

BOARD BRIEF CHINA

The Board's Changing Role in China Strategy



THE BOARD'S CHANGING ROLE

For many corporate directors, doing business in China today is tantamount to high-stakes chess. The first moves, which mostly entail sourcing to reduce costs, feel smart and fit easily within the board's purview. But as the game progresses, every move becomes more complex, the stakes get higher, and boards may even question what their involvement should be.

There's no question boards must address specific China issues. What's not clear is whether the right issues are ever reaching the board and whether directors themselves are asking the right questions, says Clarence Kwan, the national managing partner of Deloitte's Chinese Services Group.

"Is the board really focusing on strategic oversight on China?" he asks. On a more fundamental level, do board members sufficiently understand the opportunities and risks in China? Moreover, do shareholders recognize your company's achievements in China?

To explore these issues, the Chinese Services Group, in cooperation with the Deloitte & Touche USA LLP Corporate Governance Center, joined with Global Navigation, the international affiliate of Corporate Board Member magazine, to survey directors from Fortune 1500 companies on a wide range of topics related to their China investments. The survey results provided new insights for a roundtable discussion with directors from numerous industries, including manufacturing, financial services, shipping, retailing, consumer goods and energy. The directors who participated in the roundtable not only brought a wealth of knowledge about business practices in China, but also a willingness to share their experiences and exchange ideas with their peers.

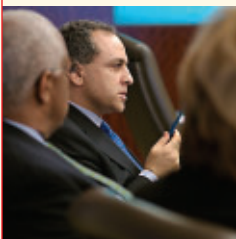
To kick off the discussion, the group was briefed on the results of the Deloitte-Global Navigation Director Survey.

SURVEY HIGHLIGHTS

Among the Fortune 1500 companies surveyed—a universe that includes mid-cap companies and larger—the most enduring relationships they report having with China involve sourcing products from third parties. More than one-third of survey respondents have been sourcing from China for more than six years; another 31% have done it from one to five years. The second most common activity is manufacturing in China for export, involving 45% of all respondents. The new frontier is selling to Chinese markets, which ranks as the “highest priority” for 46% of respondents. As for mode of investment in China, respondents were almost four times more likely to have made greenfield investments in China than acquisitions, although going forward, roughly one-third report that mergers and acquisitions (M&A) would be their preferred means of entry or expansion. In terms of ownership of existing operations, roughly one-third of respondents report having a wholly-owned greenfield subsidiary, with 62% reporting that this was the form taken by their most recent investment in China. At 13% each, respondents are as likely to have a greenfield majority joint venture in China as they are to have acquired controlling interest in an operation through M&A, while only 11% say they hold a minority interest of any sort.

The success of a company's Chinese operations hinges on many factors, among which is ownership structure. Companies with wholly-owned subsidiaries in China—whether the result of organic growth or acquisition—seem to enjoy the most success, with 80% of directors reporting that their subsidiary meets or exceeds its goals. In contrast, just 15% of those with a minority interest in a Chinese business report that those operations meet or exceed their goals.

With respect to future investments in China, almost a quarter of all respondents say that acquiring a controlling stake in a Chinese enterprise through M&A would be their preferred means of investing in China, second only to investing in new wholly-owned greenfield operations. Interestingly, one-fifth of respondents report that their preferred means of



IN CHINA STRATEGY

future investment would be a majority joint venture arrangement, with another 9% favoring minority ownership. With so few sectors in China still requiring them, the enduring appeal of joint ventures may reflect a collective sense that selling effectively to Chinese consumers requires extensive local knowledge that only a Chinese partner may possess. Nonetheless, directors are still expressing a clear preference for obtaining majority ownership and, hence, management control, over these new ventures.

One surprise in the survey is the grades directors give themselves on their company's China performance relative to competitors'. Only 17% see themselves as being in the top third for capturing value from manufacturing goods in China for sale to the local markets, and just 22% rank their companies in the top third for exporting to China. And across a range of China activities, more than a quarter of directors don't know how they rate relative to competitors.

The survey also reveals a lack of consensus on best practices for keeping boards apprised of company activities in China. Just over half of respondents say management reports on its activities in China at every board meeting or every other meeting. Yet some 35% say they receive reports only once a year, less often, or never at all. The ad hoc nature of many boards' oversight of Chinese operations is striking. Indeed, in the absence of well-established

processes and regular reviews, corporate boards may find themselves addressing China-related issues only when problems arise, rather than as part of a creative and comprehensive strategy. It's not surprising then that nearly three out of four respondents don't believe their company's business activities in China have maximized shareholder value. Yet, respondents apparently see profits just over the horizon. More than seven out of 10 directors believe their company's Chinese initiatives are going to have a positive impact on shareholder value over the next five years.

THE DIRECTORS WEIGH IN

One of the biggest issues for many corporate boards with respect to China, Kwan suggests to the directors gathered, is that they may not be giving China all of the attention it needs.

"As your company's China operations move beyond basic sourcing, how do you identify the new issues which are sufficiently strategic to warrant board attention?" he asks. For example, with managerial talent in short supply in China, do top-level staffing matters come to the board's attention? Should they? And what should directors know about regulatory issues in China, where adverse rulings can break a project?

Jan Scites, a director of Central Vermont

A Snapshot of Roundtable Participants

Clarence Kwan, national managing partner of Deloitte's U.S. Chinese Services Group, joined **Joan Susie**, CEO of Global Navigation, as co-facilitator of the discussion, which included:

Rene-Pierre Azria, a director of Jarden Corp., which owns familiar brands like Coleman and Sunbeam
Marsha Evans, retired U.S. Navy Admiral and a director of Huntsman Corp., Lehman Brothers, Office Depot and Weight Watchers
Robert Holland, a director of Carver Bancorp, Lexmark International, Neptune Orient Lines and Yum Brands

David Londoner, a director of publishing house Meredith Corp., as well as London-based music company, EMI

David Meachin, a director of Lyondell Chemical Company
Jan Scites, a director of Central Vermont Public Service and a member of the governing committee of Overseas Military Sales Corp., a private Swiss company

Roger Vincent, a director of energy distributor UGI Corp. and Chairman of the ING Funds

Dennis Wu, currently CFO and director of UCBH Holdings, a bank holding company, and a retired managing partner for Deloitte's U.S. Chinese Services Group

IS YOUR COMPANY CURRENTLY INVOLVED WITH/IN CHINA AND, IF SO, FOR HOW LONG?

(by percent)	10 years or more	6-9 years	1-5 years	Less than 1 year	No activity
Sourcing from third parties in China	19.4	16.3	30.6	5.1	28.6
Manufacturing in China for export	13.5	8.3	17.7	5.2	55.2
Manufacturing in China for sale to the local market	12.4	5.2	18.6	5.2	58.8
Exporting to China	13.0	9.8	25.0	4.3	47.8
Conducting R&D in China	2.3	4.5	18.2	5.7	69.3
Outsourcing/off shoring business processes to China	1.1	4.4	18.7	-	75.8



Kwan

Public Service and Overseas Military Sales Corp., points out that simple guidelines often work best for deciding when to involve the board. “At Overseas Military Sales Corp. where I am on the Governing Committee, they have a standing rule that any discussion of advancing themselves in another country comes to the board. Because that’s just the rule, it makes no difference if [the plan] is small, big, whatever.”

However, American boards, who must contend with the demands of Sarbanes-Oxley and highly inquisitive investors, may have more time limitations and more compliance

complexities to address at board meetings. Still, what emerges from this discussion is unanimity that, aside from divergent views and business practices, China is such a critical market that boards must deal with its challenges strategically, rather than reactively.

So how best to determine what does and doesn’t reach the boardroom? Roger Vincent, president of Springwell Corp., believes the size of a potential investment is a good measure for determining what deserves to get the board’s attention, particularly for long-term capital investments. “It’s a lot easier to make the decision to be in

China if you’re not putting an enormous amount of the company’s capital behind it.” On the other hand, he adds, major capital commitments may present a “fork in the road” for a company, which requires thoughtful oversight from the board.

Of course, it’s not always apparent from the outset what will become a major investment in years ahead. Robert Holland, a director of Yum Brands, says Yum currently has over 2,000 outlets in China, most owned outright or through joint ventures. Today, Yum China accounts for 16% of the group’s total operating profit. But it wasn’t obvious that would be the case years ago when Yum first moved into China.

“Ten years ago, China was a modest part of our international strategy,” says Holland. “It was far less important than Australia or many of the other countries in which Yum operated. Today, China is rapidly becoming Yum’s most important source of net income. Soon we’ll be opening more new units in China than we’ll open in the rest of the world—strategic vision eventually calls for more than 20,000 units.” During those 10 years, he adds, the board’s international processes have been supplanted by Chinese processes—many of Yum’s best practices now originate in China.

Incremental expansion allows for a learning curve and process improvements for the board. But many companies facing challenges in China today don’t have the luxury of time that companies had a decade ago. “Corporate boards need to do more to include China in their broader discussions and educate their directors on critical China-related issues,” says Kwan.

How can issues related to China be put on a track to reach board attention early, but not overwhelm directors with non-essential information? This question begets a related question, says Kwan. “Certainly, the approach

may vary from industry to industry and from company to company. But from a director’s standpoint, the real question is whether the board believes that the frequency of communication is sufficient or not. If not, they need to address the issue.”

Holland put his finger on the current state of affairs for U.S. boards in regard to China: “Things are changing so fast that practices haven’t caught up with reality,” he says.

HOW FREQUENTLY DOES MANAGEMENT SUBMIT ITS CHINA INVESTMENT STRATEGY FOR BOARD APPROVAL AND HOW OFTEN, IN YOUR VIEW, SHOULD THIS PROCESS BE OCCURRING?

Frequency (by percent)	Present practice	Preferred practice
Every year	63.3	75.3
Every 2-3 years	4.4	9.6
Less often than once every 3 years	5.6	–
China strategy not submitted to/approved by board	2.2	–
No China investment strategy in place	20.0	8.2
Don’t know	2.2	–
Other	2.2	6.8

PLEASE RATE THE FOLLOWING PRIORITIES FOR YOUR COMPANY’S CHINA INVESTMENT STRATEGY FOR THE NEXT 5 YEARS.

(by percent)	Highest priority	2.00	3.00	4.00	Lowest priority	Mean*
Increase China sourcing	24.7	25.9	16.0	7.4	25.9	2.8395
Shift production capacity to China	18.3	18.3	22.0	11.0	30.5	3.1707
Increase sales to Chinese markets	46.1	20.2	9.0	7.9	16.9	2.2921
Expand R&D in China	6.0	18.1	15.7	15.7	44.6	3.7470
Outsource/offshore business processes to China	6.4	11.5	16.7	11.5	53.8	3.9487

* Mean - The lower the mean, the higher the priority.

What often challenges boards most is formulating a long-term strategy for Chinese growth and operations. “I think it takes great discipline at the board level to focus on that 10-year out question, because public company boards face such competing pressures from SOX and all of the other business processes,” says Marsha Evans, a retired U.S. Navy Admiral and director on multiple boards.

Evans believes companies can adopt procedures that will prompt periodic consideration of China-related issues by the board. She points out that the annual board self-evaluation provides a good opportunity to remind all directors that a critical responsibility of the board is to spend time looking forward. “But I don’t think it comes naturally,” says Evans. “I think it takes board members to speak up because the survey results show that a pretty high percentage of the board members said they don’t talk about strategy. And I say, shame on them.”

The changing complexion of U.S. corporate revenues is yet another reminder that the competitive ground is shifting and that boards need to adapt. “China has become so much more important, and the rest of the world has become so much more important,” says David Meachin, a director of Lyondell Chemical Company. “Today a growing number of Fortune 500 companies have as much as 60% or 70% of their business offshore one way or another. Some companies manufacture very little or nothing in this country any more, and their U.S. operations are mainly focused on marketing their brands.”

In light of these changes, Meachin argues that directors need to shift their focus accordingly. “More of our time needs to be spent discussing strategic matters and acting as mentors to the CEO rather than as the traffic cop of SOX.”

WHAT TO DO ABOUT RISK

If corporate boards are to entertain China-related issues on a more strategic basis, they must also deal effectively with enterprise risk questions. Scites says boards are struggling to

define their role in mitigating enterprise risk.

“If you look at all that was said under COSO, enterprise risk is now right up there as a top board priority,” says Scites. “I think the debate is really about where enterprise risk will report at the board level. A lot of audit committees do not want it.” She suggests that enterprise risk oversight may need to be split up among the board committees simply because one committee can’t manage it all.

Rene-Pierre Azria, a director of Jarden Corp., which owns such familiar consumer brands as



Scites

IN TERMS OF PROVIDING OVERSIGHT FOR CHINA-RELATED STRATEGIES AND MANAGING THE ASSOCIATED RISK, HOW WOULD YOU ASSESS YOUR BOARD’S PERFORMANCE OF THE FOLLOWING TASKS?

(by percent)	Excellent performance	2.00	3.00	4.00	Poor performance	Mean*
Understanding of China related opportunities	16.1	40.9	23.7	12.9	6.5	2.5269
Ability to question management’s assumptions	23.7	36.6	24.7	8.6	6.5	2.3763
Ability to offer alternative solutions	14.0	28.0	31.2	18.3	8.6	2.7957
Understanding of China specific risks	11.7	39.4	27.7	10.6	10.6	2.6915
Understanding risk controls	11.8	39.8	24.7	11.8	11.8	2.7204
Ability to respond to risk failure	9.8	38.0	30.4	13.0	8.7	2.7283
Readiness to address China specific M&A risk	17.6	14.3	38.5	17.6	12.1	2.9231

* Mean - The lower the mean, the better the performance.

Coleman and Sunbeam, agrees, but proposes a reason audit committees may shun the enterprise-risk question. “I think audit committee chairmen don’t want it because most audit committee chairmen are accountants by training, and it’s a scary thought to take on this responsibility.”

Perhaps it’s time to create a new committee. That’s the route that the board of Neptune Orient Lines took, and Holland was appointed to head it up.

“I’m certainly not an expert on risk management, but I’ve got to tell you, you really spend a lot of waking hours asking questions that nobody has asked before—many of which start or end with China. It turns out that this company, like most multinationals, is highly dependent on what happens in China.”

Recently, for example, Holland says the board approved a decision to buy a billion dollars



Vincent

worth of ships, which raised a number of questions related to risk. Even though a billion dollars translates into only a modest capacity expansion in this industry, the sheer size of the expenditure really gets your attention. Because the company's core trade lanes are in the Pacific, almost any hiccup in China could have serious

China. If a company were to move anywhere else, the new location is not likely to have the whole supply chain to support operations, or even if it does, it may not have the economy of scale to compete with China," says Kwan.

That in and of itself makes diversification difficult. Moreover, for some companies diversifying may not be enough to mitigate the significant dependence they have on China. Kwan explains: "Let's say that you're already sourcing 90% of your product from China and 10% from Vietnam. If there's a significant trade issue with China, you cannot ramp up your 10% fast enough."

Indeed, as risks multiply or, perhaps more accurately, as risks receive greater recognition by corporate boards, the challenge becomes one of sustaining growth in the face of such

daunting challenges.

"You know, on any of these matters, you're constantly trading off risk versus opportunity," observes Meachin. "And it hopefully becomes clear when assessing these tradeoffs where the opportunities far surpass the risks."

Still, the list of risks to consider grows daily. "We're not only going to be faced with the rules by the Chinese regulators," says Meachin, "but we also have the U.S. regulators. And when you're doing an acquisition in China, you not only have to worry about the normal due diligence, but all these new risks."

Dennis Wu, director and CFO of UCBH Holdings, points to an earlier acquisition considered by his company. They engaged Deloitte Touche Tohmatsu's member firm in China to perform a comprehensive due diligence review of the target company, as well as a review for compliance with the Foreign Corrupt Practices Act. They wound up passing on the acquisition due to economic reasons, but they learned a great deal in the process, says Wu.

"I think this whole area of risk is a much, much bigger area that boards do need to be concerned about," he says. "I know that in our organization, we not only have an operational risk management committee, we have a credit risk committee, we have a market risk committee, and we also have an enterprise risk committee. And to head up the newly created enterprise risk committee, we actually hired the number two person from the Western region of

PLEASE RATE THE FOLLOWING INVESTMENT GOALS AS TO THE LEVEL OF OVERALL RISK THEY PRESENT TO YOUR COMPANY'S FUTURE SHAREHOLDER VALUE.

(by percent)	Highest risk	2.00	3.00	4.00	Lowest risk	Mean*
Increase China sourcing	10.2	13.6	29.5	25.0	21.6	3.3409
Shift production capacity to China	11.8	18.8	36.5	15.3	17.6	3.0824
Increase sales to Chinese markets	14.6	13.5	27.0	20.2	24.7	3.2697
Expand R&D in China	21.6	9.1	20.5	19.3	29.5	3.2614
Shift business processes outsourcing services to China	11.3	16.3	28.8	15.0	28.8	3.3375

* Mean - The lower the mean, the higher the perceived risk.

consequences for Neptune Orient Lines.

Companies sourcing products from China face similar risks. "As we can see from the recent pet food issue, there are risks when everybody is [buying] from the same place [and being supplied] the same ingredient," says Azria. "So at Jarden, we wanted to make sure that we didn't have a sourcing concentration. And these issues are not interesting enough to naturally come up to the board, but they are important enough that they would be disruptive. In terms of process, we have parked them at the audit committee level in the internal audit function."

Azria, who chairs the audit committee at Jarden, identifies another creeping risk issue facing companies doing business in China. "So much of our sourcing is risky because it comes from China, and it's getting expensive. We need now to look for other [sources]. And where are they? North Korea? No. Vietnam, Philippines, Indonesia, Bangladesh, Turkey?"

Deloitte's Kwan thinks this risk will only grow, and the options for addressing it will be fewer. One thought-provoking example he points to is the shoe industry. "The shoe industry already has a complete infrastructure in



Holland

IN YOUR VIEW, HAS THE BOARD DISCHARGED ITS RESPONSIBILITIES FOR BOTH STRATEGIC OVERSIGHT AND RISK MANAGEMENT FOR CHINA-RELATED BUSINESS ACTIVITIES TO ITS FULL POTENTIAL?

(by percent)	Frequency
Yes	71.0
No	15.1
Don't know	14.0

the FDIC.”

NURTURING BOARD EXPERTISE

An overriding issue on China facing many boards is the lack of deep Chinese expertise. “I think that American directors, for the most part, didn’t grow up with a lot of knowledge of China,” observes Vincent. “When we were going to college, if you had a chance to spend a junior year abroad, you were probably going to Europe, not Peking, as China’s capital was then known.”

So how does a U.S. company infuse its board with knowledge of China? Evans says the companies she works with are responding by putting more emphasis on high quality director education. She points to the one-day seminar as especially effective because it affords the opportunity to bring together board members from other companies to share best practices or even to bring in regulators. “It’s one-stop shopping from an orientation point of view,” she says.

Of course, the major investment of time and resources that goes into such seminars may not make sense for all companies, says Meredith Corp. and EMI director David Londoner. “If you are a company doing business in China, but it is not 10% of your business, but 5%, to comprehend all of the things that you need to know about China in one or one-and-a-half days is virtually impossible.”

Clearly, he’s right. Educating board directors is an ongoing process. Vincent breaks down board education on issues like China into three steps. The first one is to provide directors with a global view. “You’d invite in a firm like Deloitte [Touche Tohmatsu] or other experts, and you’d set aside time at an offsite [location] just so you really have the quality time. And I think I might do that a couple of times. I mean, you’re not going to learn everything you need to know in one or two presentations.”

The next step is getting board members on the ground in China. However, Vincent cautions against expecting too much from country visits. “Suppose there was a foreigner who says, ‘We’re going to bring our foreign board into the United States, and we’ve got three-and-a-half days, and we’re going to split it between New York and

Washington, and we’re going to carve out a half-day to take you to Monticello so you can see Jefferson’s home. By the time you finish that,’ he says, ‘I think you’re really going to have an understanding of the United States.’ I mean, we all realize how facetious that is when applied to China.”

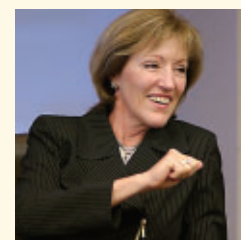
BY WHAT MEANS HAS YOUR COMPANY INVESTED DIRECTLY IN CHINA IN THE PAST, AND WHAT, IN YOUR VIEW, SHOULD BE THE COMPANY’S PRIMARY MEANS OF MAKING FUTURE INVESTMENTS IN CHINA?

(by percent)	All investment		Most recent investment	Future investment	
	Yes	No		Yes	No
Greenfield					
Minority joint venture	8.7	91.3	17.6	8.7	91.3
Majority joint venture	12.6	87.4	11.8	20.4	79.6
Wholly-owned subsidiary	33.0	67.0	61.8	29.1	70.9
M&A					
Minority interest	1.9	98.1	2.9	8.7	91.3
Controlling interest	12.6	87.4	5.9	22.3	77.7
Don’t know	12.6	87.4	–	15.5	84.5

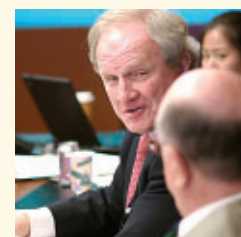
But Wu believes directors get something from travel that they cannot get at offsite seminars and meetings. “If people are having difficulty making up their mind whether or not the China market is worth an investment, until they go over there and see the potential, they don’t have a full sense of the factors. In today’s climate with Sarbanes and the kind of litigation that goes on, a lot of independent board members rightfully are nervous and concerned, and that could mean a lost opportunity.”

Lyondell Chemical Company also believes in the value of exposing its board to its overseas operations. This summer, the Lyondell board is going to Rotterdam where it has two very large plants. Meachin points to three tangible benefits that result from the board being there. First, employees get the message reinforced that they are part of a bigger team. Second, other interested parties—such as important customers, suppliers, and government representatives—may get a chance to meet board members, which helps solidify relationships. Third, international shareholders and stakeholders see that Lyondell is interested in the rest of the world and is not just focused on what it’s doing in the United States.

There’s also a hidden benefit to board travel. According to Holland, the boardroom time has become so SOX dominated and proforma oriented that it’s often an ineffective



Evans



Meachin



Azria

place to ask questions unrelated to SOX.

In contrast, the informality of unofficial meetings offers a special respite from formal board procedures and opens the door to creativity. “One thing I’ve really appreciated is the off-agenda dinners,” says Holland. “It’s common knowledge that in order to be an effective director, you’ve got to invest a lot more time than that spent in formal meetings—I’d say by a factor of ten times the actual meeting and travel time.”

Logistically, that can be tough for time-pressed directors, but Holland argues that in

new plant, which is going to take two years to finish in China, is finally done, that we will have a board meeting in Shanghai or elsewhere in China, and we can tie it all together.”

Meachin does not favor bringing on directors just based on their expertise on China. “I don’t think it makes sense to pick somebody who’s good for this country or that,” he explains. “What one has to do is look very hard these days when you have an opportunity to hire a new board member at what skill sets they have, where have they done business, and if they’re American, have they lived abroad, or vice-versa.

What you want is to have a board that mirrors as best you can the problems that we are faced with day in and day out.”

Azria believes the board’s bench needs to be deeper, but not necessarily focused on China. “I think we have a lot of international experience on the board as it is, but we have emphasized increasing the bench, or having a deeper bench of Asian experience, which we didn’t have. I’m not just talking about Chinese experience, but in a wider way, for Japan and Southeast Asia.”

At present, such experience is in short supply on America’s corporate boards, notes Wu. “Clarence [Kwan] and I belong to an organization called the Committee of 100, a national organization of prominent Chinese-Americans. The Committee updated a study recently of the boards of Fortune 500 companies. Only 1.5% of the board members are people of Asian background [but comprise about 4.9% of America’s population]. The discrepancy is important because unless you have some more diversity on the boards, you’re not going to get diversity in senior management in the major U.S. companies, and that’s a major issue that I think America is not facing yet.”

“As a chair of a nominating committee, I can tell you that it is a real challenge to develop real diversity,” says Evans, “the kind that enriches intellectual capacity on the boards.”

It’s a compelling issue, says Evans, and one that has real consequences. “We can have these strategy discussions, and we can address the risks, and we can talk about the numbers from an investment point of view, but unless we have the ability to execute, it’s all for naught. And my experience to date is that the execution is even harder than the strategic discussion, the decision process to make the investment. Where do you get that magical cadre of people who can pull it off, and pull it off successfully?”

The shortage of well-qualified employees in

today’s rigid board environment, making time for informal interactions is critical. If directors are in a city for a two-day board meeting, he suggests they make time, not just for one dinner or lunch together, but for two. It’s those sessions, he says, where the discussion changes to strategy, and directors can raise important questions. In this context, a board trip to China could be valuable from multiple perspectives.

BOARD/EMPLOYMENT CHALLENGES

The third step in Vincent’s three-part strategy for creating a board with a strong understanding of the challenges presented by China would be to seat someone on the board with a strong background on China or, if that’s not appropriate, to ensure directors have access to in-house experts on China.

“Boards are going to have to ask management to make sure they produce experts in the company that have spent the time grinding it out. And even if their title is not senior vice president, have them come and address the board on their particular area of expertise, because that’s how we can stay educated,” Meachin says. “I’m hopeful that when Lyondell’s



Londoner

HOW WELL HAVE THE MEANS FOR INVESTING IN CHINA EMPLOYED BY THE COMPANY THUS FAR SERVED ITS WIDER INVESTMENT GOALS FOR CHINA?

(by percent)	Exceeded goals	Met goals	Did not meet goals	Don't know
Greenfield				
Minority joint venture	–	62.5	37.5	–
Majority joint venture	10.5	57.9	15.8	15.8
Wholly-owned subsidiary	30.5	50.0	13.0	6.5
M&A				
Minority interest	–	70.0	20.0	10.0
Controlling interest	9.5	66.7	4.8	19.0
Don't know	66.7	–	–	33.3

China or willing to go to China is a growing frustration for many Western companies, notes Clarence Kwan. “The challenge for companies looking to grow,” he says, “is very much a human resources challenge. The question to ask yourself as a director is, ‘Does this company have enough qualified people, a big enough pipeline of talented managers, to move up the ranks in China?’ ”

EVOLVING IDEAS ON OWNERSHIP

When American companies first moved into China, the need to gain access to Chinese talent and know-how caused many U.S. companies to choose joint ventures. However, as Meachin points out, “sometimes your joint venture partner was reliable, sometimes they were not as reliable and a significant amount of the business went out the back door and lots of other things happened.”

In response, companies opted for wholly-owned subsidiaries. The advantages of full ownership can be enormous. Take the development of Yum in China, as an example.

Initially, the company opened joint-venture restaurants in China, but eventually determined outright ownership was better than either joint ventures or franchising. Yum’s management decided that if they were to build a “world-class, number one, leading dining segment,” they would have to concentrate on the customer experience. To this end, when developing a market, there needs to be trade-offs made between maximum customer traffic (and the resulting per-store earnings) and the quality of the customer service. Yum management decided they could make better decisions for the long-term if they owned the units.

Joint ventures, however, may be the better option for some companies. “It’s one thing to have a wholly owned subsidiary if it’s going to manufacture something in China and export it,” says Meachin, “but if you need to go through the distribution systems in China to sell it locally or if the Chinese investment is very significant, you may well be better served to have an appropriate partner or partners to help ensure success.”

LOOKING FORWARD

Finally, Kwan asks the roundtable participants to identify their biggest worry with respect to their companies’ China growth. For Scites, Overseas Military Sales Corp.’s governing

committee worries that China may sprint past the United States in product development.

“China is in such an innovation phase,” says Scites, that she is concerned that China will “out-innovate what is going on in the United States. We will miss the entire innovation phase. It will be built up in China, and there will be no way to catch up, or offset it, or even compete. And they’ll skip a whole bunch of steps in the innovation cycle.”

She points out that the Chinese, unlike their counterparts in the United States and other mature economies, do not have well-established



Wu

COMPARED TO THE PERFORMANCE OF YOUR PRINCIPLE COMPETITORS, HOW WOULD YOU ASSESS YOUR COMPANY’S PERFORMANCE IN CAPTURING CHINA-RELATED VALUE OVER THE PAST FIVE YEARS?

(by percent)	Top third	Middle third	Bottom third	Don’t know
Sourcing from third parties in China	32.4	22.1	19.1	26.5
Manufacturing in China for export	33.3	21.1	19.3	26.3
Manufacturing in China for sale to the local market	17.0	24.5	30.2	28.3
Exporting to China	22.0	37.3	20.3	20.3
Conducting R&D in China	13.5	19.2	30.8	36.5
Outsourcing/offshoring business processes to China	13.0	21.7	28.3	37.0

development protocols, which may enable them to make quantum leaps in creating new products and services.

“I can imagine whole companies, or whole products, or things just being blasted [by Chinese innovations],” says Scites. “That’s what a global economy to me would be all about, even though I think in the United States we’re scared of that and don’t know how to compete with it. That’s kind of exciting and good.”

Indeed, while some at the roundtable saw Scites’ vision as creative destruction, Scites preferred a new label, “disruptive innovation.”

Holland voices a very different worry: the uncertainties of doing business in a state-driven economy. “You can’t predict based on history where [China’s] economy is going to go because it can, with a

HOW WOULD YOU CHARACTERIZE THE IMPACT OF YOUR BUSINESS IN/WITH CHINA ON YOUR COMPANY’S SHAREHOLDER VALUE?

(by percent)	Over past 5 years	In next 5 years
Positive	61.1	84.1
No impact	34.4	13.6
Negative	4.4	2.3

centralized decision, radically change,” he says.

What could that mean? “I don’t mean political instability. I mean a decision where the investors don’t understand the process or the logic behind it. And I worry that there are a number of these...that [could] really radically alter the investing public’s appetite for your China strategy.”

“The incredible build up and continual re-build up of foreign currency reserves in China” troubles Azria most, since it has great potential to have either adverse or unintended consequences.

For Evans, China’s shortage of managerial talent may ultimately be the juggernaut’s biggest problem and create headaches for Western investors in China. “I worry about the human resources element of it because I’ve seen already that a good strategy and good opportunities are not enough. We try to convince the top performers in our U.S. operations to go over, and that’s a hard, hard sell if you’re in a company that has not emphasized international service. I think there’s a finite amount of human capital that will have the ability to execute these very important strategies.”

Other directors still see the biggest challenges as residing within the American boardroom. “My own concern for the longer run, five years to 25 years, is that boards are going to have to learn how to be unbelievably flexible and focus on the world as it comes,” says Meachin. “China is a proud nation, and if it gets very powerful again, it could get quite tough. So we just have to learn to be flexible and keep our eyes open.”

Wu’s worries also are focused on the West. “I recently started being more concerned about people’s ignorance about China, especially our regulators and our people in Washington, and the effect that’s going to have on all of us. A wrong move by America could be very, very damaging to the world’s economy, and you’d be surprised how little people in Washington really understand about what’s outside of Washington.”

Londoner also puts U.S. behavior at the top of

his worry list. “We do have a remarkable ability to tick everybody off, and that could really come back on any of our investments in China,” he says.

Despite these worries, American boards have tremendous opportunities in China that could translate into long-term, bottom-line growth.

PLEASE INDICATE THE DEGREE TO WHICH YOU AGREE OR DISAGREE WITH THE FOLLOWING STATEMENT, THEN ASSESS THE CONSENSUS OF THE BOARD AND VIEW OF MANAGEMENT AS WELL.

“Successfully doing business in/with China is critical to the future of my company.”

	You	Board	Management
(by percent)			
Strongly agree	55.9	42.1	48.3
Somewhat agree	23.7	31.6	29.2
Somewhat disagree	7.5	9.5	7.9
Strongly disagree	12.9	13.7	12.4
Don’t know	–	3.2	2.2

Holland says the growth possibilities in China became clear to him a few years ago when he was visiting Nanjing.

“I was in the tower of what was until recently the tallest building in Nanjing. It was Sumec Trading Company’s business tower. I looked around, and there were probably a dozen buildings already taller than it was, and more importantly, I think every crane that ever existed in the world was in Nanjing or Shanghai erecting new buildings.

“Later, I thought back to a *New York Times* story I’d read 20 years ago about the completion of the interstate highway system in China. It was sort of tongue-and-cheek in that it showed this completed interstate system and occupying the roadway were rickshaws and motorcycles. However, when you go to China now, you appreciate what an incredible leap that was to get the road finished before they needed it, because it’s now the artery that fuels China’s export and internal economic development.

“What I realized was that the Chinese were very good at planning 25 years in advance, in getting this [system] completed maybe 15 years before it was needed. So what else are they doing that’s got a 25-year time horizon? I looked at all these new buildings in Nanjing, and in my New York mindset said, ‘That’s commercial space.’ I just assumed that was the answer. It turns out, it’s wrong. It’s apartment buildings. All this construction going on in Nanjing, and a lot of



Kwan

IN YOUR VIEW, HAS YOUR COMPANY FULLY REALIZED ITS POTENTIAL TO DERIVE SHAREHOLDER VALUE FROM ITS BUSINESS WITH AND/OR IN CHINA?

(by percent)	Frequency
Yes	18.3
No	72.0
Don’t know	9.7

places, are for residents. So they're already planning for this incredibly large consumer explosion where people are not just going to move to jobs and stay in temporary dormitories, which they do now, they're going to actually relocate families.

"Bottom line: This consumer economy is going to be off the charts. And multinational companies that are not prepared for the consumer explosion and demand inside China are going to miss it. It's enormous!"

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