Memo

To: Scott Kennedy

From: Abraham Gerber

Date: 12/9/09

Re: Chinese Investment Plan

Executive Summary

This report advocates a widely spaced investment throughout China's alternative beverage industry, a high growth emerging market encompassing milk, fruit juices, bottled water, and bottled teas and coffees. There a number of challenges in entering this market. First, from a purely economic perspective, ensuring proper management of investment is a crucial challenge, as is educating the Chinese consumer to accept your product. In addition, China's unique governance system also creates further challenges because of the state's continued high level of involvement in the economy. These challenges partly encompass the range of regulations and laws by Chinese government from anti-trust to product safety which have the potential to harm your interests. In addition, the implementation of regulations (as well as the legal resolution of disputes between firms) tends to be biased against foreign companies. To overcome these challenges, it is recommended that you invest in a set of widespread majority stakes in firms and factories in the alternative beverage industry in order to have the independence to decide factory managers yourself and avoid legal disputes with Chinese partners. You should adopt a proactive strategy of engaging the national and particularly local governments, sponsoring dinners and other venues to provide them information and build relationships and also in addition, pursuing a high visibility clean water campaign for schoolchildren.

Economic Analysis

The opportunities present in the Chinese market are undeniable. China in recent years has seen a continual stream of torrid economic growth (Bradsher, 2009) , and while its economy significantly smaller than that of Japan and the United States (Woetzel, 2004), its continued rapid development and the flux accompanying this development provide many opportunities for the enterprising investor, especially in the consumer goods market. Even though only 4% of China's population have an annual income exceeding $20,000, given the size of China's population that adds up to over fifty million consumers, a substantial group that in future will only continue to grow and further increase market demand for high quality consumer goods. (Woetzel, 2004) In this environment, it would be foolish for any firm or investor to ignore China in pursuing its global strategy.

At the same time, even in this background of great potential, there remain a number of challenging dynamics on the Chinese business scene likely to burn firms who recklessly invest.

The first, in many sectors of the Chinese economy, is the continued dominance of state-owned enterprises (SOEs). SOEs continue to make up a huge proportion of the Chinese economy and in certain sectors, due to government interference, would-be investors have no choice but to partner with state-owned enterprises to have any role in the market. Such cooperation is often exceedingly difficult. In the first place, due to the legacy of state control, many SOEs are in an extremely weak financial position, with over 40% of state-owned firms losing money (Mufson, 1998). Even for those companies which are profitable, investing is risky because they are often saddled with an entrenched corporate culture and also often remain subject to governmental interference both of which can make reform extremely difficult. (Sender, 1999).

Looking beyond SOEs, many Chinese firms are risky investments because their management practices are simply not at par with Western standards. Besides issues with basic honesty, such as avoiding managers' embezzling funds (Mr. China), there are cultural issues that have to be addressed. Because a number of China's successful private companies were founded by families, they are often rife with nepotism (Lawrence, 1999), and even in the case of clear competence, many companies are still dependent on their initial founder such that is not clear once he is gone what will happen to their company (maybe note the visionary founder of the air conditioner) One huge problem (Business Week, 2004). As a result, a huge proportion of foreign firms presently establish their own independent subsidiaries in China wherever possible, to avoid dealing with the difficulties of direct investment (Woetzel, 2004).

Beyond the difficulties of choosing appropriate channels for investment, in many sectors, foreign firms contemplating entering the market must cope with its growing maturity and fierce competitiveness. Business Week has called China "the most competitive market in the world." (Business Week, 2004) On the one hand, native Chinese firms have established themselves firmly as producers of low technology, low input goods, innovating in taking of their low cost labor base to produce goods at only 30% to 50% of what a foreign firm would spend. (Woetzel, 2004) In addition, as China has gradually reduced barriers to entry in a number of sectors over the last twenty years, foreign investment has flooded to the point that at this stage in the game, firms entering a host of industries not only lack first mover advantage, but will also have difficulty penetrating the market at all without the help of a number of local partners. (Woetzel, 2004) Due to the saturated market, the initial boom years for certain industries (in particular manufacturing) may be over now (Areddy, 2009). While foreign capital and technology can still have an impact in the market, investment needs to be strategic to hope to get a good return.

Finally, in the Chinese consumer good market specifically, firms must deal with two challenges. The first is the relatively low income of Chinese consumers, whose wealthier segment remain fairly small and fragmented (Kroeber, 2006). Because Chinese consumers are highly price sensitive, the vast majority of goods sold are high-volume, low profit margin products as opposed to more profitable "luxury" goods. At the same time, for foreign firms, Chinese consumer tastes are also a challenge, because for many products they specialize are new to Chinese consumers. Here, fortunately, although products will need to be localized to some degree, a number of companies including Starbucks, Dell, and Mccormick Spices have been very successful in getting their product accepted through the educating Chinese people (Adamy, 2006) (Elder, 2004) (Gelb, 1997).

Of the various sectors of the Chinese economy, it is recommended that you invest in the Chinese alternative beverages industry. The Chinese beverage industry as a whole is healthy, showing continual growth in recent years, with net profits increasing between 2001 and 2007 from 2.6 billion to 16.4 billion CNY. (Alexander & Way) In addition, this sector of the consumer goods market has further advantage of encompassing a broad range of products. Your risk level can be managed by investing throughout this range so your portfolio encompasses products for a number of different tastes and income levels.

Within the beverage industry, you are discouraged from investing in either the cola or beer sub-sectors, because in both market entry could prove extremely difficult and profits questionable. The Chinese beer industry looks particularly sickly. China as a whole has over 1500 brands of beer with over 300 breweries. Of these firms, however, only 20% are profitable and over 45% lose money. (Alexander & Way) Firms seeking to enter the market would face two huge challenges. First, many industry leaders, such as Tsingdao, already have agreement with global brewing firms and are likely not open to additional foreign investments. Second, in this sector, the Chinese national government has clearly pursued a preventing foreign acquisition of national brands. (Matthew Bachrack, 2009) As such, a foreign firm is unlikely to be allowed to have a majority stake in a major brewery.

Similar problems exist in the cola industry, which as in other parts of the world, remains dominated by Pepsi and Coca-Cola, who control over 70% of the market. Although the market for soft drinks has grown strong growth of an annualized rate of over 20% over the last 20 years, a projected rate of over 15% well into the future, profits remain a challenge, with Pepsi's operations continuing to be unprofitable over 20 years after its entry into the market. (FDI Magazine, 2002).

In contrast, opportunities abound with China's alternative beverage sector, by which is meant a broad range of newer products including fruit juices, bottled water, bottled teas and coffees, and milk all which have just recently emerged in force onto the Chinese market. To take just one example, the Chinese dairy industry has been undergoing rapid expansion in recent years, with milk production increasing from 5.8 million tons to 28.7 million tons in 2005 and the number of firms processing increasing from 377 in 2000 to 690 in 2005. (Gaugle & Oland) Alternative beverage products are all likely to continue to experience rapid growth in the future as they penetrate poorer areas of the country and Chinese consumer tastes continue to shift towards healthier products, leaving huge potential for Western investment in developing new products and providing capital for expansion. (Gaugle & Oland)

Policy Risks

China has undergone sweeping economic reforms since the late 1970s that have greatly freed its economy from the state controls of communism. However, the actions of the Chinese state remain of critical importance to investors, as the Chinese national government has remained extremely active in the economy, since the early 1980s, promulgating a huge number of regulations affecting every stage of doing business in China from registering to expatriating profits. Because of the great impact of regulations on business profit, it is crucial for businesses to be aware of the Chinese national policy environment before they invest. (Kennedy, 2007) In the case of investing in the Chinese beverage industry, you should be aware of several principle risks.

First, you should be aware that the Chinese national government actively interferes in currency markets, keeping a firm control over its currency (the renminbi) by strictly controlling capital flows. On one level, this is troublesome to foreign firms because there is a great difficulty in moving funds in and out of China, or repatriating profits (Adamy, 2006). On another it creates risks because the Chinese government's currency policy is necessarily opaque, opening the possibility of sudden currency movements that could cut into business profits. The good news on this front is that relative to the dollar, since the early 1990s, , the Chinese government has pursued a policy of holding steady the value of the renminbi or allowing it to gradually appreciate. Given, presently, market forces are strongly pushing for the yuan to appreciate versus the dollar, the government is likely to further devalue the currency. As an investor directly into production within China to be sold on the Chinese market, such a policy serves your interests because any appreciation of the currency will increase the dollar value of your profits earned on the mainland. As a result, the government's currency should not be great risk to you.

Second (and of greater concern) is that at the national policy level, the Chinese government can enact (or fail to enact) policies in a way contrary to your business interests. On the one hand, the Chinese government sometimes implements regulations that have a fairly sound basis in theory, but through their implementation put foreign firms at a clear disadvantage. Because of their foreign roots or their higher visibility, sometimes foreign firms are obligated to follow regulations more closely than Chinese firms. One example of this in the case of the beverage industry was the imposition of safety regulations on beer bottles in the late 1990s, a regulation followed closely by at least one major foreign investor, leading to serious cost disadvantages for them when lack of adoption of the regulation elsewhere in the industry lead the government to abandon implementing it. (Clissold, 2004)

In addition, the Chinese government, in some cases, seems to deliberately seek to use laws with a separate (stated) purpose to protect domestic firms, giving them a legal cover to pursue protectionistic designs. The examples of this most relevant to your purposes are China's laws concerning mergers & acquisition, especially China's recently implemented anti-monopoly law. While this law has the stated purpose of preserving a healthy competitive environment, based on certain decisions, it seems to have a separate purpose of providing a cover for the Chinese national government to prevent major domestic brands from being acquired by foreign firms. The two cases most illustrative of this, Coca-cola's failed acquisition of Huiyuan and InBev's aqusition of Anheuser-Busch, are also directly relevant to your own acquisition strategy.

(Matthew Bachrack, 2009) In the case of Coca-cola/Huiyuan, the merger was blocked, and in that of InBev/Anheuser approved only with a number of restrictions attached limiting any further acquisitions. In both cases, the documentation provided by the Chinese government was quite minimal compared to what would have been provided in the a Western country, and given the fact that both cases were dealing with politically sensitive major brands in China, there is ample reason to suspect the Chinese government was at least partially motivated by protectionism. What this means for you in attempting to break into the alternative beverage industry is that you cannot simply assume any business deals to acquire a Chinese company will be approved as a matter of course.

In addition, the Chinese national government in area of intellectual property rights has not moved to adequately protect foreign firms' interests. There are two dimensions of this relevant for your investing in the alternative beverage industry. The first is that because of the Chinese government's vested interest in technology transfer to Chinese companies, if a Chinese partner steals some proprietary technology which you have bought or developed, there is a risk that the government will not step in to protect you. A further issue is that of trademarks. The national government continues to drag its feet in removing from the market products with fake labels, a problem apparently extending to the beer industry. (Behar, Beijing's Phony War on Fakes, 2000) As a foreign investor, the major asset you will bring to the market besides capital is through your Western business connections helping firms improve their technological efficiency and product/brand design. If contributions you make are copied easily by your competitors, your profits will suffer dramatically.

Political Risks

Beyond the broad policy preferences of the national government, you should also be aware that in China it is also possible that the government will discriminate against your particular company. Sometimes this can be very direct. In China, the national government has shown a clear willingness to directly target specific companies and individuals whose actions it dislikes, in a broad range of cases ranging from the execution of a number of milk firm executives associated with a quality scandal (Barboza, 2009) to briefly cutting of access to Google. (AFP, 2009) This kind of direct governmental pressure is not only restricted to cases involving a scandal or a direct conflict between the firm and the government; the government has also been known to interfere in business disputes. For example, in one notable recent case, the government arrested a mining firm executive on what appears to have an attempt to intimidate suppliers of iron ore then negotiating with Chinese steel makers. (Barboza, Espionage Charges in China May Be Linked to Negotiations Over Iron Ore Prices , 2009)

On the other hand, even if the law is fully on your side in a dispute, the government may be unwilling to aid you by enforcing the law. Both the executive and judicial branches of China's government are very important to foreign business, as it is very important for the interests of foreign firms that both regulator officials and courts enforce the law, but their cooperation with foreign firms is not guaranteed even if the national policy environment is favorable. (Seligman, 1999) (Behar, 2000) In the case of the courts, it not perfectly clear that they are reliable at any level of government, as at all levels they are subject to control by the Chinese Communist party. They are restricted legally in often lacking the authority to interpret law as well practically in being understaffed and lacking the real authority to ensure their decisions are enforced. In this environment, they are often decline to take on cases that could prove controversial. (Cohen, 2008) Even at the national level the China International Economic and Trade Arbitration Commission (CIETAC) which is responsible for handling many cases involving foreign companies suffers from rife conflicts of interest and sheer unprofessionalism in its deciding of cases. (Cohen, Time to Fix China's Arbitration, 2005) In this environment, if a business deal goes sour, suing may not be effective or practical.

Another complicating variable is that local governments often sometime pursue policies contrary to those at the national level. Although China remains an authoritarian governmental system, in practice, due both to the country's size and diversity (and perhaps deliberate policy on the part of the central government), there remains a sphere for local officials to influence policy, particularly in the economic sphere. This can both help and hurt foreign firms. On the one hand, many local governments are very focused on encouraging development, they actively compete for foreign investment, and as a result, are often extremely willing to cater to foreign demands. (Liu, 1992) (Oi, 1995) To you in entering the alternative beverage industry, depending upon the precise terms you can negotiation, benefits that could be offered included free land on which to build as well as freedom from local taxes for a number of years. At the same time, this local developmental focus can prove a disadvantage to firms when they seek to market goods across a national market, as local governments will often seek to protect their local industry at the expense of goods "imported" from outside their district or province. Although this situation has improved recently, local governments can continue to use their authority to slant the competitive playing field. (Lubman, 2004) This is important to you because you will need to produce and market your products in many different parts of China.

China's fragmented authoritarianism also creates risk in that you will likely have to use some unorthodox measures to influence the authorities in order to be competitive, especially in dealing with local officials and other agents of the national government. You will need to find the right balance in employing these means. In particular, personal relations are extremely important in China to getting anything done, and as a result, it will be very important for you to cultivate relationships with government officials (Seligman, 1999). At the same time, you do not want to appear overly close to the ruling regime, both to preserve your international reputation and to avoid being targeted if the ruling regime collapses or the person you have cultivated falls from power. Despite its risks, cultivating governmental ties is necessary to avoid a situation in which by some unlucky chance, you become involved in a dispute with a firm or person of influence, who uses these tools to bring the power of the government down on you.

Action Plan

At the broadest level, I recommend investing in China's various alternative beverage industries, specifically milk, fruit juices, bottled water, and prepared teas and coffees. As mentioned above, this industry covers a broad range of products, has excellent growth prospects, is largely untangled with China's previous economic system, and remains small, lacking overwhelmingly dominant market players as in the case of soda (and beer). In this industry, your one billion can get a substantial "bang for the buck."

However, specific investments within this industry must still be made with care. The Chinese market is growing rapidly and holds a tremendous amount of potential. However, the side of this rapid growth is rapid change which brings with it risk. The alternative beverage industry as a whole in future will experience rapid growth, but this does not guarantee any particular kind of product, much less any particular firms will succeed. The investment in these industries should be made based on three criteria:

1. Investment should be *broadly distributed* throughout the industry. Specifically, I recommend funneling $225 billion into small firms in each of the four major components of the alternative beverage industry: milk, fruit juice, bottled water, and prepared teas and coffees. This will serve to help ensure a good return for your investment in the future, in an environment in which Chinese consumers tastes remain in flux and the alternative beverages they will ultimately favor remains undetermined. Choosing small firms is also important because it will enable you to avoid the kind of protectionism Coca-cola faced in attempting to acquire the famous brand Huiyuan.
2. Investment should be *deep*, that is, it should encompass different components of the industries. Emphasis should be placed on investment in the final processing of the product because of its profitability, but some investment should also be made into the inputs and distribution of the various products to ensure your investment maintains a good return in an environment rapidly-changing market forces. Specially, the inputs into the various products should be secured via long term contracts and where possible purchases of land on which they can be produced. This will help smooth out moves in the spot prices of commodities like unpasteurized milk, tea leaves etc as well as giving valuable quality control over your inputs.
3. Investment should be *targeted*. By this is meant, investment should take the form of controlling stakes in the enterprises you are investing in, not a sprinkling a smaller stakes among smaller companies. This is necessary to ensure real accountability on the part of people to whom you will be giving capital. Because as mentioned before, Chinese management sometimes lags behind Western standards, it is important that as much as possible you retain the power to hire and fire managers at will.

In order to effectively implement this investment, it is necessary to also invest in human capital. I recommend spending $30 million finding and hiring a number of different groups of people to help you more effectively implement your investment. Four groups of people are particularly important:

1. Market Researchers. While several individual firms (name them) are worthy of investment, you need more information than it is within the scope of this report to provide, to enable you to pinpoint small individual factories or firms worthy of investment. Specifically, you need a number of people with substantial experience to personally investigate and visit specific prospective targets. Ideally, aside from having appropriate industrial background, these candidates will be Westerners with substantial working experience in China, or else Chinese with substantial experience working with Westerners.
2. Agents. Once you've determined you're interested in a specific firm or factory and have a clear idea of how much you value it at, to actually conclude the deal within certain parameters which you set beforehand, it is recommended that you use agents. This is important because properly-selected agents will be much more sensitive to Chinese business culture than you yourself, as well as likely being much capable of reading Chinese people. This will likely enable them to conduct better deals then you yourself personally. These people will need to be native Chinese. You will need to be very careful in hiring them, looking carefully at their reputation to ensure that they will represent your interest strongly.
3. Legal staff. Once a deal is concluded, before anything is signed, it is recommended that you have your own (Chinese) lawyers look over the agreement. While the

Chinese court system on occasion certainly does rule in favor of foreign firms, because of apparent bias in many situations, it is in your interest to avoid ever having to go to court, or in event you must, have a crystal-clear agreement to stand on.

4. Managers. Finally, to run your factories once acquired, it is recommended that you bring in a leadership team of quality managers. Other than standards qualifications of competence, it is of critical importance that any potential hire (Western or Chinese) have substantial working experience in the Chinese context. If possible, they should have a Western (or Western-style) business education. But their most central function is to be your representative at the factory, the face of your demands and requirements. For them to perform this role effectively, it is critical that they be able to function in Chinese workplace politics so as to be accepted and obeyed by the workers under them.

Finally, although your central objective as a company in order to be profitable is to simply be well-run and low visibility so as to avoid being targeted by or having to rely upon the government, because of how pervasive the government is in Chinese society it is still very important that you cultivate good relations with the government. To avoid the government interfering with your acquisition process, avoid local protectionist measures against your products, and generally reduce the risk of problems down the road, it is recommended that you invest $70 million initially into a public relations campaign. This should have two components. First, at local level, it is recommended that you host a series of banquets for officials in districts where you will be operating to attempt to establish relationships with them. The line you should push is your commitment to their local economy, that you do not intend simply to purchase the factory and pocket whatever profits come, but that you intend to bring to the factory the capital and technology to over time, increase employment and produce international-quality beverage products in their region. In addition, you should invest some money in concrete corporate responsibility projects. This could a number of different forms, but specifically, it is recommended in areas you operate that you invest in providing clean water to schoolchildren, as (1) Chinese water, especially in rural areas, remains far below Western standards, (2) Providing clean water, either in the form of investing in building clean wells or providing free bottled water to schools can benefit a large number of schoolchildren and generate a large amount of publicity at a fairly low cost (3) Doing this ties directly into your company's products, and thus could not only benefit your company, but could also cause consumers to view your products a more desirable.

Bibliography

(2004, November 8). *Business Week* .

Adamy, J. (2006, November 29). Eyeing a Billion Tea Drinkers, Starbucks Pours It On in China. *Wall Street Journal* .

AFP. (2009, June 25). Google briefly cut off in China. *AFP* .

Alexander, K., & Way, E. *Foreign Breweries in the Chinese Market: SAB Sizzles; Others Fizzle.*

Areddy, J. T. (2009, March 27). China Slowdown Stunts Entrepreneurs. *Wall Street Journal* .

Barboza, D. (2009, February 2). Death sentences given in Chinese milk scandal. *New York Times* .

Barboza, D. (2009 , July 10). Espionage Charges in China May Be Linked to Negotiations Over Iron Ore Prices . *New York Times* .

Behar, R. (2000, October 30). Beijing's Phony War on Fakes. *Fortune* .

Behar, R. (2000, October 30). Beijing's Phony War on Fakes. *Fortune* .

Bradsher, K. (2009, December 9). Recession Elsewhere, but It's Booming in China . *New York Times* .

Clissold, T. (2004). *Mr. China.* New York: HarperCollins.

Cohen, J. A. (2008, December). China's Reform Era Legal Odyssey. *Far Eastern Economic Review* , pp. 34-38.

Cohen, J. A. (2005, January-February). Time to Fix China's Arbitration. *Far Eastern Economic Review* .

Elder, R. (2004, May 19). Dell is poised to see gains in China; High growth rate could put PC maker at No. 2 by end of year. *Austin American-Statesman* .

FDI Magazine. (2002, August). Pepsi was one of the earliest multinational companies. *FDI Magazine* .

Gaugle, K., & Oland, B. *China's Soft Drink Industry: Potential Profits through Innovation and Distribution.*

Gelb, C. (1997, July-August). Shanghai McCormick aims to add zest to every Chinese meal . *China Business Review* , pp. 25-28.

Kennedy, S. (2007). Transnational Political Alliances: An Exploration with Evidence from China. *Business & Society* , 174-200.

Kroeber, A. (2006, December 14). Consuming China: pretty fictions, hard facts. *China Insight* .

Lawrence, S. V. (1999, February 15). Answer to a Prayer: Officials pin job hopes on private sector . *Far Eastern Economic Review* .

Liu, A. (1992). The 'Wenzhou Model' of Development and China's Modernization. *Asian Survey* , 696-711.

Lubman, S. (2004, September). Law of the Jungle. *China Economic Review* .

Matthew Bachrack, C. H. (2009, July-August). Merger Control under China's Antimopoly Law: The First Year. *China Business Review* .

Mufson, S. (1998, April 12). China's Beefed-Up Private Sector; Jerky-Makers Typify Capitalist Trend Shaking Economy to Its Communist Roots . *Washington Post* .

Oi, J. (1995). The Role of the Local State in China's Transitional Economy. *China Quarterly* , 1132-1149.

Seligman, S. (1999, September-October). Guanxi: Grease for the Wheels of China. *China Business Review* , pp. 34-38.

Sender, H. (1999, April 29). Friends in High Places: Inefficient state firms leave China's leaders in a quandary. *Far Eastern Economic Review* .

Wedeman, A. (2005, February). Anticorruption Campaigns and the Intensification of Corruption in China. *Journal of Contemporary China* , pp. 93-116.

Woetzel, J. R. (2004). A guide to doing business in China. *The McKinsey Quarterly* .

WuDunn, S. (1993, March 30). Uproar Over Killing in China's 'Model' Village. *New York Times* .

Yang, H. (2009, August 13). Gripping Conclusion Nears for Pension Fund Scandal. *Caijing* .

Yatsko, P. (2000, October 2). Knocking Out the Knockoffs. *Fortune* .

Zamojski, J., & Miller, M. *Analysis of the Milk and Dairy Industry in China .*