

Trends Affecting Global Investment Strategies in China

The A.T. Kearney China City FDI Attractiveness Index™ 2010





A.T. Kearney's China Research Center is a strategic research and discussion platform focused on understanding the underlying forces shaping the unique opportunities and challenges of the China market and delivering business insights to our clients.

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Since 2002, A.T. Kearney's FDI Confidence Index® has ranked China the top destination for foreign direct investments. Now, as the China economy roars ahead—and the country becomes a crucial economic force in helping to stabilize the world economy amid the global crisis—things within the country are changing. Tier 1 cities are no longer the only investment strategy for global companies, as tier 2 cities and even tier 3 cities are becoming major players. In a country with such vast geographic and economic disparity, every business should understand and take advantage of the latest trends within China as they develop their investment strategies.

Building on the methodology of the A.T. Kearney Foreign Direct Investment (FDI) Confidence Index, A.T. Kearney's China Research Center has launched its first A.T. Kearney China City FDI Attractiveness Index™.¹ The 2010 Index aims to provide an objective and pointed view of the attractiveness of the top 30 cities in China, with respect to FDI in four sectors: traditional manufacturing, high-tech manufacturing, financial services and business headquarters, and service outsourcing.²

The Index is based on a proven attractiveness model that collected quantitative and qualitative data for more than 30 indicators of the top 30 Chinese cities in the past five years (see sidebar: *About the Study on page 3*). The data was then analyzed by applying appropriate weightings to these indicators based on their relative

importance to the attractiveness of a particular type of sector, from which we generate the Index on a relative basis (see figure 1 on page 2). Key investment trends and implications were also drawn from A.T. Kearney's extensive experience both in helping global companies select sites in China and in advising many regional and local governments in China about their industry development strategies. This paper outlines our findings.

Key Findings

Five major trends can be drawn from the 2010 China City FDI Attractiveness Index.

1. For *traditional manufacturing*, the coastal areas are still strongholds, but western and northern regions of China should be considered for future investments.

¹ A.T. Kearney's China Research Center is a strategic research and discussion platform focused on understanding the underlying forces shaping the unique opportunities and challenges of the China market and delivering business insights to our clients.

² Selection of the top 30 cities is based mainly on administrative divisions rather than economic affluence to provide a cross-section and diverse view of China's geography and economy.

Figure 1

The A.T. Kearney China City FDI Attractiveness Index™ 2010

City	Traditional manufacturing	High-tech manufacturing	Financial services and business headquarters	Service outsourcing and offshoring
Beijing	16	1	1	3
Tianjin	13	12	6	9
Shanghai	5	3	3	1
Chongqing	17	13	9	17
Guangzhou	2	8	4	12
Shenzhen	19	2	2	8
Harbin	30	29	25	10
Changchun	22	16	18	—
Shenyang	21	24	14	18
Dalian	7	21	13	7
Qingdao	10	5	8	—
Ningbo	3	15	16	—
Fuzhou	26	28	24	—
Hangzhou	1	4	5	4
Wuhan	14	17	11	5
Huizhou	23	18	15	—
Urumqi	12	27	30	—
Hefei	9	11	23	15
Zhengzhou	8	10	22	—
Chengdu	4	6	12	14
Changsha	25	22	19	16
Xi'an	28	14	17	6
Guiyang	24	25	29	—
Nanchang	15	19	21	13
Nanning	18	26	28	—
Taiyuan	29	30	26	—
Lanzhou	11	23	27	—
Nanjing	27	20	10	2
Xiamen	6	7	7	—
Jinan	20	9	20	11

Source: A.T. Kearney China City FDI Attractiveness Index; analysis by A.T. Kearney's China Research Center

- For *high-tech manufacturing, and the financial services and business headquarters* sectors, tier 1 cities are still the most attractive because of the large knowledge-based workforce—and despite higher labor and living costs.
- For the *service outsourcing* sector, it is a mixed picture. Tier 1 cities have an abundance of

skilled workers and are close to commercial activities, while some tier-2 cities offer a low-cost service workforce and a friendly business environment. Thus, investors should consider one of two strategies: Begin in a tier 1 city for the convenience and move to a tier 2 city when the cost to serve becomes too high; or begin

- immediately in a tier 2 city that has a proper balance between cost and delivery capabilities.
4. As the primary purpose of investments in China changes from exports to domestic markets, companies should invest in new product and technology development and in the distribution capability of tier 2 and some affluent tier 3 cities.
 5. Risk mitigation strategies are necessary to address the four most prevalent short-term investment

risks in China: currency, trade conflicts, excessive competition and a domestic financial crisis.

Finding 1. For traditional manufacturing, the coastal areas are still strongholds, but western and northern regions of China should be considered for future investments.

The Index reveals that the labor-intensive traditional manufacturing sector has already migrated

About the Study

The China City FDI Attractiveness Index is conducted by first identifying a set of more than 30 key indicators that can best measure different aspects of investment attractiveness of a city. The relevant indicators are then selected and properly weighted for measurement in the four different sectors, namely traditional (labor intensive) manufacturing, high-tech manufacturing, financial services and business headquarters, and service outsourcing. The sectors are deliberately defined broadly enough to cover different industries but specific enough to capture the different measures for evaluating city attractiveness. By applying the city data to the selected indicators with different weighting, we are able to create the city rankings for the four different sectors. The 30-plus indicators are grouped into the following four categories:

- **Existing industrial base.** The industrial base developed in the city, including size of industries, number of enterprises, number of

employees in the related industries, and conditions of the industry clustering areas; this category of indicators evaluates the current level of strength of the respective industry sector

- **Operating costs.** The key factor costs of different sectors in a city, for example, costs of labor, managerial staff, energy, transportation and facilities
- **Business environment.** A comprehensive selection of indicators that measure the overall business environment, for example, economic development levels, availability and quality of business facilities, city infrastructure, openness and global connectedness, and living standards
- **Government support.** A comprehensive selection of indicators for the level of government support, including industry specific government funding, general government fiscal support, talent attraction and retention policies, and government efficiency

Heavier weightings for the four types of sectors were applied loosely as follows.

- **Traditional (labor-intensive) manufacturing.** The existing industrial basis, and operations costs
- **High-tech manufacturing.** The cultivation of innovative capabilities, the current situation and potential of high-tech human resource pool, and the preferential policies that attract relevant human resources and investment
- **Financial centers and business headquarters.** The overall functionality of a city, which includes the macroeconomy, business environment, civil municipalities and the development levels of service industries
- **Service outsourcing.** The human resource pools that are relevant to outsourcing, for example, language skills, cultural adaptability and relevant preferential policies

For a more detailed understanding of the ranking methodology, please contact the authors.

away from tier 1 cities such as Shanghai (5), Beijing (16) and Shenzhen (19) into the tier 2 coastal cities such as Hangzhou (1), Ningbo (3) and Xiamen (6).

However, labor costs in these coastal cities are rising rapidly, and the large numbers of immigrant workers traveling across China and gathering at the coastal cities is creating social problems. As such, the Chinese government is pushing hard for further geographic shifts for industries; we foresee the trend continuing to move further west, inland and to the north. By directing funding for infrastructure development to the inland areas, the Chinese government hopes to make it easy for investors to manufacture and transport goods from these areas. Lately, the State Council has issued seven key initiatives to support expanded investments in the west.

Some cities in the inland regions are already gaining strength. For example, in the west, Chengdu now ranks 4th in attractiveness for traditional manufacturing. In the inland area, Zhengzhou is 8th and Hefei is 9th. In the north, Dalian is 7th.

Hence, for investors planning to continue leveraging low-cost labor from China, it is time to look beyond the current manufacturing base in the coastal cities to the west, inland, and to the northern regions.

Finding 2. For high-tech manufacturing, and the financial services and business headquarters sectors, tier 1 cities are still the most attractive because of the large knowledge-based workforce—and despite higher labor and living costs.

For high-tech manufacturing, Beijing (1), Shenzhen (2), Shanghai (3) and Hangzhou (4) lead the rankings because of the abundance of

knowledge-based labor. Beijing and Shanghai share several common characteristics, including high living standards, numerous well-educated local graduates and overseas returnees, and a friendly business environment. Yet Shenzhen and Hangzhou also have several common characteristics, such as good living standards and a strong sense of entrepreneurship that attracts many

In late 2009, the government officially declared its support for Shanghai to become China's "international financial center."

talented people from around the nation. Tier 2 city leaders include Qingdao (5), Chengdu (6), and Xiamen (7). These cities have made the list largely due to their strength in the electronics manufacturing sector. For example, Qingdao has arguably the strongest consumer electronics manufacturing base in China with two strong local brands, Haier and Hisense.

For financial services and business headquarters, Beijing (1), Shenzhen (2), Shanghai (3) and Guangzhou (4) are the top four. The relative ranking may be argued but in aggregate the result is not a surprise. Being the most dynamic and most globally connected cities in China, these four cities naturally become the most attractive for financial centers and business headquarters.

Beijing, the capital and the national political center of China, has an advantage in that all key

central government agencies and supervisory bodies are located there. Companies in regulated markets recognize the advantage of having headquarters close to regulatory bodies. For example, in the financial sector, all major local banks have set up their headquarters in Beijing to be close to the “Street” where the banking regulators reside.

Shanghai, by comparison, is favored by most multinational companies because of its open and friendly business environment and partly due to its legacy of having been the business center of the Far East in the early 19th century. Many Fortune 500 companies have set up their China headquarters in Shanghai, and more so for the foreign banks. In late 2009, the central government of China officially declared its support for Shanghai to develop China’s “international financial center,” which will allow experiments of targeted regulatory reform, thus making Shanghai a more attractive destination for investments in the financial sector.

For those investing in the high-tech manufacturing industry, the financial services sector or in setting up a business headquarters, Shanghai, Beijing, Guangzhou and Shenzhen are still generally the most attractive and best able to provide an abundant supply of much-needed talent.

Finding 3. For the service outsourcing sector, it is a mixed picture. Tier 1 cities have an abundance of skilled workers and are close to commercial activities, while some tier 2 cities offer a low-cost service workforce and a friendly business environment. Thus, investors should consider one of two strategies: Begin in a tier 1 city for the convenience and move to a tier 2 city when the cost to serve becomes too high; or begin immediately in a tier 2 city that has a proper balance between cost and delivery capabilities.

Tier 1 cities such as Shanghai (1), Beijing (3) and Shenzhen (8) have built a headquarters presence to effectively develop the shared services function for the Asia-Pacific region or, in Shenzhen’s case, to serve as the back office for many Hong Kong-based financial institutions.³

Multinational companies such as ExxonMobil and Kodak have created regional shared service centers for their finance functions in Shanghai. Major information technology outsourcing (ITO) and business process outsourcing (BPO) operators such as Accenture and IBM have also established strong delivery bases in tier 1 cities for their global clients.

The abundant supply of people skilled in foreign languages and software development, proximity to dynamic commercial activities and global connectedness are the three primary reasons to choose these cities for outsourcing or offshoring services. However, as living standards improve and outsourcing and offshoring activities grow in tier 1 cities, the competition for talent has increased. As a result, people attrition rates can be as high as 30 to 35 percent for outsourcing and offshoring service centers, which creates a major challenge in managing costs and operational continuity in the delivery centers.

Meanwhile, first movers in tier 2 cities are also attracting service outsourcing activities. Dalian (7) is the most frequently cited early success story. The city, which started developing its services outsourcing sector a decade ago, has focused on attracting outsourcing businesses from nearby countries such as Japan and Korea by promoting its supply of graduates with top-notch language skills. The city developed software parks with first-class office buildings and communication facilities, and the local government provides attractive

³ Shenzhen’s ranking could be underestimated due to lack of statistical data on the captive shared service functions, but we know that many financial institutions in Hong Kong use Shenzhen as a back-office delivery center.

preferential policies to reduce the cost of doing business there. After 10 years of nurturing, the service outsourcing sector is prospering. That said, Dalian's future growth amid competition from other cities has yet to be tested.

Some other tier 2 cities have followed a similar path with varying degrees of success.⁴ Najing (2), Hangzhou (4), Wuhan (5), Tianjin (6) and Xian (7) are the rising stars. While the overall supply of skilled workers in these cities can be small, the attrition rate is often lower, at around 15 to 20 percent. For those considering service outsourcing and offshoring, there are two investment strategies to consider:

1. Begin in a tier 1 city for the convenience and move to a tier 2 city when the cost to serve becomes too high.
2. Begin immediately in a tier 2 city that has a proper balance between cost and delivery capabilities.

Finding 4. As the primary purpose of investments in China changes from exports to domestic markets, companies should invest in new product and technology development and in the distribution capability of tier 2 and some affluent tier 3 cities.

In the past, a large number of investments in China have been for exports, leveraging the country's lower labor costs and manufacturing efficiencies. Such investments were concentrated in the manufacturing capacity along the coastal cities where infrastructure was better and import and export was easier.

As the China economy grows and consumer purchasing power rises, domestic markets are China's new economic growth engine. This trend is expected to accelerate as a global economic rebalancing occurs and China must grow more of its domestic consumption. The China central government has, accordingly, developed or changed policies to stimulate domestic consumption. This trend brings about two investment opportunities in China:

It is crucial to invest in national distribution capabilities to the geographically dispersed tier 2 cities and the more affluent tier 3 cities.

First, companies are increasingly investing in new product development or even technology innovation functions to best serve the local Chinese market. The automotive sector is a case in point. Since 2009, China surpassed the United States to become the largest passenger car market in the world. And the auto market in China is expected to continue its strong growth for the next few years. Companies that took different investment strategies will benefit from the growth to very different levels: Japanese automakers have been conservative in investing in product and technology developments in China. By comparison, German automakers are bringing more products

⁴ It is difficult to differentiate between tier-2 cities' rankings due to lack of valid statistical data. However, these cities are among the most active in attracting BPO and ITO industries.

to their Chinese joint-venture (JV) partners. And U.S. automaker, General Motors, has established a local R&D center to tap into local talent to develop car technologies for China. It is not surprising that the German and American automakers are winning in the China market at the moment.

Second, as national markets are forming, it is crucial to invest in national distribution capabilities to the geographically dispersed tier 2 cities and the more affluent tier 3 cities.

The China market can be tiered based on consumer affordability. In the past, domestic consumption for high-priced foreign brands or JV products was solely concentrated in tier 1 cities such as Shanghai, Beijing, Guangzhou and Shenzhen. However, in recent years, the purchasing power of tier 2 cities and some richer tier 3 cities has reached a level that is attractive for most foreign brands or JV products. With a big population base and a herd purchasing pattern, these cities can often trigger a nationwide demand surge for products that become affordable.⁵ The challenge for companies is then to develop the capability to distribute products to geographically dispersed tier 2 and 3 cities. Therefore, investing in national distribution systems becomes not only attractive but also essential to grow market share in China.

Finding 5. Risk mitigation strategies are necessary to address the four most prevalent short-term investment risks in China: currency, trade conflicts, excessive competition and a domestic financial crisis.

All investors must assess and manage risks in China. Our latest assessment of China markets reveals four major risks: currency, trade conflicts,

excessive competition and domestic financial crisis. The first two are particularly important for those investing in China for exports; and the latter two are most important for those investing in the China local market. The following discusses each in more detail.

Currency risk. The United States and other European countries have continued to push for the appreciation of the Chinese currency (RMB) in the past few years. The tension is high at the moment given the trade surplus between China and the United States, and U.S. unemployment, both of which are at historically high levels. It is our belief that the Chinese central government has no choice but to take a hard-line approach in managing the pace of RMB appreciation. An overnight 20 to 30 percent appreciation of RMB could result in the complete collapse of the China export sector and in turn create major social turmoil with millions of migrant workers suddenly losing their jobs.

On the other hand, it is indeed very costly for Beijing to maintain the current level of exchange rate by issuing billions of high-powered local currency, which could result in overliquidity. The Beijing authority is also convinced that it is to the long-term economic strength for China to allow the RMB to become free-floating gradually. Therefore, whenever the macroeconomic situation is favorable, we expect the Beijing authority to continue to make incremental changes in its currency policy.

Risk of trade conflicts. As currency policy is too critical a topic for China to compromise on, sector-by-sector trade conflicts become unavoidable. Since the unprecedented financial crisis, many countries have resorted to protectionism measures. From tire, to steel and many other

⁵ Please see the A.T. Kearney China Research Center's upcoming study: "Invest China: A New Strategy Approach," at www.atkearney.com. The paper will be published in December 2010.

products, China becomes the obvious target for conflicts. Therefore, strategic investors seeking low-cost-country sourcing opportunities from China must continually monitor the risk of trade conflicts in their respective industries.

Risk of excessive competition. Since the financial crisis, many export companies have turned their eyes to the domestic market in China. The rapid economic recovery propelled by the artificial stimulus package also caused a capacity build-up in many sectors in China, including the auto industry. Yet it must be remembered that in the China market, where overliquidity is a constant, any demand surge could result in a big wave of excess capacity in just one or two years. Such patterns can quickly turn an attractive market into a “red ocean”—something that occurred in consumer electronics (televisions), consumer durables (cars) and consumer packaged goods (beer) over the past 15 years. This pattern is expected to repeat in the coming years.

Risk of a domestic financial crisis.

China is not out of the woods in experiencing its own financial crisis. As the unprecedented stimulus package was executed, many local municipalities in China pledged their credit to borrow money and invest in major infrastructure projects, which are not always productive investments. An early report (May 2009) from the central bank revealed local government borrowing at RMB5 billion. Almost a year later, a report by *21st Century Economics Review* found that the amount borrowed by local governments already exceeded RMB8 billion, of which about RMB7 billion (it estimates) was borrowed from commercial banks based on local government’s fiscal income and land sales.⁶

⁶ 21st Century Economic Review, March 2010.

There is deep concern about such unprecedented levels of borrowing, particularly at county levels, as most counties do not have the ability to pay back such large debts. According to the same report, the RMB7 billion government borrowing accounts for around 18 percent of China commercial banks’ total lending balance. A failure of a local government to pay back its debt could hit the commercial banks hard.

As land sales and taxes from real estate transactions are major sources of income for local gov-

A major real estate price adjustment poses a potential financial crisis as local governments will not have money to pay back the bank.

ernments, there has always been a struggle between central and local governments over control of the real estate sector. The central government fears a bursting real estate bubble, which could cause a major economic collapse, while local governments rely heavily on the real estate industry for economic development. Such misalignments underpin the situation and illustrate why many of the central government policies geared toward tightening the real estate industry are not executed at the local level.

A major price adjustment on real estate poses a potential financial crisis as local governments will not have money to pay back the bank.

Demographic Changes in China

In addition to the Index findings, it is important to note the demographic changes in China—particularly an aging population—that are shaping the mid- to long-term market opportunities and risks. According to a recent A.T. Kearney Global Business Policy Council study, China as a national economy will “grow old before growing rich.”⁷ Due to the continued birth control policy

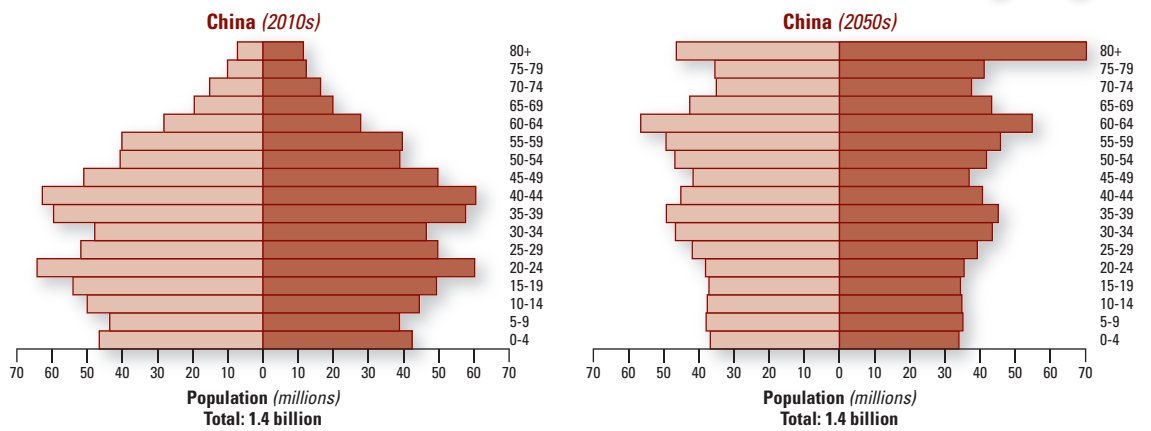
and increasing life expectancy, by 2015 the Chinese population structure will reach the end of its “sweet spot”—where the dependency ratio is less than one. And China’s elderly population, ages 65 and older, will nearly triple between now and 2050 (see figure 2).

Such demographic changes will, in the mid to long term, bring about both market opportunities and risks. The shortage of working age

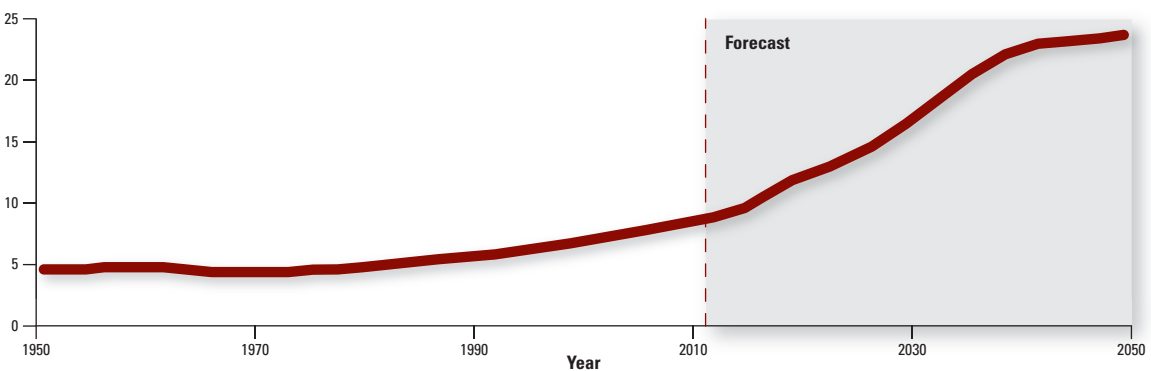
Figure 2

Percentage of retirees in China will nearly triple between now and 2050

Chinese age structure



Elderly (65+) in China’s population (% 1950-2050)



Sources: U.S. Census Bureau International Division, Center for Strategic and International Studies, A.T. Kearney analysis

⁷ See “New Global Demographic Trends: Who Is the Consumer of the Future?” at www.atkearney.com.

population will keep an upward pressure on wages. Recent labor disputes at Honda's China assembly plant and Flextronics' China OEM plants are all early signs of rising upward pressure on labor costs.

On the opportunity side, industries relating to an aged population, including travel and leisure, healthcare, insurance and financial services, and nutrition, will all prosper. Companies operating in these sectors should move quickly to enter China (if they have not done so already) and improve their market position to capitalize on this market trend.

On the risk side, companies that are in China simply to leverage the lower labor costs should consider diversifying their footprints. There are

two strategies to contemplate: 1) within China, locating further inland where low-cost labor is still available and, 2) across the globe, developing a more balanced regional network by setting up operations in India, Vietnam, Indonesia and Malaysia.

The Path Forward

The global financial crisis has dampened investment enthusiasm in the past two years. However, being the first country to lead a v-shaped recovery, being a critical stabilizing force for the global recovery, and being the market with the greatest future growth potential, China should no doubt stand as one of the most attractive destinations for investments in the post-crisis era.

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