Banks on the move
Midwestern China the regional service delivery location of the future?
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Management summary

China’s aim of attracting multinational corporations to establish service delivery centers — offshore centers that perform designated functions for organizations — is embedded as part of the 13th Five-Year Plan for Economic and Social Development (2016-2020). This goes hand in hand with its strategy to shift from a heavy industrial and manufacturing economy to a consumption and service driven economy.

From international banks’ perspective, Mainland China has remained an alluring and viable service delivery center option, due to its well-educated labor pool, rising innovation and technology focus and an acceptable cost-base supported by governmental incentives. It is expected that the support needs of international banks in Greater China will continue to grow, which raises the question — where in Mainland China should international banks invest in service delivery center capabilities?

To form a view, Deloitte looked at the historic service delivery center footprint for international banks, Chinese banks, and IT service providers as well as trends in location strategy decision factors. Based on our analysis, we found the following:

1. There are four key regions for banking service delivery centers, each with different advantages:

   ![Graph 1: Emerging vs. traditional service delivery center locations](image)

   **Emerging Locations**
   - **Midwestern Region**
     - Chengdu, Chongqing, Xi’an, Wuhan
     - Availability of workforce, cost savings, growth, new governmental incentives
   - **Bohai Rim Region**
     - Beijing, Tianjin, Dalian
     - Mature infrastructure, high density of experienced talent and new graduates, SOE HQs, Korean and Japanese language

   **Traditional Locations**
   - **Yangtze River Delta Region**
     - Suzhou, Hangzhou, Shanghai
     - Mature infrastructure, availability of workforce, financial center, English language, MNC HQs
   - **Pearl River Delta Region**
     - Guangzhou, Shenzhen
     - Mature infrastructure, cluster of high-tech companies, opening-up policies (special economic zone)

Source: Deloitte Research
2. **Location options are becoming less concentrated:**
Historically, the coastal regions (Bohai Rim, Yangtze River Delta, and Pearl River Delta) were hubs for both Chinese and International IT and banking service delivery centers due to sound business infrastructure, abundant talent, early governmental incentives as well as proximity to clients and existing operations. Development in the Midwestern region of China, combined with a large available talent pool, lower labor costs, and novel government incentives is pulling service delivery centers toward Midwestern China, a large inland zone centered on the municipality of Chongqing, creating more location options.

3. **International banks’ investment decisions have shifted from "if China" to "how China":**
A growing share of affluent individuals, paired with the Chinese governments more open policy, is prompting foreign banking players to rethink their China strategy. Rising education levels and supply of talent are likely to overrule pure economic evaluation criteria, in an aspiration to not miss out on China’s prosperous future. We are likely to see more service delivery centers being placed in China as more banking players enter the market and respective licenses will be granted.
China is not a new name among service delivery center location options. In the mid 90’s, many international banks developed technology, operations and risk management centers in China, capitalizing on the favorable cost structures, as well as effectively souring language skills such as Korean and Japanese. At the same time, many domestic Chinese banks have set up their software development, IT support, research and training facilities away from their headquarters. All this has taken place, as well as global IT service providers having established presence and further expansion in China.

At present, banking institutions continue to monitor the increasing potential of China for service delivery center establishment, serving both domestic and Asia Pacific customers. For many international institutions, Chinese centers are typically considered as additional service nodes to traditional hubs such as India, Malaysia and the Philippines.

This is especially the case for IT and banking operation functions. Key differentiators compared to other popular global outsourcing hubs include China’s noticeable transformation to a service driven economy paired with a significant and growing supply of well-educated and tech-savvy talent. Additionally, on a provincial level, government incentives encouraging selection of special economic zones and IT parks for service delivery centers.

Graph 2: Service delivery center overview in China

Source: Deloitte Research

1. Banking providers assessed in this study: Australia and New Zealand Banking Group (ANZ), Bank of China, China Construction Bank, Citibank, HSBC, ICBC, Morgan Stanley, Nomura, Standard Chartered and UBS.

IT service providers assessed in this study: Accenture, Arvato, Capgemini, Genpact, HCL, Hewlett Packard, IBM, Infosys, Sutherland Global Services, TCS, Xerox, Wipro and WNS.
The graph above provides an overview of key service delivery center locations of representative international banks (blue), Chinese banks (green) and IT service providers (aquamarine), covering a range of IT and banking operations. These three groups have traditionally favored more developed regions, surrounding tier-one cities along the east-coast region due to abundant talent, governmental incentives as well as proximity to clients and existing operations. In recent years, the establishment of service delivery centers inland, in China’s Midwestern region, has seen a steady growth in momentum given the continuous development of the region paired with a large available talent pool, lower labor and occupancy costs, and novel government incentives. As an example, for a decade already, China Construction Bank has an operations center in the city of Chengdu, in the Midwestern province of Sichuan. Likewise, in 2011, ANZ set up an operations hub in the same city with the aim to support the bank’s growth across the region. Furthermore also Deloitte China launched its own Global Delivery Center in Chongqing, Midwestern China, in early 2015. The center focuses on IT delivery, finance and tax as well as human resources services and employs more than 1,400 members of staff.

Nonetheless, most international banks, whilst maintaining a presence in China for decades, have made relatively little progress in the geographic diversification of their service delivery centers location strategy beyond their core operations sites. This is understandable, as some players do not yet possess a full banking licence, or operate through a joint venture. Furthermore, international banks typically have comparably smaller operations, which do not justify major investment into service delivery centers. However, as announced by the Chinese government, more international banks will be granted licenses in the financial market and we will likely see more of these banks to set up Chinese service delivery centers in the future.

Chinese banks tend to have two or more service delivery center locations; some opting for proximity to their headquarters while many others choose a geographically dispersed footprint. A key reason for the geographical dispersion is due to the operations of Chinese banks’ being much larger and farther reaching than international players, both in terms of customer base and branch network. This, coupled with their desire to establish centers close to these established operations can account for the scattered footprint.

In contrast, IT service providers tend to have multiple service delivery centers established across the country and rarely elect to operate centers within close-proximity of each other. It can be assumed that IT service providers prefer to leverage their centers to support local clients directly and therefore they are more likely to operate on a larger scale in locations where their clients are based and talent is abundant.

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2. Traditional tier-one cities are defined by Chinese authorities by all or at least two of the following factors: GDP over USD 300 billion, more than 15 million inhabitants and/or directly controlled by central government (e.g. Beijing, Shanghai, Shenzhen and Guangzhou).
Traditional and emerging hubs

China can be split into four key regions. Traditional hubs are the Bohai Rim Region, surrounding Beijing and Tianjin; the Yangtze River Delta around Shanghai; the Pearl River Delta encompassing Guangzhou and Shenzhen; and an emerging hub in the Midwest, a large inland zone centered on the municipality of Chongqing. For comparative purposes, we have defined each region based on specific provinces (see graph 3).

Although coastal regions have a longer history of national and international focus and investment, the Midwestern region displays some promise when comparing key selection criteria: high-level macro-economic prosperity, infrastructure readiness, availability and quality of talent and operational cost considerations.

Growth and Foreign Direct Investment (FDI) flows have shifted

Macro-Economic factors such as Gross Domestic Product (GDP) and FDI differ greatly in size across the four regions. Whereas the Bohai Rim region observes the slowest growth, the Yangtze River and Pearl River Delta regions are on par with the overall national growth rate. In contrast, the Midwest region is growing the fastest and above the national average, at 8.7% (five year) CAGR. Crucially, the Midwest is the only one of the four regions where FDI growth is positive, increasing by three percent over the last five years.

Business infrastructure readiness by region is converging

In terms of business infrastructure readiness, the country as a whole has benefited from huge advancements over the past decade. Comparing communication infrastructure, such as availability and speed of broadband internet, as well as connectivity via fixed and mobile phone lines, all coastal areas are comparably well developed. The Midwest however, has a slightly less competitive internet speed and a higher potential of interruptions in some areas. The situation is similar with regards to transportation (national and international air routes, national train routes and highways): Bohai Rim and Yangtze River regions lead the way, followed by the Pearl River Delta region, which demonstrates good infrastructure but with slightly lower availability on international air connections. The Midwest, although having obtained a good base, has remaining improvement potential across all factors assessed: highway, rail and air infrastructure.

An enormous resource pool with varying debt of relevant skills

Availability and sustainability of skilled labor is a critical factor — oftentimes the key criteria, of strategic location selection. Attrition rates across all the regions are high, relative to mature markets abroad. While the Midwest reportedly has a slightly lower attrition rate, it is increasing due to the wide range of career opportunities and the demand from competitor companies vying for finite skills. The Bohai Rim region, with its rich stable of well-regarded tertiary education institutions (see graph 4) has the largest college graduate pool. Furthermore, English language ability is higher, and cities within the region such as Dalian, known as hub for Japanese or Korean speakers, allow companies to source a larger number of multilingual resources. The Midwest presents an increasingly viable alternative, with its very significant and improving resource pool. However, it should be noted that service delivery quality and language skills, although making positive progress, still lag behind the coastal hubs.

Cost arbitrage opportunities cannot be ignored

With increasing economic and social development in China, the cost base for service delivery center establishment (including labor cost, commercial rent and other operating expenses) is rising across China. Most prominently, salary levels have increased significantly according to the National Bureau of Statistics of China. Over the years between 2007 and 2016, national average compensation has risen by 12% annually to USD 10,800 p.a. IT sector specific salaries, starting from a higher base, similarly increased by 11% to USD 19,500 p.a. over the same time period.

While China’s three coastal regions demonstrate a similar cost structure, the Midwestern region presents a considerably cheaper alternative. This is especially the case for real estate related expenses. In many cases, real estate and occupancy costs in the Midwest are up to 50% lower than the coastal locations. Similarly, we observe the upper end of the Midwestern salary bands barely reaching the lower end of the salary bands in the other three regions. While this considerably lower cost base will likely experience upward pressure as new players enter the region, disturbing the existing supply and demand for educated talent and office space, the gap is likely to be meaningful for the foreseeable future.

It is important to note that average labor cost analysis can be deceptive. Highly experienced or specialist resources can earn a multiple of the average salary cost stated before and these levels are by no means lower than similar roles in western countries. Hudson, a recruiting firm, provided indicative ranges for senior IT resources in tier one cities with an experience of eight to twelve years are as follows:

- IT management:
  USD 85,000 — 141,000 p.a.
- Software development:
  USD 70,000 — 110,000 p.a.
- Solution architect:
  USD 78,000 — 118,000 p.a.
Graph 3: Overview of four main regions for service delivery center establishment

<table>
<thead>
<tr>
<th>Region</th>
<th>Macro-Economic</th>
<th>Infrastructure</th>
<th>Workforce</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bohai Rim Region:</strong> 5 Provinces</td>
<td>(2017, Bn USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP 5-Y CAGR</td>
<td>2,654</td>
<td>large capacity and stable speed (fixed/ mobile/ broadband)</td>
<td>1,200k+ graduates from 500+ universities/colleges</td>
<td>IT labor cost (p.a.)</td>
</tr>
<tr>
<td>FDI 5-Y CAGR</td>
<td>67</td>
<td>17 out of top 60⁶</td>
<td>700k+ IT employees</td>
<td>Real estate cost (p.a./ psm)</td>
</tr>
</tbody>
</table>

| **Yangtze River Delta:** 3 Provinces |                | large capacity and stable speed | 800k+ graduates from 300+ universities/colleges | IT labor cost | USD 20.7k-29.6k |
| GDP 5-Y CAGR    | 2,485          | 15 out of top 60⁵ | 400k+ IT employees | Real estate cost: | USD 0.2k-0.5k |
| FDI 5-Y CAGR    | 60             | Turnover rate: | | | |

| **Pearl River Delta:** 1 Province |                | large capacity and stable speed | 450k+ graduates from 140+ universities/colleges | IT labor cost | USD 19.3k-25.2k |
| GDP 5-Y CAGR    | 1,331          | 4 out of top 60⁵ | 400k+ IT employees | Real estate cost: | USD 0.2k-0.5k |
| FDI 5-Y CAGR    | 21             | Turnover rate: | | | |

| **Midwestern Region:** 4 Provinces |                | less competitive broadband speed | 1,000k+ graduates from 350+ universities/colleges | IT labor cost | USD 14.1k-20.7k |
| GDP 5-Y CAGR    | 1,702          | 15 out of top 60⁶ | 500k+ IT employees | Quality & language skills improving, not yet | Real estate cost: | USD 0.1k-0.2k |
| FDI 5-Y CAGR    | 36             | 500k+ IT employees | improving, not yet | at costal levels | |

Turnover rate:

**Legend**

- high/advanced
- moderate
- low

Source: Deloitte Research, National Bureau of Statistics of China

4. (A) Bohai Rim: Beijing, Hebei, Liaoning, Shandong, and Tianjin; (B) Yangtze River Delta: Jiangsu, Shanghai, and Zhejiang; (C) Pearl River Delta: Guangdong; (D) Midwest: Chongqing, Hubei, Shaanxi and Sichuan.
5. According to Times Higher Education 2018 University Rankings, 60 of the Global Top 1,000 Universities are located in China.
The rising midwest

Midwestern China encompasses the Sichuan, Shaanxi and Hubei provinces amongst others, and the municipality of Chongqing. The latter has been one of the focuses of the Chinese development agenda over recent years, as the country refocuses its development efforts to the non-coastal regions. Midwestern China, along with other locations, shifted into the international spotlight with the announcement of the "One Belt and One Road Initiative" 6, activating significant development efforts of the Chinese government in the region.

In recent years, the Midwestern region has experienced a variety of macro-economic, social and governmental driven changes, all of which have played a role in enhancing location selection options for Mainland service delivery centre establishment.

The Midwest is becoming a growth engine for China

China's GDP growth rate over the past decade has been steadily declining from over 14% in 2007 to under 7% over the past couple of years, with a ten year average of slightly over 8%. Whereas urbanized coastal areas contributed a fair share of early growth, recent years indicate the Midwestern region as an additional driving force, with a compounded average GDP growth rate (five years) of 8.7% compared with 7.4% in the coastal region. Regional growth has a verity of positive side effects, one of it being that it attracts talent and therefore fosters opportunities for delivery centers too.

Population in the Midwest is growing faster than China as a whole

Growth triggering economic prosperity and growing opportunities for the individual, have affected population growth numbers within different parts of China. While comparing average compounded population growth rates between the costal and Midwestern regions, it becomes apparent that:

- growth rates on the coast have declined from 1.2% at the beginning of the century (2000-2011) to 0.7% in more recent years (2011-2016)
- growth in the Midwest, during the same period, are up from zero to 0.5%, newly reaching the countries average growth rate

6. The One Belt and One Road Initiative aims to foster economic interconnectivity and establishment of two significant trading routes, the northern land route "Silk Road Economic Belt" (from China, over central Asia to Iran, Turkey, Russia to Central and West Europe) and the corresponding Maritime Silk Road. The project includes significant investments into an infrastructure net between China and over 60 nations in Asia, Europe and Africa.
Along with population shifts, changes in the academic landscape are also apparent in China. According to the Ministry of Education of the Peoples Republic of China, the largest number of colleges and universities, as well as the highest concentration of top education institutions in the country, can be found in the Bohai Rim region, in particular in Beijing. Furthermore, we see a concentration along an inland belt, from the province of Hebei over Henan down to Hubei and Guangdong, with an average of more than 120 universities per province. Furthermore, the North Yangtze River Delta region, and in particular Shanghai, is home to many Chinese top tier universities.

Nonetheless, 21 of 116 educational institutions ranked as tier one within the 211 program, run by the Chinese government, are located in the Midwest region. The city of Wuhan alone hosts three of the top 15 universities in the country. As a result of both the density and quality of education in the region, Chinese students continue to flock to the Midwest. When comparing compounded annual growth rates of Chinese graduates, we observe a widening gap between the Midwest and coastal regions:

- 2005-2011: Midwest: 10%; coast: 11%
- 2011-2016: Midwest: 7%; coast: 4%

7. Project 211, initiated by the China Ministry of Education, includes 116 institutions which meet certain scientific, technical, and human resources standards, and generally require the highest entrance scores in the admission exams (3 universities belong to the Chinese Army and have not been included in this study).
**Costs are escalating at a slower rate**

Inflation, rising education levels and competition among employers for talents are just some of the factors driving up labor costs. As outlined previously, according to the National Bureau of Statistics of China, salary levels can differ significantly between provinces; the labor cost gap between the coastal and Midwestern region rose by a factor of approximately 2.5 over the past ten years:

- Gap in 2007: ~USD 2,700 p.a. (IT sector ~USD 2,500 p.a.)
- Gap in 2016: ~USD 6,800 p.a. (IT sector ~USD 5,500 p.a.)

**The Chinese government is promoting investment in the Midwest**

In line with its 13th Five-Year Plan for Economic and Social Development, the Chinese government is steering regional development via the implementation of preferential policies and incentives:

- Five new free trade zones were established in the Midwestern region in addition to the existing six on the coast
- Tax incentives for 31 cities — nine in the Midwest — were introduced to encourage business process outsourcing services
- Additional incentives may be negotiated with local governments for the establishment of service delivery centers within specific economic zones and IT parks
Tying everything together: location strategy considerations

There is no one location that is right for every bank. As a part of the location strategy assessment, a bank should consider its priorities for a variety of critical factors such as cost, talent sustainability and risk, among others. Additionally, factors such as proximity to clients, proximity to existing operations, and change tolerance (e.g. the willingness to invest in an area that may undergo political or cost-base changes in the foreseeable future) are to be considered. For example, a bank that requires a high level of English proficiency, is less cost-sensitive, and has existing operations near Shanghai may lean towards establishing a service delivery center in the Yangtze River Delta region. In contrast, a bank with higher cost sensitivity, primarily Mandarin language skill needs, and an openness to investing in an area that may see economic and social alterations, may lean more toward Midwestern China.

To select the best location for one’s business, it’s critical to choose the right strategy, weighting relevant location factors to enable an objective comparison between different sites.
In summary, when exploring the feasibility of establishing or expanding a delivery center presence on the Mainland, companies must carefully assess their priorities and gain clear alignment before embarking on their location selection journey. The aforementioned factors combined, present a positive outlook for China and in particular for the Midwestern region as a future leading delivery center hub.

To learn more about Deloitte's location strategy services please feel free to contact one of our service delivery center specialists.
Authors

Morgan Davis
Managing Director
FSI Consulting Leader, Hong Kong
Deloitte China
morgandavis@deloitte.com.hk
+852 6162 9955

David Wu
Partner
Operations Transformation Leader
Deloitte China
davidwwu@deloitte.com.hk
+852 9269 4468

Carlos Zhou
Partner
Global Business Services Leader
Deloitte China
carloszhou@deloitte.com.cn
+86 21 6141 1788

Matt Highfield
Managing Director
Real Estate & Location Strategy
Deloitte Consulting LLP (US)
mahighfield@deloitte.com
+1 612 308 5765

Dewi Dallaway
Director
Monitor Deloitte
Deloitte China
ddallaway@deloitte.com.hk
+852 2238 7192

Patric Niffeler
Manager
Monitor Deloitte
Deloitte China
patricniffeler@deloitte.com.hk
+852 5566 1510

Contributors: Lisa Clinton, Nancy Liu, Alex Robinson, Chelsie Qi
Endnotes

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Office locations

**Beijing**
8/F Tower W2
The Towers, Beijing Oriental Plaza
1 East Chang An Avenue
Beijing 100738, PRC
Tel: +86 10 8520 7788
Fax: +86 10 8518 1218

**Changsha**
20/F Tower 3, HC International Plaza
No. 109 Furong Road North
Kaifu District
Changsha 410008, PRC
Tel: +86 731 8522 8790
Fax: +86 731 8522 8230

**Chengdu**
Unit 3406, 34/F
Yanlord Landmark Office Tower
No. 1 Section 2, Renmin South Road
Chengdu 610016, PRC
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161

**Chongqing**
36/F Deloitte Tower
8 Corporate Avenue, 10 Ruitian Road
Yuzhong District
Chongqing 400043, PRC
Tel: +86 23 8823 1888
Fax: +86 23 8859 9188

**Dalian**
15/F Senmao Building
147 Zhongshan Road
Dalian 116011, PRC
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297

**Guangzhou**
26/F Yuedu Financial Tower
28 Pearl River East Road
Guangzhou 510623, PRC
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121

**Hangzhou**
Room 1206-1210
East Building, Central Plaza
No.9 Feiyunjiang Road
Shangcheng District
Hangzhou 310008, PRC
Tel: +86 571 8972 7688
Fax: +86 571 8779 7915 / 8779 7916

**Harbin**
Room 1618, Development Zone Mansion
368 Changjiang Road
Nangang District
Harbin 150090, PRC
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056

**Hefei**
Room 1201 Tower A
Hua Bang ICC Building
No.190 Qian Shan Road
Government and Cultural New Development District
Hefei 230601, PRC
Tel: +86 551 6585 5927
Fax: +86 551 6585 5687

**Hong Kong**
35/F One Pacific Place
88 Queensway
Hong Kong
Tel: +852 2852 1600
Fax: +852 2541 1911

**Jinan**
Units 2802-2804, 28/F
China Overseas Plaza Office
No. 6636, 2nd Ring South Road
Shizhong District
Jinan 250000, PRC
Tel: +86 531 8973 5800
Fax: +86 531 8973 5811

**Macau**
19/F The Macau Square Apartment H-N
43-53A Av. do Infante D. Henrique
Macau
Tel: +853 2871 2998
Fax: +853 2871 3033

**Mongolia**
15/F, ICC Tower, Jamiyan-Gun Street
1st Khoroo, Sukhbaatar District, 14240-0025 Ulaanbaatar, Mongolia
Tel: +976 7010 0450
Fax: +976 7013 0450

**Nanjing**
6/F Asia Pacific Tower
2 Hanzhong Road
Xinjiekou Square
Nanjing 210005, PRC
Tel: +86 25 5790 8880
Fax: +86 25 8691 8776

**Shanghai**
30/F Bund Center
222 Yan An Road East
Shanghai 200002, PRC
Tel: +86 21 6141 8888
Fax: +86 21 6335 0003

**Shenyang**
Unit 3605-3606, Forum 66 Office Tower 1
No. 1-1 Qingnian Avenue
Shenhe District
Shenyang 110063, PRC
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067

**Shenzhen**
13/F China Resources Building
5001 Shennan Road East
Shenzhen 518010, PRC
Tel: +86 755 8246 3255
Fax: +86 755 8246 3186

**Suzhou**
23/F Building 1
Global Wealth Square
88 Su Hui Road, Industrial Park
Suzhou 215021, PRC
Tel: +86 512 6289 1238
Fax: +86 512 6762 3338 / 3318

**Tianjin**
45/F Metropolitan Tower
183 Nanjing Road
Heping District
Tianjin 300051, PRC
Tel: +86 22 2320 6688
Fax: +86 22 8312 6099

**Wuhan**
Unit 1, 49/F
New World International Trade Tower
568 Jianshe Avenue
Wuhan 430000, PRC
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032

**Xiamen**
Unit E, 26/F International Plaza
8 Lujiang Road, Siming District
Xiamen 361001, PRC
Tel: +86 592 2107 298
Fax: +86 592 2107 259

**Xi’an**
Room 5104A, 51F Block A
Greenland Center
9 Jinye Road, High-tech Zone
Xi’an 710065, PRC
Tel: +86 29 8114 0201
Fax: +86 29 8114 0205
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