

“Adventures in China”

by Margaret S.C. Johns

Reader,

This is the sixteenth edition of BlueLake Partners’ Newsletter – ***The Perspective from BlueLake***. The Newsletter is published periodically, and focuses on and analyzes trends in growth-oriented industries. We’ve taken exception in this newsletter, and chosen to focus on a country, China, rather than an industry.

We hope you find it informative and thought provoking, and we welcome any suggestions or thoughts you might have on the content. Please feel free to pass it along to others that you think might find it interesting.

Sincerely,

BlueLake Partners, LLC

I recently returned from a 16 day tour of China with an international group of business travelers. The trip made a profound impression on all of us: the pride, energy and enthusiasm of the Chinese people; the distance the country has come and the distance China, as a country, has yet to go.

Over the past two to three years, I’ve observed professionals for my client companies embark on monthly and quarterly trips to China to set up manufacturing facilities with the goal of dramatically reduced costs. With even the small company M&A market becoming increasingly global, and the increasing number of Chinese company IPO’s, it was time to view the Chinese juggernaut for myself.

The overall impression one gets in China is that of a country in a hurry: in a hurry to make up for lost time. The energy and pace is frenetic. The GDP growth is an enviable nine to ten percent. New buildings, new highways, new subways are everywhere, in every part of the country. In fact, China’s national bird is often said to be the (building) crane.

The sheer magnitude and scale of China is evident wherever you go. From the 1.3 billion people, the population and density of the cities, and size of everything, everywhere, even the historic attractions. The Forbidden City is one mile by 0.6 miles; Shanghai has the tallest buildings in the world, the Great Wall is over 2000 miles long and the tomb of Emperor Qin is massive, with over 7,000 life size soldiers bearing real arms as well as a slew of chariots with horses.

In Beijing the energy on the street is palpable. Young people wear the most fashionable jeans and accessories, a long way from the drab grey-blue Mao suits of lore. In some respects, China is like the sleeping giant, and has abruptly woken up and is scurrying to make up for all the lost decades of isolation. Since the mid 1980's, China has gradually been allowing their population to engage in for profit businesses. Now every Chinese person wants to be a millionaire. Nowhere is it more apparent than in Beijing, with the thousands of sidewalk peddlers.

Still, you do see anecdotal evidence of China's censorship and control. For example, for some unknown reason, we were unable to reach certain benign (to us) websites. Also, when I attempted to use Skype over a wireless network, China Mobile, which is 75 percent state-owned, took over my computer and rendered it useless until I did a full restart. In Hong Kong, Skype worked flawlessly on a wireless network.

Counterfeit currency is a problem, but only for foreigners. The locals either know the game, or it's not considered polite to rip off your fellow countrymen with counterfeit currency. When dealing with street vendors, the change one receives is often counterfeit. By the end of the trip, those of us who had engaged in barter with street vendors had acquired counterfeit 50 and 100 Yuan bills. In New York City, when you engage in trade with vendors, you may be purchasing watches that don't accurately tell time, but the change you receive is never counterfeit. We had been advised not to engage with the street peddlers. Once we, as a group, had collected a fair amount of counterfeit currency, the tour guides shared with us the methodology the street peddlers used to cheat us, and warned if we were to engage with the street peddlers to always deal in small amounts of currency, be it dollars or Yuan.

We traveled to six cities: Hong Kong, Shanghai, Anhui, Huangshan, Beijing and Xian. We found a definite pecking order in the cities:

- As would be expected, Hong Kong was the most sophisticated and modern city. With a population of approximately seven million people on 36 square miles and a population density of 91,500 per square mile. As a point of reference, Manhattan's population density is 66,940 per square mile. We were told that often, three generations will live in a single room. Drinking water is a proxy for sophistication of a civilization. We were told that in Hong Kong we could brush our teeth with tap water, but to only drink bottled water. Once in the airport and on our way to Shanghai, we were told that from that point forward to use only bottled water, for anything that had the potential to be ingested.
- Shanghai is the financial capital of the China, and you see it in the tall buildings that are being erected, one every twelve days. It is also the most international city in China, with the French quarter, the Bund and Pudong. Shanghai's population is estimated to be 13.6 million "permanent" residents with official papers, and a total of "long term" residents at 17.78 million. Shanghai, also has its fair share of "guest workers," or illegal immigrants, from other areas of China.
- Beijing is the governing capital of China with 11.6 million "permanent" residents and 15.2 million "long term" residents. The city has the largest number of cultural tourist attractions in China, with the Forbidden City, the Summer Palace, The Temple of Heaven, Tiananmen Square and proximity to the Great Wall. As such it, we observed the largest number of street vendors, in where ever we went, congregating wherever the tour buses parked. This was true capitalism at work, with hard, seemingly earnest bargaining and counterfeit change.

A proxy for financial sophistication in China might be the number of people who had graduated from Harvard's MBA program: 250 in Hong Kong, 65 in Beijing and 118 in Shanghai. We met with one of my engineering school classmates in Hong Kong. He and his wife (who is a U.S. attorney and employed by the Hong Kong Securities and Futures Commission) tell us that the well-off Chinese come to Hong Kong to buy goods whose authenticity they deem to be important, including baby food.

I spoke with a senior executive, formerly with Pepsi, who had worked for a major Hong Kong consumer products company. From his

perspective, the big news in China is the education and training of the new generations. The multinationals have recruited the 'best and the brightest' and these young people have managed to adapt to the multinational corporate cultures, and are leading China forward. In China, the multinationals now have strong work forces of well-trained Chinese young people who are their future.

My Anecdotal Observations:

One World with Global Communication: Easy access to inexpensive worldwide communication has made it a tiny world. When in China, the Blackberry messaging system operated flawlessly, and Skype was crystal clear at rates of either 'free,' when computer to computer, or 2-1/2 cents per minute when calling computer to telephone. I was able to follow the World Series, relishing the Red Sox's victory, as soon as I woke up in the morning, and email back and forth to my husband, (when I wasn't talking to him on Skype) almost instantaneously. The world has shrunk.

The other side of this coin is that the Chinese people are much better informed as to what is happening in the rest of the world. And much as many U.S. professionals have learned how to circumvent the blocking of certain websites at work by accessing restricted websites through intermediary websites, the Chinese have also learned these tricks.

Respect, or Lack Thereof, for Intellectual Property: My observation is more about IP than about the Chinese' capability at technology industries. While we know major technology companies including IBM, Dell and Oracle, occupy huge buildings in Chinese Industrial Parks, I'm more than a little suspect that any American company would perform confidential research or product development in China. Though, I'm willing to be proven wrong.

In addition, the average Chinese person doesn't seem to understand the concept of intellectual property. Copy cat products are inimical to their culture. The Silk Market, a modern five story building, bigger than a football field, is filled with booths selling rip off designer and other products. At the Silk Market we were able to bargain for "Max Mara" raincoats for \$20, a designer pair of jeans for \$9, "Canon" cameras for \$90 and of course "Rolex" watches for \$12. And those were the expensive Rolex's, fact, the fifteen two dollar Rolexes one of colleagues purchased are still working.

The response of the Chinese government to complaints from international manufacturers is that the Chinese people are an incredibly entrepreneurial population, and impossible to control. However, the Chinese government deals quite effectively with counterfeit manufacturers of official Olympic promotional products. The offending parties disappear, with not a soul knowledgeable of their whereabouts.

If I was a high tech manufacturer, I would not be in a hurry to set up factories in China where any sort of sensitive IP was involved. My skepticism runs high, after seeing the plethora of incredibly cheap counterfeit goods being sold. A booming industry that appears to be sanctioned by the government. The scale of the counterfeit goods industry is impossible to convey, and even includes BMW's.

Once the Chinese have developed IP that they wish to protect and profit from internationally, I am sure they will begin to respect the IP of others. Currently, it is in China's best interest to copy on an unrestricted basis.

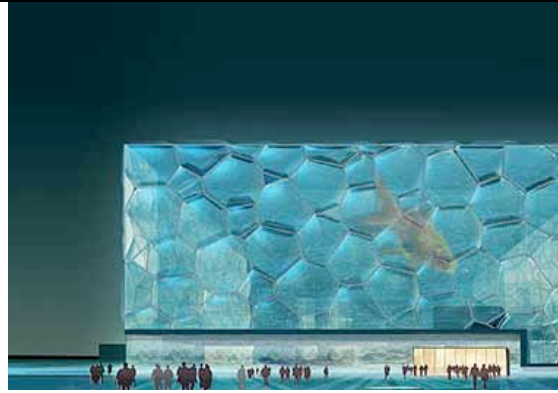
Capitalism: The Chinese are more capitalist than Americans. It's not an exaggeration to say that everyone wants to be a millionaire. The Chinese are making up for the time lost in the Cultural Revolution. According to the Hurun Report, a year ago, there were 15 billionaires in China; now there are 106. And the rest of the 1.3 billion Chinese want to join the Club. Thank you Alibaba.com.

The Olympics: China's coup in hosting the 2008 Olympics is a very, very big deal to its citizens. You can feel a genuine sense of pride and a feeling of anticipation. Our Beijing hotel gave each guest a set of Olympic mascot dolls, which my stepdaughter was thrilled to receive. The Olympics gives China and its government a feeling of arrival and legitimacy. The Chinese share not an ounce of the skepticism of the citizens of Los Angeles, Athens, and Salt Lake City about whether the cost of the Olympics is worth it.

The Olympic buildings and architecture are breathtaking. The stadium is called the "Birds nest" for obvious reasons; the National Swimming Center is known as the "Water Cube." The construction for the Olympics is everywhere, and includes athletic competition centers, facilities for the athletes and the addition of hotels for the international guests. Nothing, be it expense or otherwise, is being spared.



Olympic Stadium, Beijing



Olympic National Swimming Center

And how long are those new Buildings, Highways and Bridges going to last? The buildings, highways and bridges are going up so fast, that one has to wonder about the quality of construction. We visited a four year old resort that was an architectural showplace, and already the houses appeared to be very worn. Each unit in the tall new high rise apartment buildings appears to be self ventilated, through a fan to the outside. There are already instances of bridges collapsing—but more due to illegal substitution of poor grade materials. And heads literally did roll.

Homogenization of the World: When we went to our hotels in the major cities, you could have been in almost any city in the world. The same luxury goods retailers staked their presence close by, no matter the city: Burberry, Cartier, Louis Vuitton, Hermes. Also, Starbucks was present in density in every city but Beijing. In the Forbidden City, there was a brouhaha about having a foreign brand located in such a magnificent Chinese jewel. The local Starbucks kiosk was replaced shortly after opening in 2000 by a domestic look-alike. This occurred also with Kentucky Fried Chicken in Beihai Park and McDonald's in Tiananmen Square. Still, McDonald's, Yum Brands (Kentucky Fried Chicken, PizzaHut) and Subway Shops are well represented in the cities. In Xian, which is considered to be unsophisticated by the East Coast Chinese, we walked through a passageway that bordered the first floor of a department store. You would have thought you were in the first floor of Lord & Taylor. You can't help but feel at home, as the store had exactly the same cosmetics brands and layout as any upscale department store in the United States.

Pollution: The pollution problem has not been over-hyped. It is huge. The Chinese are major users of coal as a heating and power source. The homes are heated by cylindrical coal briquettes and the factories are powered by coal fuel power plants. We saw very little pollution in Hong Kong, Shanghai and Beijing, because of the trip's time of year. October is historically one of the best months, pollution-wise. Typically, August, which is hot and humid, is one of the worst months. There was a lot of conversation about how the Chinese government is trying to 'manage' the pollution for the 2008 summer Olympics. Already, they have started experimenting, temporarily shutting down coal plants and polluting factories near major cities and banning one-third of the cars from the road on given days, to no avail.

On our trip, nowhere was the pollution more evident than in Xian, which is more towards the center of the country. There was a continual haze in the air. That same haze is present in the manufacturing areas near any of the major cities, though the air in the actual cities is cleaner.

The Party Line: We found an interesting mix of candor, and lack thereof, in our guides. They would candidly talk about the 'one child policy' and its impact on Chinese society, but claim that the students shot at each other in Tiananmen Square. I was impressed by some of their candor, and then surprised by some of the obfuscation of the truth. It shows how one adapts to survive in a changing society, always aware of the nuances that keep one safe and those that bring one into dangerous territory.

They do have a well developed sense of humor, up to a point. When one of our colleagues tried to buy the hat off an Army officer, our tour guides became noticeably nervous.

Impact of One Child Policy: In the mid-1980's China instituted the 'One Child Policy.' They have somewhat relaxed it, such that if a couple today are only children, they are allowed to have two children!

One impact of the One Child Policy, is that the child now has two parents and four grandparents focused exclusively on that child. Which is creating the type of Generation Y or MTV Generation struggles that the United States and other countries are now grappling with.

China now has three generations with completely different lifetime experiences: 1) the Lost Generation, that became adults in the midst of the Cultural Revolution and were denied education, and sent out to communes for the majority of the productive portion of their adult life, 2) the Late Cultural Revolution generation, when China gradually loosened its tight strictures and the population became more capitalistic, and 3) the current Y Generation.

The retirement age in China is 50, probably due to the much lower life expectancy due to the environment and poor healthcare. Gen X and Yers are now supporting that "Lost Generation."

National Pride: The Chinese people are very proud of their country, their leadership and how far they have come. On the morning we left Beijing, we went to the flag raising in Tiananmen Square. It was 6:00 AM and crowds of people were scurrying to the square. We saw several huge buses parked and lining the road. There was no access to the Square, so everyone viewed the flag raising from behind the barricades across the street. The soldiers marched in, and raised the flag to the national anthem. Once the flag was raised, the crowd quickly disappeared. Of course, the omnipresent vendors were at work, selling small Chinese flags.

Are there still bad feelings between China and Taiwan? In a word, YES. Not being attuned to the issue, we were more than a bit surprised at how big an issue it is. When one of the business people we met in Hong Kong talked about Taiwan his voice and face became full of emotion. From mainland China's perspective, Taiwan will always be part of China.

Friend or foe? Well that depends on whether our interests are aligned with those of China or not. China is aggressively sourcing oil from the Sudan, Russia and Iran, stepping in wherever the Western World leaves a void. My experiences on this trip reinforced this thought in spades.

Can you speak English: The number of people in China who are fluent in English is absolutely amazing. In Xian, our restaurant hostess had an American accent, and claimed she had never been out of China. When we took the Beijing subway, it wasn't long before we found some people who spoke English who could direct us to our destination.

What happened to the art museums? For a country China's size, its art museums are miniscule. The Shanghai Art Museum was probably ten percent of the size of the Metropolitan Museum of Art. As far as I know, Beijing does not have an art museum of note. While touring the Shanghai Art Museum was a pleasant experience, it left me wondering what happened to the all the art. Certainly, a great deal of China's art was destroyed during Cultural Revolution, mixed in the bonfires composed of the nation's books.

The truly valuable art is now in Taiwan, or museums in the rest of the World. Notably, the Yale Art Museum, Boston Museum of Fine Arts, and the Metropolitan Museum of Art.

Where are the pugs? Pugs are said to originate in China, but I saw very few dogs, let alone pugs. In Huangshan, one of our group saw two officials come up to two wandering dogs, where a nearby woman was walking her dog. The officials shot and carried off the two wandering dogs and the woman picked up her dog as if to protect it. Our Chinese tour guides told us that the Chinese will eat anything. That must also include pugs.

At the end of the trip, I came away energized and impressed by this huge nation. I also came away with a healthy respect for the power and force China has now, and will possess in the future. 1.3 billion is a lot of people, and translates into a gargantuan power, when directed to an end. When I spoke with my ten year old step daughter, I advised her to learn Chinese, as she may well be working for a Chinese company when she grows up. While sourcing from China today is fraught with potential problems, some day they will "get it" and will compete most effectively.

Mei Zhang, the founder and owner of WildChina, the travel agency the group used within China sums up China's present well:

Developing as fast as it is, China has got its allure but it's also got its problems. This trip has exposed you to both sides. I remember you saw the leaning towers of China Central Television (CCTV) on the way to Panjiayuan antique market in Beijing, two weeks later back in the US, I read in the *Wall Street Journal* about the architectural challenges of joining the two towers. Apparently, the design is so delicate, that the joining has to take place before dawn, otherwise, the heat of the sun can distort the building material just so slightly, but enough to make

the whole project collapse. This, to me, is China today – perched for either greatness or peril. Let's hope for the former.

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