EXECUTIVE SEARCH

FEBRUARY 2019

NEWSLETTER INTERNATIONAL

ENGLISH VERSION

CHINA

CHINA: IS THE GLOBAL GROWTH ENGINE STUTTERING?

INTERVIEW:

Silke Besser

"CHINA IS HIGHLY INNOVATIVE"

P. 2

Christian Tegethoff

"HALF OF CLIENT REQUESTS CONCERN SHANGHAI"

P. 5

ANALYSIS:

Thibaut Minot

FIVE FRAUD PREVENTION STRATEGIES

P. 6

"CHINA IS HIGHLY INNOVATIVE"

Silke Besser
Managing Director of the German-Chinese Business Association (DCW) e.V.
For more than 30 years DCW has been supporting economic relations between Germany and China. It is the largest joint network of German and Chinese companies and institutions and supports both sides in their engagement in the other country.

What impact does the trade dispute between China and the US have on German companies?

One thing is clear: even many medium-sized companies operate globally today and maintain subsidiaries all across the world. Their supply chain is directly affected when disruptions occur between individual economies. In a global economy, a trade dispute between the two largest economies inevitably has direct or indirect consequences for companies in third countries.

Of course, the impact of the trade dispute on German companies depends on their global interdependence and their respective business model, but they cannot be overlooked. A deterioration of the economic development in the USA and China, because of their sheer size alone, directly affects the global economy as a whole.
For Germany, China has a great and still growing importance. In terms of volume, the People's Republic is already Germany's largest trading partner. In 2017, goods worth a total of 186.6 billion euros were traded. Germany imported goods worth 100.5 billion euros from China, the sum of German exports to China was 86.2 billion euros. In 2018, exports to China still grew by 8.1 percent, although economic growth in the target country already began to slow down.

This places China in 5th place of German exports. After the US, the People's Republic is the second largest market for German companies outside Europe. For many German companies - especially in the automotive industry - China is even the most important foreign market.

And how does the trade dispute affect the Chinese economy?

The trade dispute between the US and China has, among other factors, led to lower growth in the People's Republic. For the last year, according to official figures, a growth of 6.6 percent is expected. While the first half of the year was still relatively stable, the Chinese economy's growth in the fourth quarter was only 6.4 percent. For 2019, the World Bank expects under 6.5 percent.

The slower growth in China affects German companies directly, not just as exporters. Around 5,200 German companies are currently represented by a subsidiary in China. They mainly produce for the Chinese market, but of course they are also integrated into the international supply chains.

Almost all Chinese and American exports contain inputs from German companies, so that trade barriers in these countries are noticeable. Currently affected are automotive suppliers, electronics producers and mechanical engineering.

In China's domestic consumption, too, the uncertainty created by the trade dispute has left its mark. For example, after two decades of growth, the automotive market saw a drop in demand of around 4 percent.

Although German carmakers were able to increase their market share in 2018, a stronger collapse of the market would also significantly dampen their growth. German car manufacturers currently sell about 35 percent of their total production in the Chinese market.

As long as a solution to the trade disputes is not in sight, declining sales expectations dampen the demand for capital goods. So far, some only talk of a "growth dip". It is to be hoped that agreements at the political level will open new perspectives for companies.

What opportunities arise for German companies from the Chinese initiative "One Belt, One Road"?

Launched in 2013 by President Xi Jinping, the Belt and Road Initiative already includes over 60 countries in Asia, Europe and Africa. Their gross domestic product adds up to around 21 trillion dollars or nearly 35 percent of global economic output. Around 4.4 billion people are encompassed – that is 60 percent of the world's population.

In about ten years, China wants to more than double its trading volume from 1.1 trillion dollars today to 2.5 trillion dollars. The new Silk Road is thus the largest geostrategic project of our century.

It will be important that the Silk Road does not become a one-way street. Experts estimate that the initiative can increase international trade by 12 percent, while trading costs are likely to fall by 50 percent.

The People's Republic has already invested more than 25 billion dollars in infrastructure projects over the last five years. Numerous projects that are in the construction or planning phase are not included in this figure.

There are already several direct train connections between Germany and China, e.g. from Chongqing to Duisburg, from Zhengzhou to Hamburg and from Chengdu to Nuremberg. Thus the Chinese market and the neighbouring countries along the Silk Road, can now be supplied from Germany much faster than by ship transport. The goods arrive in about 12 days at the respective end point of the routes. Of course, this opens up further business opportunities for the logistics and transport industry.

In addition to further intensifying trade relations with China, the countries along the route will also be developed. It remains to be seen whether this will also promote the local national economies and strengthen the stability of these countries.

While infrastructure upgrading is currently being carried out mainly by Chinese companies, there are already several projects involving German companies and consultants. German companies from the fields of environmental technology, energy, construction and engineering are also seizing the opportunities.

Do you continue to observe new German companies coming to China? In which sectors do you see particularly great opportunities for European companies?

Yes, we are still seeing new subsidiaries of German and other European companies in China. Despite lower growth, the Chinese market continues to impress with its immense size and the enormous increase in its social middle class, resulting in a considerable consumer market. In part, companies that have been active in China for many years expand their commitment. Despite known obstacles to investment, there is still a great deal of interest in entering into the People's Republic.

Some companies which have been involved in China for decades are continuing to expand there. Examples include BASF, Rheinmetall, Fresenius Medical Care, Knoll or Webasto and the major automobile manufacturers.

But also small and medium-sized companies are moving on to China. In addition to manufacturing companies, service providers are intensifying their activities, such as the logistics companies Lufthansa Cargo, Deutsche Bahn or Deutsche Post DHL Group. Even German football clubs are increasingly considering the great potential of Asia in their internationalization strategy and establish their own offices in China. Further market openings in some areas, such as banking and insurance, have recently created new opportunities for investors. For example, Allianz is the first foreign insurance company to set up its own holding company in China, in which no Chinese joint venture partner will be involved.

China is also an interesting field of activity for start-ups from Germany and Europe. The country is highly innovative and benefits from skipping development steps other countries had to take in the past.

In areas such as artificial intelligence, mobile payment and electromobility, the China is already ahead, thanks in part to considerable state funding. This not only creates opportunities for established European and German companies, but also for start-ups to benefit from the overall positive innovation climate.

"HALF OF CLIENT REQUESTS CONCERN SHANGHAI"

Christian Tegethoff
Managing Director
CT Executive Search

What kind of assignment do you currently work in China?

The structure of our client base in China has been unchanged for some time. We work mainly for medium- to large-sized companies from Europe that have been active in China for a long time. Many of them have production capacities here and China is one of the most important international locations for them, with group-wide importance also for procurement.

Our assignments are predominantly replacements or mandates in the context of business expansion, with projects in connection with new market entries clearly being in the minority.

Our assignments concern almost exclusively the local C-level. Usually, we place CEO, Plant Manager or Sales Director positions, as well as financial roles. We operate across all sectors, with a slight overweight in the B2B industry - for example in the mechanical engineering, construction and automotive sectors. However, we also work a lot in the consumer goods sector, for example in the food industry.

Does the US-China trade dispute affect your business in China?

It is obvious that building tariff barriers hampers companies and they are watching the issue closely.

However, noticeable effects do not exist for us so far. This would be the case, for example, when foreign companies leave China or refrain from originally planned recruitment. I cannot recognize either, and we do not expect the US-Chinese conflict to escalate in a way that would affect our activities in the country.

In which provinces are you working mainly at the moment?

The majority of our clients' sales offices is located in Shanghai, from where our Chinese partner company also operates. Around half of the inquiries relate to assignments in Shanghai or the adjacent Yangtze Delta.

Other important locations for European companies are the Pearl River Delta, the regions around Beijing and Tianjin, and Jiangsu – they are manufacturing hotspots.

FIVE FRAUD PREVENTION STRATEGIES

Thibaut Minot
is an Assistant Manager on the International Business Advisory team of Dezan Shira & Associates in Shanghai.

Foreign companies entering a high-risk market like China must pay attention to their compliance programs at the local level. Passive supervision from the top simply will not suffice.
As a starting point, the below internal control measures should be carefully considered and strengthened where appropriate.

1. Embed internal controls in the corporate governance structure

When starting a new business venture in China, it is vital to embed internal control mechanisms within the company's governance structure.
The corporate governance structure of a wholly foreign-owned enterprise (WFOE) in China is made up of an executive director or alternately several directors constituting a board, one or several supervisor(s), and an authorized representative of the shareholder(s).

In addition, one individual shall occupy the position of the company's legal representative, a role that can be assigned either to the Executive Director (alternately to the Chairman of the Board of Directors) or to an optional General Manager position.
A clear segregation of duties sets the foundation for an effective reporting line, allowing shareholders to have better supervision and control over their China operation in the long term.

Lured by the prospect of a leaner and more efficient decision-making structure, foreign businesses in China too often entrust considerable authority to a sole employee, usually the legal representative, paving the way to a loss of transparency and control.
When an employee is able to perform important duties without supervision or prior authorization from a manager higher up in the reporting line, there is always a risk that this individual ends up acting in his or her self-interest. An opportunistic legal representative could do considerable harm to the company if proper checks and balances are not in place.

2. Monitor custody of company chops

On an ongoing basis, the shareholders should monitor whether each person is fulfilling their duty in accordance with the company's Articles of Association and PRC Company Law. Likewise, in China, careful consideration should be awarded to the assignment of the custody of the company chops.
Sometimes also referred to as seals or stamps, chops in China are engraved with a given company's details, such as its registered legal name and are used to legally authorize documents – much like the signature of a senior executive in other countries.

In effect, whoever holds the company chops is de facto granted authority to act in the company's name. In the day-to-day operations, this could mean signing contracts on behalf of the company, or authorizing payments at the bank, for example.
"A failure to monitor the custody of company chops could provide an opportunity

for local employees to perform fraud," said Ivy Gu, who is a Manager on Dezan Shira & Associates' Business Risks, Internal Controls & Investigations (BRICI) team.

Gu: "We recently encountered a case where the General Manager of a WFOE in Ningbo had used the company chop and the Legal Representative's signature chop to transfer RMB 12 million to his personal company right after capital was injected by the shareholders into the WFOE."

Thus, all companies in China are advised to develop thorough internal control mechanisms to ensure its employees use chops legitimately. The solution may lie in dividing the chop usage and guardianship responsibility between different persons, or better yet, appoint a third-party custodian to safeguard the company chops.
In addition, it is recommended to establish who at the senior-management level permits to use a given chop if the regular holder is absent, and to clarify when the chop's guardian is required to secure additional approval prior to usage.

In certain cases, it could be requested that the signature of a senior manager be applied prior to chop usage, to further strengthen the segregation of duties.
Finally, creating a log documenting the time, date, and reason each time a chop is used or accessed from the company's safe, is also advisable.

3. Automate inventory management, segregate purchasing functions

For trading or manufacturing companies, implementing internal controls related to inventory management is essential.

Having an automated warehouse management system could significantly limit the incidence of inventory misappropriation, while physical stock takes should also be performed periodically to verify the accuracy of electronic data and reduce the risk of employees tampering with the system.
"Earlier this year, an investigation we conducted revealed that the local warehouse manager of an international company was able to steal inventory undetected by intentionally making an incomplete count of the raw materials during the quarterly stocktaking process," said Gu. "Such incidence of asset misappropriation could have been prevented if a third-party had been entrusted with the physical stock count," Gu added.

It is also essential to appropriately segregate the duties of the purchasing manager and warehouse manager to limit the risk of collusion of a sole decision-maker with suppliers.
There should be a clear reporting line defined whereby the warehouse manager instructs the purchasing manager to place new orders with suppliers, upon authorization from a senior manager.
Obviously, the decision regarding the choice of suppliers to begin with and pricing should be carefully controlled.

More generally, different steps in any purchasing process should be assigned to different staffs, and variances in the price paid for goods and supplies should be investigated, to limit the incidence of cash theft or collusion between staffs and suppliers.

4. Control sales prices and monitor shipping

Similarly, on the sales-side of things, price ranges for different products should be firmly set.
For some businesses, each product might have a set price, while for others, there is room for negotiation with each individual client.

In the latter case, businesses should establish firm ranges for which employees can sell a given product, whether it is in a certain range for all sales or different ranges based on the quantity sold.
Prior to proceeding with a sale outside the set range, the sales team should be requested to secure additional approval from a senior manager. This dampens the potential for cash theft or collusion with customers.

Additionally, businesses should record any item shipped out with the relevant invoice, to avoid back-channel sales profiting individuals as opposed to the company. The consistency between inventory data, shipping records, invoicing, and the sales figures in the books should be carefully monitored, and the relevant duties appropriately segregated.

5. Separation of roles in cash management

Last but not least, a segregation of duties regarding cash management is absolutely essential to limit the incidence of cash theft. The responsibility to initiate and approve e-banking requests, for instance, should be separated.

One practical solution could be for the finance manager at HQ level to hold the e-banking token required to approve payments.
Likewise, the cashier holding the corporate check book should not have free access to the company chops; otherwise, that employee would have the opportunity to initiate payments at the bank undetected.

The cashier and bookkeeping functions should also be segregated, to ensure that all banking transactions and cash movements are properly recorded.
Referring to another recent fraud investigation performed by her team, Gu recounted: "The General Manager of a WFOE in Suzhou had instructed the local cashier to open three bank accounts under her name, and the General Manager would transfer money from the company bank account into the personal bank accounts of the cashier from time to time. The cashier also was responsible for the bookkeeping and was instructed to record the payments as payables to suppliers in the company books."

"Such cash embezzlement and asset misappropriation could have been prevented if the cashier and bookkeeping functions had been properly segregated," said Gu.
Once such internal control processes have been implemented, compliance to these internal policies should be closely monitored and further encouraged by evaluating key staffs and business partners.

EXECUTIVE SEARCH

EXECUTIVE SEARCH EXPERTS IN THE EMERGING MARKETS

CT Executive Search focuses on placing key positions in the emerging markets – in Russia/ CIS, Africa, the Middle East and Asia.
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