



## The construction sector in China

*Despite increasing scrutiny on the real estate market, construction activity remains a large percentage of China's Gross Domestic Product (GDP). The sector is dominated by Chinese State Owned Enterprises supplying the bulk of construction activity. Western companies are often found at the top end of the technology and quality spectrum where a lot of interesting niches exist and new technologies are introduced.*

*On account of rising labour costs, a burgeoning middle class and a mounting concern over environmental issues, innovative products and services able to respond to the challenges posed by a changing economy are gaining considerable momentum in China, creating opportunities for EU SMEs that can bring technology and know-how into the market.*

### 1. The construction market in China

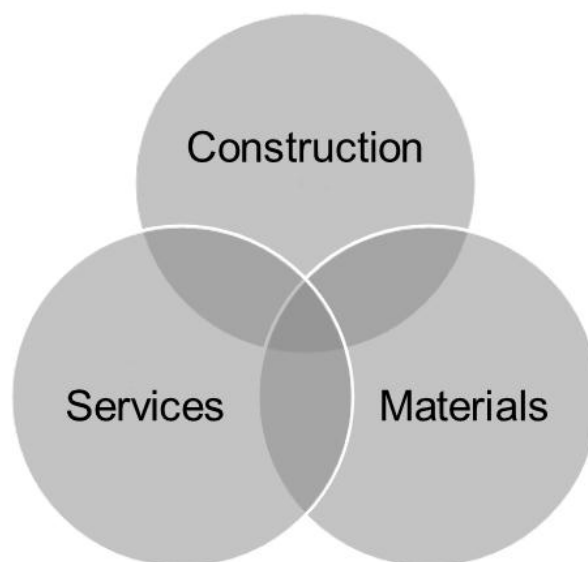
#### 1.1 Defining construction

The sector consists of a wide range of products and service categories with distinct market features. In this report we define the sector in three broad areas: construction, services and materials.

**a. Construction proper:** this includes project management and building by contractor companies. Firms in this area can either be responsible for the complete fulfilment of a project (usually after a tendering process) or take part in one of its stages (as a subcontractor). However, due to the existing regulatory framework, the structure of the market and the customary practices within, it is a very difficult sector to enter, especially for SMEs.

**b. Services:** this area includes companies that produce drawings, calculations and designs and manage checks, supervision, advice, and sales.

**c. Materials:** companies that provide the actual building materials, or the equipment that is put in place to help the builders, are covered here. A distinction can be made between primary materials



(such as steel, cement, glass, etc.), downstream products (such as steel frames, windows, concrete parts, etc.) and complete systems (e.g., air-conditioning, elevators, security, etc.) that are put in place by system providers.

It is common practice for the companies engaged in this market to provide a mixture of the above mentioned products and services, also including engineering and design as well as the supply and the installation of equipment.

In this paper, we will follow the categorisation of products and services in the construction industry as presented above. However, it should be noted that Chinese authorities use a different classification system<sup>1</sup> which includes:

- Building and civil engineering;
- Construction installations;
- Construction decorations;
- Other construction.

## 1.2 Market size

China's construction market is enormous. Despite the volatility of the real estate market, the sector still accounts for a large part of China's GDP and hence remains a cornerstone of the domestic economy. Some basic economic indicators are shown below:

**Table 1: Basic economic indicators**

Indicator	2006	2007	2008	2009	2010	2011
Household consumption (RMB bn)	8,210	9,561	11,059	12,113	13,329	16,494
Sale of commercial buildings (RMB bn)	2,083	2,989	2,507	4,436	5,272	5,912
Total sale of residential buildings (RMB bn)	1,729	2,557	2,120	3,843	4,412	3,998
Share of residential buildings sale in household consumption (%)	21.1%	26.7%	19.2%	31.7%	33.1%	24.2%
Consumer price index	101.5	104.8	105.9	99.3	103.3	105.4
Gross fixed capital formation (RMB bn)	8,795	10,395	12,808	15,668	18,234	21,304
Foreign direct investments (USD mn)	63,021	74,768	92,395	90,033	105,735	116,011
Total investment in fixed assets (RMB bn)	11,000	13,732	17,283	22,460	27,812	31,149
Investment in residential buildings (RMB bn)	1,933	2,501	3,088	3,643	4,594	NA
GDP (RMB bn)	21,631	26,581	31,405	34,090	40,120	47,288

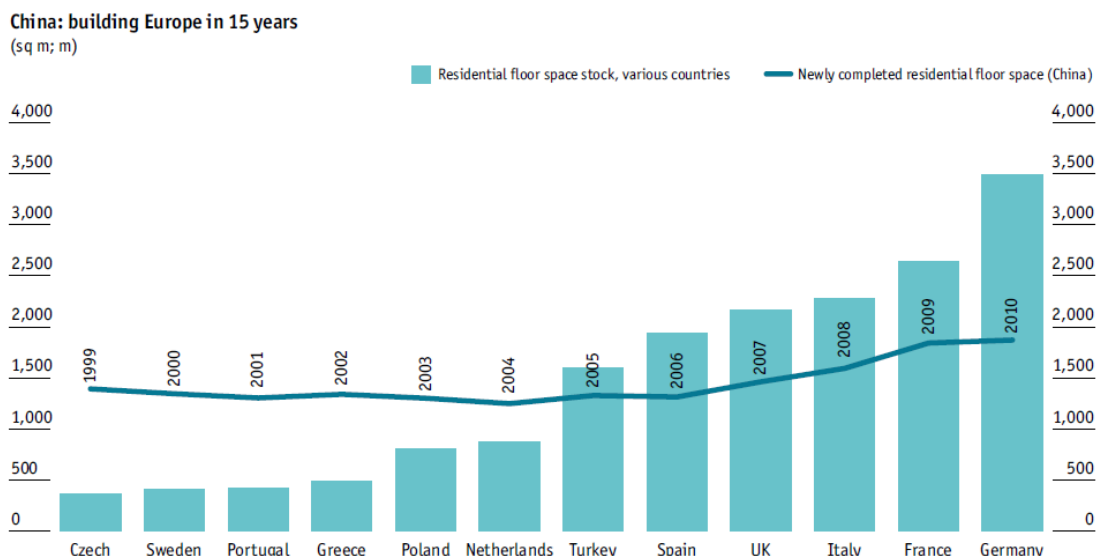
Source: EMIS – Emerging markets Information Service

In residential real estate alone, China is building about 1.8bn m<sup>2</sup> per year. To put this number in perspective, China is building more than one third of all the buildings in the world, producing and consuming 55% of the cement globally in doing so. It builds the equivalent in square metres of living space of a city like Rome in about two weeks and a country like the UK or Spain every single year.<sup>2</sup>

<sup>1</sup> Chinese standard GB/T 4754-2002, category E: Construction

<sup>2</sup> EIU: Building Rome in a Day: The sustainability of China's housing boom. April 2011.

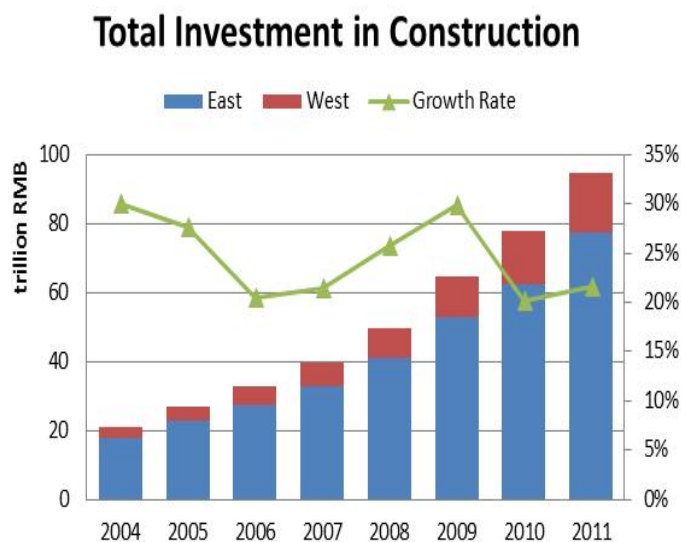
**Chart 1: China's newly completed residential floor space by year VS Europe's stock**



Source: EIU

**Total investment** in construction has reached about RMB 100tr (EUR 12tr) in 2012, with growth rates fluctuating between 20 and 25%. Expectations are that this number will continue to grow faster than GDP, at least in the short term.

**Chart 2: Total investment in construction in China**



Source: National Bureau of Statistics of China

With the government resorting to adjustments in real estate parameters (interest rates and regulations) and fixed assets investments (through bank financing) as a tool for macroeconomic policy, the growth of the construction sector will depend deeply on future government plans. With consumption expected to balance off the investment as main driver of economic development, it is very likely that the government will try to reduce the weight of construction in the GDP figures in the future.

**Geographical distribution** remains skewed towards the Eastern part of the country. Although Western areas are slowly increasing their share in the total pie, this 'shift to the west' will likely

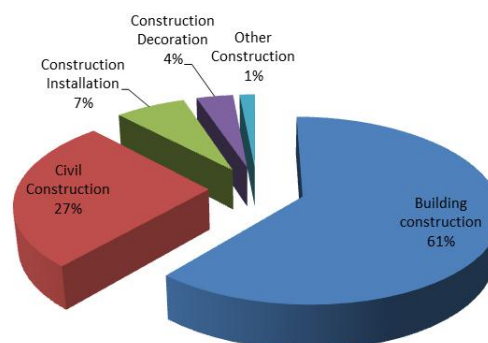
remain a long-term evolution, since more than 85% of the building activity is still happening in the Eastern (seaboard) part of China. However, it is obvious that there is a considerable shift of building

activity from first tier cities (like Beijing or Shanghai) to second tier cities (like Chengdu, Chongqing, Changchun, etc.).

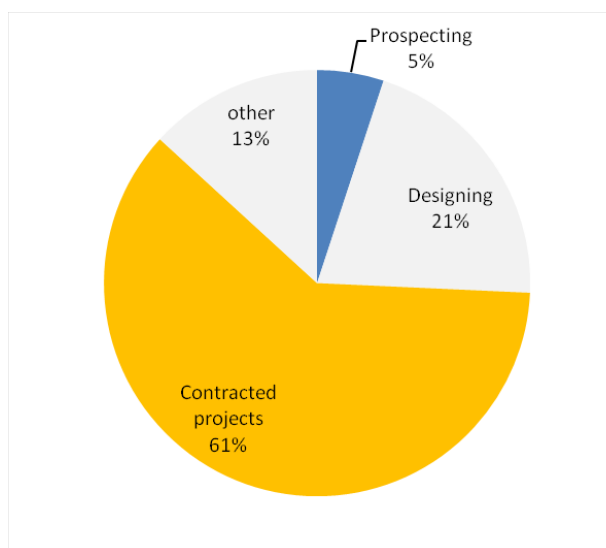
When **divided into sectors**, it is clear that “buildings” – including residential, public and industrial buildings remain the lion’s share of the market. It is expected that on a nationwide scale this distribution will remain similar, although the situation can change from province to province and regional differences can be enormous.

A closer look at the ‘prospecting and design’ and ‘construction supervision’ subsectors reveals opportunities for SMEs on account of the large market shares of ‘designing’ and ‘project supervision’.

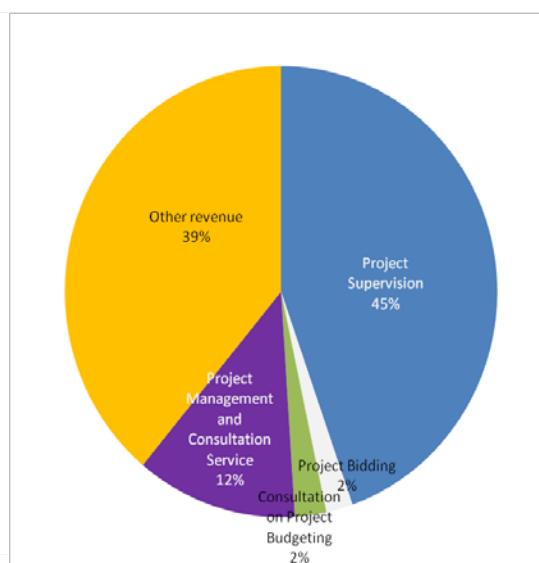
**Chart 3: China’s construction sectors**



**Chart 4: Prospecting and design (2011)**



**Chart 5: Business revenue of construction supervision enterprises (2011)**



### 1.3 Forecasts

Forecasts for the short to mid-term future remain positive, with growth rates well above GDP rates, as shown in the below table.

**Table 2: Forecasts for selected indicators in China's construction sector**

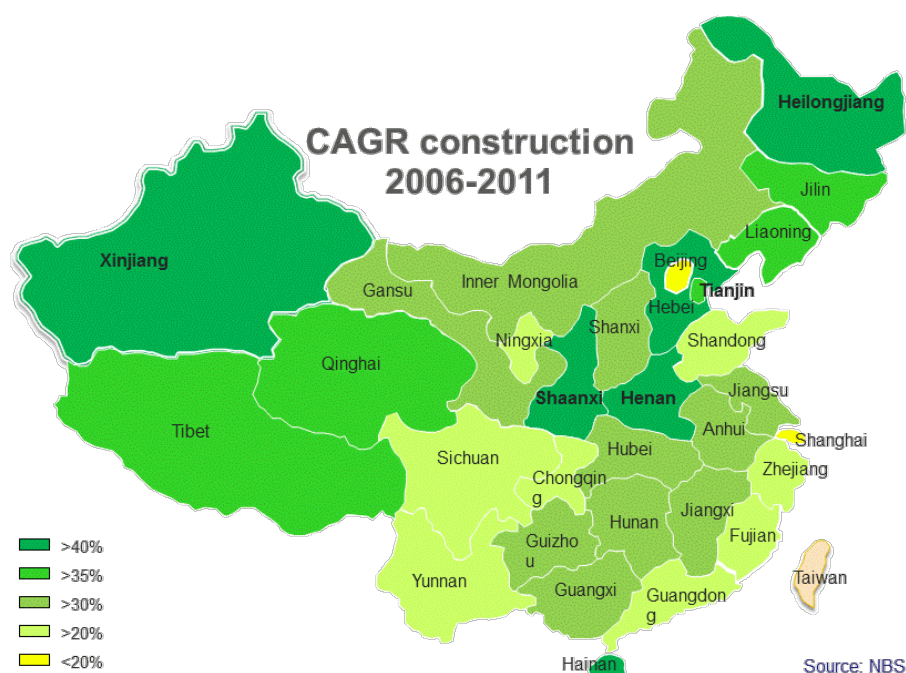
Indicator	2013f	2014f	2015f
Construction % in GDP	5.4%	5.3%	5.2%
Total output value of construction (RMB bn)	14,584	16,772	19,456
Construction output growth (%)	13%	15%	16%
Output value of building construction (RMB bn)	838	947	1,079
Growth of output value of building construction	12%	13%	14%
Value added of construction (RMB bn)	2,781	2,976	3,214
Growth of value added of construction (%)	10%	7%	8%

Source: EMIS – Emerging markets Information Service

### 1.4 Regional differences

Due to government intervention aimed at reining in the overheating of the sector and developing the infrastructure network in Western provinces, growth rates have declined on the eastern seaboard.

**Chart 6: Compound annual growth rate (CAGR) in China's construction sector 2006 – 2011 by province**



Cities like Beijing, Shanghai and Guangdong have growth rates that have dropped below 20%, while some of the highest growth rates are found in the northeast and in a number of central provinces like Henan, Shaanxi and Hebei. Massive infrastructure projects (such as high speed rail, water transportation and road works) and fast growing second and third tier cities have definitely contributed to this growth.

However, this should not lead foreign investors to abandon the seaboard areas and focus only on the inlands: the Eastern provinces will remain a key market for more sophisticated Western products for the foreseeable future.

### 1.5 Who is servicing the market?

Figures from the National Bureau of Statistics (NBS) illustrate clearly who is servicing the construction market: Chinese private enterprises represent the key actors with a group of large state-owned enterprises (SOEs - mostly involved in infrastructure building) accounting for the rest. Within the total scope of the Chinese construction industry (as defined by the statistical authority), Western companies only service a meagre 1% of the market, a share which has been on decline over the last 5 years.

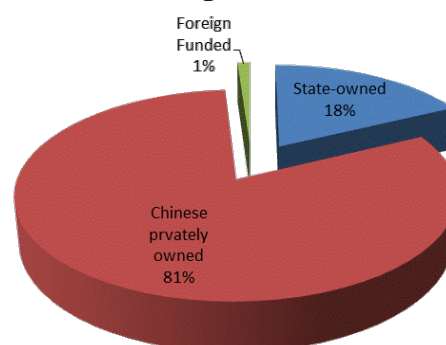
The latest data shows that Western companies are mostly focusing on niche markets, in which they enjoy a technological or brand advantage over local competitors. Such a limitation to niche markets is the result of a series of factors, which can be summarised in the following three categories:

**a. Regulation:** in many subsectors within construction, foreign or even recently established Chinese entities experience strong regulatory constraints. Especially in the ‘building’ sector, licences are difficult to come by (and take a long time to obtain), if possible at all. Chinese regulations very often prohibit new materials and construction methods from entering the domestic markets due to the limited ability of the country to assess the business application of those materials and technologies. China is – even more than Western countries – risk averse in its adaptation of new building materials and techniques. On the flip side, however, the market can change quickly once government approval is obtained<sup>3</sup>.

**b. Business practices:** as in many other sectors in China, business is often rewarded through ‘guanxi’ lines; relationships are often more important than product and service quality. Business is to some extent promoted through practices which cannot be followed by Western companies. Indeed, in many areas of the construction market the Western ‘advantages’ – higher quality, innovative products and established business processes – are not sufficient to level the playing field.

**c. Price competition:** the Chinese construction market is relatively early in its development and social structures do not foster quality consciousness. Builders (very often local mayors or real estate developers) are keen to build more, rather than better quality infrastructure with the budget they have.

**Chart 7: Key actors in construction servicing**



Source: NBS (National Bureau of Statistics)

<sup>3</sup> Usually those changes find their reason in disruptive events, such as collapsing buildings, fires, earthquakes, falling wall panels, and they are promptly translated into government policies.



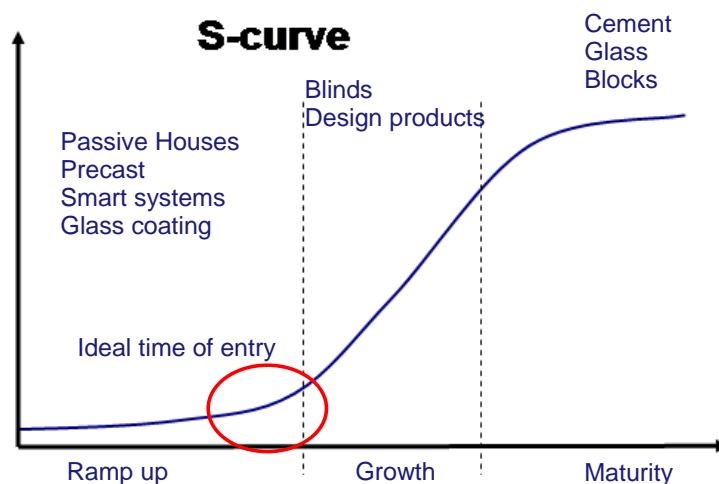
As builders and buyers are not the same people, total cost of ownership is a concept rarely entering the equation, and price often remains the only criteria.

### 1.6 The S-curve shift

Although China is developing a network of advanced infrastructure, many of the innovative products and techniques adopted in Europe have not entered the PRC yet. These products belong to different sections of the S-curve and therefore require different market approaches.

In addition, geographical S-curve shifts must also be taken into account: new technologies, concepts and products are first introduced in major centres (tier one cities like Beijing, Shanghai or Guangzhou), creating a distinct shift in the product development curve.

**Chart 8: China's construction sector and the S-curve**



Some examples of this “S-curve shift” are given below:



**Precast:** although Western Europe has developed a large range of precast technologies in the 50s and 60s of the last century, China is still largely dependent on on-site casting. Cheap (unskilled) labour, cost pressure and less stringent quality requirements have hindered any development of precast technology in the construction of buildings. Due to increasing labour costs, quality and time restrictions, environmental regulation and government incentives, the first precast factories are being built at the moment, mostly in tier 1 cities.

**Sun blinds:** although sun blocking systems have been used in Europe for decades, it is only recently that the growing Chinese middle class has been looking at house decoration and upgrading living comfort. As new buildings are equipped immediately and existing buildings are upgraded, sun blocking systems have seen 30-40% growth rates in recent years.



**Gas boilers:** Central heating of large city areas by power stations or other boilers has been the standard in Northern China. In the warmer Southern parts, heating was often not even considered. The

demand for comfort, the growth of villa-estates, government regulation and the rapid development of gas distribution have created a new market for individual gas boilers, which hardly existed ten years ago. The more expensive and efficient ‘condensing’ technology – which has replaced most of the normal boilers in Europe in the last 15 years – still only has a tiny market share in China.



**LED lighting:** China can also be quick to adapt and implement new technologies. As electricity bills are quite often paid by the same people installing lighting, there is an incentive to go for more expensive, but longer lasting products. We expect that LED lighting penetration will be as fast in China as it is in Europe.

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## 2. Regulation

### 2.1 Regulators

A number of Chinese government departments are involved in the regulation of the construction industry in China. Some of the major ones are listed below:

**The Ministry of Housing and Urban-Rural Development of the PRC** ([www.mohurd.gov.cn](http://www.mohurd.gov.cn)) is responsible for the administration and supervision of construction works including licences, requirements, surveying, design, tenders and bidding procedures. This ministry is also responsible for the supervision and administration of requirements for construction enterprises in China.

**The Ministry of Transportation of the PRC** ([www.moc.gov.cn](http://www.moc.gov.cn)) is responsible for the administration of construction for ports, highways, waterways, airports, water conservation projects and hydropower facility projects. It plans them, but also manages their maintenance and quality control.

**The National Development and Reform Commission of the PRC** ([www.ndrc.gov.cn](http://www.ndrc.gov.cn)) is responsible for general macro-economic planning issues associated with the construction industry.

**The Ministry of Railways of the PRC** ([www.china-mor.gov.cn](http://www.china-mor.gov.cn)) is responsible for the administration of services relating to the survey, design, and tendering and bidding for railway construction projects. The Ministry will be split into two separate entities in the near future due to restructuring following major scandals regarding the safety of China’s high-speed railway system and widespread corruption. The Ministry of Transportation will oversee the railways’ administrative functions, while a private company will handle its commercial operations.

**The Ministry of Environmental Protection of PRC** ([www.zhb.gov.cn](http://www.zhb.gov.cn)) is responsible for the supervision and administration on environmental protection control during the construction process.

**The State Administration of Work Safety** ([www.chinasafety.gov.cn](http://www.chinasafety.gov.cn)) is responsible for the supervision of work safety in construction projects.



## 2.2 Real estate market control

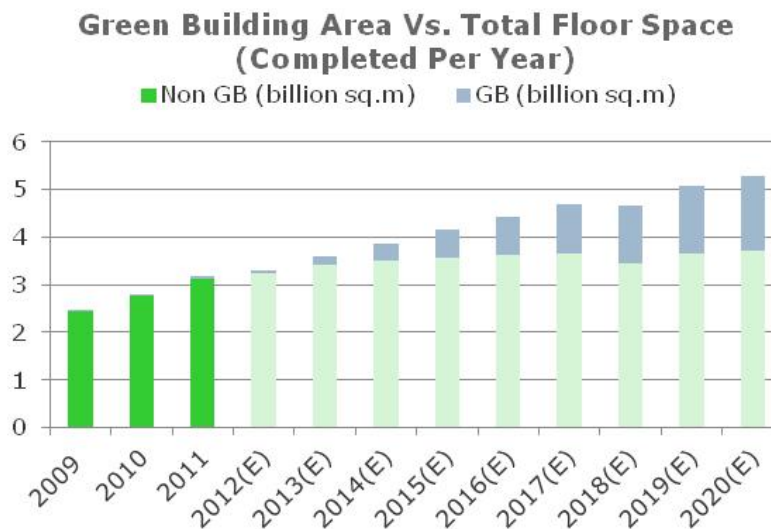
The construction of real estate plays a crucial part in the economy in many aspects, including: GDP, inflation, employment, target for private investment, loans, social policies, local government income and non-performing loans. At the same time, it is an enormously important social issue, with strong potential for popular discontent. As a result, regulating the real estate market is high on the agenda at local, provincial and state level. Policies and interests are not always aligned, sometimes even contradicting each other. The main goal is to avoid fast rising (or dropping) prices and asset bubbles.

In 2010, tightening measures were intensified to avoid the overheating of the sector. Measures aimed at suppressing the demand for second and luxury homes included new taxes, raising interest rates, banning the purchase of second and third houses, and minimum down-payment rates. In Shanghai and Chongqing, for example, a (limited) property tax is being levied.

## 2.3 Green housing policies<sup>4</sup>

To promote sustainability and energy efficiency, action has been taken by the national authorities in favour of the construction of 'green' buildings. Chinese standards have been introduced in an attempt to replace the international Leadership in Energy and Environmental Design (LEED) standard.

**Chart 9: Forecast of green building floor space in China up to 2020**



At national level, the NDRC has required five provinces<sup>5</sup> and eight cities<sup>6</sup> to include low-carbon development models in their regional 12<sup>th</sup> Five-Year Plans. Subsidies and tax breaks are provided to developers that comply with the new regulations.

At local level, second tier cities are expected to showcase high growth rates in the years to come. Many cities have developed plans for the establishment of green buildings, eco-cities and low carbon

<sup>4</sup> A report on the green building sector in China will be published by the EU SME Centre later this year.

<sup>5</sup> Guangdong, Liaoning, Hubei, Shanxi, and Yunnan.

<sup>6</sup> Tianjin, Chongqing, Shenzhen, Xiamen, Hangzhou, Nanchang, Guiyang, and Baoding.

communities, in full accordance with the framework for a sustainable development recently adopted by the central authorities.

The policies seem quite successful, as the number of green buildings – although still limited in numbers – is rising fast.<sup>7</sup> The latest Five-Year Plan forecasts the construction of 1 billion m<sup>2</sup> of ‘green building’ floor space by 2015 – up to 20% of the total floor space constructed during that period.

## **2.4 Social housing policies**

In 2009, The Chinese government announced the construction of 21 million affordable apartments; 11 million units were successfully completed during the period 2009-2011. From less than 4% of the total market, social housing has increased to 11% in 2011. The 12<sup>th</sup> Five-Year Plan forecasts the construction of 36m units by 2015.

## **2.5 Builders permits**

Permits for construction companies are strictly regulated in China. According to the existing regulations, new companies are required to prove their building experience in advance in order to obtain a licence. As a result, very few foreign companies – if any – succeed in entering the market or accept a steady expansion of the scope of their licence over a 10-15 year period. Therefore, acquiring or investing in local companies is the only viable way to reduce or avoid these measures.

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## **3. Major trends**

We expect three major trends to be the most influential in shaping the future development of the construction market in the next five to ten years:

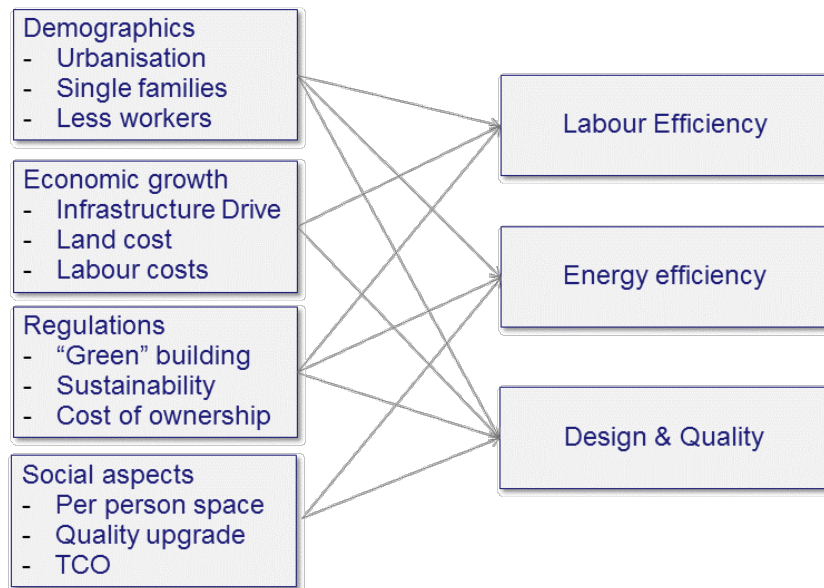
- Increasing labour efficiency;
- Increasing energy efficiency;
- Design and quality.

We expect them to impact aspects such as building practices, services and products more than the total volume of buildings itself. In doing so, they will determine the ability of foreign companies to establish a successful business in China.

Each of these trends is in itself driven by social, political and economic drivers in the Chinese society.

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<sup>7</sup> Source: Ministry of Housing and Urban-Rural Development.

**Chart 10: Major drivers and trends in China's construction sector**

### 3.1 The growth drivers

Besides those trends, other major forces can be seen to be driving the market:

**Demographics:** as discussed before, China is promoting and undergoing a process of continuous urbanisation with more than the 50% of the population now living in urban centres and an expected 70% doing so by 2020. This has profound effects on the required living areas in these urban centres and the infrastructure to support it (road, rail, subways, etc.). In addition, factors related to demographics - such as the tendency to relocate elderly people into nursing homes, a decreasing supply of unskilled workers, a growing elderly population, etc. - are also playing a major role in driving the expansion of the market.

**Economic growth:** economic growth not only has a profound effect on the total construction volume, but also influences a large number of other factors that contribute to transform the industry: land prices, labour costs, the rapidly growing number of middle-class incomes, energy consumption, environmental pollution, etc.. Each of these can impact regulations, social trends and building needs.

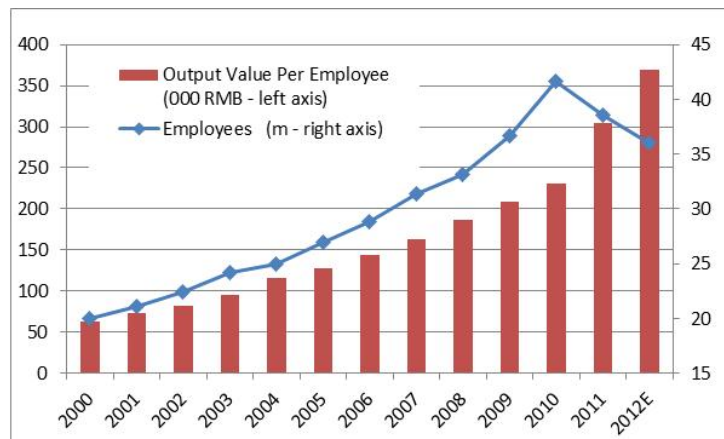
**Regulation:** because of the strong influence on the overall economy, regulation will also guide the future expansion of the construction sector in China. Not only in terms of the total number of buildings, but also concerning the technologies and other inputs used. Regulations and subsidies will also play a strong role in 'greening' the building industry.

**Social aspects:** with the ageing strata of the population increasingly seeking their own living quarters, a growing divorce rate and the rise of single parents, the demand for new and better houses will certainly rise in the near future, additionally spurred by experience with the first generation of (poorly built) houses and the spreading of quality awareness amongst buyers.

### 3.2 Labour efficiency

As can be seen from the chart below, China has been experiencing a dramatic increase in labour productivity in the construction sector over the past few years. In 2010 the number of employees peaked at 42 million and is expected to decrease considerably in the coming years. Whereas construction used to be a welcome pool to employ unskilled labour – rice in summer, buildings in winter – the sector now needs to cope with fast increasing salaries (>10% annually) and shortages of unskilled labour in many areas of the country.

**Chart 11: Labour productivity in China 2000 - 2012**



Source: National Bureau of Statistics of China

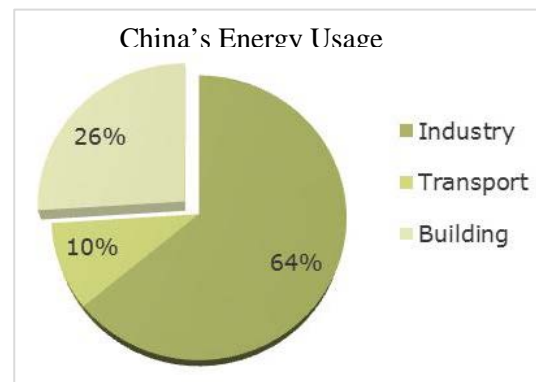
The sector has always been based on a pool of unskilled, cheap and untrained labour, and it will not develop into a skilled model overnight.

However, the sector is adapting to the changing circumstances and is gradually adopting equipment, materials and systems that require fewer efforts to be installed and maintained.

### 3.3 Energy efficiency

Heating systems account for 26% of China's energy demand. In the 1970s the share was only 10% and it is expected to reach 36% by 2020. Whereas it is relatively easy to increase energy efficiency in industry, the existing buildings are difficult to retrofit. Relatively cheap coal, the lack of insulation know-how, the disconnect between builders (paying for the insulation) and users (paying for the heating costs) and the central (district) heating systems used in Northern China have created a building stock that is grossly underperforming in energy efficiency. The widespread (de-centralised) use of air conditioners in the last ten

**Chart 12: China's energy usage**



Source: World Resource Institute 2009

years has also added to the high energy consumption.

The central government has set precise targets for energy savings and green buildings. Although not yet a dominant feature in residential construction, many of the government edifices (schools, hospitals, airports, government administration etc.) have stringent energy norms and are implementing a large range of energy conserving or generating technologies.

The CO<sub>2</sub> tax – possibly to be introduced in 2016 or 2017 – which is under discussion in the Chinese government is expected to increase the pressure on energy conservation significantly.

### 3.4 Design and quality

With private real estate being a relatively new phenomenon, design has only recently entered the equation. As home ownership and available income increase, people want to enhance the quality of living and differentiate themselves through design and lifestyle.

Experience with the first generation of buildings and building materials is also increasing quality awareness in the market. Realising the high cost of low quality (in maintenance, decreased aesthetic value or replacement costs), the market for quality products is growing faster than the average, creating more “European” market models.

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## 4. Opportunities for European SMEs

### 4.1 China is not for the fast buck

As is the case in many sectors and industries, entering China is a long-term game. Establishing an effective business model, building a critical mass, launching your brand name, knowing the regulations, training the team, understanding the fast evolving market and creating ‘China experience’ at home are long-term goals making market entry into China time- and work-intensive. Cash flow forecasts and ‘management time’ estimations should take this into account.



*Chinese chess: playing on a different chess board is hard*

Although the initial hurdles can be daunting, the prize for successful entry is large: successful business models can be quickly replicated in other provinces and cities and business can grow at rates unheard of in a European context.

The ability to replicate successful models in different areas and locations is of crucial importance. It would be a missed opportunity to spend time and energy perfecting a business model only to let your local competitors reap the profits by emulating your approach.

#### 4.2 The basic building blocks: know-how, brand and niche

As mentioned above, the Chinese ‘mass’ market is a difficult arena for large Western companies, let alone SMEs. It is therefore imperative to focus on a niche market where the company has distinct know-how – either through intellectual property (IP) or a special skill – that can be defended in the market and to create strong (European) brand awareness.

Owing to the experience and the business practices that local competitors have gained and developed over time, engaging in a price war is not a good strategy either. Reliability, quality, European branding, innovation, niche markets and premium prices are better tactical approaches.

#### 4.3 Labour efficiency

Increasing labour costs (more than half of China’s population has received a salary increase of over 10% in 2012) and workforce shortages are forcing builders and owners to look for labour-saving practices. This will affect:

- The production of building materials (increased mechanisation);
- Installation procedures (more towards integrated systems, rather than single parts);
- Systems and technologies with limited manual maintenance requirements;
- Higher demand for reliable systems, reducing maintenance and replacement costs.

##### *Labor efficiency opportunities*

- Building systems (i.e. precast)
- Equipment for building materials production
- Sophisticated building equipment
- Training and schooling
- Easy-to-install building systems
- Low-maintenance materials
- Automatic monitoring

As a result there is a growing demand for trainings (of the workforce and the overall construction process): architects, designers, design institutes, builders, contractors and subcontractors and real estate developers.

#### 4.4 Energy efficiency

Government subsidies and regulations, increasing awareness of the economic total cost of ownership (TCO) and rising energy costs will have a profound effect on the construction of green buildings. The introduction of the Chinese Green Building Standard<sup>8</sup> and its implementation in the case of public buildings is causing an annual growth rate of 60% in the green building sector, compared to a general market growth of about 5%. Although growing from a low base – green buildings were unheard of in 2009 – these growth rates will ensure China becomes the largest market for green buildings by 2017.

Evidently, this will be concentrated in the eastern seaboard cities as can be seen from the distribution of green building projects in 2012. The expected ‘green building boom’ will provide a wide range of

<sup>8</sup> China launched its Green Building Evaluation Standard in 2006, and the evaluation work was formally carried out in 2008. The Green Building Label, also known as the Three Star System, assesses the building based on several environmental indicators, such as energy and water efficiency, indoor air quality and maintenance requirements.



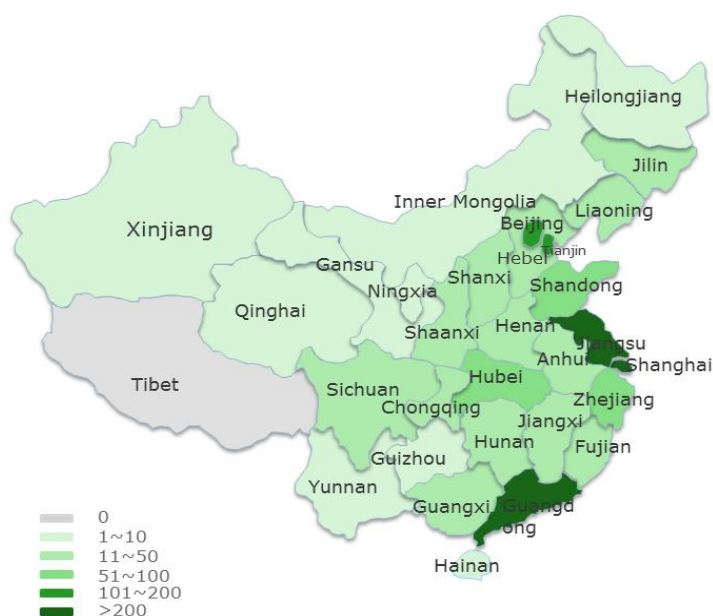
opportunities to those companies that can offer the right services and products. SMEs can capitalise on this either through the direct provision of services and products to builders and architects, or through cooperation with builders and suppliers. As Chinese companies are only now starting to develop the necessary know-how and technology, the present time is ideal to enter this market through distributors, technology licences or joint ventures with local agents.

#### *Energy saving opportunities*

- Energy-efficient appliances (LED etc.)
- Efficient heating devices
- Smart measuring and control systems
- Energy generating devices, heat pumps
- Energy storing technology
- Retrofitting services
- Energy service companies (Escos)

We foresee excellent market opportunities for businesses active in specialised construction technology, building upgrades, energy efficient devices (e.g. LED lighting, heating devices), insulation techniques and products, smart systems (energy monitoring and energy consumption control), building elements like cold bridges, energy generating devices for buildings, heat pump systems, energy storing technology, retrofitting know-how and products, etc., but also for Escos' (energy service companies that pay for energy upgrade equipment in exchange for a part of the savings) or other service companies.

**Chart 13: Green building projects in China 2012**



Source: [www.gbmap.com](http://www.gbmap.com) - 2012

In almost all aspects of the construction sector, European companies have developed a sound know-how and advanced technologies that are ahead of the present Chinese building practices. However, not all of them can find immediate application in China, and will be introduced gradually in the next 5-10 years.

#### 4.5 Design and quality

The desire to enhance living comfort is stimulating a growing demand for high-quality and design products. European design and brand names are leading this movement, holding large market shares at the top of the pyramid with significant premiums over local products. From revolving doors for five-star hotels (Boon Edam), to sanitary products (Hans Grohe),

##### *Design and quality opportunities*

- Space-saving building know-how
- Materials and systems with high reliability
- Quality supervision
- Comfort devices
- Design lighting

sun-blocking products (Somfy) and concrete accessories (Halfen), European companies have been successful in building a top niche and occupying a dominating market share.

We see opportunities for any decorative products, high-tech design, architecture, supervision (quality labels), but also in comfort devices (e.g. individual gas boilers), lighting, etc.

### 5. Challenges for SMEs

The challenges for SMEs in the construction sector are in principle not different from those in most other industries. However, the prevailing culture, the overwhelming dominance of Chinese companies in many sectors and the fast growing markets create challenges that are in most cases unfamiliar to European SMEs. We have summarised them in the table below:

Risk management	Timing	Partner	Business model
<ul style="list-style-type: none"> <li>• Keep up-to-date on changes in the regulatory framework;</li> <li>• Protect your IP;</li> <li>• Avoid price competition.</li> </ul>	<ul style="list-style-type: none"> <li>• Long profit horizon;</li> <li>• Choose the right moment on the S-curve.</li> </ul>	<ul style="list-style-type: none"> <li>• Find the right partner (distributor, licence taker, etc.);</li> <li>• Manage relationships personally.</li> </ul>	<ul style="list-style-type: none"> <li>• Localise the business model;</li> <li>• Find best practices through experimentation;</li> <li>• Be cautious with local business practices (guanxi 关系);</li> <li>• Prepare a plan B in advance.</li> </ul>

## 5.1 The basics: risk management

**Government regulation:** as a developing country, China's regulatory frame is in constant evolution. Amendments to existing regulations or the introduction of new norms should be expected at any time, creating opportunities or breaking business models.

**Intellectual property:** Chinese companies are less likely to respect IP. Products, technologies, colours, designs and brands are easily copied, quite often by the employees themselves. Although the range of possible actions companies may take to protect themselves is increasing, businesses should act proactively and: register their own brands and website addresses, use non-compete contracts with employees, keep sensitive data (customer lists, production manuals, cost prices, etc.) confidential within the company, train employees, avoid any potential misunderstandings when entering into agreements with partners on IP items, and much more. European companies can contact the EU-funded China IPR SME Helpdesk in Beijing for further information (see Box).

The China IPR SME Helpdesk is a free service which provides practical, objective and factual information aimed to help European SMEs to understand business tools for developing IPR value and managing risk: [www.china-iprhelpdesk.eu](http://www.china-iprhelpdesk.eu)

**Price competition:** a business model based on price competition is hard to sustain in a Chinese environment where local competitors are capable of rapid cost-cutting and can employ sales practices that are unavailable to Western companies. Western companies therefore need to build a business model based on niche products, branding and marketing as well as quality.

## 5.2 Get the timing right

The best time to enter the Chinese market may not necessarily coincide with your company's intended time to enter. Entry strategies will differ dramatically depending on the market situation and the positioning on the S-curve of the specific product or service. Understanding the market, the position on the curve, the growth rates and other factors of success is crucial before entering the market. Entering too early will cause you to spend a disproportionate amount of time on convincing the market of the benefits of your product; entering too late will prevent you from reaping the benefits of being recognised as a premium brand.

## 5.3 Find the right partner

Finding a local partner presents an alternative option for many SMEs. The choice of partner is one of the most crucial decisions to make. Developing personal relationships and doing basic due diligence is time consuming, but vital. Too often partners are chosen based on a coincidental encounter rather than on the analysis of which kind of partnership could be the most suitable for business (see section 6 for a recommended strategy). SMEs have less time and resources to spend on the search and evaluation of potential partners compared to larger companies. However, as a wrong choice can seriously damage the market entry or render it unsuccessful, adequate resources should be allocated to the careful selection of a business partner.

#### 5.4 Find the right business model

As the dynamics of the Chinese market are different from Europe's, business models cannot be transferred wholesale. Many companies will be tempted to adopt the model that they have used successfully in their home country or other markets. However, in most cases these business models will need to be adapted when it comes to China, and in some cases a totally different business model will emerge. Finding an effective business model and experimenting with different product offerings, pricing and sales channels can take a considerable amount of time. Good preparation through solid market research, a willingness to adapt and hiring talented local employees form the basis of a good business approach to the market.

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#### 6. Ways to enter the market<sup>9</sup>

We are recommending a route to the market that has proven to be successful for many companies. As with other markets, China requires companies to do their homework before entering. There are fundamental questions that companies should address before implementing their entry strategy.

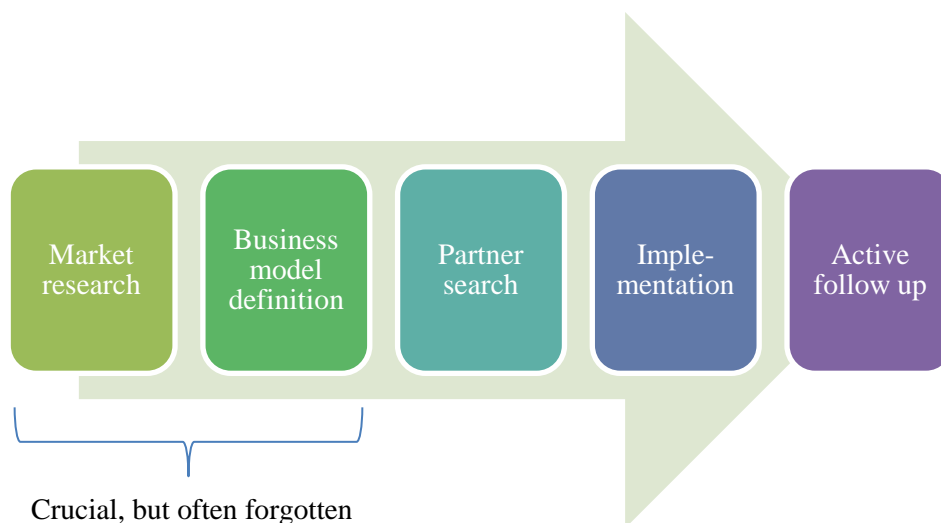
Too often, companies commit to a distributor or partner without answering a number of basic questions:

- Is the timing correct for my product or service?
- Which sectors, areas and customers should I sell my product to?
- Should I use a distributor or sell myself?
- If using a distributor, what kind would be best for my purposes?
- What technical competence should he have?
- Where should he have sales representatives?
- Which skills and connections does he need?
- What is normal practice in this market?
- How does reasonable pricing work?
- What targets do I have for the Chinese market?
- How much technical support, marketing support and training can I devote to the Chinese distributor?
- Do I want to develop an Asia strategy?

Besides these, there are many other questions to be answered before choosing a potential partner and discussing business terms. A large number of private and public service providers concerned with EU-China business relations will be able to help you to come up with a list of questions as well as answers in this regard.

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<sup>9</sup> Gauge your readiness for the Chinese market by answering the EU SME Centre online quiz 'Are you ready for China?' at the following link: [www.eusmecentre.org.cn/quiz](http://www.eusmecentre.org.cn/quiz).

**Chart 14: Basic steps of market entry**

### 6.1 Know your market

The first step should always be decent market research, either by your own people, external advisors or a combination of both. It should answer questions on:

- Timing - is this the correct time to enter the market in China?
- Market structure - who are the customers, the competitors and the intermediaries?
- Price levels - which products are in the market at which prices? How is the price made up?
- Evolution - how will the market evolve in the next years? And
- Government and social environment - which current and future changes will have an influence on my market?

Without adequate preparation it is impossible to outline an initial business model that will then define the entry strategy.

### 6.2 Define your business model

Defining the business model is the next step. Companies should not be afraid of exploring ideas that are different from the model at home. Consider the following:

- The product - what kind of product or service will I offer? What kind of packaging will I use?
- Price - how will I price it?
- Customers - who are my target customers? Where is my niche? How will I reach them?
- Distributor/partner - do I really need a local partner? What kind of distributor or partner do I need? What would be the ideal profile? What is the interest of the partner?
- Structure - do I need my own people on the ground or can I use other organisations to represent our company?

- Intellectual property – how will I protect my IP against counterfeiters and my partner?
- Growth - if this proves to be successful, how and where do I expand my business?
- Plan B - if the approach does not work, what are the alternatives?

### 6.3 Looking for a partner

Only when the market is known and the role of the partner/distributor has become clear should you start discussions with potential partners and suppliers. Having done your ‘homework’ will help you in

- Knowing the partner’s/distributor’s strong and weak points;
- Negotiating on equal terms;
- Understanding their long-term goals;
- Aligning interests.

As discussions and negotiations with partners can take a long time, it is recommended to work in parallel with several potential candidates.

**The search for a distributor/partner:** attending trade fairs represents a valid method for approaching business partners and is highly recommended. The appearance of the booths, the quality of presentations and language skills will create a first impression, but can sometimes be misleading and do not eliminate the necessity of getting to know your partner or conducting basic due diligence<sup>10</sup>.

**Characteristics of the construction sector:** within the construction sector there are some extra reasons for caution. The sector is prone to practices that are incompatible with a Western code of conduct: distributors and partners do not necessarily always follow the Western way of doing business. This issue needs to be clearly addressed during partnership negotiations. An independent source of information on the distributor/partner is sometimes necessary to understand all circumstances clearly.

### 6.4 Implementation and follow-up

Following up with distributors and partners is normally quite labour-intensive, especially at the start-up phase. It involves setting up reporting systems, understanding how the partner works, negotiating issues that have not been cleared beforehand, customer issues, training, preparing marketing materials, checking translations, setting boundaries on what can be sold and what cannot. Experience with partners and distributors in other countries will definitely help in implementing the partnership. Temporary support can also be given by consultancies in this phase.

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<sup>10</sup> Learn how to conduct due diligence on potential Chinese partners through the EU SME Centre guide “Knowing your Partners in China” available at: <http://www.eusmeccentre.org.cn/content/knowning-your-partners-china>



## 7. Conclusions

Although government intervention may cause the Chinese construction sector to experience fluctuations and unequal growth paths, it remains a pillar industry of the domestic economy and represents a market which should not be ignored by any company with international ambitions.

The bulk of the market is dominated by Chinese enterprises, with only the niche markets – more often than not at the top end of the spectrum – left to foreign companies. However, these niche markets can grow fast and be very profitable for those businesses that can offer technological solutions and build a brand name in China.

The rapid changes in many aspects of the Chinese society are causing increasing labour costs, mounting pressure on environmental performance and the emergence of a middle class endowed with financial resources to spend on its comfort and living environment. This creates opportunities for companies that can offer technologies to support labour productivity and energy saving or products of high quality and sophisticated design to the Chinese market.

Despite high growth rates, entering the Chinese market remains an enormous challenge for European SMEs. It requires good planning, timing and an effective choice of business partner.

## 8. Resources

### Further reading

*Building Rome in a Day: The sustainability of China's housing boom*

[www.excellentfuture.ca/sites/default/files/Building%20Rome%20in%20a%20Day\\_0.pdf](http://www.excellentfuture.ca/sites/default/files/Building%20Rome%20in%20a%20Day_0.pdf)

Published by: Economist Intelligence Unit, April 2011

*China Construction Industry Overview 2011*

[www.tusiad.org/\\_rsc/shared/file/ChinaBusinessInsight-June2012-ChinaConstructionIndustryOverview2011.pdf](http://www.tusiad.org/_rsc/shared/file/ChinaBusinessInsight-June2012-ChinaConstructionIndustryOverview2011.pdf)

Published by: Turkish Industry & Business Association, August 2011

*China's Construction Industry: Strategic Options for Foreign Players*

[www.thebeijingaxis.com/tca/editions/the-china-analyst-mar-2011/2](http://www.thebeijingaxis.com/tca/editions/the-china-analyst-mar-2011/2)

Published by: The China Analyst, March 2011

*China to be largest construction market by 2018*

<http://english.people.com.cn/90001/90778/90860/6811992.html>

Published by: People's Daily Online, November 2009

*Chinese Challenge or Low Carbon Opportunity: The Implications of China's 12th Five-Year-Plan for Europe*

[www.e3g.org/programmes/europe-articles/chinese-challenge-or-low-carbon-opportunity/](http://www.e3g.org/programmes/europe-articles/chinese-challenge-or-low-carbon-opportunity/)

Published by: E3G, 2011

*Greening China: Outlook for European SMEs*

[www.friendsofeurope.org/Contentnavigation/Library/Libraryoverview/tabid/1186/articleType/ArticleView/articleId/2319/Greening-China-Outlook-for-European-SMEs.aspx](http://www.friendsofeurope.org/Contentnavigation/Library/Libraryoverview/tabid/1186/articleType/ArticleView/articleId/2319/Greening-China-Outlook-for-European-SMEs.aspx)

Published by: Friends of Europe, China Dialogue, spring 2011

### Exhibitions

*The 15<sup>th</sup> Domotex Asia/China Floor*

[www.dacf.cn/en/](http://www.dacf.cn/en/)

March 26 to March 28 2013, Shanghai New International Exhibition Centre, China

*The 9<sup>th</sup> International Conference on Green and Energy-Efficient Building & New Technology and Products Expo*

[www.chinagb.net/gbmeeting/igebc9/english.shtml](http://www.chinagb.net/gbmeeting/igebc9/english.shtml)

April 1 to April 3 2013, National Convention Centre Beijing, China

<p><i>Ecobuild China 2013</i></p> <p><a href="http://www.ecobuildchina.com/Home/tabid/3938/language/en-US/Default.aspx">www.ecobuildchina.com/Home/tabid/3938/language/en-US/Default.aspx</a></p> <p>April 1 to April 3 2013, Shanghai New International Expo Centre, China</p>
<p><i>The 2<sup>nd</sup> China (Shenyang) International Modern Architecture Exposition</i></p> <p><a href="http://www.cimae.org/cimae/file/yw.htm">www.cimae.org/cimae/file/yw.htm</a></p> <p>April 17 to April 19 2013, Shenyang International Exhibition Centre, China</p>
<p><i>The 15<sup>th</sup> China (Guangzhou) International Building Decoration Fair</i></p> <p><a href="http://www.gz-jbh.com/">www.gz-jbh.com/</a></p> <p>July 8 to Jul 11 2013, China Import and Export Fair Complex Guangzhou, China</p>
<p><i>Green Building China 2013</i></p> <p><a href="http://www.greenbuildingchina.com/HomeEn">www.greenbuildingchina.com/HomeEn</a></p> <p>October 9 to October 11 2013, Shanghai World Expo Exhibition &amp; Convention Centre, China</p>

#### Administration and Associations

<p><i>The Ministry of Housing and Urban-Rural Development of the People's Republic of China</i></p> <p><a href="http://www.mohurd.gov.cn">www.mohurd.gov.cn</a></p>
<p><i>China Construction Industry Association</i></p> <p><a href="http://www.zgjzy.org/">www.zgjzy.org/</a></p>
<p><i>China Building Decoration Association</i></p> <p><a href="http://www.cbda.cn/">www.cbda.cn/</a></p>
<p><i>China Building Materials Federation</i></p> <p><a href="http://cbmia.cbminfo.com/">http://cbmia.cbminfo.com/</a></p>
<p><i>China Architectural Design Association</i></p> <p><a href="http://www.zgjzsjsxh.org/">www.zgjzsjsxh.org/</a></p>
<p><i>International Construction Decoration Interior Design Association</i></p> <p><a href="http://www.icda-hk.com/index_1.asp">www.icda-hk.com/index_1.asp</a></p>
<p><i>China Exploration &amp; Design Association</i></p> <p><a href="http://www.chinaeda.org/">www.chinaeda.org/</a></p>



**Contact the Centre at:**

Room 910, Sunflower Tower  
37 Maizidian West Street  
Chaoyang District  
Beijing, 100125

T: +86 10 8527 5300

F: +86 10 8527 5093

[www.eusmecentre.org.cn](http://www.eusmecentre.org.cn)

[info@eusmecentre.org.cn](mailto:info@eusmecentre.org.cn)

The EU SME Centre assists European SMEs to export to China by providing a comprehensive range of free, hands-on support services including the provision of information, confidential advice, networking events and training. The Centre also acts as a platform facilitating coordination amongst Member State and European public and private sector service providers to SMEs.

The Centre's range of free services cover:

- Business Development – provision of market information, business and marketing advice
- Legal – legal information, 'ask the expert' initial consultations and practical manuals
- Standards – standards and conformity requirements when exporting to China
- HR and Training – industry and horizontal training programmes
- Access to a service providers directory and information databases
- Hot-desking – free, temporary office space in the EU SME Centre to explore local business opportunities
- Any other practical support services to European SMEs wishing to export to or invest in China.

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