

Member Survey

US-China Business Council | 2019



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THE US-CHINA BUSINESS COUNCIL

美 中 贸 易 全 国 委 员 会

Member Survey

US-China Business Council

August 2019

In the 19th consecutive year of the US-China Business Council's annual member company survey, and more than a year since tariffs have been imposed, three major themes dominated 2019 member survey outcomes. First, US-China trade friction is negatively impacting US companies operating in China. Second, an unlevel playing field favoring domestic companies over foreign ones is making it increasingly difficult for US companies to compete. Third, while China continues to be a priority market for most of the companies surveyed, market optimism is moderating. All three of these trends are forcing companies to reevaluate company strategies and supply chains. American companies also remain concerned about recent developments in intellectual property rights (IPR), technology transfer, and data flow and cybersecurity policy.

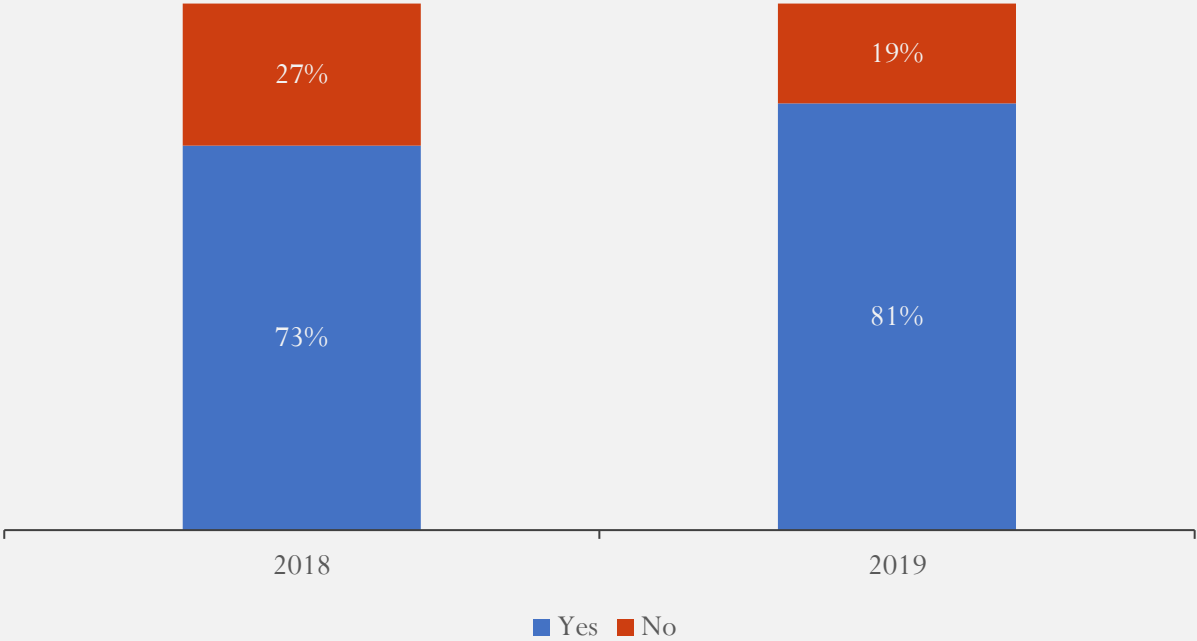
Top 10 Challenges

1. US-China relations
2. Competition with Chinese companies
3. Licenses and approvals
4. Cost increases
5. Data flows
6. IPR enforcement
7. Uneven enforcement
8. Human resources
9. Innovation policies
10. Investment restrictions on foreign companies

US-China Relations

The relationship between the United States and China—particularly, bilateral trade tensions—is overwhelmingly the top concern of American companies operating in China in 2019. Last year, bilateral trade tensions prompted anxiety over how punitive tariffs contribute to an unpredictable business environment. While uncertainty still pervades the 2019 data, companies report that trade tensions are having a measurable impact on US company competitiveness in the Chinese market, especially their competitiveness vis-à-vis domestic Chinese companies. Over 80 percent of American companies report that trade tensions have affected their business operations in China, an 8 percent increase from the year before.

Has your company's business with China been affected by US-China trade tensions?



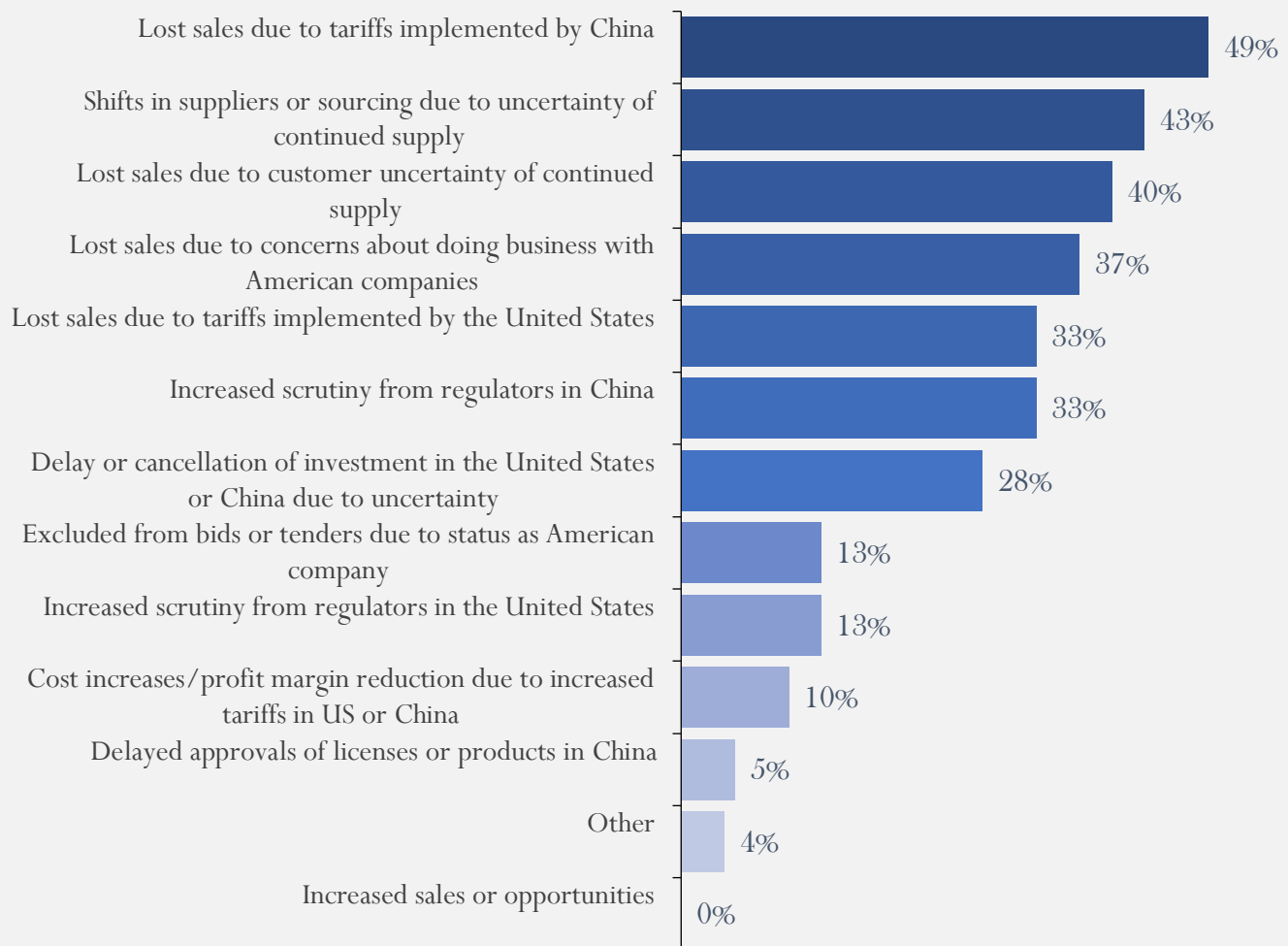
Lost Market Share

Nearly half of respondents report lost sales and ceding market share to foreign competitors. The primary contributor to lost sales is the implementation of both US and Chinese retaliatory tariffs, as evidenced by lost price competitiveness, shifts in supply chains, and uncertainty of continued supply.

Chinese customers are concerned about supply chain links that depend on American companies, which they increasingly view as unreliable business partners as a result of the volatility of the bilateral commercial relationship. In 2019, a staggering 37 percent of respondents indicate lost sales in China due to Chinese partners' concerns about doing business with American companies, a seven-fold increase over 2018.

Similarly, one third of companies report in 2019 that they have been subjected to increased scrutiny from Chinese regulators as a result of bilateral trade tensions.

Impact of US-China Trade Tensions on Business

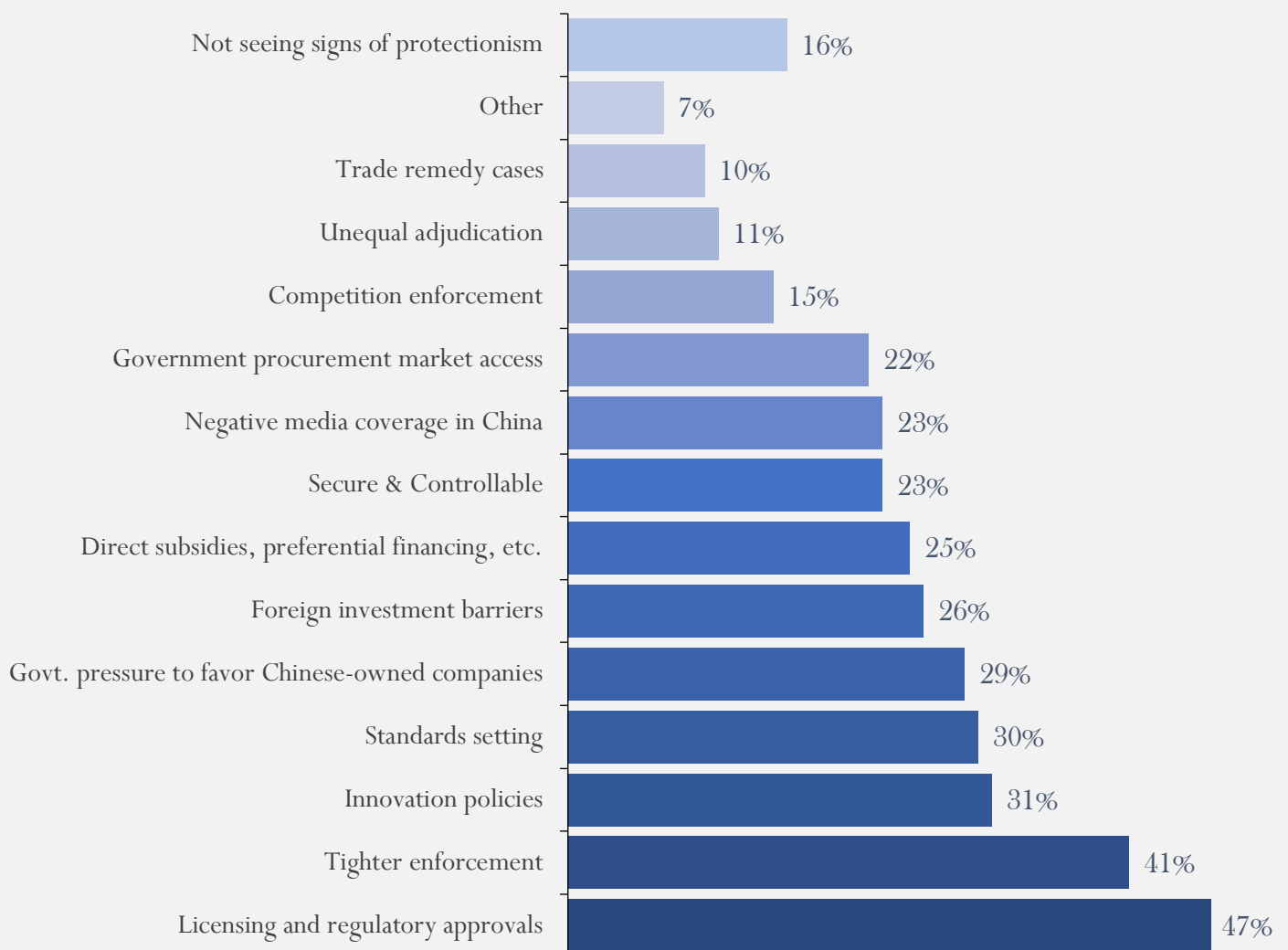


An Unlevel Playing Field

Responses to survey questions regarding competition with Chinese companies and signs of protectionism convey a distinct trend: unequal treatment between foreign and Chinese companies remains a concern in 2019. The competition issue has made the list of top 10 concerns throughout all previous USCBC surveys, and was the second-ranked challenge for the last two years.

Many Chinese companies excel by producing innovative, high-quality goods. However, Chinese government policies and practices frequently offer competitive advantages to domestic companies that are not offered to foreign companies. Unfair competition is a root concern in several of this year's top 10 challenges: licenses and approvals (#2), data flows (#5), IPR protection (#6), uneven enforcement of rules and regulations (#7), innovation policies (#9), and investment restrictions on foreign companies (#10). Beyond the top 10 challenges, companies also note that domestic preferences in Chinese government procurement, as well as domestic advantages in standard setting and preferential financing, contribute to an anti-competitive operating environment.

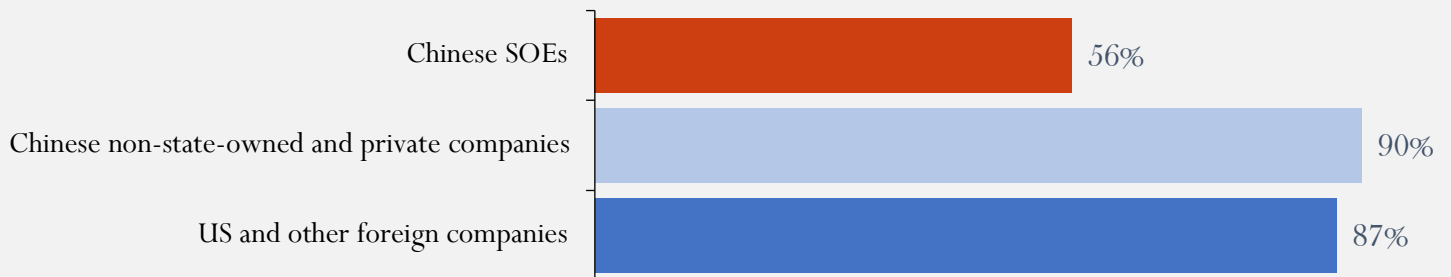
Signs of Protectionism in China



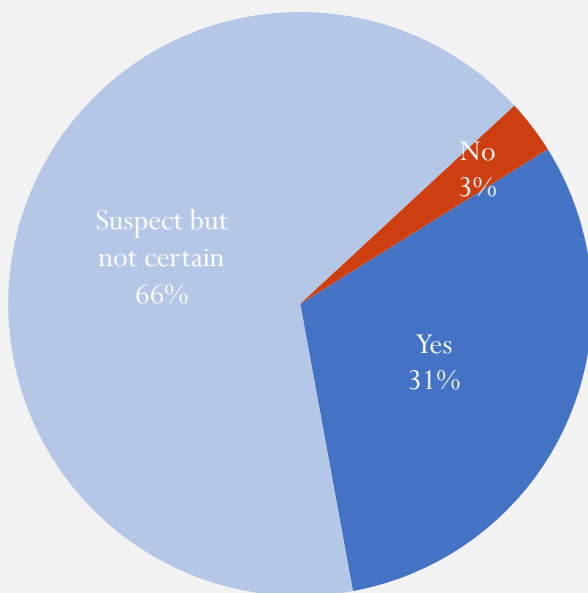
Preference for Domestic Companies

Most American companies are concerned about the preferences that China provides to domestic companies through innovation and manufacturing policies. These benefits, in tax policies, financial subsidies, and licensing and approvals, are given to both state-owned enterprises (SOEs) and private companies.

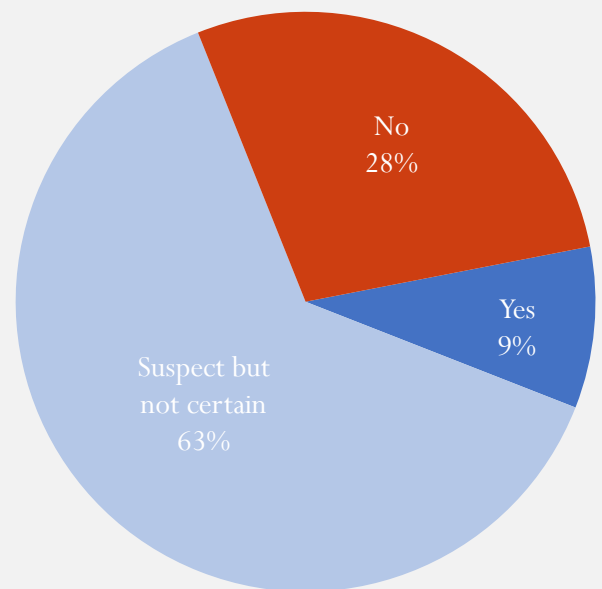
Who are your competitors in China?



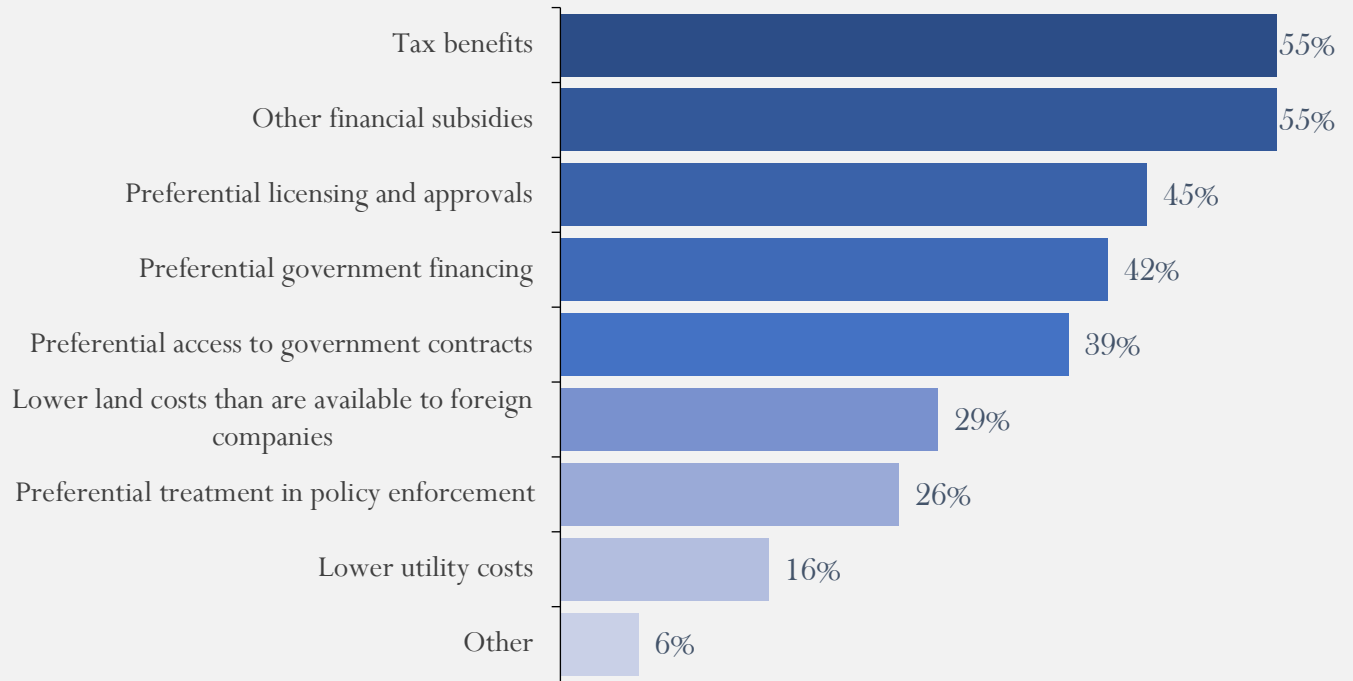
Are state-owned competitors receiving tangible benefits?



Are non-SOE Chinese competitors receiving the same benefits?

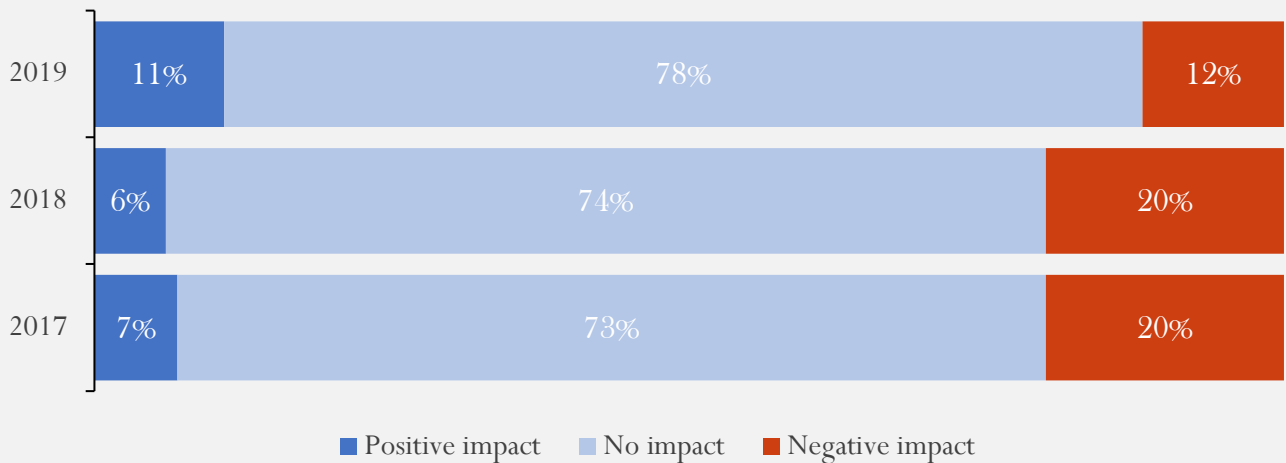


What kind of benefits do SOE competitors receive?



However, one of China's most high-profile and controversial industrial policies, Made in China 2025 (MIC 2025), has reportedly had limited impact on the majority of American companies surveyed. In a shift of sentiment, the number of companies indicating that MIC 2025 offered positive opportunities for their business in 2019 has nearly doubled since 2018. This shift may indicate that some of China's efforts to offer foreign companies increased access to industrial policies are beginning to take root.

Has Made in China 2025 impacted your company's operations?



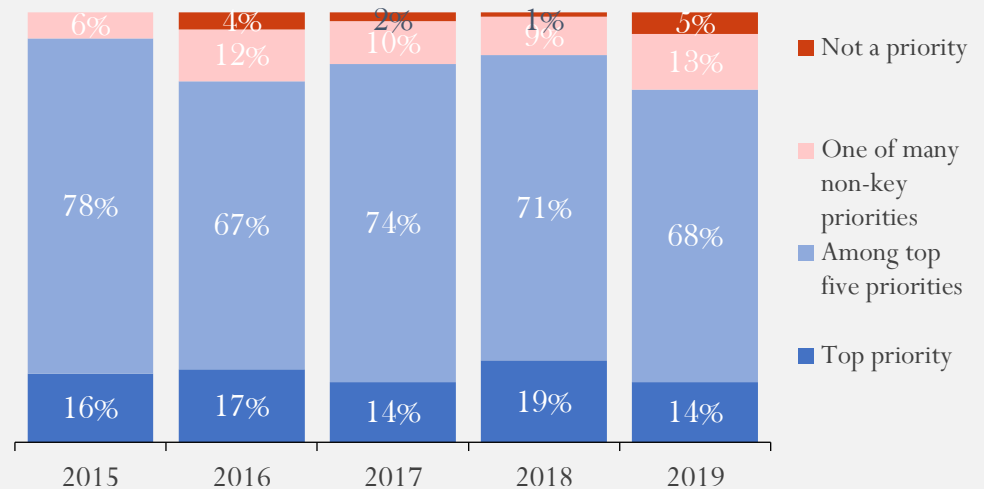
China Remains an Important Market, but Optimism Dipped in 2019

China’s importance as a market for American companies should not be underestimated. China continues to be among the top five global markets for American companies.

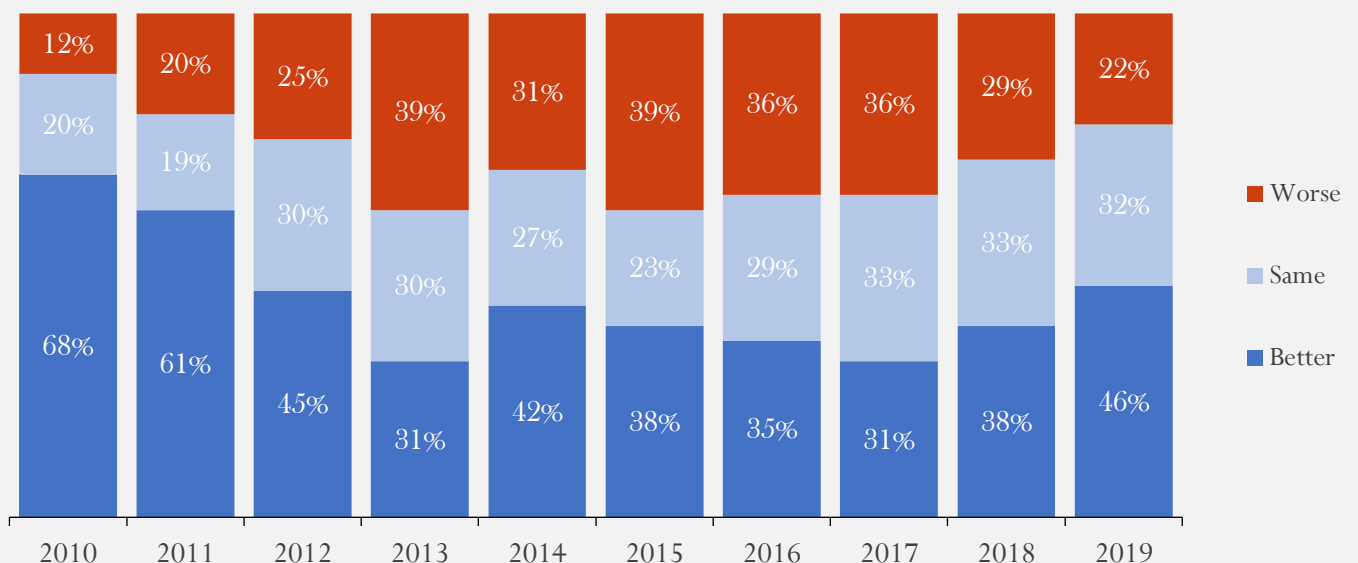
The China market is a priority over other markets due to its comparative significance as a driver of revenue growth. The vast majority of companies report that their China operations are profitable—so much so, that the number of respondents reporting a profit margin rate for their China operations that is higher than that of their overall operations jumped from 38 to 46 percent in 2019. Similarly, the majority

of companies consistently report that revenue from their China businesses has increased in the previous year. However, only a slight majority anticipate that revenue will increase in 2020, down 26 percent from last year, showing that tariff uncertainty, the trade conflict, and a deteriorating market environment are negatively affecting the business outlook for American companies.

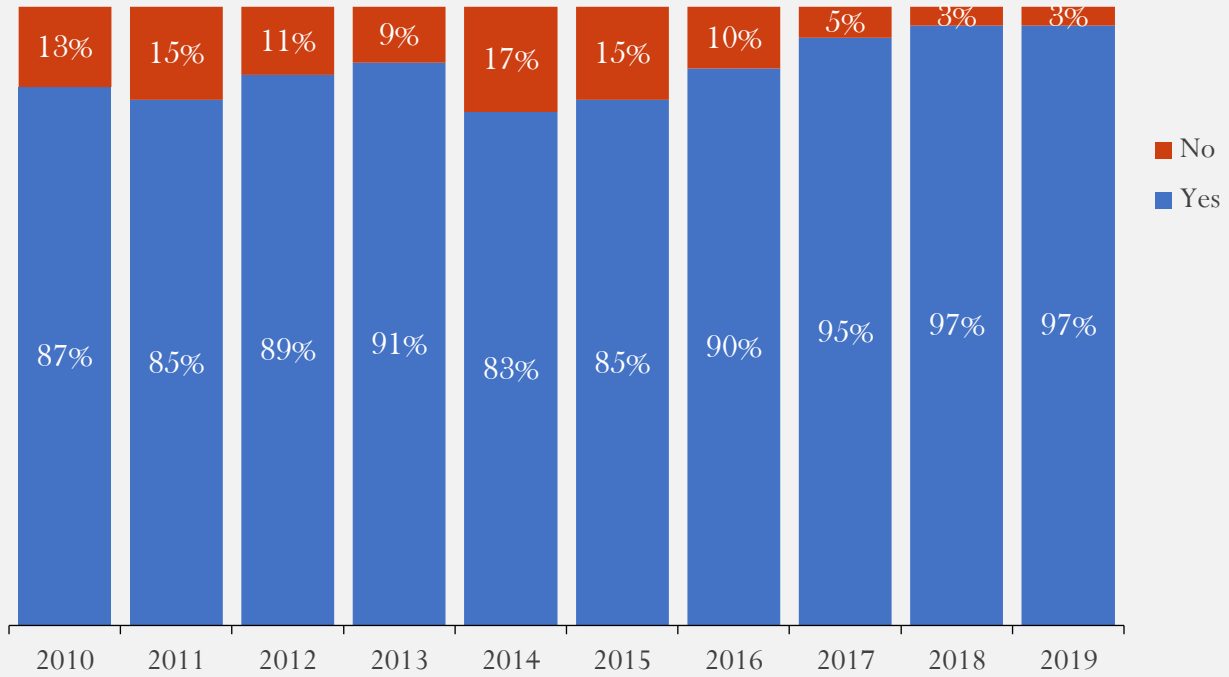
China’s prominence in overall company strategy



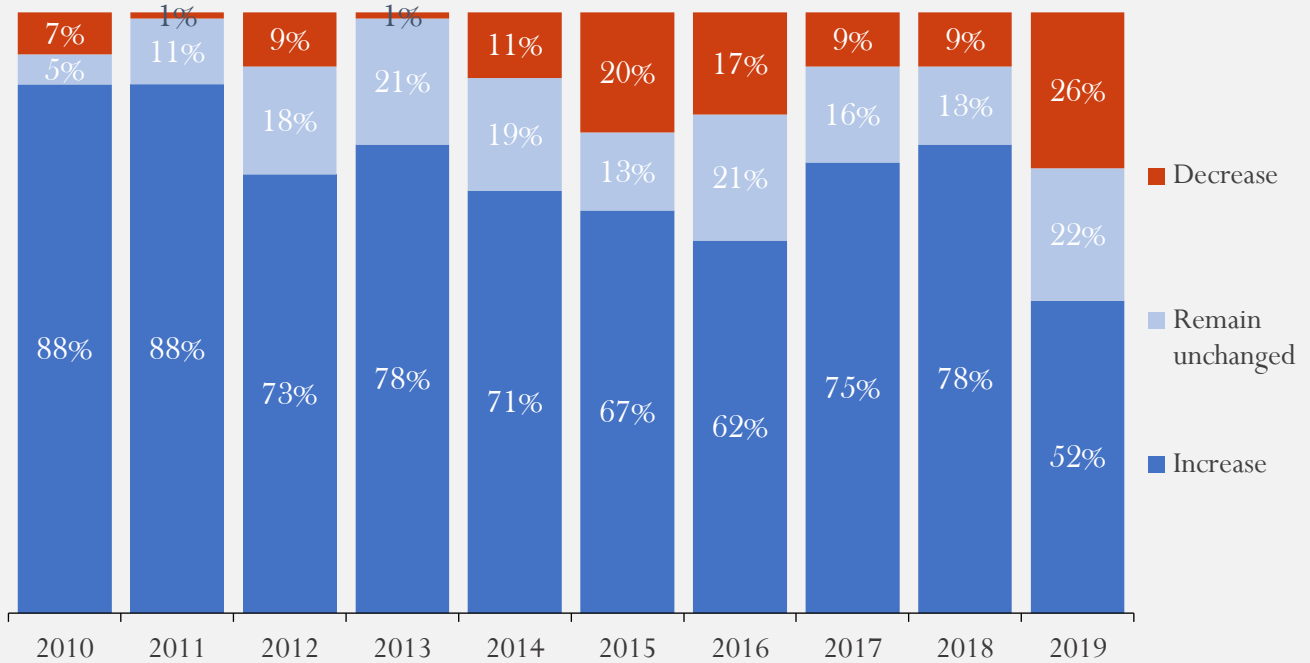
Profit margin rate of China-based operations compared to overall operations



Are your China operations profitable?



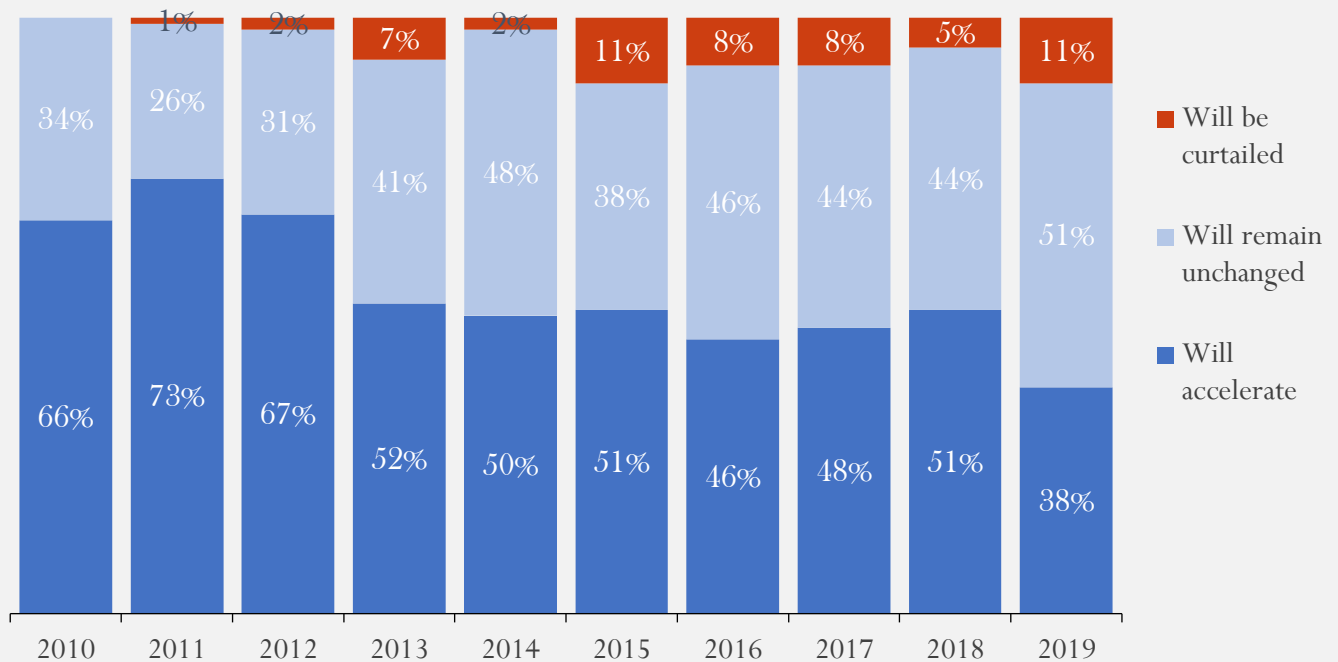
Current year revenue from China projection



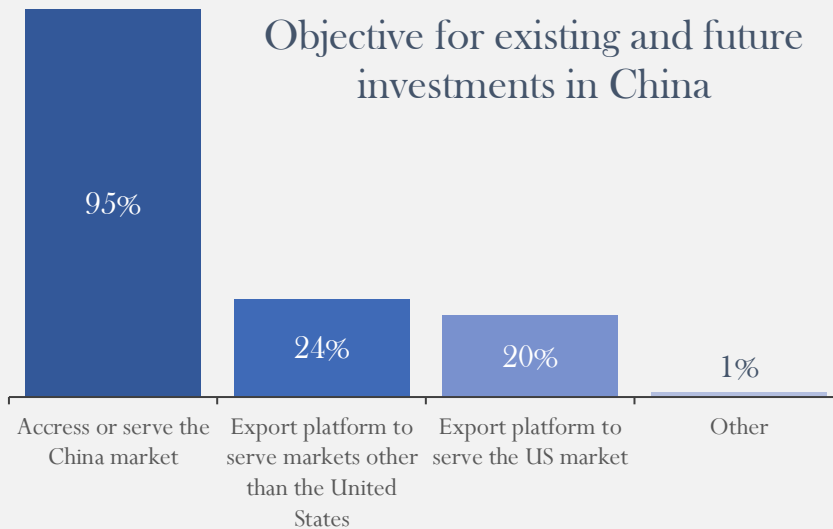
Rising Costs

The majority of American companies surveyed remain committed to the China market and few are currently divesting existing operations. However, responses allude to a cautious evaluation of their supply chains in China. Rising costs in China—a long-time trend appearing in this survey—is a significant impetus for this review, but the impacts of deteriorating US-China relations are also a contributing factor. The political uncertainty may be causing companies to delay or cancel planned investment decisions; this year marked the lowest percentage of respondents reporting that they will accelerate investments in the China market. Nearly 30 percent of respondents report slowed, delayed, or cancelled investment in the United States or China due to the uncertainty from heightened tensions—twice the number reported in 2018.

Resource commitment to China for the next year

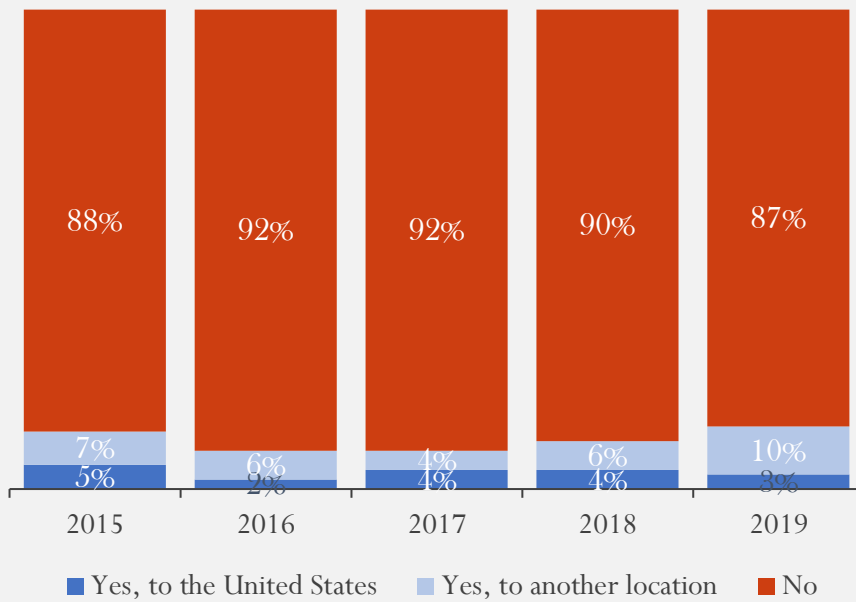


Objective for existing and future investments in China



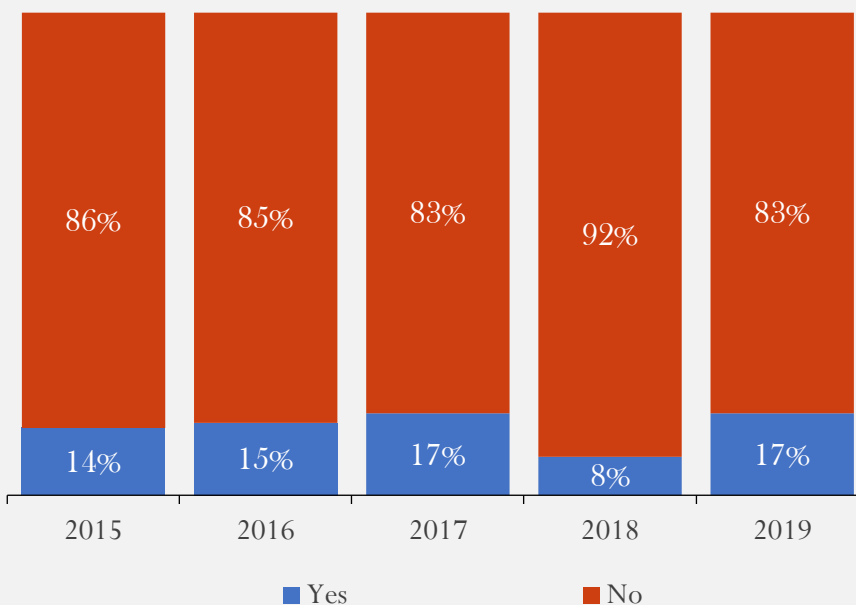
Company investment objectives in China are crucial to understanding the shifting resource commitments reported in survey responses. The overwhelming majority of USCBC member companies—95 percent—invest in China to access the domestic market. Less than a quarter of companies invest in China to export regionally or to the United States.

Has your company moved or does it plan to move any operations out of China?



As a result, there is a bifurcation of investment and operational strategies beginning to take place. Companies will continue to invest in China to access Chinese consumers, but at the same time, rising production costs will push more companies to divest export-focused operations from China. The bifurcation is taking place both between and within companies. The pace of divestitures is unlikely to see a major shift in the coming years, as a sharp uptick would make it difficult for companies to maintain the investment levels required to remain cost competitive in China.

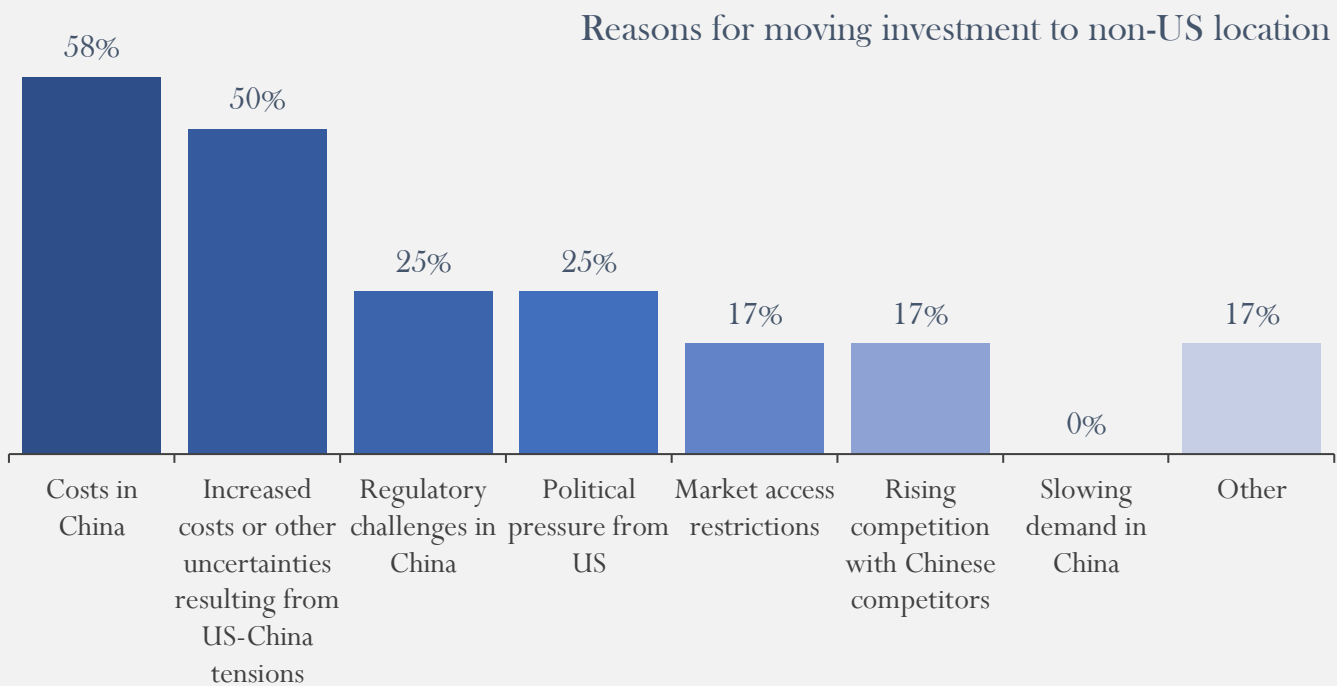
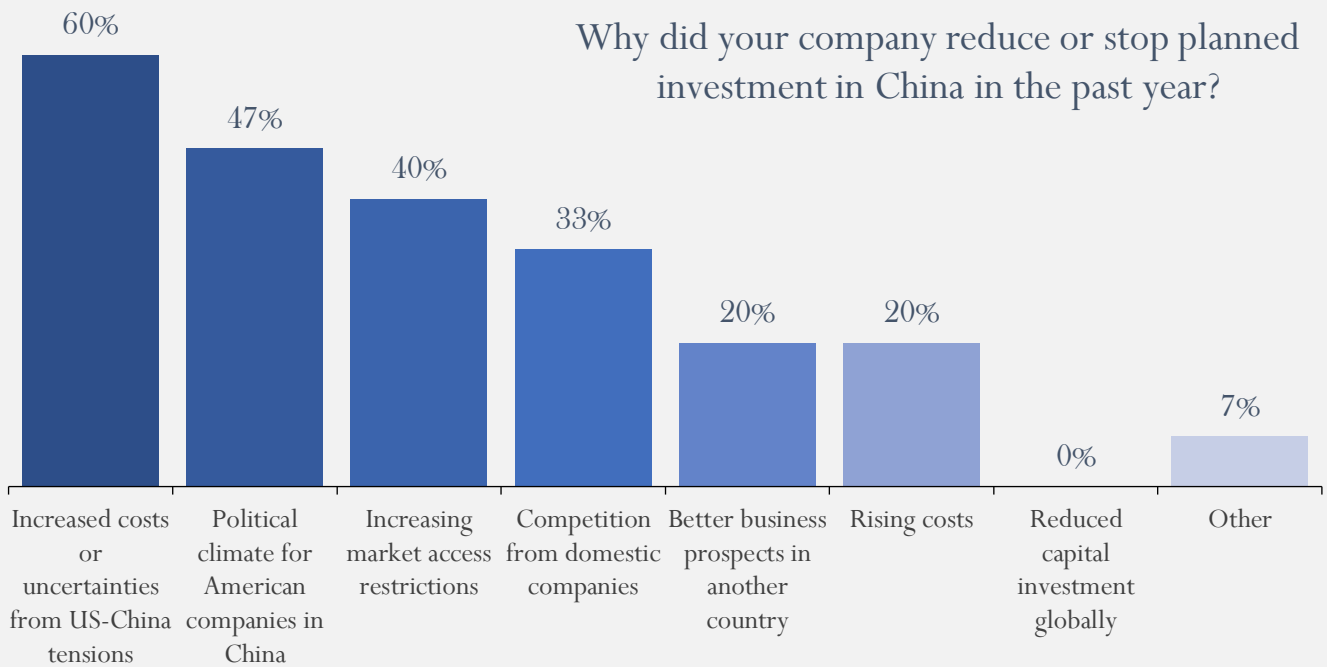
Did your company reduce or stop planned investment in China in the past year?



For companies with upstream inputs impacted by Chinese retaliatory tariffs, or those that export to the United States, tariffs are increasingly impacting bottom lines, as evidenced by half of respondents emphasizing increased costs from US-China relations as contributing to their decision to shift investments to another location.

More telling is the uptick in companies which decided to stop or reduce new investments. Though 17 percent is largely in-line with historic trends, the rationale for this reduction points to

new company pressures in the local market as a result of US-China tensions. Sixty percent of respondents cited increased costs or uncertainties from US-China trade tensions. Forty-seven percent cited the political climate for American companies in China as the top reason for reducing or stopping planned investment in 2019. This reason was not cited in the past two years' survey data, despite being included as an option.



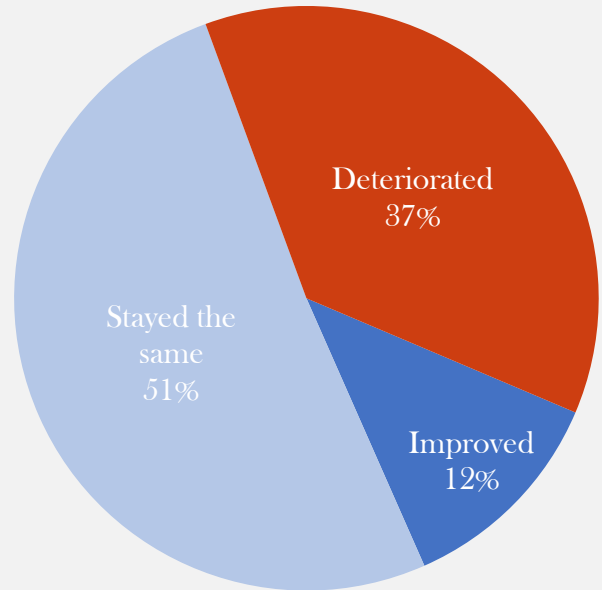
Declining Optimism

Still, US company commitment to the China market should not be a foregone conclusion. Though revenue from China operations increased last year, and profit margins compared to overall operations ticked up slightly, the view that China’s market environment deteriorated in 2019 was held by 37 percent, up from 21 percent in 2018, of those businesses surveyed. In fact, USCBC survey data indicate moderating optimism over the past several years, a trend that continued in 2019. Companies with positive outlooks cite domestic market growth and profitability of China operations as key determinants. Conversely, a pessimistic outlook is the result of an uncertain policy and regulatory environment, unlevel competitive environment, and rising costs.

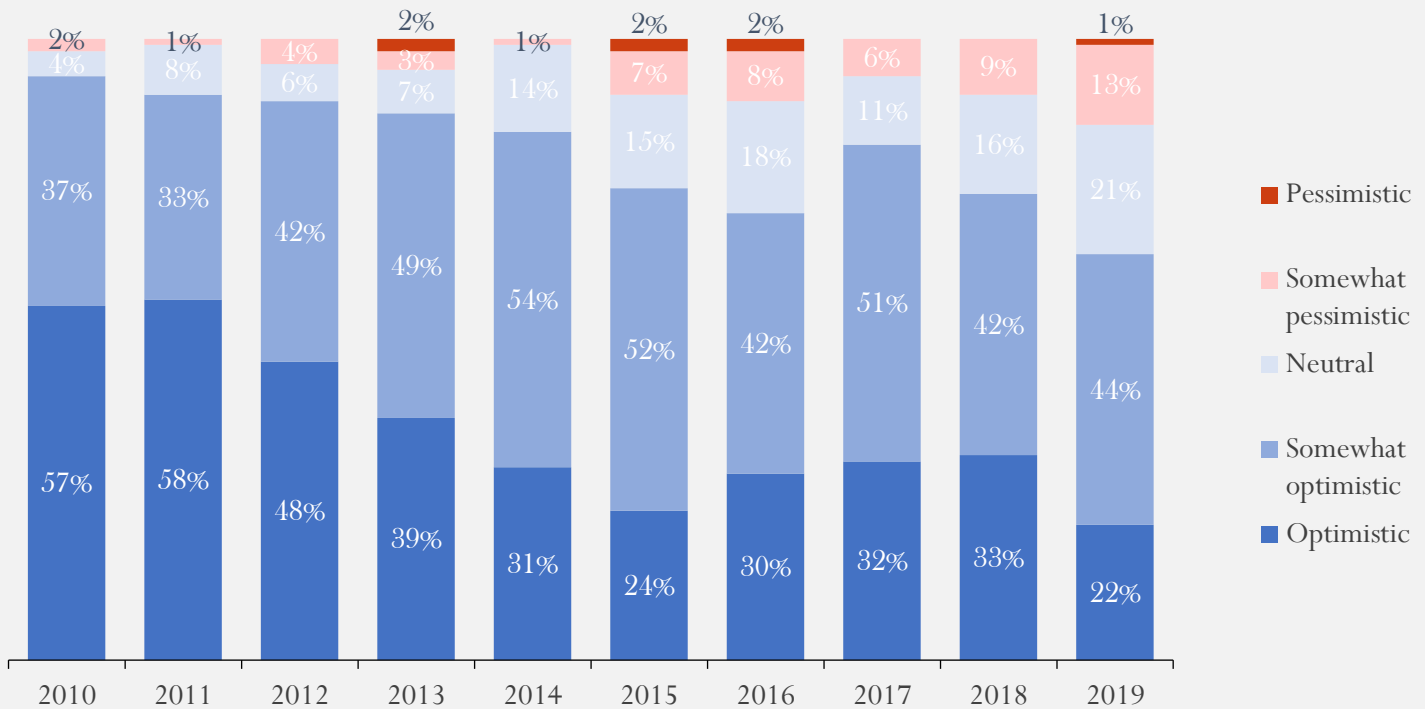
While few companies are pessimistic, respondent optimism about China market prospects five years from now is at a historic low. While the trade conflict is a pressing reason for this sentiment in the short term, survey data shows that China’s policy and regulatory environment is a significantly larger contributor to companies’ deteriorating outlook in the long term.

This trend is not lost on China’s leadership. Recent calls for improving the business environment recognize the positive impacts of reform for domestic economic interests.

China market environment over last 12 months

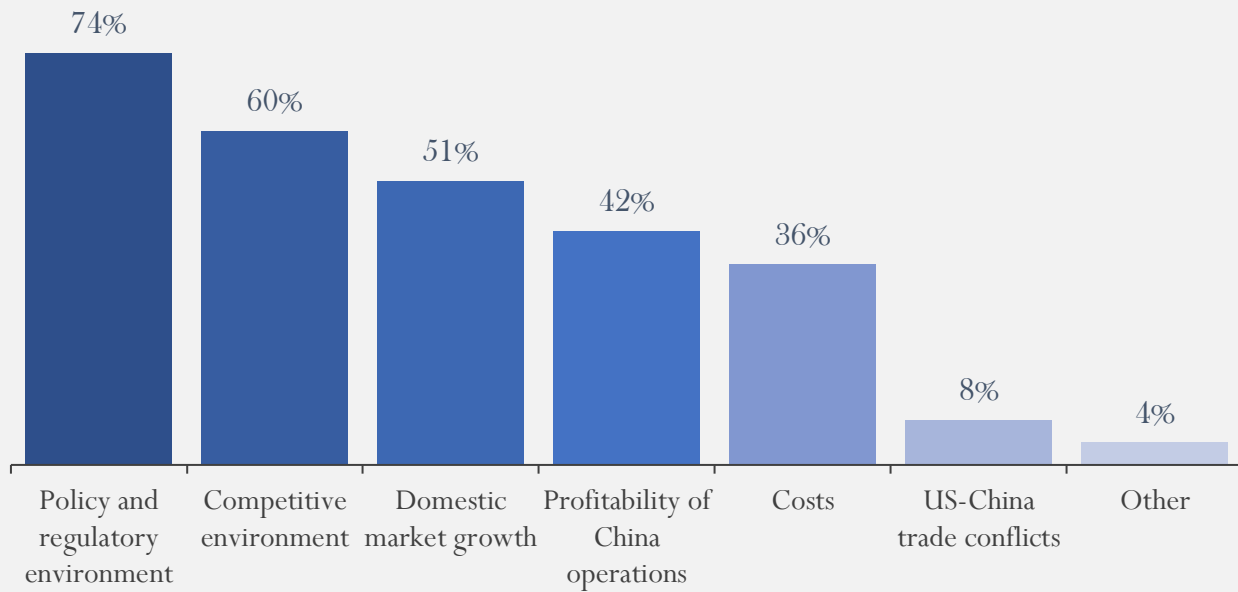


Five-year outlook for business in China



However, based on the 74 percent of respondents who cited the policy and regulatory environment as the top contributor to their five-year outlook, it appears that the pace of implementation has not been satisfactory. Implementing reforms that equalize treatment between foreign and domestic firms, improve IPR protection, and address market-distorting factors that lead to unfair competition would reverse these trends and demonstrate to critics that China has embraced its position as the second largest—and soon to be largest—economy in the world.

Issues impacting five-year outlook

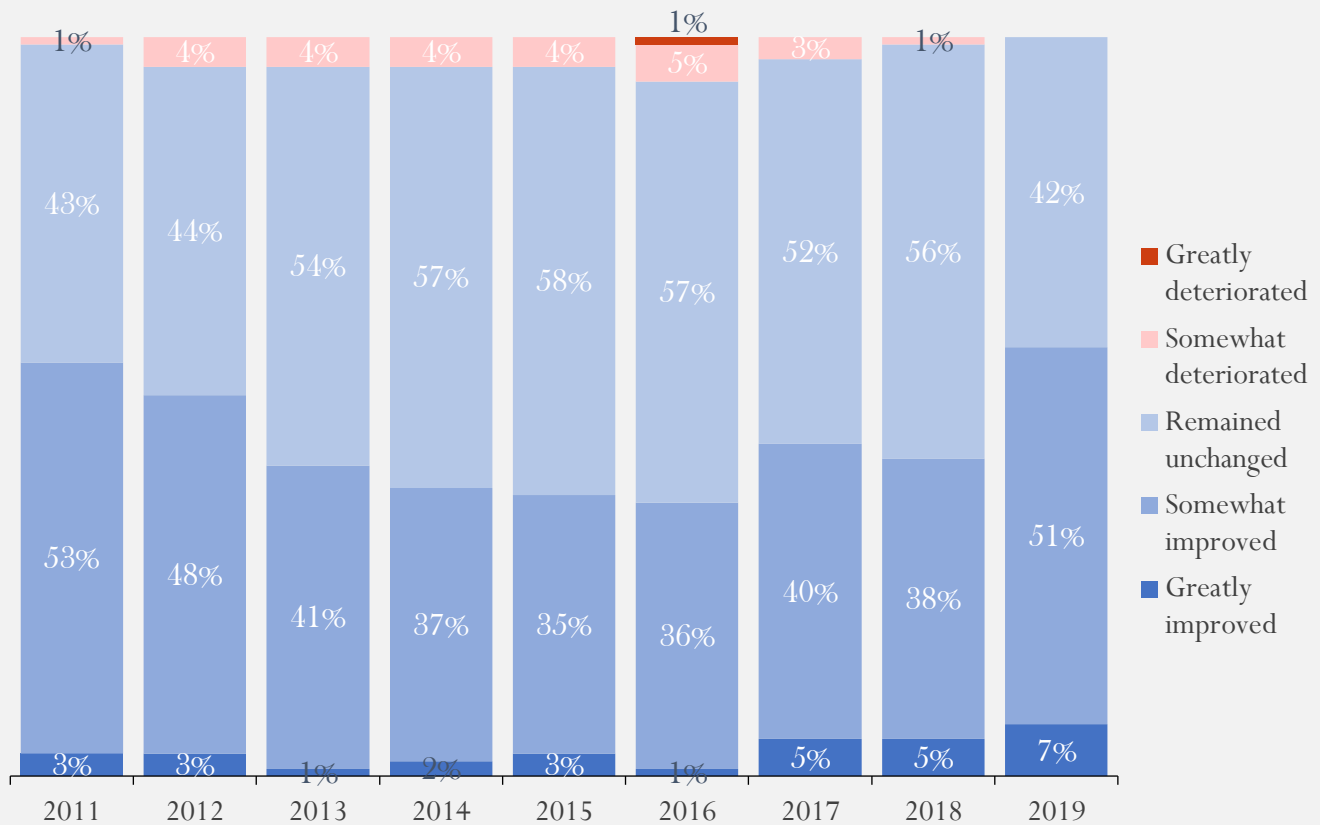


Areas for Improvement

Intellectual Property

IPR protection is a core issue in bilateral trade tensions and commands a significant portion of attention from both governments. Notably, nearly 60 percent of respondents this year report improved IPR protection in the China market, the highest level in any USCBC member survey. American companies attribute these improvements to the Chinese government’s increased emphasis on IPR protection, as well as a variety of new laws and regulations that aim to enhance protections.

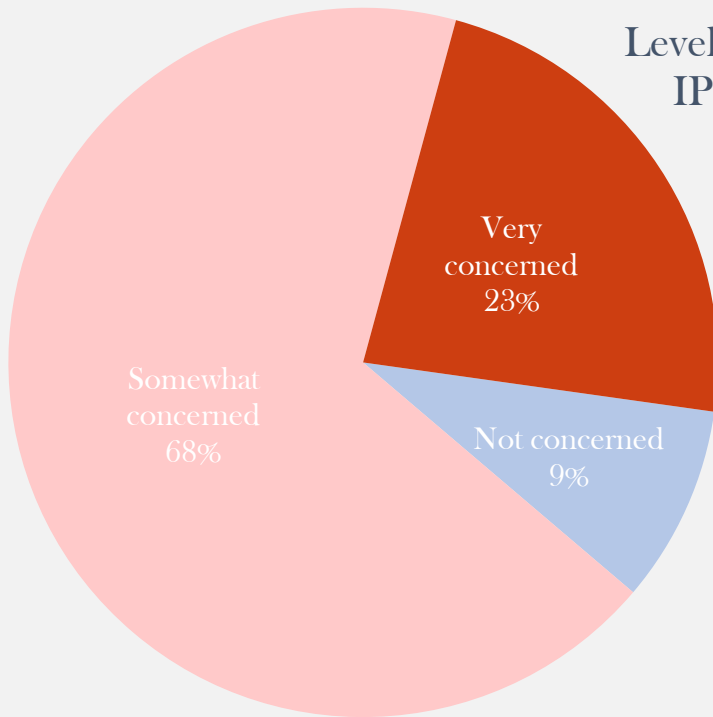
Over the past year, China’s protection of IPR has:



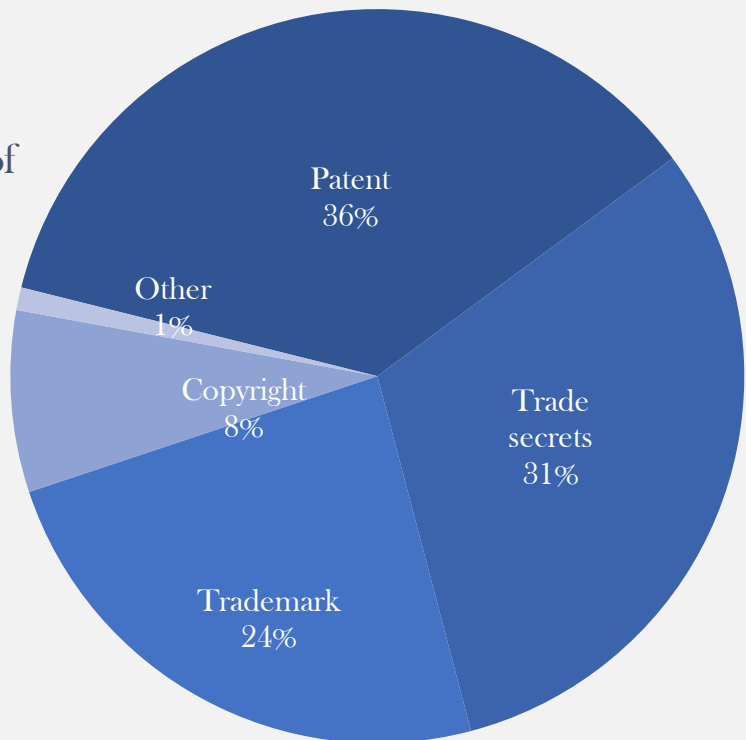
While these improvements are welcome, companies distinguish between IPR protection—which has seen marked improvement—and IPR enforcement, which still falls short of expectations. In 2019, 91 percent of companies expressed concern over China’s enforcement of IPR protections.

As in previous years, most companies report that their IPR concerns curtail what they are willing to do in the market. This is yet another lost opportunity for China's economic growth. Further reforms, with follow-through in enforcement, would also help to reduce tensions between China and its major trading partners—something that industry would welcome.

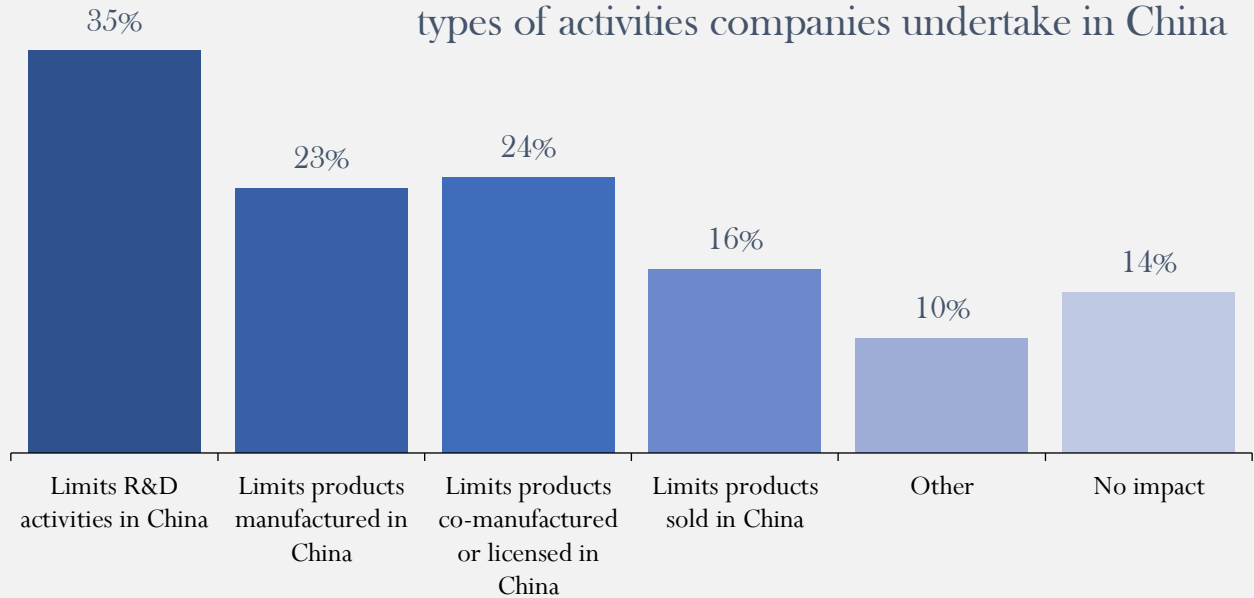
Level of concern about IPR enforcement



IP infringement of greatest concern



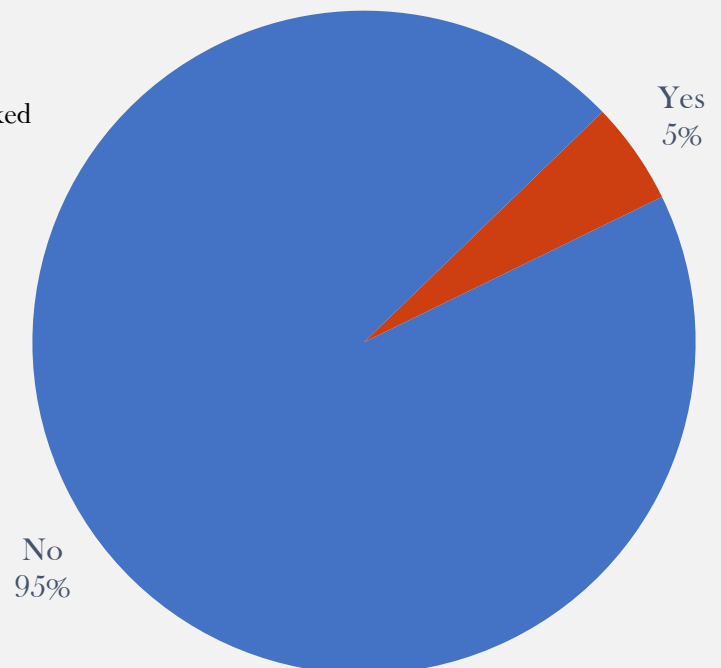
Impact of China's level of IPR enforcement on types of activities companies undertake in China



Technology Transfers

Technology transfers remain a key sticking point in US-China tensions, yet this concern ranked 24 out of the 27 possible top challenges companies face in the China market. While only 5 percent of survey respondents report being asked to transfer technology in the past three years, the issue is an acute concern of affected companies in key sectors. The companies that are asked to transfer technology must make high-consequence decisions and manage the tradeoff of technology sharing and market access. Industry would welcome continued reform to current JV and administrative licensing requirements that increase the vulnerability of trade secrets.

Has your company been asked to transfer technology to China?



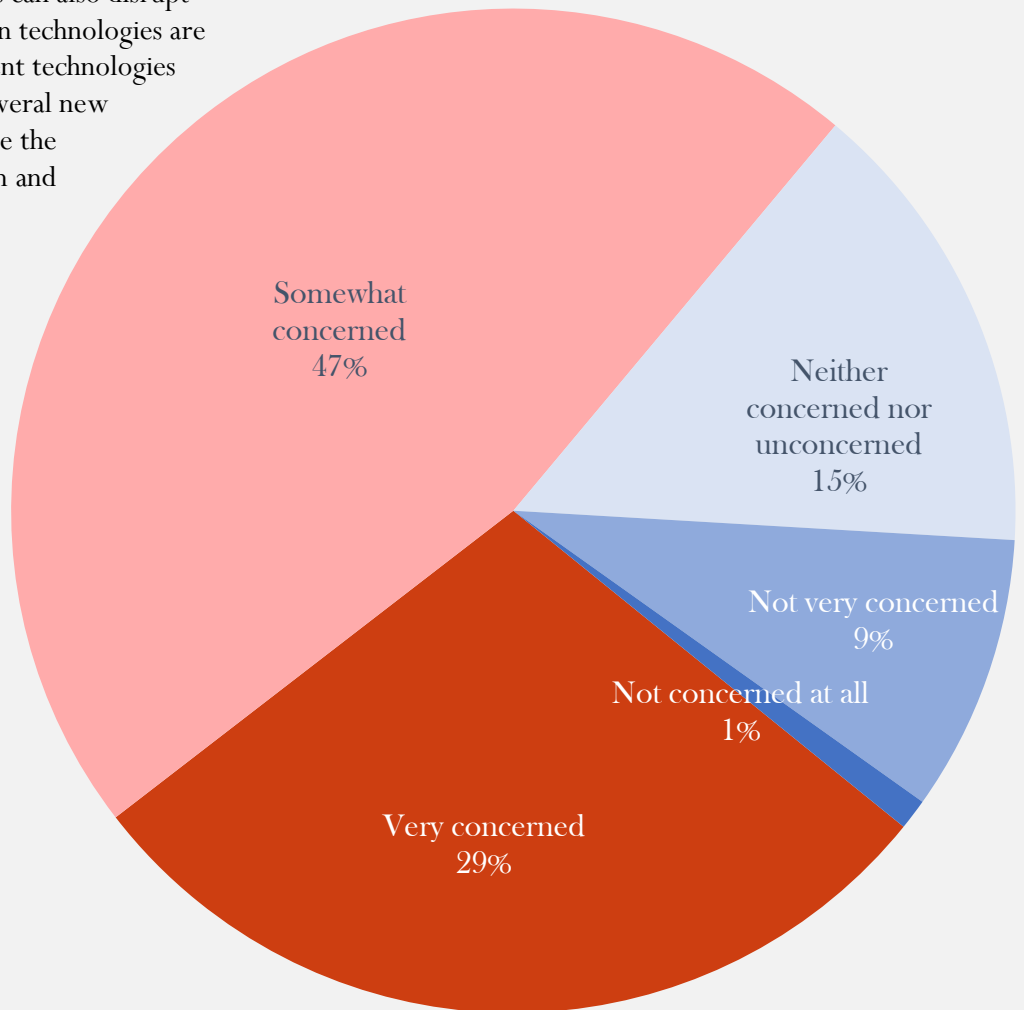
Data Flows and Cybersecurity

Data flow and cybersecurity issues impact almost all companies in China, and are not exclusively a concern of technology firms. As a consequence, it is not surprising that data flows has appeared consistently in the top 10 issues since 2015, the first time the issue was included in this survey.

A majority of companies, 76 percent, have some level of concern about China’s policies on data flows and technology security. A recurring theme this year, 64 percent of respondents report US-China political tensions as their top cyber-related concern. The next two most prominent concerns are more operational, with concerns around restrictions on cross-border data flows and data localization requirements.

China’s updated data regime may have adverse consequences. American companies report that, in addition to increasing infrastructure and local vendor costs, these restrictions can also disrupt network security. Many foreign technologies are still the most secure and resilient technologies available commercially, and several new requirements would undermine the security that global information and communications technology companies build into their products. These types of policies create more widespread vulnerabilities in Chinese networks, which could undermine China’s broader economic security and development goals.

Concern about China’s information flow and technology security policies



As regular bilateral engagement has abated, so too have the opportunities for industry to engage with regulators on their data and cybersecurity priorities. It is essential that the United States and China find ways to discuss these issues regularly and identify areas of mutual agreement to reduce cyber-related tensions.

Concerns regarding cyber-related issues

