Go East: How to Make it in China

Thorsten Gerhard and Arnold Lau

China is the new "New Economy". The rate of expansion may have slowed after years of double-digit growth, but the IMF's forecast for growth in 2005 is still 7.5 percent - a figure that developed countries can only dream of. And there is still room for optimism. But what does China mean for business? In spring 2004 Arthur D. Little conducted a survey asking CEOs how they see their chances in China, looking particularly at the impact on multinational corporations. In this article Gerhard and Lau present the key findings and suggest how companies should respond.

China's red-hot market has economists the world over brimming with optimism about the country's future. Growth has been so rampant for years now that the government has decided to step up and cool it down - but only slightly. Take a look at the oil and steel market. Here China's incredible hunger for resources has sent prices through the roof in the course of 2004. Last year China alone consumed nearly half of the world's cement and one third of the world's steel and coal output. And this at a time when China's GDP per capita, at US $ 4,700, is still only a fraction of those in developed countries. Such stupendous growth offers plenty of opportunities for multinational corporations.

During the first half of 2004 Arthur D. Little conducted a global survey and evaluated the importance of China in strategic terms for different types of companies in different industries. We wanted to know what CEOs thought about the country and generated insights and key lessons, both from success and failure, from companies that already have or plan to undertake business in China. Senior executives from 35 multinational corporations from around the globe shared their views with us in face-to-face interviews. While intrigued by the fast-growing economy on the one hand, the participants in the survey showed certain concerns about doing business there on the other. We ended up with four central findings:

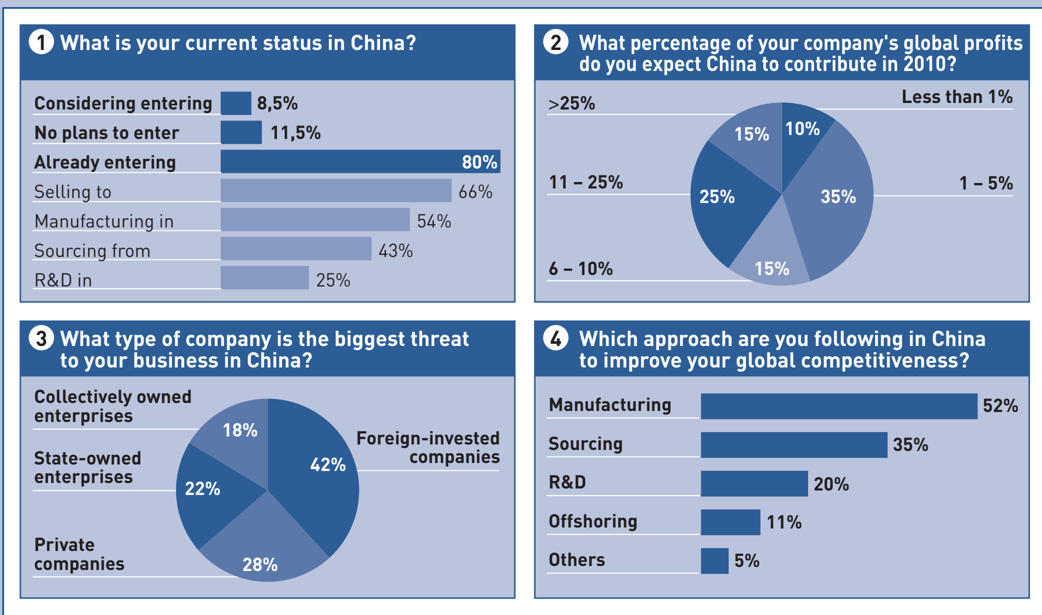
1. China as a market is too important to ignore.

2. China is no longer just the world's "manufacturing base".

3. Chinese companies are increasingly competitive and influential in the global marketplace.

4. It is not too late for multinational corporations to benefit from opportunities in China.

Exhibit 1 | Main Results of Arthur D. Little's Survey



Source: Arthur D. Little analysis

1. A Market too Important to Ignore

The heat is on in China - so much so that the Chinese government has already tried to cool it down a little. But this should not worry investors, as China is still in its early growth cycle and we do not see a "hard" landing of the Chinese economy in the near future. Given the right conditions, China's growth should be sustainable at least until the Olympic Games in 2008 in Beijing or even the World Expo in 2010 in Shanghai. Several arguments support this view. The cooling down mechanisms were introduced by the central government in only very specific segments, where overcapacity exists and investments in efficiency improvements have a limited effect. The growth of the economy is still mainly driven by investment, while consumer spending currently has only a minor effect on growth. In addition most macro indicators, such as rising cost, are in line with GDP growth or slowed monetary growth, and micro economic signs, such as rising profits and falling accounts receivable, are not indicating a overheating of the economy. Most of 2004 should see a growth rate of around 9 percent, while forecasts for 2005 range between 7 and 8.5 percent.

Managers all over the world have recognised the importance of this growth. One of our interviewees, the managing director of a key product of GE Plastics, told us that a "significant part of the growth is in China." Nobuyo Habuchi, managing director of Mabuchi Motor Co Ltd, stated that "China is important for strengthening global competitiveness."

No matter what industry one talks about, China offers huge growth potential. Consumer electronics, automobiles, pharmaceuticals and electrical appliance producers all enjoy double-digit growth in China. China is now the world's biggest market for refrigerators, beer, beverages and mobile phones, and already the fifth-biggest market for automobiles. Just take a look at Volkswagen, the German car manufacturer, which has a market share of 30.8 percent in China. In 2003, China was Volkswagen's second-biggest market after Germany.

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Eight out of ten of our interviewees consider China an "important" market within their company strategy. Among them, almost half regarded China as "very important". Besides being a market with large growth potential, China is also the source for some executives of a significant share of revenue and profit. In some cases China is the only growing market for the industry at all, with overall staffing levels having been reduced in other countries but not in China. More than 60 percent of the interviewees affirmed that their companies will invest more in China in the next five years.

Managers all over the world are closely scrutinising China and multinational corporations are excitedly exploring opportunities to enter the country. In many cases their competitors and clients are already there, which increases the pressure.

A separate question was whether or not companies' subsidiaries in China were actually profitable. The answers varied from industry to industry, but the trend was clear: more and more multinational companies are making a profit in China. Official data for manufacturing and industrial profits from sources like the American Chamber of Commerce confirm a rising trend. According to a survey conducted by the ACC, 75 percent, or more than 190 of 254 companies questioned, declared that their Chinese operations were "profitable". For 10 percent they were even "very profitable". Our survey led to the same conclusion: all companies but one were profitable in China. However, we see many companies that are still not covering their cost of capital. We also see an increasing number of companies, in particular joint ventures and wholly owned foreign companies, improving their profitability by launching efficiency improvement programmes. Volkswagen Shanghai, having been one of the most profitable companies in the past, recently announced a restructuring programme in the face of decreasing market share and enormous price pressure. The "BaseZERO" programme aims not only to improve the cost base of Volkswagen Shanghai but also to introduce new management structures and incentive schemes. Undoubtedly the most profitable outside investors have been those companies, mostly from Hong Kong and Taiwan, that have ignored the domestic market and concentrated on China as a cheap base for manufacturing and export.

Multinational corporations' expertise in marketing and branding differentiates them from the domestic competition, while the technology they possess is another key to success.

Country development is still a big issue in China, with the result that there is huge demand for industrial and infrastructure-focused sectors such as basic materials, energy, cement and construction. The rapidly growing economy is also increasing GDP per capita, which is creating plentiful opportunities for automobile, electronics and consumer goods industries. Another factor making China even more attractive to multinationals is the admission of the country to the World Trade Organisation, and the improved legal system and business environment.

Multinational corporations' expertise in marketing and branding differentiates them from the domestic competition, while the technology they possess is another key to success. And, after years of operation in China, multinationals have come to understand China's business environment and culture much better. As we will see later, this is of the utmost importance, as sticking to their usual global formulas simply would not work in China.

2. Just the World's Factory? Not Any More

For a long time China was regarded as a manufacturing centre due to its supply of low-cost labour, and it remains so. China is seen as the "factory for the world". But lately multinationals have started making use of the country's resources beyond manufacturing to help them increase their competitiveness in the global market. Seven out of 10 senior executives we interviewed considered China a remarkable place to help them increase their global competitiveness by other means than just cheap labour. Many have already started to engage in marketing, selling, distribution, sourcing, customer service, research and development and back-office operations in China.

R&D facilities

According to the Chinese press almost 100 Fortune 500 companies have set up R&D facilities in major cities in China since 1999. Moreover, more than 400 companies have R&D centres there. Given the huge pool of highly skilled engineers and scientists plus various incentives offered by the government such as free rent, favourable lease terms, construction loan assistance and tax rebates, an increasing number of foreign companies have set up R&D facilities in China.

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But the focus of this investment has changed over time. In the past, the primary purpose of setting up R&D facilities in China was to form the strategic partnerships required to enter the Chinese market. R&D investments were often the product of pressure applied to foreign companies to obtain government approval for establishing Sino-foreign joint ventures. This has changed with China's entry into the WTO. Regulations were eased with the result that companies started to show interest in moving up the value chain and are now seeking a local R&D base.

Chinese policies created a favorable environment, leading to considerable scientific and commercial successes. With more than 10,000 research institutes, China has created a scientific research powerhouse. The level of research has reached international standards (e.g. with the mapping of rice genome) and Chinese industry is developing from a low-quality copycat to high international standard. We are already seeing the first co-operative research between Chinese institutes and international companies.

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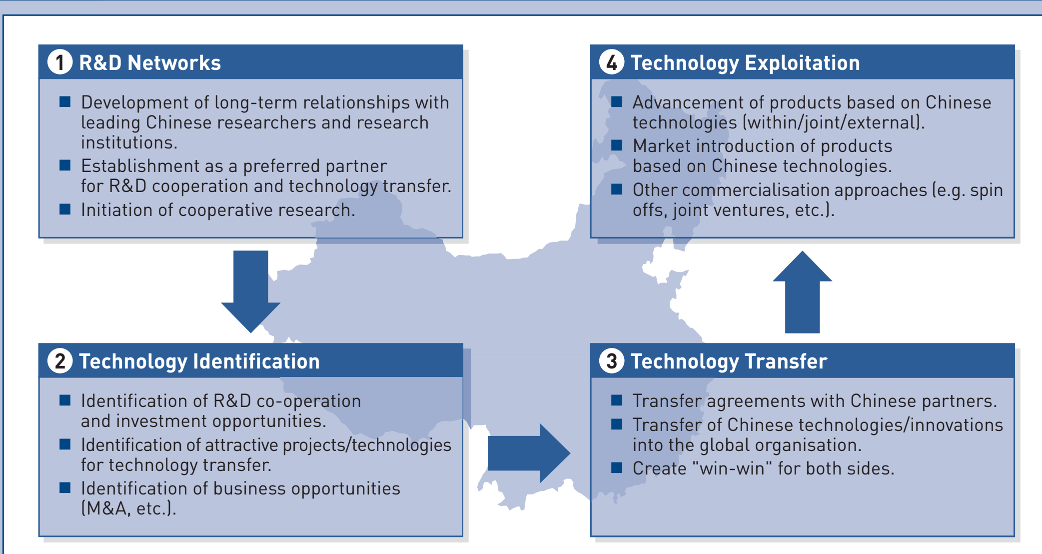
These R&D facilities take various forms, including companies' own research centres, technological development centres, research partnerships with Chinese universities and hiring university researchers under contract. They can serve to capture and export technology coming from within China as well as to develop products that are catered to local or global markets.

The potential of the Chinese research environment has been recognised by leading Western companies. Motorola, Roche, Microsoft, IBM, Siemens, Alcatel, GE and Nokia have all set up global research centres in China. BASF has established a Sino-German R&D fund to support scientific co-operation, which has led to the establishment of 39 scientific and research cooperation projects with 15 colleges and research organisations. Tri-annual symposia are held to gather and exchange information with Chinese scientists, and BASF's innovation strategy is enhanced by developing new processes, products and markets in China.

Exhibit 2 **The Four Steps of Technology Transfer with China**



Source: Arthur D. Little analysis

Looking down the road, we see four steps that can improve the competitiveness of multinationals by leveraging China's R&D capabilities and resources. Technology transfer and commercial exploitation should be the ultimate goal for multinational companies. (see Figure 2)

This shows that, unlike in the past, R&D activities are now widely considered to be strategically important to multinational corporations' long-term future growth in both China and the global market.

**A Chinese Wall for Knowledge:
Protecting Intellectual Property (IP) in China**

From software to cars, almost all companies face the reality of IP infringement in China. Lately even counterfeit Volkswagens have come onto the market. In the software industry it is (conservatively) estimated that China accounted for 20 percent of the global counterfeit loss in 2002.

Companies have reacted with various measures. GE Plastics, for example, produces its parts with the most strategic and sensitive research knowledge only in the US and Europe. This means that the R&D done in China focuses more on "development" than "research". This is widely true for many companies and industries, some of which even go so far as to build their own version of the Chinese Wall.

Corning, the US technology firm, built concentric moats with multiple protection layers. All the detailed planning on what technology to bring to China, how to build the office and most of the security issues were executed outside China. Other strategies include having well specified, rigid contracts right from the start of partnerships with Chinese companies, and vocational training and education for IP recipients. Companies should exercise stringent control over their ownership of IP, which prevents their rights from being infringed.

The government, realising how much this problem can discourage foreign investment, has started to be more active in promoting intellectual property rights (IPR) enforcement. China signed the Agreement on Trade-Related Aspects of IPR upon its accession to the WTO, which defined the minimum standards for IP protection. The legal environment regarding IPR protection has been improved. The period of patent protection has been extended to 20 years. Significant improvements have also been made in data protection and patent linkage.

Service Centres

Another finding of the study is the rise of China as a location for service centres. Many companies find it beneficial to set up global/regional service centres there for a number of reasons. Firstly they profit from the low wages, and more importantly, they can now serve their clients around the globe in shifts spanning 24 hours. GE, for example, located its North Asia customer-service center in Dalian, while IBM, Microsoft and Hewlett-Packard have opened IT-services support centers in Shanghai, Wuhan, and Dalian.

A considerable number of Japanese and Korean companies have outsourced functions to China. The reasons are simple: China is very close to both countries, culturally they share certain similarities and a large number of Chinese are fluent in Japanese and Korean. But the place is also attractive for American companies. NextFocus, a US-based, Asia-focused telecoms outsourcing service company, has set up a call centre in Dalian providing back-office support for clients in South Korea. Accenture established an outsourcing center in Dalian in 2003 for serving clients in North Asia.

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IT and Back-Office Operations

In order to further drive down costs, companies have begun outsourcing their IT and back-office functions to China - even from India. Lately there has been an influx of Indian IT-services firms, namely Tata, Wipro, Satyam and Infosys. Satyam Computer Services Ltd. set up its development centre in Shanghai to provide software support for multinational companies. BearingPoint, a US-based systems integration, consulting and managed services firm, opened a new software development centre in Shanghai offering outsourcing services to reduce software development costs. Microsoft will outsource US$ 50 million in projects to Chinese software companies and directly invest US$ 60 million in its Chinese partners in the coming three years. Gartner Inc., a provider of research and analysis on the global IT industry, predicts that China will emerge as one of the top three countries for overseas IT outsourcing before 2010.

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In 2004, the Chinese State Development and Reform Commission, the Ministry of Commerce and the Ministry of Information Industry introduced a plan for establishing five software export bases in Shanghai, Dalian, Shenzhen, Tianjin and Xi'an.

As for the outsourcing of back-office operations, HSBC has set up large-scale centralised back-office support centres for the group's global business. The call centre set up by Work Applications, mentioned earlier, also provides back-office services, including payroll and document management, with the aim of serving the Japanese market. Work Applications claimed that it would be able to cut costs by more than 30 percent by moving these operations from Japan to Dalian.

3. Chinese Companies are Increasingly Competitive Globally

Target Markets for Chinese Companies

Due to crowded markets in China, companies' business ambitions, government support and various other reasons, Chinese companies have started expanding abroad. A few rising upstarts in China are becoming very active and competitive on a global scale. Haier, for example, has overseas sales of US$ 1 billion. According to Euromonitor's statistics on company sales, Haier ranks fifth among global whitegoods manufacturers and has the biggest world market brand share for refrigerators. The company has offices and factories in more than 100 countries, and in 2002 set up its American headquarters in midtown Manhattan, New York, signalling its determination to develop in the US and globalise its products. Its European headquarters was established in Italy, the ideal place in which to achieve its clear goal of improving design and styling. According to Haier's executive vice-president, Chai Yongsen, the company's target is to become the number three appliance maker in the world after Whirlpool Corp. and Electrolux. In 2003 Haier erected an electric billboard in Tokyo's swanky Ginza shopping district, a direct symbol of its determination to sell in Japan. To further extend its global reach, Haier has also entered into a number of strategic alliances with Taipeibased Sampo Corp., Japan's Sanyo, Korea's LG Electronics and Hong Kong's CCT Telecom. Haier products are sold in 10 American supermarket chains and 12 out of 15 European chains. In January 2004 Haier was listed as one of the world's 100 most recognised global brands by the World Brand Laboratory, one of the leading world brand evaluation organisations.

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When going abroad, Chinese enterprises tend to open initially in other developing countries where price is often the most critical element in any purchasing decision. With the rapid development of China's economy, its telecommunication equipment manufacturers have pushed their services to overseas markets, expanding from Africa, South-East Asia and Latin America to the Middle East, Europe and North America.

Huawei Technologies, established in 1988, is a high-tech enterprise which specialises in R&D, production and marketing of communications equipment and provides customised network solutions for telecom carriers in optical, fixed, mobile and data communications networks. With more than 20,000 employees and over US$ 3 billion in revenues, Huawei has expanded its penetration into the global market. Its international revenues almost doubled to US$1.05 billion in 2003, up from US$ 552 million in 2002, and international sales now account for 27 percent. The company has established 32 branch offices worldwide to support its global operations, along with eight regional headquarters and a number of customer support and training centres. Research institutes have been set up in Stockholm, Moscow, Dallas, Bangalore, Beijing and Shanghai. Huawei's products are used in over 40 countries including the UK, France, Germany, Spain, Russia, Singapore, Thailand and Egypt.

Another telecommunication equipment manufacturer that deserves attention is Zhongxing Telecommunications Equipment Corporation (ZTE). ZTE is China's largest listed telecommunications equipment provider, specialising in customised network solutions for telecom carriers worldwide. The company develops and manufactures telecommunications equipment for fixed, mobile, data and optical networks, intelligent networks and next-generation networks as well as mobile phones. ZTE's annual revenue rose to US$ 1.9 billion in 2003, while its international sales doubled to US$ 610 million, accounting for 17.6 per cent of total sales. ZTE has set up 13 wholly owned R&D centres worldwide and undertaken research partnerships with electronics giants like Texas Instruments, Motorola and Agere Systems. Recently ZTE signed agreements or established joint ventures with companies and governments in Pakistan, Vietnam, Romania, India, Congo and Yugoslavia. ZTE's products are deployed in more than 40 countries and regions including the US, Russia, Egypt, Kenya, Congo, Zambia, Thailand, Cyprus, Bangladesh and Hong Kong.

Both Huawei and ZTE have belligerently captured market share from strong multinational competitors. The key to their success is their low-priced products, which offer a level of performance that can rival products from multinational competitors.

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Going Global: Chinese Companies on the Move

By taking advantage of low labour costs, knowledge of the local market, direct access to Chinese consumers and government support, Lenovo Group Ltd., China's largest manufacturer of personal computers, and Ningbo Bird Co. Ltd. (aka. Bird), the largest China-based cellular phone producer, are dominating the domestic market and using this as a springboard to international success.

Lenovo Group Ltd., as the largest IT corporation in China, takes the lion's share of the commercial PC, consumer PC and notebook computer markets. In China's commercial PC market, Lenovo had a market share of 29.3 percent in 2003, whereas Dell, IBM and HP accounted for 6.6 percent, 4.6 percent and 4.3 percent respectively. In consumer PCs, Lenovo took 27 percent, while no multinational firms made it to the top 10. Lenovo is also the number one PC brand in the Asia-Pacific market (excluding Japan) with a market share of 12.6 percent in 2003.

Bird grew very quickly by concentrating its energy on rural areas and small cities and making use of a wide net-

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work of distribution channels. Another key to the success of these Chinese companies is that they have a better understanding of local preferences, which means they can better cater their products to Chinese consumers. Bird designs for domestic consumer tastes whereas global manufacturers design for the global market. Bird is also famous for its innovative designs. Today Bird is the number one cellphone maker in China, surpassing archrivals like Motorola and Nokia. Revenue was RMB 10.8 billion (US$ 1.3 billion) in 2003, up 70.3 percent from 2002, and net income amounted to RMB 245 million, up 13.5 percent. In 2003, Bird had a market share of 15 percent compared with Motorola's 14.2 percent. Facing a domestic market on the brink of saturation, Bird is extending its activities to Asia and Europe, exporting cellphones under its own brand to France, Italy, Russia, Finland, India and South-East Asia. Recently, it has formed a partnership with Siemens which will allow Bird to take advantage of Siemens' global market knowledge and presence to open export markets for its products. The Siemens-Bird partnership is likely to do more damage to the position of Motorola and Nokia as market leaders.

Linking up with the locals

For many Chinese companies, buying foreign companies, especially those with lucrative potential, is an efficient and cost-effective way to acquire technology or established brands as well as valuable distribution channels, boosting them in areas in which they are generally weak.

A Chinese electronic appliance company, the TCL Group, has purchased the assets of the bankrupt German television maker, Schneider Electronics. Schneider's production line, inventory and trademarks are now owned by TCL. The Schneider brand provides TCL with access to its worldwide distribution network, which helps TCL to enter the European market. TCL also signed a sales co-operation agreement with the Dutch electronics giant, Philips, in 2002. Under this agreement, TCL helps sell Philips products through its sales network in China.

The Chinese government encourages overseas investment by oil companies to secure its supply of oil and other resources and to offset the strong capital inflows that have been generating pressure for a revaluation of the Chinese currency. In 2002, Sinopec and China National Offshore Oil Corp. (CNOOC), the two largest oil companies in China, bought oil and gas fields in Indonesia to increase their oil reserves.

As for Sino-foreign partnerships, British Petroleum Plc. has established a US$ 25 million joint venture with Sinopec Zhenhai Refining and Chemical Co. Ltd. with the two parties each holding 50 percent of the venture. In total the three giants PetroChina, CNOOC, and Sinopec have invested more than EUR 3 billion outside China in the last two years.

Shanghai Volkswagen, the largest foreign-invested enterprise in China in terms of sales, is a 50:50 joint venture between Volkswagen and Shanghai Automotive Industry Corp (Group). Its standard Santana model is the best-selling sedan in China. Volkswagen also established 160 joint ventures between foreign and Chinese suppliers, approximately 100 licence and know-how agreements and 250 tools and equipment agreements.

Motorola, the largest foreign investor in China's electronics industry and the largest foreign company in China, has nine joint ventures in the country, which produce

Exhibit 3 **The Chinese Dragon Shows its Teeth**

Strengths of Chinese Companies

- Low capital cost
- Well qualified R&D resources at low cost
- Low production cost including sourcing and energy
- Fast and pragmatic decision making and implementation

Weakness of Chinese Companies

- Low productivity
- No (global) brands
- Insufficient capabilities in
  - Supply Chain Management
  - Marketing
  - Service
- Limited international experiences

Implications

- Acquisition of (smaller) foreign companies or brands
- Recruiting of Chinese talents from MNC's

Source: Arthur D. Little analysis

cellphones, CDMA equipment, semiconductors and other high-tech products.

The vast number of successful partnerships in China demonstrate that rising Chinese companies do not necessarily present only a threat to multinational corporations, but can in fact present opportunities.

4. Key Lessons from Early Movers

China has already become a powerhouse and is getting more powerful every minute. However, due to its unique culture and vast differences from other countries, China is no easy market to enter. Entrepreneurship in China is unlike that in the US and Europe and traditional Western models do not always apply.

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Understanding China is critical to success. In talking to senior executives of multinational corporations in different industries we identified a number of strategies that foster success. According to our survey, the five most important issues identified are (in decreasing order of significance): attracting and retaining local talent, gathering market data, identifying and building a successful local partnership, understanding business and local culture, and building a reliable local supplier network.

HR / Management

Senior executives we interviewed acknowledged that the biggest challenge they are facing is in recruiting and retaining local talent. China has an abundant supply of low-skilled labour but, as foreign companies begin to look for people higher up the value chain, the number of eligible candidates rapidly decreases while prices rise.

Companies should formulate strategies to attract the targeted group they want to recruit. Special compensation packages, including attractive loans, housing, company options and stocks to staff have been introduced to develop loyalty. Opportunities for training and career development also help in attracting the best people. Some bigger multinationals, such as GE, Motorola and Nokia, have built formal on-site staff training facilities, while other strategies include establishing multi-year executive development programmes and mentoring programmes, offering overseas postings and providing structures for local people to advance.

Another problem related to human capital is the development of a strong management team. Most senior executives prefer hiring a local person as manager to hiring someone from abroad. It costs less to employ local staff than to import expatriate executives, and local managers also understand the local market and Chinese culture better. Companies revealed that they are going after Chinese people with MBAs from the US and Europe and those with a career in the US. These people possess international experience as well as intimate knowledge of local market and Chinese culture. Other essential attributes of managers include an appropriate vision of the business, credibility and trust in headquarters, well developed interpersonal skills, and the ability to mentor, coach and train local employees.

Most senior executives prefer hiring a local person as manager to hiring someone from abroad. It costs less to localise staff than importing expatriate executives, and local managers also understand the local market and Chinese culture better.

Good market data

In the past, many executives were not realistic enough and were swept up in the big numbers. It is not uncommon to hear sayings like “China has a population of 1.3 billion. If everyone spends one dollar on your product, you will earn 1.3 billion dollars.” However, the opportunity is often not as large as people let themselves believe.

Having accurate market data is thus of the utmost importance as it determines the general direction and strategies to be applied. However, raw data is often not available in China and the validity of the available data is questionable. Apart from hiring consultants for reliable market data, companies have set up their own research teams to do extensive research on the China market. Undertaking continuous research is a prerequisite as the markets change rapidly.

Partnerships

Although it is no longer vital to set up joint ventures, it is crucial for multinational corporations to have good relations with Chinese companies. No general answer can be given to the question regarding whether multinationals should form joint ventures, as the answer varies across industries. For some industries, joint ventures might be a good way to get into the market because local partners can contribute their understanding of the consumer demand, valuable distribution and customer networks, and low-cost manufacturing. A good and trustworthy partner can be a significant asset. Senior executives told us that being physically present in China and effective communication with partners are keys to establishing the right local partnerships.

Most executives are convinced that they should base their success on Chinese culture, instead of trying to change the Chinese mentality and culture.

Understanding business and local cultures

Business and local cultures in China are vastly different from those in other countries. According to our interviewees, getting a strong local management team in place puts a company in a much better position in this respect. Most executives are convinced that they should base their success on Chinese culture, instead of trying to change the Chinese mentality and culture.

Furthermore, the importance of cultivating “guanxi” (relationships) should not be underestimated. Although the importance of well established relationships is fading, it still has a significant impact on companies’ ability to influence the regulatory environment in their favour, especially in heavily regulated sectors such as the financial and professional sectors. Some companies have set up government relations departments to take care of this issue.

Reliability of local suppliers

Our interviewees reported a lack of reliable local suppliers in China, and said that the quality of final products can be different from that of samples. To resolve the problem, multinationals have established supplier development programmes. Some companies also implemented constant quality assurance in which quality standards are examined before shipment. Constant assured quality check, in which quality standards are examined before shipment, is also implemented in some companies.

Insights for the Executive

China is on every agenda of almost all (business) publications. To understand the potential and opportunities that China offers, Arthur D. Little conducted a global survey among CEOs of multinational companies in spring 2004. The results presented here show that China has outgrown its former status of being a cheap production site. Instead successful companies are already using the huge and well qualified reservoir of engineers and scientists to strengthen their global R&D base. We are confident that this is only the beginning - and will keep you updated on further developments.

Being early in China does not necessarily guarantee success. There will always be emerging opportunities. In fact there may be some advantages in being late. Regulators are getting increasingly flexible as they gain experience in working with foreign investors. We have also seen that many companies are facing opportunities to enter China at a rather low risk by following customers in shifting production to China. The country is simply too important for nearly every company to be ignored.

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