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Is It Too Late to Enter China?

by Edward Tse

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Is It Too Late to Enter China?

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Is now a smart time to enter or expand in China? On the one hand, the answer seems like a no-brainer. While many other countries have slipped into an economic coma, China is humming along, with Goldman Sachs projecting that the economy will grow by more than 11% in 2010. On the other hand, these are not happy times for many foreign investors. The clash between Google and the Chinese government, along with the ongoing vulnerability of intellectual property rights and continuing restrictions on foreign ownership in China, makes CEOs wonder if a presence there is worth the risks.

In a recent article in *Time*, James McGregor, a consultant and former chairman of the American Chamber of Commerce in China, voiced some of the problems vexing foreign investors: competition from inexpensive knock-offs; rivalry from state-owned enterprises that enjoy special advantages; and seemingly duplicitous government policies such as the selective enforcement of World Trade Organization norms. McGregor wrote that CEOs are “losing

sleep over expectations that their onetime [Chinese] partners are morphing into predators—and that their own technology and know-how will be coming back at them globally in the form of cut-price products from subsidized state-owned behemoths.” There’s also a growing perception that the Chinese government has hardened its attitude toward the outside world, blaming the United States for creating the global financial crisis, and favoring local companies over foreign ones.

These challenges are real, but they aren’t new—and they certainly don’t tell the full story. To enter a complex country like China without understanding the context is folly. Although the Chinese government began freeing the economy from controls in 1978, it has always wielded a strong hand over business, balancing the need for economic growth—and the entrepreneurship that demands—with its overriding desire to maintain political and social stability. The government still prevents foreign companies from entering core sectors such as telecommunications and media. It has

also restructured and rejuvenated state-owned companies, including Baosteel, Industrial and Commercial Bank of China, China National Petroleum, and China Mobile. They are becoming fierce competitors, particularly since they enjoy government backing.

In the sectors that any company may enter, China is awash with competitors, both local and foreign. Look at the figures. The number of private companies in China shot up from 140,000 in 1992 to 6.6 million by the end of 2008, even as the number of foreign corporations grew to 435,000. Of the *Fortune* 500 companies, about 480 are already in China, according to its government. This makes for a marketplace in which Chinese and foreign companies battle for survival. Several surveys report that profits are slowly rising but that most multinationals still find it tough to earn the margins they can realize at home. Indeed, many enterprises and entrepreneurs believe that soon it might be too late to enter China successfully.

Although it may be scary to consider entering what is arguably the world's most complicated and competitive market, the notion that it isn't necessary to do so is misguided. Few Western companies were prepared for the speed of China's recovery; fewer still are ready to handle the fact that China will soon be the world's growth engine in terms of output and consumption. Consider two pieces of evidence. One, China surpassed the U.S. as the world's largest automotive market in 2009. Two, according to a September 2009 report from the China Enterprise Confederation and the China Enterprise Directors Association, the top 500 Chinese companies' net profits were \$170.6 billion in the first half of 2009, exceeding for the first time the net profits reported by the top 500 American companies, which were \$98.9 billion for that period. Not only will China replace the United States as the world's largest economy faster than predicted, but China's (and India's) growth may make Asia the source of about 50% of the world's gross domestic product by 2030.

At the same time, doing business in China doesn't mean what it used to. Many companies believe they have figured out how to operate there, but the scale and intensity of change in the Chinese economy is rendering even successful strategies inadequate. It is no longer sufficient to develop a freestanding business in

the country. In most industries, China is becoming a game changer, with companies' operations there altering the basis of competition the world over. CEOs must therefore develop a new China strategy—one that isn't simply a plan for selling in or sourcing from China. They must integrate the China business with their operations elsewhere, so that China can provide them with a global competitive advantage. I call this a one-world strategy with China at its core.

Making the transition will be difficult even for companies that have operated in China for decades. But those that don't make the shift will be pushed aside by rivals, old and new, that are already using China to transform their competitive positions—as I will show in the following pages.

The China Context

Executives usually consider three *c*'s when formulating strategy: customers, competitors, and the company. As I suggested earlier, they must add one more for China: context. That's easier said than done; three factors keep changing the context in China.

Official China. Despite recent controversy over the Communist Party of China's attitude toward foreign companies, economic liberalization will continue. Growth generates legitimacy for China's government and guarantees social stability. However, the party will continue to determine the pace at which it frees the economy from controls. Companies that wish to do business in China must understand the government's priorities and modify their strategies accordingly. The government has retained ownership of key companies in the communications, energy, finance, resources, and media sectors, and contrary to foreign investors' hopes, it has no intention of letting go of them in the near future.

A handful of companies may eventually decide, as Google did, that China just isn't right for them. Google entered the Chinese market in early 2000 by creating a Chinese-language version of its home page. Because the facilities were located on U.S. soil, Google wasn't subject to Chinese censorship laws and didn't need a license from the Chinese government to operate its business. In 2004 Google realized that rivals such as Yahoo and Microsoft were getting ahead because they had established a presence in China. In January 2006, after a year of

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preparation, the company announced the creation of Google.cn, located in China and subject to Chinese filtering.

The decision to physically enter China and expose search results to censorship drew a lot of criticism, and Google has been of two minds about the decision since then. The company had to decide whether to “compromise our mission by failing to serve our users in China or compromise our mission by entering China and complying with Chinese laws that require us to censor search results,” a Google spokesperson said at the time. “Self-censorship, like that which we are now required to perform in China, is something that conflicts deeply with our core principles....This was not something we did enthusiastically or something that we’re proud of at all.”

Google’s January 2010 announcement that it would close its China operations if the government didn’t lift censorship wasn’t surprising. Like almost all the Western internet majors, Google has found competing with Chinese companies difficult. Yahoo has long since opted for a minority stake in a joint venture with China’s successful business portal, Alibaba.com, in a market dominated by Sohu.com, the leading online media company. Because China’s online auction market is dominated by Taobao.com, eBay hasn’t done very well either. A lot of money will be made in China’s internet market, but it will go mostly to domestic companies that are better able to handle the political intricacies of running such businesses in China. And Google hasn’t yet left China—at least not at the time of this writing. It used its announcement to clarify its views, to publicize its concerns about cyberattacks, and to open talks with government representatives. The company is still trying to establish a position in the Chinese context, knowing that if it can find a way to manage the reputational risks, maintaining its China operation will not be a bad thing.

Google may not succeed, because its business touches on one of Beijing’s most sensitive areas: politically related debate, which the party insists on controlling. In other sectors, though, the potential benefits outweigh the risks. For example, foreign carmakers are restricted to joint ventures in which their maximum stake is 50%. This limitation is balanced by the possibility of selling products in the world’s largest automobile market and gaining

unmatchable economies of scale. Even five years ago it could be argued that the unknowns of entering China made delaying a decision to do so worthwhile. Since then its business environment has become more accessible and transparent, so companies that continue to hesitate may find it difficult to break into the Chinese market in the future.

Many Westerners believe that where economic freedoms lead, political freedoms must follow. They’re wrong. China will remain a communist nation in the near future. The party’s 75 million members, who dominate government and society, believe that China’s development can take place only under its leadership. Although Beijing recognizes that the rest of the world expects it to play a leadership role, it is having a tough time balancing global expectations with the desire to follow former party leader Deng Xiaoping’s doctrine that China must keep a low profile. This tension results in outsiders’ believing that the Chinese government is arrogant, whereas it is merely undecided about how much attention it should pay to the world outside the Wall when it has so many challenges to tackle at home.

Competitive China. Many executives take for granted that China—compared with, say, Russia and India, or even Japan and South Korea—has an open marketplace. Unlike Asia’s other economies, China opened its markets to foreign companies when its economic reforms began and has opened them wider ever since. It spawns the world’s largest number of start-ups; is growing global giants such as Lenovo, Haier, Huawei, and ZTE; and attracts the most foreign companies, too. That results in intense competition and creates a host of business opportunities in China, particularly for forging alliances and partnerships.

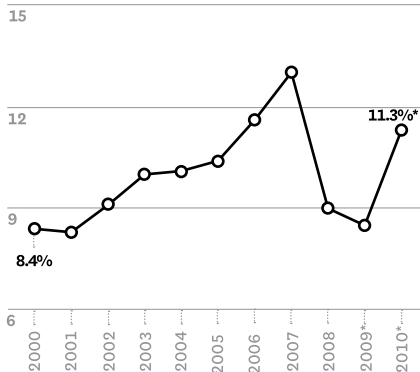
Large investments and cheap labor have propelled economic growth in China until now, leading to enormous waste and environmental damage. Over the next decade government policy will drive a switch to efficiency and conservation. Companies in China will have to reduce their consumption of raw materials, mitigate the environmental impact of their operations, radically improve quality, and hone their management skills. That will make them even more competitive than they are today.

Consumer China. The money generated by China’s growth has created a substantial mid-

CHINA’S SCORCHING PACE OF GROWTH

The recent recession seems to have been just a temporary setback for China.

REAL GDP GROWTH RATE



*PROJECTED

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dle class. As a result, no other country—not even Japan or the United States—has as many products and brands as China does. This has resulted in a lack of brand loyalty and quick shifts in market share. Chinese consumers have become as diverse in their tastes as their Western counterparts, and they're just as demanding.

In addition, China is changing from a largely rural nation to one of cities. By 2020 city dwellers will account for 60% of the population, compared with 40% in 2009, and new metropolitan areas will form across the country. The migration of 200 million people will transform markets afresh: Urban consumers differ from rural ones in the products and services they want. Over the next 10 years China's mass market will morph into differentiated and multitiered segments. Because these new markets will be linked with one another, with the coastal areas, and with the rest of the world by a reliable transport and communications infrastructure, they will be far easier to reach than they were five years ago.

Thus executives who believe that the Chinese government is welcoming but opaque should regard it as a powerful player on the world stage. Those who have been treating China's companies as suppliers must treat them as potential competitors. And those who have been approaching China as a mass market would do well to approach it as a collection of different consumer segments. Because of the size of the market and the reach of the corporations in it, almost every company must compete, at least in some form, in China.

Five Questions for Shaping a China Strategy

To fashion a China strategy that can ride these forces, executives must answer five questions. These questions apply to most industries and situations; they're based on my two decades of experience in helping foreign companies enter China.

The first three help establish where companies are in relation to China's economic development:

How open is—and will be—our industry in China? The Chinese government imposes legal restrictions on both the nature of corporate ownership and the products and services that companies may offer. Although the state is opening up more industries to competition, it

doesn't follow a timetable. Companies must monitor the extent to which—and the pace at which—the government frees industries from controls. It's important to bag a license the moment an industry is deregulated, so companies in sectors that are currently closed should build connections (*guanxi*) with key officials as a source of competitive advantage.

Few sectors in China are completely off-limits, but the rules can be complex. For example, both foreign automobile companies and foreign banks are permitted to set up fully owned operations in China, but, as I stated earlier, the former may hold a 50% share in a local company, whereas the latter may control only 25% of a Chinese bank's equity. Moreover, there are few constraints on the cars that companies may make, but new banking products often face a lengthy approval process. Even in completely open industries, the Chinese government will intervene whenever it deems it necessary. For instance, China's soft-drinks sector was deregulated decades ago, but in 2009 the Ministry of Commerce wouldn't permit Coca-Cola to buy Huiyuan Juice because it feared that the takeover would reduce competition.

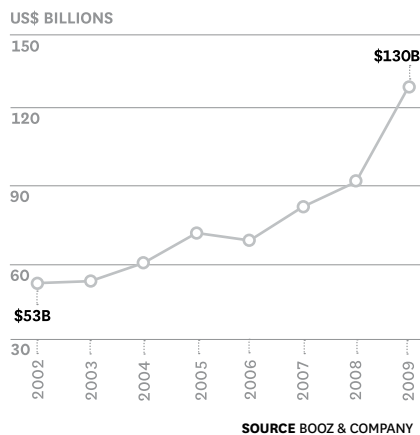
What business models should we use? Foreign companies' business models fall into two categories: *sourcing-centric* and *sales-centric*. Enterprises using the former, particularly in sectors such as consumer electronics and mobile communications, have established export bases in China, but their local marketing and sales capabilities are limited. Those deploying the latter, particularly in the fast-moving consumer goods and automotive industries, focus on the Chinese market.

Smart companies combine the two models as they expand. For example, they design some product lines both for China's wealthiest consumers and for export to the developed world, while aiming less-expensive products at a broader range of consumers in China's upper-tier markets—large, cosmopolitan cities such as Shanghai, Beijing, and Guangzhou. Some of these companies also offer a third set of products to frugal consumers who are adjusting to urban life in China's middle-tier cities. Managing multiple business models is tough but often necessary to cash in on the opportunities in China.

Can we live with China's uncertainties? The pace of change, lack of data, and high executive turnover in China render decision making

THE GROWTH OF OUTSIDE INVESTMENT

In seven years foreign companies more than doubled their investment in China.



hard for foreign companies. Nevertheless, it's better to be approximately right than precisely wrong. Anticipating specific changes is impossible, but leaders should be ready to act when opportunities or new constraints appear.

Many Chinese chief executives thrive under these conditions, so it's a good idea to learn from them. Haier's Zhang Ruimin and Huawei's Ren Zhengfei, for instance, don't succeed by trying to get things right all the time. They are fearless experimenters who are willing to learn, launch, adapt, and improve in quick bursts. The Chinese market demands managers who see things in a nonlinear fashion and can act boldly when necessary.

However, it's a good idea for foreign companies to temper opportunism with experience. For instance, many experts saw Toyota as a latecomer and a slow mover in China. Volkswagen and GM established joint ventures with prestigious local companies and racked up large market shares before the Japanese company teamed up with Guangzhou Auto, in 2004. However, because its partner was a relative lightweight, Toyota learned more about doing business in China and gained greater control over the venture than its rivals had. By 2008 Toyota was China's largest car company by revenue (110 billion yuan versus Volkswagen's 96 billion yuan) and the second largest by sales (525,000 cars to Volkswagen's 760,000).

The two remaining questions enable companies to develop a one-world strategy with China at its core:

How can we integrate our China operations with our businesses elsewhere in the world? The stand-alone business models that many multinational companies have been using in China are coming under pressure from rising costs—particularly those of labor and raw materials—as well as the yuan's appreciation. The rise of the yuan stopped in the second half of 2008, largely because of the global financial crisis, but its value is bound to increase in the future. In order to keep costs down, companies will have to integrate their China operations with their businesses elsewhere—for instance, by developing products in China and manufacturing them in other Asian countries—and vice versa. This will make management more complex, but it will be essential if these enterprises are to remain globally competitive.

Some companies, such as Coca-Cola and Nokia, have started by setting up R&D laboratories and product development centers in China so that they can tap into the large supply of engineers and scientists in the country. These companies develop products by combining insights into the Chinese consumer with global platforms and then finding markets outside the country for those innovations. For instance, a little more than half of the handsets Nokia develops in China are sold in other countries. A.O. Smith, the American water heater manufacturer, has introduced in the U.S. products designed in China and is using some of its Chinese manufacturing capacity to make water heaters for the Indian market. In 2008 A.O. Smith China attained a 33% growth rate and ranked second only to Haier in the Chinese market.

Can we move more parts of our value chain to China? The relocation of value-creation activity to China has gone through several stages. The first involved setting up manufacturing facilities there, and the second involved making China a major sourcing location. In the third stage, which began in the early 2000s, companies incorporated their China facilities into their global manufacturing networks even as they started building distribution networks to reach China's prosperous regions. In the fourth stage, companies are making China a key part of their value chains. This entails moving some operations from headquarters to China. For example, by monitoring research labs, enterprises are drawing on Chinese R&D as it matures. They are also extending their value chains from China. Global networks of suppliers have grown to include foreign companies operating in China as well as Chinese companies and entities funded by Chinese investors.

These two trends, increased R&D and the development of global value chains, favor enterprises that locate each element—from research, through manufacturing, sourcing, and procurement, to distribution and marketing—in the most appropriate place. Such one-world companies can take advantage of China's growing markets, its increasing dominance of parts of the value chain, its talent pools, and its integration with global communications and transport networks. They will protect themselves against intellectual property theft by developing highly innovative product designs, keeping

5 Questions to Ask Before Investing in China

1. How open is—and will be—our industry in China?
2. What business models should we use?
3. Can we live with China's uncertainties?
4. How can we integrate our China operations with our businesses elsewhere in the world?
5. Can we move more parts of our value chain to China?

China's (and India's) growth may make Asia the source of about 50% of the world's gross domestic product by 2030.

some of their operations closely guarded, and providing customer service of a quality that is difficult to imitate. A few multinationals have already made this shift. Among them are Nokia—which treats China as its main manufacturing base, a major market, and a primary source of new handset designs—and Samsung, which earmarked \$1 billion in 2009 to develop more products and expand its operations in the country.

Honeywell, too, has developed a strategy that turns on its head the traditional approach of developing industrial controls in the United States and selling them to the rest of the world. In 2003 the company relocated its Asia-Pacific headquarters from Hong Kong to Shanghai, and in 2007 it opened a global engineering center in Chongqing and transferred the headquarters of its electronic materials division to Shanghai. From 2003 to 2009 Honeywell more than doubled its China staff to around 9,000 people, with a number of new hires going to work in a 1,000-person R&D center in Shanghai. Honeywell has developed several new products in China. Some of them have fewer functions than its U.S. range, others have the same functions, and still others are entirely new. The company designed these industrial

controls mainly for Chinese customers, but it is exporting them to other parts of the world as well. They sell for less, on average, than Honeywell's traditional range, but owing to lower development and production costs, the company earns higher margins on them. Honeywell has protected its intellectual property by manufacturing quality products and building a strong brand. Local competitors' products are not only markedly inferior but also just as expensive as Honeywell's versions. Its revenues in China rose fivefold from 2004 to 2009.

Leaders of companies that don't have operations in China today are bound to feel handicapped, but they shouldn't make the mistake of thinking they have been left too far behind. China's integration with the global economy is increasing, and the changes the country is undergoing have created a bewildering array of possibilities. Latecomers can set up globally integrated businesses from the outset, which will transform them worldwide. In fact, that's an opportunity they are best placed to exploit.

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