not apply

- **Speed of Change** – The fast-evolving regulatory and competitive environment means that the nature of risk itself changes rapidly
- **War for Talent** – High turnover and talent shortages limit the ability to institutionalize learning
- **Diversity of China’s Economy** – Wide geographic, sectoral, and ownership structure differences mean that experience gained from one investment may not apply when making another

As it is much harder to benefit from past experience in today’s China – developing the ability to “see around corners” becomes essential
Keeping Pace with China
The challenge for Massachusetts exporters

Massachusetts ranked 12th in terms of exports to China in 2009 – 2% of U.S. total - but it had the lowest 2000-2009 growth rate of any U.S. state in the top 15.

Source: USCBC, Department of Commerce

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12th FYP – Focus areas and opportunities for engagement
China’s 5-Year planning (FYP) cycle returns
12th FYP (2011-2015)

Sources: State Council, NDRC, Chinese media, ACMR
From 11\textsuperscript{th} to 12\textsuperscript{th} Five-Year Plans

Continuity

With 2-years left, China’s 4\textsuperscript{th} Generation Leadership (Hu-Wen) is looking to consolidate its legacy - a “harmonious society” achieved through “scientific development”

<table>
<thead>
<tr>
<th>11\textsuperscript{th} FYP “Five Balances” (五个统筹)</th>
<th>12\textsuperscript{th} FYP Policy Thrust</th>
<th>12\textsuperscript{th} FYP Targets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urban vs. rural development</td>
<td>Accelerate urbanization</td>
<td>Increase national urbanization rate from 47% to 50%</td>
</tr>
<tr>
<td>Harmonious development of man and nature</td>
<td>Create an energy-efficient, low-carbon society</td>
<td>Undefined interim goal to reduce carbon intensity by 40-45% from 2005 levels by 2020</td>
</tr>
<tr>
<td>Development between various regions</td>
<td>Reduce disparities through regional integration &amp; specialization</td>
<td>Increase urbanization rate of Central China from 40% to 48%; reduce energy intensity by 25% from 2008 levels by 2015</td>
</tr>
<tr>
<td>Economic and social development</td>
<td>Extend social safety net</td>
<td>Universal basic healthcare coverage by 2020</td>
</tr>
<tr>
<td>Internal development and opening up to the world</td>
<td>Lessen reliance on global markets for growth; achieve economic rebalancing</td>
<td>Increase domestic consumption to 50% of GDP from 36%</td>
</tr>
</tbody>
</table>

Source: State Council, NDRC, Chinese media, ACMR
Setting the tone from the top
From 4th generation to 5th generation leadership

“China will stick to the road of urbanization with Chinese characteristics, promote the coordinated development of medium and small cities and small towns...exert the radiation and driving effect of cities on rural communities and promote the benign interaction of urbanization and the construction of new rural communities.”

Premier Wen Jiabao, government working report at the opening of 3rd session of the 11th National People’s Congress, March 5, 2010

“By tapping into new markets and expanding business, companies can absorb rural workforce substantially. This will help create conditions for deeper urbanization. Urbanization in return can boost consumption and drive up the economy.”

Vice Premier Li Keqiang, remarks during an inspection tour of Pearl River Delta cities, December 15, 2009

Source: china.gov.cn, Chinese media, ACMR
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Rising urban-rural income disparity
A leading obstacle to the harmonious society

* 1978 = 100

1978 – A difference of RMB 209
2009 – A difference of RMB 12,022

• In 2009, urban Chinese earned 3.3 times as much as rural Chinese compared to 2.6 times in 1978, one of the largest income gaps in the world

• Urbanization is a key strategy for closing that gap, offering expanded employment opportunities to new arrivals and a source of remittances for those remaining behind

Source: National Bureau of Statistics, Ministry of Agriculture
Meeting the challenge of green urbanization

- Accounting for just 3% of global surface area and 50% of the world’s population, cities consume 75% of the world’s energy and emit 80% of greenhouse gases
- 622m urban residents in China today – 2X entire U.S. population - but still just 47% urban; plans to urbanize an additional 325m Chinese by 2030 will strain sustainability

National goals, provincial focus, local projects

### Zhejiang Province – Sample Objectives
- Enhance Zhejiang’s role in the regional integration of the Yangtze River Delta
- Reengineer Zhejiang’s core competitiveness
- Accelerate the development of modern services
- Reform the social security system
- Promote new cities
- Invest in major infrastructure network projects

### Hangzhou Municipality – Sample Objectives
- Develop high tech industry
- Transform the southern tier of the Yangtze River Delta into a modern service center
- Design layout of modern logistics
- Establish secure system of affordable housing
- Develop low carbon economy; build a low carbon city
- Coordinate urban and rural development (i.e. coordinated development of 5-county region around Fuyang and Lin’an cities)

Sources: Zhejiang Development and Reform Commission, Hangzhou Municipal Development and Reform Commission,
Identifying emerging urban growth centers
Of China’s 655 cities, 26 will have urban rail systems under construction in 2010

China intends to invest roughly US$130 billion to triple the total length of urban rail to 3,000 km by the end of the 12th FYP

Sources: PRC State Council and Ministry of Transportation, Chinese media
Identifying emerging urban growth centers
20 are also located on high-speed rail routes under construction in 2010

China will invest US$300 billion during the 12th FYP to extend high-speed rail routes

Sources: PRC State Council and Ministry of Railways, Chinese media
Identifying emerging urban growth centers
7 are also cities where demand for power is expected to surge between 2010–2020

China is weighing plans to invest nearly US$600 billion to meet rising urban power demand through 2020

Sources: State Grid
Our seven emerging urban growth centers
A closer look*

• All 7 are provincial capitals
• All 7 have populations of at least 3 million, placing all among the top five in the U.S.
• Six of the 7 are located in the interior

Sources: PRC National Bureau of Statistics
* 2009 data for Nanchang not available

GDP growth (2009 vs. 2008)

Retail sales growth (2009 vs. 2008)

Per-capita urban disposable income growth (2009 vs. 2008)

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Creating sustainable China value in 2010
Key take-aways

√ China is too large and complex to tackle as a whole

√ Study the central government's development goals as a road map for identifying emerging investment opportunities

√ Narrow your investment focus to a few promising geographic locations

√ Understand the many roles of sub-national officials – investor, manager, regulator and potential spoiler

√ Think beyond traditional means of investment (M&A and greenfield)

√ Articulate your value proposition and team accordingly
Thank You

Contact Information:
Kris Knutsen
Senior Manager
krisknutsen@deloitte.com